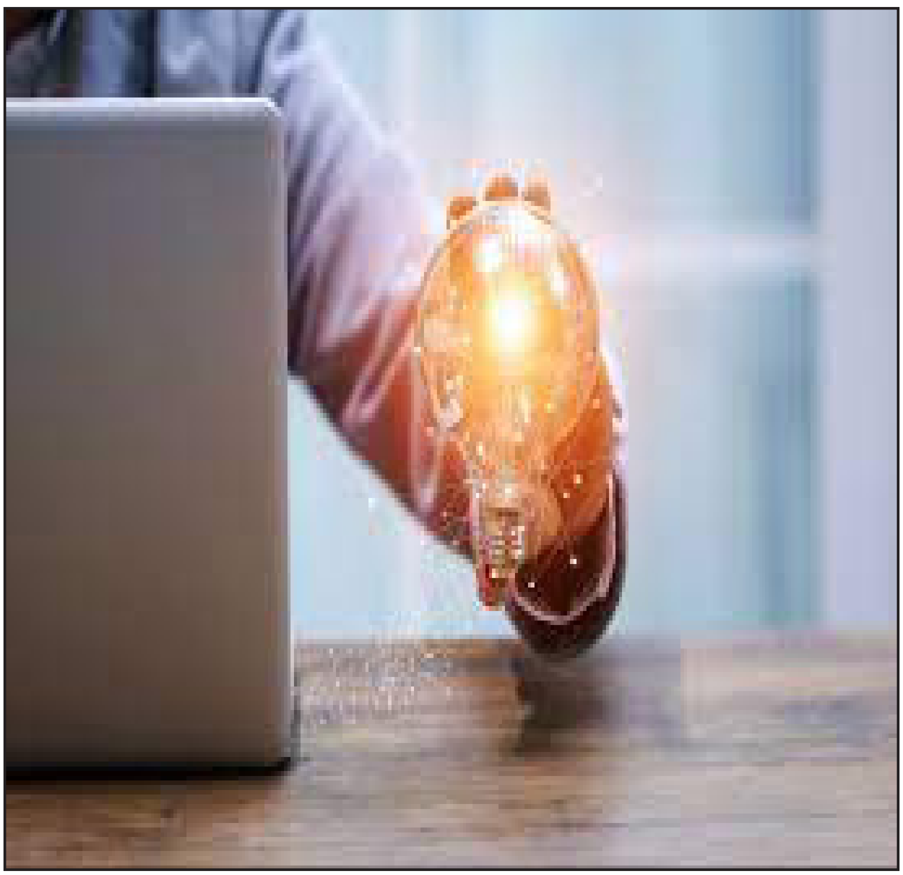
401(k) Plan Provisions That Are Great Ideas

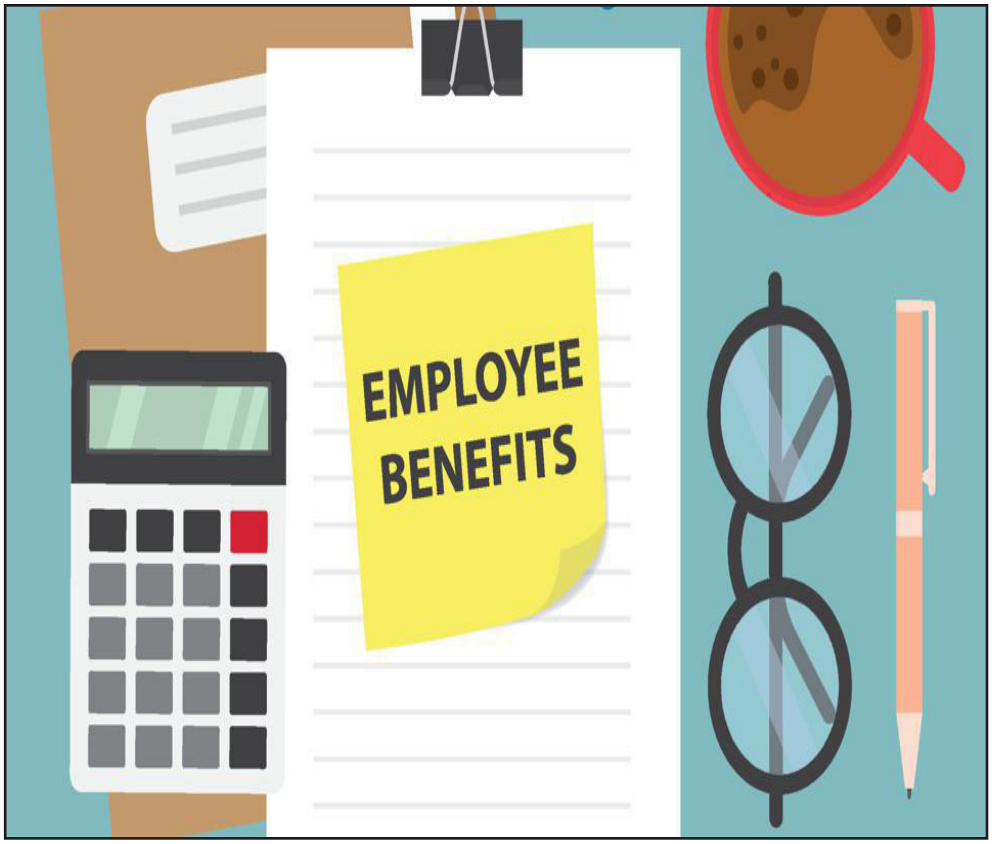
By Ary Rosenbaum, Esq.

401(k) plan sponsors can easily lose sight of why they started the plan in the first place. Plan sponsors have been distracted because they have been forced to concentrate on potential liability in connection with plan expenses and participant-directed investments. 401(k) plan sponsors should never lose sight of the fact that 401(k) plans are employer-provided benefits that were developed to recruit and maintain employees. So when possible, plan sponsors should consider the provisions I listed below that will enhance their plans at very little cost. They will make up those negligible costs in the long run through employee retention and recruitment.



Service Requirement: We have a retirement crisis in this country. Social Security is on track to run out of money in the future unless benefits are slashed and the retirement age is increased. Many private employers and some public employers either have phased out employer-provided pension plans or have cut back future benefits. Individual retirement accounts and 401(k) plans are now being used to shoulder the burden of funding an indi-vidual's retirement. While I understand why employers require a Year of Service to give participants a profit-sharing or matching contribution, there is very little reason why plan sponsors should require a Year of Service for participants to be able to make salary deferral contributions in a 401(k) plan. The reason is that even if a plan sponsor would require no service or six months of service as an eligibility requirement for deferrals, the otherwise excludible rule would allow salary deferral testing (the ADP test) to be conducted as if the salary deferral eligibility was age 21 and a Year of Service. The only down¬sides are that administrative costs would be increased because third party administration firms typically have a per participant charge and there is a concern with employee turnover that there will be many small account balances of former participants in the plan. The reasons those downsides can be dismissed is that most 401(k) plans have their administration fees paid by the participants' account balances and there are mechanisms to rid 401(k) plans of small account balances of $5,000 or less belonging to plan participants who are former employees. In addition, allowing participants to start deferring income from their date of hire will increase plan assets, which may lower costs as a percentage of assets because of the economies of scale. The ability to allow participants to defer quickly is a statement that the employer is encouraging retirement savings and it becomes a rather attractive benefit to entice potential employees and to retain current employees. Another reason to consider eliminating the service requirement is that starting in 2024, long-term, part-time employee who complete 500 hours of service or more will be eligible to participate in the deferral component of the Plan anyway.

Roth 401(k) Feature: Since 2006, 401(k) plans can add a Roth feature that allows participants to defer some or all of their salary deferrals for the year on an after-tax basis. By doing so, a participant could get those deferrals and the earn¬ings from those deferrals on a tax-free basis upon retirement. The Roth feature does not affect 401(k) limits or 401(k) testing, so other than notifying the payroll company that deferrals are going to be made on an after-tax basis, it is treated the same as the regular pre-tax deferral. Participants should have the option of whether they want their deferrals on a pre or post-tax basis. Options that have no negligible effect



on a retirement plan are good. Starting soon, highly compensated employees aged 50 and over will only be allowed to make their catch-up contributions on an after-tax basis.

Loans and Hardship Distributions: In an ideal world, 401(k) plans would be for retirement savings only. However, we live in the real world and there are reasons why participants may need to tap their 401(k) account funds. A plan loan is an attractive way to borrow money at a reasonable rate of interest that also acts as a participant-directed investment. Hardship distributions are for important reasons like burial expenses, medical expenses, educational expenses, to prevent a foreclosure or other life-important events. While many believe that participants shouldn't tap their accounts in these instances, we should allow participants to have the free will to make those choices when they re¬ally need to. Thanks to changes in hardship regulations, you don't have to verify the reasoning before the hardship request, you can merely rely on a participant's claim that they qualify for the hardship.

Automatic Enrollment: When I first heard of automatic enrollment in 1999, it was called negative election and I thought it was something out of the Soviet Union. The reason for my red-baiting was clear. Negative elections were merely designed as a cheap gimmick to artificially improve the ADP/salary deferral discrimination test by forcing participants to defer who didn't affirmatively opt out of deferring. The reason that it was a gimmick is that there was no liability protection for plan sponsors to invest that money if the plan was participant-directed and these participants didn't affirmatively elect to participate. So plan sponsors would simply park that money into money market funds that accrued very little earnings and rate of return. Legislative changes have made automatic enrollment more than a gimmick with the advent of the qualified default investment alternative (QDIA) which allows the plan sponsor to have liability protection if they place these deferrals into a qualified, default investment (all plans should have a QDIA added to their plan). Automatic enrollment can also develop into a Qualified Automatic Contribution Arrangement (QACA) that offers a form of a safe harbor contribution that has a vesting schedule and is less costly than the normal fully vested version. In addition to helping the ADP results, automatic enrollment increases the retirement savings of participants and it has increased participation. It will also increase the assets, which as discussed earlier, may help reduce administrative expenses as a percentage of plan assets. Combined with great investment education to participants provided by the financial advisor, I believe automatic enrollment can turn people who automatically defer into people that will voluntarily defer. Increasing retirement savings for all plan participants is a good thing. While many companies fear the backlash from automatically enrolled participants who complain that a portion of their pay has been automatically deducted, having these participants opt-out is fairly simple. Another reason to offer automatic enrollment is that a new law change will require almost all 401(k) plans that were started in 2023 and beyond to offer automatic enrollment starting in 2025.

Participant direction of investment: In the old days, most 401(k) plans had investments directed by their trustees and financial advisors. Thanks to the explosion in interest in mutual funds and the ability for participants to direct their investments through the phone, and eventually online, participant-directed investment became the automatic choice for most 401(k) plans. As long as a plan sponsor runs a prudent process of selecting investments and offers participants enough information to make informed investment decisions, plan sponsors will be shielded from liability from participant losses under ERISA §404(c). While trustees through their investment advisors, would certainly do better than participants in making investments, the reduction of potential liability is more important.

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