Bad Choices For 401(k) Plan Sponsors That Often Lead To Bad Results

By Ary Rosenbaum

My grandmother was very superstitious and she believed that bad luck could result from a bad choice you make. My grandmother grew up in old world Europe and she clearly was a product of her times. I'm less superstitious, I think that choices in life can lead to bad results, but I don't think it's about luck. I think you can make your own luck based on the choices that you make. For 401(k) plans, I believe that certain choices that a plan sponsor can make can lead to bad and costly results. Plan sponsors can make their own bad luck by making bad choices, so this article is a warning tale on what bad choices that a plan sponsor should not make.

Picking a TPA that isn't very good at TPA work

With apologies to any other plan providers out there, I believe that the most important plan provider that a plan sponsor can hire is the third-party administrator (TPA). The reason why the TPA is the most important plan provider is because of the intricate compliance and recordkeeping that they're entrusted with. Most problems for plan sponsors come from compliance errors that occur in day to day administration. Whether a 401(k) plan sponsor has many compliance errors is usually attributable to hiring a poor TPA. There are many great TPAs and there are quite a few that are just terrible. A 401(k) plan sponsor needs to know that they have to hire a TPA that is good at administration and plan design because a good TPA will help a plan sponsor avoid tripping in the landmine known as being a retirement plan fiduciary. Hiring a TPA for any main reason other than competence is a mistake that a plan sponsor will later regret. Picking a TPA because of cost or because they also perform another task for the plan sponsor such as payroll or financial advice is a recipe for disaster because TPAs that wear multiple hats usually don't do as good of a job than a TPA who only wears a single hat.

Not paying attention to the deposit of deferrals

The biggest error for 401(k) plans these days is something that should be like clockwork. The late deposit of 401(k) salary deferrals is the most frequent 401(k) plan error out there and it's amazing that something that should be automatic is being done incorrectly by being late. The Department of Labor (DOL)n reinterpreted the deferral deposit rule by requiring the plan sponsor to deposit deferrals as soon as possible and has been clamping down on late deferral deposits through audits and the institution of a voluntary compliance program for plan sponsors to correct late deposits. For some plan sponsors, the DOL believes that salary deferral deposits should be made within 3 days of payroll. Even being a day late, a plan sponsor might have a compliance issue of a late deposit. So it's important for a plan sponsor to make sure that salary deferrals are deposited as soon as possible. They can do that and avoid the inevitable late deferral deposit by instituting policies and procedures that if followed, will make sure that the late deferral deposits are few and far between.

Out of the box compensation definitions and the paying of bonuses

The second biggest problem I've seen these days concerning 401(k) plans is the definition of compensation in the plan document and the administration of the plan that is inconsistent with that. One example of where it happens is when the plan sponsor pays out bonuses without taking out salary deferral contributions out of it and making employer contributions based on it when the definition in the compensation actually includes it. Not allowing participants to defer or making employer contributions on this part of the definition of compensation will require the plan sponsor to make

corrective contributions that are going to come out of their pockets. A lot of errors happen when the plan sponsor has a definition of compensation that is outside the normal W-2 or 415 or 414(s) definition of compensation, usually by excluding a certain part of salary such as fringe benefits, vacation time, or a car allowance. Any out of the box definition of compensation may lead to errors by improperly including this party of salary in compensation, so it's my advice that plan sponsors try to keep it as simple as possible by using the basic W-2 compensation. The problem with these compensation issues is that the errors aren't usually one and done, they are usually errors that last several years and are only discovered many years later. I was once contacted by a bank who had a 401(k) plan where bonuses weren't included in the definition of compensation as required for over 20 years, even their auditors didn't pick up on the errors. So it's important that plan sponsors pick a basic definition of compensation and annually review that the plan document is consistent with plan operation.

The mistake of allowing multiple loans

While most 401(k) plans offer plan loans, there is one mistake with loans that plan sponsors make. The mistake they make is allowing unlimited loans under the plan. I have seen 401(k) plans where participants have five to seven plan loans outstanding. What's the problem? Many TPAs are confused with how to pay off multiple loans at the same time when a loan repayment is deducted from a participant's paycheck. I have seen firsthand when a 401(k) administrator would direct payments toward most of the loans, but forget one. The problem? Since payments were not made for half the year, the loan should have been in default and the participant should have received a 1099 form for a taxable deemed distribution representing the defaulted loan balance. This error was not caught by the administrator or the plan auditor but was discovered by an Internal Revenue Service agent on an audit. To avoid the error, plan sponsors should have a limit of one loan outstanding at all times as a loan provision which would eliminate all the issues that would emanate from allowing multiple loans because it's far easier for a 401(k) administrator to apply a payment towards one loan, instead of five to seven loans.

The Stated Matching Provision

While matching contributions under a 401(k) plan are supposed to be discretionary, for some reason or another, many plan sponsors feel the need to make that matching required by creating a stated match. A stated match is where the plan sponsor states the full formula in the plan document of what their match will be such as 50% of a participant's salary deferrals, up to 5% of the participant's annual compensation. Why is a stated match a problem? If business falters or business improves; any change to the matching formula will require a plan amendment. Also if the plan sponsor makes the matching contribution after the end of the plan year (the deadline is the plan's sponsor tax filing due date include extensions) and determines that they don't have enough money for the match, the problem is that the last day to amend the plan to eliminate the stated match was the last day of the plan year (usually December 31). Aside from some collective bargaining requirement, there is no need for a stated match provision. A simple resolution by the plan sponsor with the matching provision by their tax due date is sufficient notice to plan participants without having to put that provision in the plan document and summary plan description. A plan sponsor should never tie themselves into something by making something discretionary, mandatory.

The Match True Up

In my example of a matching contribution in the previous section, it was based on a limit on annual compensation. What happens if the plan sponsor actually makes the contribution on a more frequent basis, such as monthly or payroll? Since participants start deferring, max out the annual deferral limit, and change the rate of their deferral throughout the year, the plan sponsor would actually have to true up the matching contribution at the end of the year to meet that annual compensation limit. If the true-up is not done, then the plan sponsor has not followed the terms of their plan document and risk the tax qualification of the plan. The Match True-Up situation usually arises when the plan sponsor actually makes the matching contribution on a timely basis that contradicts the compensation limit they use. So if a matching provision limits matching on payroll compensation and the plan sponsor makes the contribution annually, many errors by TPAs may be made. The same is true if the matching compensation limits deferrals on annual compensation and they make the contributions on a payroll basis. The way to avoid is rather simple, the plan sponsor should always deposit the matching contributions on the same time basis they actually limit compensation for matching contribution purposes.

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