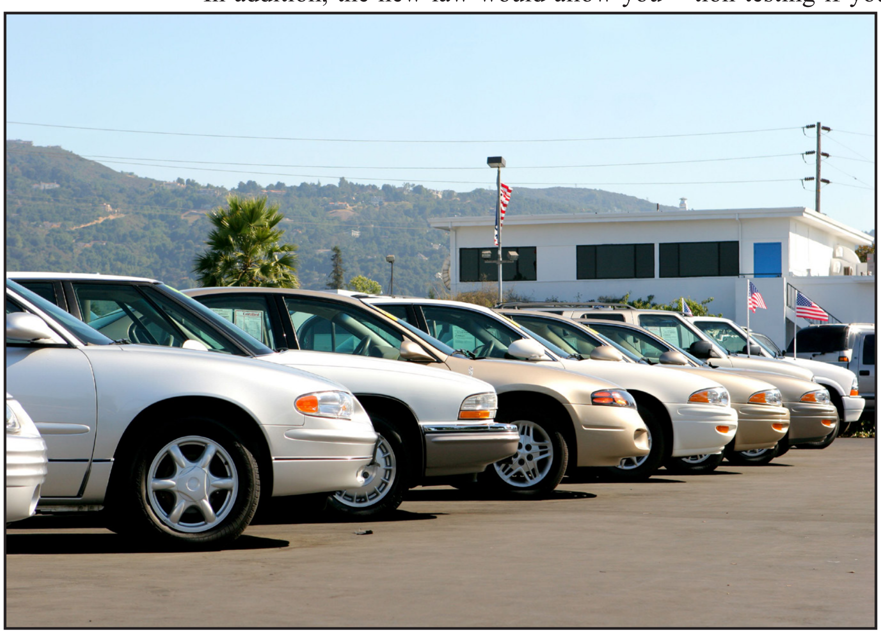
The K.I.S.S. Theory And Options For Your 401(k) Plan

By Ary Rosenbaum, Esq.

Buying a car can be one of the most harrowing experiences out there. Luckily, I haven't had the pleasure since two cars were destroyed during Hurricane Sandy. One of the overwhelming features of car buying is the options buying. The features, the trim, the extras, and some things you don't need such as etched glass can overwhelm most of us. The same can be said about options for setting up a new 401(k) plan. This article is all about the options you need and some options you probably don't.

The theory of K.I.S.S.

KISS is one of my favorite bands, up there with Aerosmith, The Eagles, Guns n Roses, and the Beatles. I also like the theory of K.I.S.S. when it comes to retirement plan options. K.I.S.S. stands for Keep it Simple, Stupid. While plan options should benefit plan participants and sponsor alike, you need to have options that aren't the stick in the wheels of proper plan administration. Outside-the-box options only create administrative errors, rather than alleviate them. Years ago, I spent 9 years as an attorney for two third-party administration (TPA) firms. I know what options make things easier for plan administration and what causes an error. I once reviewed the matching contribution formula set forth by an ERISA attorney through a plan amendment. I joked that I understand what he was trying to do, but good luck administering it correctly. Whatever options you pick for your plan, just keep it simple.



Roth Contributions

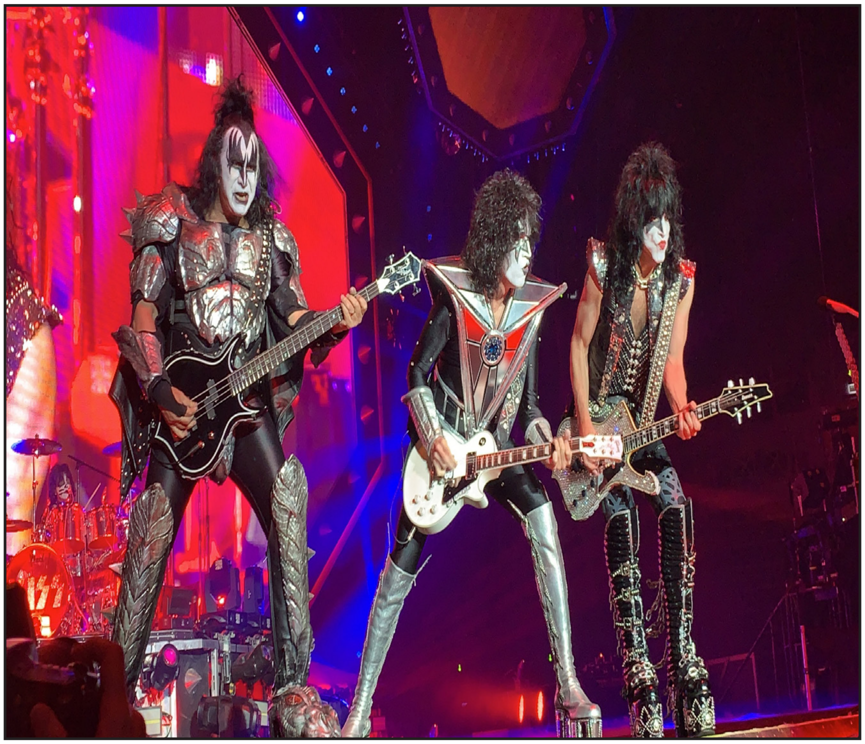
You have the right on whether to allow participants to make salary deferrals on an after-tax basis so distributions end up being tax-free at retirement. Thanks to higher tax rates, not many people take that after-tax option called Roth 401(k). However, a new law change will make the Roth feature a little more popular. Starting in 2024, the SECURE 2.0 Act requires all catch-up contributions for participants with wages over $145,000 during the previous year to be deposited into a Roth account. The wage threshold will be adjusted annually for inflation beginning in 2025 (rounded down to the lowest multiple of $5,000). In addition, the new law would allow you to offer your employer contributions on a Roth after-tax basis for participants who want to pay tax on them upfront and get the earnings from those contributions tax-free. That employer contribution feature won't be that popular because if you did offer it, those participants who elect Roth employer contributions would be fully vested in the contributions you provided.

Eligibility

In an ideal world, I would tell you that you should never require an eligibility period for people deferring to your 401(k) plan. I was an employee once (for about 12 years) and it bothered me if I had to have a one-year wait to participate in a 401(k) plan. That one-year eligibility did factor into whether I would change jobs for a company that wouldn't let me into a 401(k) plan. I certainly understand any employer that would require a one-year wait for employer contributions. As for deferrals, if you require no service as I would prefer, you still could test as if your plan still would have a one-year wait. So that means you wouldn't be penalized on discrimination testing if you decided to have no eligibility requirements for deferrals. Again, I prefer no eligibility for deferrals in an ideal world, but we don't have an ideal world. If you operate a business with a large turnover, a lot of former participant accounts with small balances could be a headache as the Department of Labor (DOL) is further concerned with missing former employees with account balances in your plan. So in my mind, consider zero eligibility for 401(k) deferrals, but don't if you have a lot of turnovers.

Entry Date

An employee who reaches the plan's eligibility requirements only becomes a participant on an entry date. With a 401(k) plan, you can essentially have just two entry dates (January 1st or July 1st for calendar year plans). For administrative ease, that's probably ideal since there would only be two dates that you need to keep track of. The problem is dealing with employees who become eligible to participate



after one of the dual entry dates passes and might have to wait another 5-6 months to finally get into the plan as a participant. I always like quarterly or monthly entry dates because it allows employees to participate when they become eligible. That being said, allowing an entry date that is immediate is just silly. That means participants could become eligible on any day on the calendar and from a recordkeeping standpoint, almost impossible to follow. Forgetting to enroll people who are eligible to participate on the entry date may result in corrective contributions for missed deferral opportunities. Like I said with the theory of K.I.S.S., immediate entry is just going to cause headaches that you don't need, it's a solution looking for a problem and a problem that will cost you.

Normal Retirement Age

Since around 1986, the Normal Retirement Age (NRA) maximum is 65. You can require 5 years of participation for that definition because attaining NRA means full vesting and recent hires aged 60-65 might attain full vesting at NRA 65, without utilizing the plan's vesting schedule. I think you need to keep it simple through K.I.S.S. and have an NRA of 65. You can utilize an NRA before 65 (no less than 62 unless you have an industry that practices earlier retirements), but I find that unnecessary.

Early Retirement Age

Early Retirement Age is a provision that provides full vesting at the attainment of that age, which could be age 55 and/or 55 and 5 years of service/participation. It's a great feature for defined benefit plans where people can actually retire and take a cutback in benefits (as compared to those who wait for NRA). Since a 401(k) plan is funded mainly by participant deferrals, I see absolutely no need to have this as a feature for your plan especially since it's a protected benefit and can't be removed if implemented.

Distributions

Utilizing the K.I.S.S. theory, I suggest distributions should be lump sum distributions in cash. You might want to offer partial cash withdrawals for, those who attain retirement but want a partial sum to pay bills. Outside of that, everything becomes more difficult. If participants want something, other than a lump sum, they could always withdraw their account balance when eligible and buy their own annuity if they want or some type of installment payment. In addition, only offer cash distributions. The other option is in-kind distributions and you don't need the hassle of transferring mutual funds or other investments to a participant's IRA or other retirement savings vehicle.

In-Service Distribution

When people attain the age of 59 ½, there is no longer a penalty for early distribution of their account balance and is the earliest that someone could withdraw their salary deferrals while still working. Upon attainment of age 59 ½ and Normal Retirement Age, you should allow participants to withdraw their account balances. In the end, the bulk of the contributions is likely going to be their salary deferrals.

Hardship Distributions

My grandmother Rose was the greatest person I ever knew. Having survived the Holocaust where her parents and 2 out of 3 siblings did not and having lived in communist Romania for 15 years before emigrating to the United States, she saw more than we could imagine. Rose was very practical about life and she said it best when she said: "life never goes to plan." When participants get enrolled in a 401(k) plan, they probably think that this is for their retirement. Unfortunately, life may get in the way of that retirement savings. Natural disasters, medical expenses, funeral expenses, and education costs may get in the way. Offering hardships may go against your idea of what a 401(k) plan should be, but remember that life doesn't go to plan and it's the participant's money. You should require a $1,000 minimum distribution, but you should allow them access.

Loans

Like hardships, loans are a means for participants to access their account balance when they need it. A loan is their own directed investment and they pay it back with interest. Since I keep on telling you that life doesn't go to plan, allow participants the opportunity to get one loan outstanding with a $1,000 minimum. Loans that aren't being paid off quarterly are a default and will get taxed to the participant. Multiple loans violate that theory of K.I.S.S. because the plan sponsor and/or TPA forgot to pay 1 out of 9 loans outstanding (this happened to a previous client of mine).

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