"Quirky" 401(k) Plan Rules That You Need To Know

By Ary Rosenbaum, Esq.

I have been an ERISA attorney for 25 years and I like what I do. Dealing with retirement plans, it's a unique part of the law that very few people and very few attorneys understand. The retirement plan business changes every day and I still like most rules regarding plans that are rational and make sense. Even with rational rules, there are rules concerning 401(k) plans that are a little quirky that most plan sponsors don't understand, but should. So this article is all about the quirky 401(k) plan rules that plan sponsors should understand.

Fiduciary responsibility

One of my favorite airplane stories (besides the movie Airplane!) is US Airways, Flight 1549, "The Miracle on the Hudson." I was working that day by Penn Station and I remember seeing the rescue vehicles down 34th Street, as they were heading toward the Hudson River. Chesley "Sully" Sullenberger glided the plane to the most successful ditching in history after a double-engine bird strike. Sully walked the plane to look for any passengers and was the last person who left the aircraft. We always know that with a sinking ship, the captain is the last to be on board. As a 401(k) plan sponsor, you're kind of the Captain of the ship because you're also a plan fiduciary. A plan fiduciary requires the highest duty of care in law and equity because you're responsible for the retirement plan assets of your employees. The problem with fiduciary responsibility is that you can only minimize it, you can never fully eliminate it. When you hire a third-party administrator (TPA) or financial advisor, the buck still remains with you. Even if you delegate a fiduciary function, such as plan administration to an ERISA §3(16) fiduciary or the financial fiduciary process to an ERISA §3(38) advisor, you're still on the hook for hiring them. People who are selling a service that claims they can eliminate your fiduciary liability are exaggerating a little bit. You can never fully eliminate your liability, but good practices and some fiduciary liability insurance can minimize your risk.

ADP/ACP Discrimination Testing

To be a qualified retirement plan under the Internal Revenue Code, you have to abide by the tax rules. The whole point of being qualified is that you can take tax deductions for employer contributions and participants defer taxes on their retirement savings until actual retirement (unless they elected Roth 401(k) after-tax treatment and paid the taxes upfront. One of the requirements of qualified plans is that they don't discriminate against non-highly compensated employees. When we think of discrimination, we usually think of obnoxious Jim Crow-like behavior. For retirement plans, we are not talking about racial discrimination, gender, disability, etc. When we talk about discrimination in retirement plans, we are talking about making sure that the plan doesn't unfairly benefit highly compensated employees. The Actual Deferral Percentage (ADP) test for deferrals and the Actual Contribution Percentage (ACP) test for matching contributions are two tests that companies must conduct to ensure that their 401(k) plans don't unfairly benefit highly paid employees at the expense of others. You must conduct the tests in order to retain the qualified status of your 401(k) plan. If your 401(k) plan fails either test, you must take corrective action in the 12-month period following the close of the plan year in which the failure occurred. The ADP test compares the average salary deferral percentages of highly compensated employees (HCE) to those of non-highly compensated employees (NHCE). An HCE is any employee who owns more than 5% interest in the company at any time during the current or previous plan year or earned more than $155,000 during the 2024 tax year. The ADP test takes into account both pre-tax deferrals and after-tax Roth deferrals, but no catch-up contributions, which may be made only by employees aged 50 and over. To pass the test, the ADP of the HCE may not exceed the ADP of the NHCE by more than two percentage points. In addition, the combined contributions of all HCEs may not be more than two times the percentage of NHCE contributions. If you fail the ADP/ACP tests, you can remedy the failure by refunding excess contributions back to HCEs in the amount necessary to pass the test. However, these refunds will mean taxable income to the HCEs. Another alternative is to make a fully vested Qualified Non-Elective (QNEC) contribution to the NHCEs. The quirk of the rule is that if HCEs defer at 7% and NHCEs defer at 4%, the plan fails the ADP test. You can make refunds to the HCEs or dig into your pocket

to make a 1% QNEC. I don't think the rule is fair. People who make more money are going to defer at a greater clip than those who don't. I also don't think anyone making $155,000 is truly highly compensated, especially if they live in New York, Boston, San Francisco, and Los Angeles. If you're consistently failing the tests, you can offer a safe harbor plan design that allows you to make fully vested employer contributions, and avoid the testing. There are some businesses that have the demographics where failure of these tests is guaranteed, such as a restaurant. I understand the concept of fairness and people who make more money, shouldn't derive all the pecuniary benefits of retirement plans. The problem is that the small spread (2%) allowed between HCEs and NHCEs does stop certain employers from ever wanting to offer a 401(k) plan, which hurts NHCEs.

Successor Plan Rules

When you set up a 401(k) plan, the idea is that it's not a one-and-done type of thing. The IRS expects your plan to have longevity, what we call the permanency rule. The plan should be in play for at least 3 years. If you terminate your 401(k) plan, you need to have a good reason for doing so, such as a reduction in the workforce. Terminating a plan means that participants are fully vested in their contributions and can withdraw their account in cash or transfer it to another plan or Individual Retirement Account. 401(k) plans and 403(b) plans have this quirky successor plan rule. Successor plan rules were created to avoid situations in which the plan sponsor could attempt a loophole around some of the plan rules, such as distributions of employee deferrals, ADP and ACP testing complications, and adopting a safe harbor plan design, by terminating a 401(k) plan and then shortly thereafter establishing a new plan to again enjoy the benefits of sponsoring a retirement plan. In most situations, a successor plan is described as any alternative defined contribution plan that exists during a period starting on the original 401(k) plan's termination date and ending 12 months following the full distribution of the plan's assets. A plan is not considered a successor plan if. during a 24-month period that begins 12 months before the termination date, less than two percent of employees who were eligible under the terminated plan are eligible for the new plan, or another plan of the employer able to receive the terminating plan's assets; the plan is maintained by a different employer (not part of a controlled group or controlled group affiliated service group); or the plan is a SEP plan, SIMPLE IRA plan, 403(b) plan, 457(b) plan, 457(f) plan, or an ESOP. Plan participants can't withdraw their 401(k) plan assets until they meet a distributable event. Although plan termination is considered a distributable event, if you sponsor another plan or establish a new plan that is considered a successor plan, then you can't treat the plan termination as a distributable event for deferrals (or for contributions treated like deferrals, such as QNECs or QMACs). Also, if you can't distribute the plan's assets within 12 months of the termination date, then the plan is not considered terminated, and future compliance requirements need to be met. Deferrals that are distributed before a distributable event occurs are treated as if they were from a nonqualified plan, making any rollovers invalid. To resolve this issue, the employer facing a successor plan situation should attempt to reclaim the funds by having the employees pay back the distributions into the successor plan. To avoid issues, your plan may transfer deferrals to a successor plan, or leave the deferrals in the terminated plan until there is a valid distributable event.

Contingent Benefit Rule

Salary deferrals are such a big part of a 401(k) plan. For many 401(k) plans, salary deferrals might be the only contributions that are part of the plan. While you are tempted to incentivize people to defer or in some cases, not defer in your 401(k) plan, you have to deal with the contingent benefit rule. Under the contingent benefit rule, you can't directly or indirectly condition any other benefits, with limited exceptions including for matching contributions or de minimis financial incentives not paid with plan assets on an election to defer or not to defer. That presented an issue for a union client once, that wanted to condition an employer-provided benefit on collectively bargained employees not making a deferral. So, in a 401(k) plan you can't require participants to make elective deferrals to your 401(k) plan in order to be eligible for your company's health insurance or provide a pecuniary bonus only to participants who don't make elective deferrals. Violating the contingent benefit rule can get your plan disqualified. So while you may want to use your 401(k) plan as a carrot, any incentive other than a matching contribution or de minimis benefit to defer (like a gift card) can put your plan at risk.

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