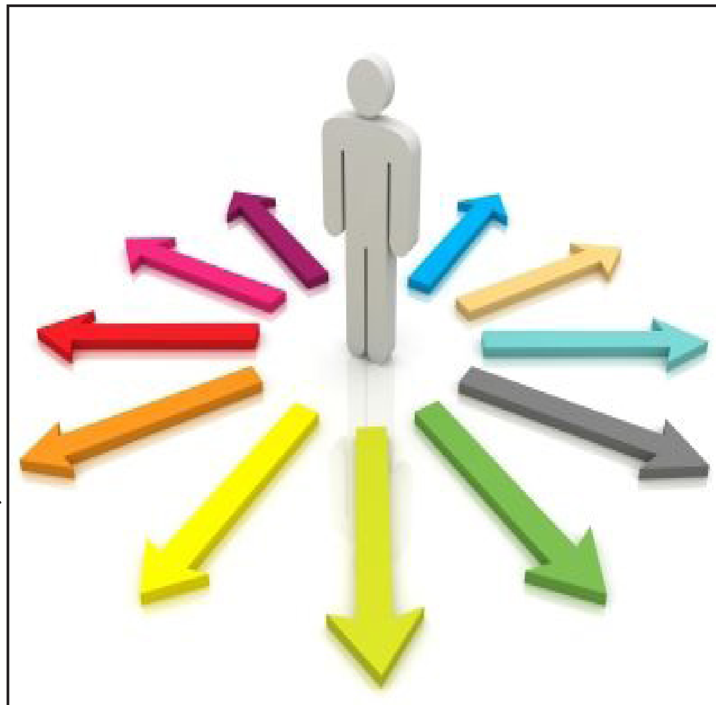
Advice To Plan Sponsors About 401(k) Plan Options

By Ary Rosenbaum, Esq.

Life is full of choices and sometimes, there are just way too many choices. That's the problem with 401(k) plan sponsors setting up their plan. There are so many plan provisions to consider and so many choices for each provision, that it can be overwhelming for you. So this article is sifting through many of the important optional provisions with ideas on what might be the right fit for you.

The thing about eligibility

If we lived in an ideal world, we would allow employees to be immediately eligible to participate in the 401(k) plan, at least in the salary deferral component. However, we don't live in an ideal world. If you have a lot of turnover with employees, then you will likely have small account balances left of former employees and most plan sponsors don't deal with these small accounts until they terminate the plan. Small account balances from former employees are a headache because of the required notices that these former employees get, as well as potential costs of required audits (if you have another participant accounts to require one) and per head charges. In addition, if you're providing for employer profit sharing and/or matching contributions, you may not want to allocate for employees who leave employment within a year of their hire date. So you have a few things to consider and decide whether providing a 401(k) benefit to the newly hired outweighs the potential of multiple accounts for former employees, thanks to turnover. There is no easy answer and it's ultimately your decision, but you have to understand that there is a cost attached to requiring an eligibility service requirement or allowing for immediate eligibility.



Vesting

Vesting issue is a lot like eligibility issues. While salary deferral and safe harbor contributions are fully vested, a plan sponsor could require up to 6 years for full vesting in employer profit sharing and matching contributions. Providing for full vesting when you have a huge turnover is like throwing away money because you're providing contributions to employees who leave without regard to their time of service and you lose the ability of using the money that these participants would forfeit if they left if there was a vesting schedule in place that they failed to meet. Immediate full vesting is an attractive tool in a 401(k) plan to recruit and retain employees, but it's of no use when there is a huge turnover. Forfeitures that accrue from former employees that lose contributions because if failing to meet full vesting where a vesting schedule is in place can be used for administrative expenses or to reallocate or reduce contributions. If you have a huge turnover, implementing an immediate 100% vesting option is wasting your employer contributions on participants who leave before even a year or two of employment is up. So whether to have a vesting schedule or not is dependent on the demographics and history of your staffing needs.

Employer contribution provisions

A 401(k) has that salary deferral component allow with provisions that allow for discretionary matching and profit sharing contributions. Yet, many plan sponsors that don't intend to make matching and profit sharing contributions decide that their plan shouldn't include these provision at all. I think that's a mistake. Since matching and employer provisions are discretionary, there is nothing wrong for a plan sponsor to have these provisions and never include them. However, if they fail to include these provisions and then have a change of mind, then they have to go through the headache of amending their plan through a plan amendment or an entire restatement (depending on the plan document they use). Even if you never intend to make employer contributions, I would still draft a plan with these provisions in place because you should never say never. Why eliminate a provision from your plan that is fully discretionary and not an issue if not really being used. Eliminating these provisions is like eliminating your appendix without appendicitis, why bother? Unlike an appendix, you might actually have a use for matching and profit sharing contributions later down the line.

Roth 401(k) contributions

Giving your employee tax savings options that don't cost you a nickel seems to

be a no brainer, but there are so many 401(k) plans out there that don't allow participants the option to make salary deferrals on a post-tax basis. Allowing these after-tax salary deferrals (what is known as Roth 401(k)) is just a payroll and recordkeeping issue that shouldn't affect you as a 401(k) plan sponsor. So I think it's a no brainer to allow this strategy that could allow tax-free retirement savings.

Automatic enrollment

Ever since it was finally implemented as part of the Internal Revenue Code, many plan sponsors have added the feature where they automatically enroll and pull salary deferral contributions from employees who fail to opt out of the plan. These provisions are a good feature if you have low participation and testing issues because lower paid employees don't defer. If you have a quality level of participation and no testing issues, you don't need to have it. If you offer a matching contribution, it would certainly increase your contribution costs because you'd be making additional contributions now to those who are automatically enrolled. Again, this is a feature that should be added or excluded on your specific 401(k) plan demographics.

In-service distributions at 59 ½ or Normal Retirement Age

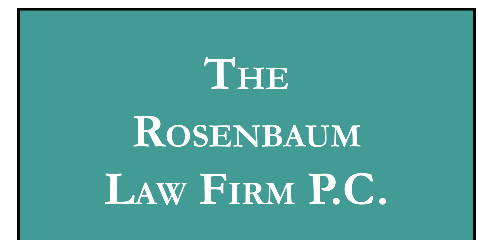
When you have employees near their retirement age, I don't think you should be in the way of them planning their retirement savings. So I encourage all plan sponsors to allow an in-service distribution while still working when they attain age 59 ½ or the definition of Normal Retirement Age under the plan.

Loans

Allowing participants to take out loans against their 401(k) account balance is a double-edged sword. While giving access to participants to take out loans when they need the money is a great idea, it does bring a host of potential compliance headaches. While allowing participants to tap their retirement savings bring up the whole moral issue that 401(k) plans are supposed to be a retirement savings plan and not a rain day fund, I think the compliance issues need to be considered. Loans are an exemption from the prohibited transaction rules dealing with retirement plans. That exemption means that certain provisions need to be followed in order to avoid a taxable event. Loans have to be made for a specific term, specific rate, and a specific repayment schedule. If payments are failed to be made or the terms of their rate aren't followed, the loan will default and there will be a taxable event. While that doesn't seem bad, there are many compliance issues when loan repayments aren't made to a loan (because of termination of employment, payments stopping, or errors in administration) and the error isn't discovered until a year or several years later. This often happens when a 401(k) plan allows participants to have multiple loans outstanding at a time. I've seen plans where participants have 8 or 9 outstanding loans at a time and an error is made where one loan isn't repaid. If you are going to offer a loan provision, make sure there is a minimum loan amount of $1,000 and there is only one loan outstanding at all times. You are offering a 401(k) plan, not a payday loan service.

Hardship provision

Like loans, allowing hardships for employees might be a good option to have, but it comes with compliance issues as well. Hardship distributions are based on financial need and there is a safe harbor list of financial reasons that could allow for such a distribution such as medical expenses and to prevent an eviction/foreclosure. The compliance issue dealing with hardship distributions is that many plan sponsors don't actually document the participant's financial needs for the distributions and just approve it. All hardship requests must be accompanied by documentary evidence of that financial needs that fit the safe harbor definition of hardship. Approving blanket request for hardship distribution is a potential compliance headache because Internal revenue Service agents have been instructed to review these hardship requests during a plan audit and told to pay special attention to multiple hardship requests from the same participant. So if you want to offer the provision, make sure you properly have all requests documented by evidence of the hardship need.



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The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com
Follow us on Twitter @rosenbaumlaw