Features That Turn Your 401(k) Plan Into A Relic

By Ary Rosenbaum, Esq.

I grew up in the 1970s and 1980s. People may say that I'm a relic of the past. In my house, we were probably the last people to get a microwave oven and push button phone, to the point where my mother had to go to a pay phone down the block because my father's pager couldn't get a text from Rotary. Even as an adult, I might have been the last person to get an HDTV. That being said, you can certainly do without new technology (I do see people still with Nokia phones), but your 401(k) plan can't be a relic and there might be provisions that might make it look like a relic.

Limits on salary deferrals for participants

Before 2002, there was an interesting dilemma for employers that sponsored a 401(k) plan. They were limited to deducting 15% of the compensation of plan participants as an employer contribution to a 401(k) plan. The problem is that when it came to that deduction limit, salary deferral contributions made by a participant counted towards that limit. I remember since I had to cut back on my deferrals, working for a small law firm where I was the only one deferring and I was receiving matching contributions too. In 2002, that was changed so an employer could deduct 25% of compensation as an employer contribution and salary deferral contributions no longer counted toward the limy. So many 401(k) plans changed their previous salary deferral limits by eliminating the percentage cap on what participants could defer from their income. So it's surprising that many 401(k) plans out there still limit participant deferrals to perhaps maybe 10-15% of compensation. While a limit on highly compensated employees may defer might make sense (so the plan can pass compliance testing), a limit for all participants makes no sense. That limit was so 2001 when we were all using AOL.

Not allowing participants to receive distributions before retirement

When 401(k) plans started popping up about 30+ years ago, they were treated like pension plans in terms of design and features. One feature that many of these early 401(k) plans had was a provision that would be found in defined benefit plans. So many of these 401(k) plans had a provision that restricted participants from receiving a distribution of their account balance until they retired, whether they still worked for the employer or not. That provision made sense for defined benefit plans when the employer was fully funding the participant's benefit and any distribution of benefit could actuarially affect the funding of the plan that the plan sponsor needed to favorably maintain. It makes no sense for a 401(k) plan to have such a provision because it's a defined contribution plan and the bulk of most participant account balances consist of their salary deferrals. Unlike a defined benefit plan, the participant has their account balance, and whatever is theirs is theirs with no need for actuarial calculations. In addition, why would a plan sponsor want to still maintain the account balances of participants who are former employees? Former employees still have the rights of participants including notice requirements, updated summary plan descriptions, and many of the other rights that current employees that are participants also have. Why keep the money belonging to some who no longer work there I always say that former employees will sue a plan sponsor a lot more frequently than current employees. Why have a headache when you don't need one? A plan participant should be able to receive a distribution of their account balance upon termination of employment, disability, or

upon attaining age 59 ½.

A Plan where the trustee directs the investments

This provision will probably get the most criticism, but that's what happens when you take a stance. Before the technology allowed for daily valuation and before the proliferation of mutual funds, most 401(k) plans were valued on an annual basis, and trustees directed plan investments like other retirement plans. Thanks to the proliferation of the Internet and the high returns of the stock market of the late 1990s made participant-directed daily valued 401(k) plans were a big thing. It also helped that ERISA §404(c) gives plan sponsors liability protection if the participants direct their investments after getting enough information to make investment decisions. While trustee-directed plans will usually use the expertise of investment advisors, they still offer far less liability protection than a participant-directed plan. While trustee-directed plans would probably offer a higher rate of return overall than participant-directed plans, they also offer a lot more liability exposure. While people will state that ERISA §404(c) is often misinterpreted in liability protection especially if investment options for participants aren't reviewed and that participants don't get enough guidance in helping them make investment decisions. That's all true, all of it. However, over the past few years, plan sponsors have been more diligent in their role in managing the fiduciary process by reviewing plan investments and giving plan sponsors enough investment education and/or advice for them to make informed investment decisions. In addition, small to medium-sized plans are still less likely to face a lawsuit from a plan participant than a larger one. So the threats of litigation from a plan participant over investment losses are probably less likely in a participant-directed plan than in a trustee-directed plan. That's just my two cents.

The stated matching provision

The stated matching provision is what it says it is. It's a matching provision where the plan sponsor states in their plan document and summary plan description (SPD) how much they will match deferrals as part of a matching contribution. What's the problem? Most of the time, nothing. Some of the time, a lot more than nothing. I don't like the stated matching provision because it takes what was supposed to be a discretionary contribution (the matching contribution) and makes it mandatory as a pension plan requires. I've been in this business for almost 25 years and have been through two huge recessions, why force a plan sponsor to state a matching provision that the business climate may force them to cut back on? The problem is that if the 401(k) plan matches salary deferrals and requires no hours of employment in their stated matching provision, they are precluded from eliminating and/or decreasing the matching provision until the following plan year. So a plan sponsor may be on the hook for a matching provision that they can no longer afford or will further put them in the red. What if the business is so good and the plan sponsor wants to increase matching contributions? It's the same problem. I always prefer a discretionary matching provision where the plan sponsor will announce through a resolution and notice to participants how much they will contribute in the form of a matching contribution. That gives plan sponsors a lot of leeway in determining whether they can afford to contribute and how much they can. It also avoids the need to consult with an ERISA attorney to see if a stated matching provision needs to be amended or not. In my opinion, the only reason you should ever have a stated matching provision is if it must be stated because of the terms of a collective bargaining agreement where union employees are participants in the 401(k) plan.

Plans with expired service provider contracts

Thanks to fee disclosure regulations that required transparency of fees, plan administration expenses have decreased as a percentage of assets. Yet there are so many 401(k) plans out there that have contracts with their service providers that date back to the year of the flood when pricing was a lot less favorable to plan sponsors. So many plan sponsors are unwittingly paying higher plan expenses just because they haven't bothered to renew their service provider contracts and haven't bothered to benchmark their fees to see if there is a better deal out there. So many 401(k) plans are paying through the nose in fees just because the plan sponsor is breaching their fiduciary duty by not paying reasonable plan expenses.

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