401(k) Options You Should Pass On As Plan Sponsor

By Ary Rosenbaum, Esq.

As a kid, I was a huge fan of Family Feud. The last show I'd watch before the bus would pick me up for PM Kindergarten was Family Feud with Richard Dawson. Players who won the initial Face-off were allowed to play or pass. In all my years watching, I don't recall any winner passing. When setting up a 401(k) plan, you will get a lot of choices and options. There are some choices and options that you might think are good ideas, but have the potential of causing greater problems. This is what this article is all about, 401(k) options you should take a pass on.

Immediate entry for eligible employees

When setting up a 401(k) plan, your plan may have an eligibility waiting period of up to One Year of Service, which is the completion of 1,000 Hours of Service during 12 consecutive months. Once an employee completes their eligibility period, they have to wait until the entry date to become a participant. Sometimes that entry date may only be twice a year, sometimes it might be quarterly, or monthly. Allowing an employee to become a participant on the exact date they become eligible is just a terrible idea. Why have 365 potential entry dates when you can just have 12? Forgetting that employees have become a participant in the plan is a giant compliance headache. That means that if a mistake is made, you might have to fork over a corrective contribution for missed deferral opportunities for the employees you forgot to enroll in the plan. You may have to make corrective contributions for any missed employer contributions. Any corrective contributions might also require you to fork over more money to adjust earnings. I come from the school, K.I.S.S., keep it simple, stupid. Less is more and I assure you that fewer entry dates are better than an entry date that could be any day of the year. You have enough to do without having to track who is eligible for the plan every day of the year.

Allowing self-directed brokerage accounts

A lot of plans offer participants the right to have a self-directed brokerage account with the plan, instead of having to just use the core fund lineup of the plan. I used to joke that the only people that offered these plans were, lawyers, doctors, and accountants. I worked for a semi-prestigious law firm that offered them. The problem was that as an associate attorney, I was never offered one. I assume the only people that were offered them were law firm partners. The problem is that it is a benefit, right, and feature that has to be offered to all participants. If not, it might be held discriminatory and that might threaten the tax qualification of the plan. Another problem at the law firm is that some of the partners who used the option had their broker work on their 401(k) account, which means they're entitled to get paid. I'm sure the trustees of my firm's 401(k) plan never conducted any due diligence on these brokers. I also believe that participants do worse With self-directed brokerage accounts than with the plan's core fund lineup. Mutual funds are going to be a better long-term benefit for most plan participants than individual stocks. 401(k) plan sponsors might have liability issues when dealing with self-directed brokerage accounts. No guidance states that 401(k) plan sponsors are not liable for losses sustained by plan participants through these self-directed brokerage accounts. Common sense would dictate that participants should be at fault for their losses, but common sense doesn't help a participant who needs to blame someone else for their losses within a self-directed brokerage account. 401(k) plan sponsors who have self-directed brokerage accounts, I'm sure 90% of them don't check what participants with these self-directed brokerage accounts do. 401(k) plan sponsors are fiduciaries and they are fiduciaries of all assets including what is sitting in self-directed brokerage accounts. If a participant has decided to invest 100% of their account balance in a single stock like AMC Theaters or GameStop, is a plan sponsor supposed to discuss it with that participant? Common sense says yes, but again, there is no guidance. Growing up in this country, we talk about freedom and freedom of choice. However, offering self-directed brokerage accounts is just great in offering you potential headaches that aren't necessary. For some participants, self-directed brokerage accounts are like a casino, don't let your plan become a casino because most casino players lose.

Using an out-of-the-box compensation definition

There is a fine line between being clever and stupid, which is a great line from the masterpiece, This Is Spinal Tap. The definition of compensation within the plan can be a problem when the plan document says one thing and the practice means something else. For example, the plan sponsor might think that bonuses and fringe benefits are excluded from the definition of compensation, but the plan document states they are included. That means the 401(k) plan sponsor might owe corrective contributions for missed deferral opportunities, and employer contributions, plus earnings. I always believe that the definition of compensation should fall under my K.I.S.S. theory. W-2 Compensation that includes everything for purposes of the 401(k) plans means fewer mistakes being made. Allow participants to defer on bonuses, include taxable fringe benefits for purposes of the plan, and make things easier for yourself, by avoiding errors.

Allowing annuities within the plan

Plans such as defined benefit plans and money purchase plans have a requirement to offer annuities as the designated payment option because they are pension plans that require minimum funding. A 401(k) plan doesn't require an annuity payment. Most 401(k) plans that had them, were allowed to remove them a few years back and it wasn't considered a cutback in benefits. A 401(k) plan that had assets from an old money purchase plan would require annuities as an option for those assets. With the Federal government being concerned about retirement plan accounts and whether they will last over people's retirement, there has been a renewed push to offer annuities, which they now call a "lifetime income option." Until the government mandates plans have one, there is no need for you to offer it. Offering annuities is more work for you. Once an employee needs to receive their benefit, pay them in cash and let them go. You don't have time to go through the whole process of finding an annuity provider for your plan. An annuity is an insurance product, making commissions for those who sell them, and I'm not convinced they are the best bet for most retiring participants. Again, annuities are an option and an option that should be turned down.

In-kind distributions and anything other than lump sum

A 401(k) plan payment option can be a lump sum in cash. You can also offer installments and partial withdrawals. You can also offer an in-kind distribution which means paying participants in property, mainly the assets within their account balance. You're not a brokerage firm and you are not a bank. Pay former participants in cash and a lump sum, and be done with them. Former participants might cause headaches, just by losing touch with you. Keep it Simple, Stupid, and pay people in cash in one lump sum.

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