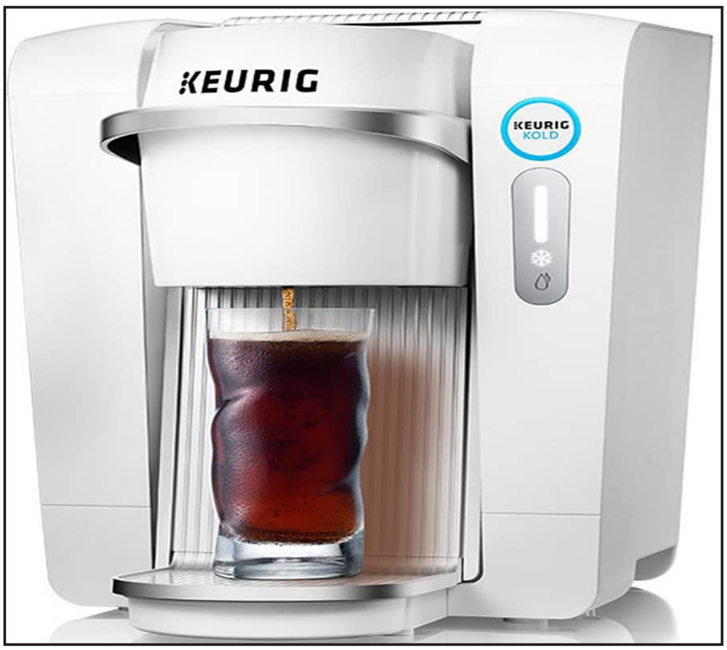
401(k) Ideas That Look Great On Paper, But Awful In Practice

By Ary Rosenbaum, Esq.

Business history is littered with ideas that looked great on paper but were awful in operation. A colorless Pepsi and Diet Pepsi sounded like a great idea until you drank Crystal Pepsi and Diet Crystal Pepsi with that weird fruity flavor. A Keurig soft drink machine with Coca-Cola seemed like a home run until you saw the huge machine that produced 8-ounce drinks, that was more expensive than a 12 ounce can of the same drink. With 401(k) plans, there are some ideas that look great on paper but are just a potential nightmare for you as a 401(k) plan sponsor.

Immediate entry date

As an ERISA attorney, I support the idea of allowing employees to participate as soon as possible, especially on the salary deferral side. I like it because it increases retirement plan coverage for employees and allows them to save for retirement quicker. In addition, compliance testing could treat your Actual Deferral Percentage requirements as if your plan still had an age 21 and One Year of Service requirement. However, there are certain reasons why employers like you may hate that idea. Immediate eligibility might not be great if you have a lot of part-time employees or if you have a huge turnover for employees who complete a year of service. While I still like immediate eligibility, I think immediate entry is the dumbest idea out there. While a participant can become immediately eligible, they may have to wait until the next entry date, which could be the following month, plan year quarter, or January 1st or July 1st. Allowing eligible participants to immediately enter the plan is one of the worst ideas out there. The reason is tracking and immediate entry increases the number of days you have to track. Going from 2, 4, or 12 to potential 365 different entry dates is just a bad idea. If you fail to allow participants to enter the plan, per the plan document, you may have a missed deferral opportunity that may require you to make an employer contribution to the participant or participants that you failed to enroll in the plan. When it comes to plan administration, I believe you should follow the policy that I have called K.I.S.S. (keep it simple stupid). Allowing employees to participate in the plan on any day in the calendar including weekends and holidays is just a terrible idea.

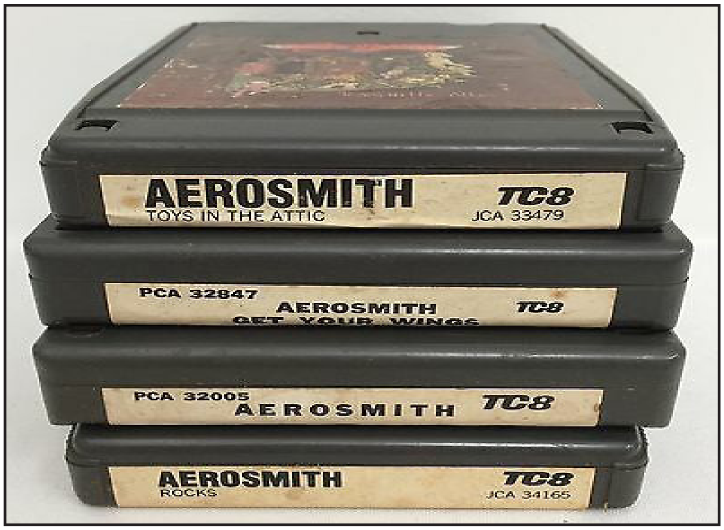


Self-directed brokerage account

I used to tell a joke that the 401(k) plans that ask for a self-directed brokerage account belong to doctors, lawyers, and accountants. While there are other types of companies that ask for them, I've known many advisors who have told me there is a lot of truth to that joke. What is a self-directed brokerage account, you may ask? A 401(k) self-directed brokerage account allows your participants to make investments outside of the plan's investment lineup. So rather than investing in a limited number of options offered on the plan's lineup, a self-directed brokerage account often includes many more investments like stocks, bonds, mutual funds, and ETFs. There are many reasons why I don't like self-directed brokerage accounts. The first reason is that people using these accounts do worse than with the investment fund lineup that your plan's financial advisor selected. Second, you are a fiduciary of all plan assets, so you have a duty to monitor what participants invest in these accounts. Third, it's not settled law on whether you are liable or not for the losses sustained by participants with their investments made within these self-directed brokerage accounts. Call me a stick in the mud, but do we really need people within your 401(k) plan to start day trading and making potentially reckless investments? You have enough headaches to worry about, then now having to monitor what investments participants make in these brokerage windows. I love the freedom of choice, but too much freedom for participants isn't a great idea because participants unlike most investment professionals, make irrational investment decisions and tend to lock in losses when markets go south.

Bitcoin investments

With the surge in demand and returns for cryptocurrency investments, such as Bitcoin and Ethereum, there is huge interest in allowing these investments within 401(k) plans. As a law professor used to say: "stomp out that silly notion." Crypto investments are not regulated, so why offer non-regulated investments in your 401(k) plan? While some providers are offering it within a window where the maximum crypto investment is 5-10% of a participant's account balance, a crypto window is a potential disaster. Crypto investments have had tremendous growth, but they have wild swerves in terms of positive and negative gains. At the first sign of trouble, many 401(k) participants would just lock in losses after a negative stretch. Crypto investments are part of my non-retirement portfolio and I'm a huge fan, but not within a 401(k) as long as it's non-regulated and the Department of Labor (DOL) hasn't approved the use of it within a plan.



Unlimited plan loans

I'm all for participants having a right to borrow against their account balance within a 401(k) plan if they need the money. The problem with 401(k) plans and loans are when plans offer. unlimited loans. I have seen 401(k) plans where participants have five to seven plan loans outstanding. What's the problem? The problem is when 401(k) plan sponsors offer unlimited plan loans. I've seen too many errors because a plan sponsor's third-party administrator (TPA) can't figure out how to pay off multiple loans at the same time when a loan repayment is deducted from a participant's paycheck. I have seen too many times where there would be repayments that are made towards most of the loans, but there would be one loan that slips through the cracks. The problem? Since payments are not made for more than a plan year quarter, the loan that slips through the cracks would be in default and the participant is supposed to receive a 1099 form for a taxable deemed distribution representing the defaulted loan balance. It doesn't seem fair that a participant gets penalized for that, but correcting that error with Internal Revenue Service (IRS) can be costly too. This could be even more expensive if the error is caught on an IRS or DOL audit. To avoid the error, you should have a limit of one loan outstanding at all times as part of your loan provision. You can certainly allow for refinancing of loans, but offering more than one loan outstanding is a huge mistake waiting to happen.

Hiring the two top payroll companies as your TPA

401(k) plans involve taking salary deferrals from a participant's paycheck and your payroll. So you would think it would make sense in hiring one of those top two payroll companies to also handle your 401(k) plan? You would be wrong. Aside from salary deferrals and payroll data, 401(k) plans have not much to do with payroll and these two top payroll companies haven't shown that they're very good at being a 401(k) TPA. There should be payroll integration between your payroll provider and your TPA, but there are plenty of payroll companies that offer it with independent TPAs. There are many reasons why you should hire a company to serve as your TPA and hiring a TPA just because they're your payroll provider isn't one of them. My very public criticism of these payroll providers doesn't get me many referrals from them, but I make it up in legal fees for fixing the errors of their former 401(k) TPA clients.

Using revenue sharing paying funds

Before fee disclosure regulations in 2012, many plan sponsors had absolutely no idea how much their TPA was charging them and that was a problem when plan sponsors have a fiduciary duty to only pay reasonable plan expenses for the services provided. One of the issues with fee transparency was the use of revenue sharing paying mutual funds within a 401(k) lineup. TPAs used to convince plan sponsors that using revenue-sharing funds would cut down plan expenses, except they didn't. The idea of revenue sharing is that mutual fund companies would help pay TPAs for the recordkeeping they were doing for mutual funds within a 401(k) plan, rather than the mutual fund doing it directly. On paper, revenue sharing seems fair except for one big thing: not every mutual fund pays revenue sharing. One of the many reasons why not every mutual fund pays revenue sharing is that some have such low plan expenses such as index funds can't. An index fund with a 5-10 basis point administrative expense can't pay the 25 basis points revenue sharing to TPAs if they want to stay in business. The problem with revenue sharing paying funds was that many TPAs and advisors were pushing it because they claimed it would offset expenses and forgot to tell them the problem on the backend: that revenue sharing paying funds tend to have higher expenses than plans who don't. The other problem is that many TPAs and advisors were pushing revenue-sharing funds for the main reason that they paid revenue sharing. Without fee disclosure, plan sponsors wouldn't have a clue whether the TPA was using revenue sharing to offset expenses or just putting that money as an additional fee. Thanks to fee disclosure regulations and plan litigation, the truth about revenue-sharing funds are out there. Disclosure requirements allow plan sponsors to finally understand the true cost of revenue sharing in how it does reduce plan expenses but has higher fund expenses. Also, litigation has made most plan sponsors very wary of using revenue-sharing paying funds because large plans have been successfully sued for offering them. There are many reasons to use a certain mutual fund, I just don't think using them because they pay revenue sharing is a good enough reason. Revenue sharing is starting to become the 8 track tape of the 401(k) industry, it is obsolete and sparingly used.

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