Employee Benefits Corner

Mandatory Automatic Enrollment for New 401(k)/403(b) Plans Gets Much Needed Guidance

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Section 101 of Setting Every Community Up for Retirement Enhancement ("SECURE") 2.0 mandated, for the very first time, a special automatic enrollment arrangement be added to all new 401(k) and 403(b) plans established on or after the enactment of SECURE 2.0 (*i.e.*, plans established on or after December 29, 2022). The provision, which is set forth in Code Sec. 414A, is first effective beginning January 1, 2025, and earlier this year (January 14, 2025), the Internal Revenue Service ("IRS") issued proposed regulations[1] ("Proposed Regulations") that provide much-needed guidance on how this mandate works. The Proposed Regulations provide important preliminary guidance on how to implement the mandate and what plans are impacted by the new law. A summary of the guidance, in question-and-answer ("Q&A") format, is set forth below.

What plans are covered? 401(k) and 403(b) plans—except (1) plans established prior to December 29, 2022 (*e.g.*, plans adopted prior to December 29, 2022) (so-called grandfathered plans), (2) church plans, (3) governmental plans, (4) Savings Incentive Match Plan for Employees ("SIMPLE") 401(k) plans, and (5) plans maintained by certain new or small businesses. For new businesses, the mandate does not apply to employers that have been in existence for less than three years. Therefore, under the Proposed Regulations, the mandate applies at the start of the first plan year in which, as of the first day of such plan year, the employer has been in existence for at least three years. For small businesses, the mandate does not apply to businesses with 10 or fewer employees. For this purpose, the Proposed Regulations require the same methodology that applies when counting employees for purposes of the Consolidated Omnibus Budget Reconciliation Act ("COBRA's") continuation coverage requirements.[2] For example, each full-time employee counts as one employee, while part-time employees are counted on a fractional basis. Moreover, the mandate does not apply until the first plan year that begins at least 12 months after the close of the first taxable year of the employer maintaining the plan with respect to which that employer normally employed more than 10 employees.

What are the required features of the automatic enrollment mandate? The mandate requires that the plan offer an eligible automatic contribution arrangement ("EACA"), as described in Code Sec. 414(w), in which participants are enrolled at a uniform deferral percentage of between three and 10 percent, with annual one percent increases up to a maximum of between 10 and 15 percent. Participants must be allowed to withdraw their deferrals within 90 days of the first automatic contribution to the plan. Notably, the one-percent increase does not apply until after the initial period—which runs from when the employee is first eligble to make elective deferrals under the plan (or, if later, when Code Sec. 414A first applies to the plan) and ends on the last day of the plan year that follows the plan year that includes the date the initial period begins. Importantly, this provision is an expanded version of the EACA provisions originally set forth in Code Sec. 414(w), which did not mandate an annual accelerator nor coverage of all participants. This provision tracks the qualified automatic contribution arrangement ("QACA") rules regarding exceptions to the uniform percentage requirement under Reg. §1.401(k)-3(j)(2)(iii), so it is permitted that (1) the percentage used for the default election varies based on the number of years (or portions of years) since the beginning of the initial period for an employee, (2) the rate of contributions that is in effect for an employee immediately prior to the date that the default election under the Proposed Regulations first applies to the employee is not reduced, (3) the rate of contributions can be limited so as not to exceed certain applicable limits under the Code, and (4) the default election is not applied during the period an employee is not permitted to have contributions made on the employee's behalf under Code Sec. 414(u)(12)(B)(ii) (six-month suspension related to military service). Moreover, a plan is permitted to have an affirmative election expire and have, as of a specific date, the default election apply unless the employee makes a new affirmative election. Lastly, there is an investment requirement as part of the mandate, which under the Proposed Regulations would provide that an EACA satisfies the mandate only if amounts contributed pursuant to the EACA, and for which no investment is elected by the employee, are invested in accordance with the requirements of 29 CFR 2550.404c-5 (or any successor regulations). (Note we are still waiting for guidance as to the impact of the Employee Retirement Income Security Act ("ERISA") as a result of this mandate for otherwise non-ERISA 403(b) plans.)

What employees must be covered under the mandate? The Proposed Regulations clarify that, in general, all employees eligible to make salary deferrals to the plan, including long-term part-time employees, are subject to the mandate—even pre-2025 hires that do not have an affirmative election in place. Specifically, if a participant has an affirmative deferral election in place on the date that a plan first becomes subject to the mandate (including an affirmative election not to defer any compensation), the participant's existing election can remain in place. Notably, there is transition relief that allows for a delay in covering the pre-2025 hires until the final regulations are effective (which is the first day of the plan year that begins more than six months after the final regulations are issued). The rate of deferral for the pre-20225 hires, however, may vary if the plan sponsor elects the one-year restart rule described below for rehires.

While we await final regulations, plan sponsors with new 401(k) or 403(b) plans should ensure that their plan complies with this new EACA mandate, or otherwise meets one of the exceptions, and document the appropriate treatment in the plan files to demonstrate compliance.

Is there a special one-year restart rule for rehires? Yes, the Proposed Regulations apply the QACA rules for determining the applicable deferral rate. Therefore, the Proposed Regulations allow plans to provide that if an employee is not eligible to have default contributions made on their behalf for an entire plan year, they may be treated as a new employee for purposes of determining their default deferral percentage upon rehire. For example, if employee A is automatically enrolled in 2025 with a three percent deferral rate, which is automatically increased to four percent in 2027, and A terminates employment in late 2027 before being rehired in early 2029, A may be automatically enrolled at three percent upon rehire (if the plan so provides).

Are there special rules for multiple employer plans ("MEPs")? Yes, for MEPs, which include pooled employer plans ("PEPs"), the Proposed Regulations clarify that whether the mandate applies (including the exceptions for new and small businesses) is determined on an employer-by-employer basis. Notably, this means that a plan established prior to December 29, 2022 ("pre-enactment plan"), or a plan sponsored by a new or small employer, will not automatically become subject to the mandate merely by joining a MEP or PEP, regardless of when the MEP or PEP was established. This apparent change in IRS position was an important step to treat MEPs, PEPs, and pre-approved plans on equal footing—no loss of grandfathered status just because you merge/restate your plan into a MEP/PEP.

What is the impact of a plan merger or spin-off? Depending on the facts, a plan merger or spin-off transaction may impact the grandfathered status of the plan and could result in the plan being subject to the mandate. The Proposed Regulations largely incorporate prior Q&A guidance from IRS Notice 2024-2, which was the initial guidance issued on this new mandate. For example, the Proposed Regulations explain that the merger of two pre-enactment plans into a single plan does not cause the post-merger plan to be treated as "newly established" and subject to the mandate. Conversely, the merger of a plan that is subject to the mandate with a pre-enactment plan would generally result in the post-merger plan being subject to the mandate. However, if the merger of a pre-enactment plan and a post-enactment plan subject to the mandate occurs within the transition period described in Code Sec. 410(b)(6)(C) (generally a two-year window), and the sponsor designates the pre-enactment plan as the post-merger ongoing plan, then the entire ongoing plan will be treated as a pre-enactment/grandfathered plan, and the mandate will not apply. Regarding plan spin-offs, a plan resulting from the spin-off of a portion of a pre-enactment plan generally will also be treated as a pre-enactment plan and the mandate will not apply. The Proposed Regulations provide a number of helpful mergers and acquisitions ("M&A") examples.

Will a plan amendment result in loss of grandfathered status? Generally, no. The Proposed Regulations confirm that most plan amendments will not affect a plan's status as a pre-enactment/grandfathered plan. However, with respect to M&A and MEP/PEP amendments, the special MEP rules and M&A rules described above may be triggered to change the status of the plan.

What is the effective date of the guidance? Although the mandate applies now (2025 plan year), the pending final regulations will not be effective until the first plan year beginning more than six months after the IRS issues final regulations. Until the final regulations are effective, plans will be treated as compliant as long as they follow a reasonable, good-faith interpretation of the law.

Does the guidance address participant notices? Yes. The Proposed Regulations address Section 320 of SECURE 2.0 regarding certain unenrolled participants, which generally provides for an annual "reminder" notice in lieu of the full suite of annual plan notices provided to active participants. The Proposed Regulations confirm that for plans subject to the mandate, EACA notices do not need to be provided to unenrolled participants who receive the reminder notice. The Proposed Regulations also confirm that the required EACA notices may be combined with other required participant notices, including automatic enrollment and default investment notices, notices required for pension-linked emergency savings accounts, QACA notices, and annual safe harbor notices.

Action Steps

While we await final regulations, plan sponsors with new 401(k) or 403(b) plans should ensure that their plan complies with this new EACA mandate, or otherwise meets one of the exceptions, and document the appropriate treatment in the plan files to demonstrate compliance. And for plan sponsors with existing plans that have M&A activity, consideration should be given to make sure the mandate was not triggered (or if triggered, that the plan complies with the mandate). And if plan sponsors are unsure about compliance with this mandate, check with your plan recordkeeper as failure to comply with the mandate raises qualified cash or deferred arrangement concerns and potentially expensive corrections for missed deferrals/match (adjusted for earnings). Lastly, stay tuned for final regulations, which will finalize these rules and provide the deadline for getting certain pre-2025 hires under the automatic enrollment mandate.

ENDNOTES

1 90 FR 3092.

2 *See* Reg. §54.4980B-2, Q&A-5.