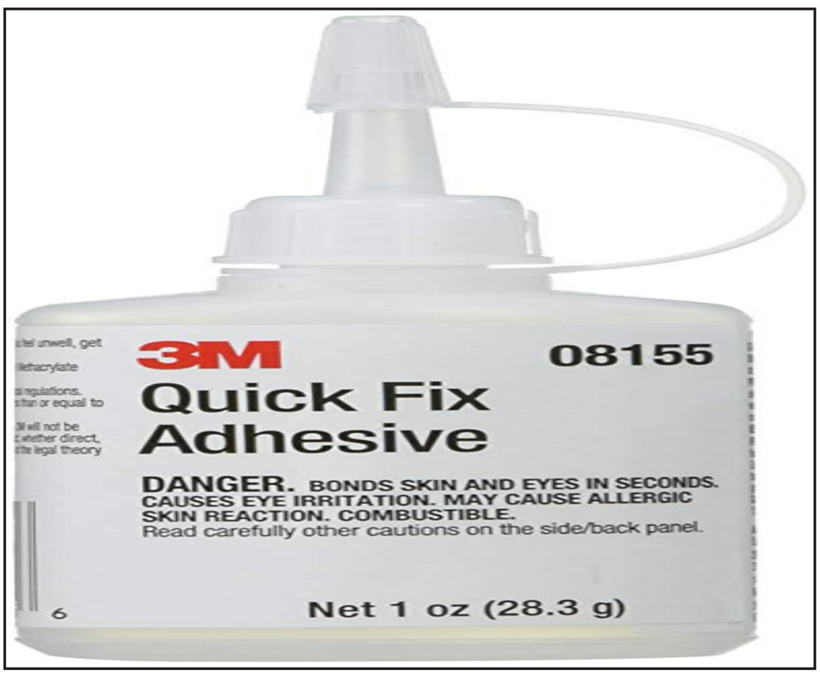
Quick Fixes For A 401(k) Plan Sponsor's Errors and Problems

By Ary Rosenbaum, Esq.

The beauty of 401(k) plans is that no matter the problem that a plan sponsor may have, there is a rational solution to that problem. Sure it doesn't involve such quick home fix remedies such as baking soda and vinegar, but there are enough quick fixes for a plan sponsor. The only problem is that most plan sponsors are unaware of these fixes because they're unaware that what they have in their 401(k) plan may be a problem. This article is about quick fixes that a 401(k) plan sponsor may utilize to fix a problem they should be aware of.



A low deferral percentage rate

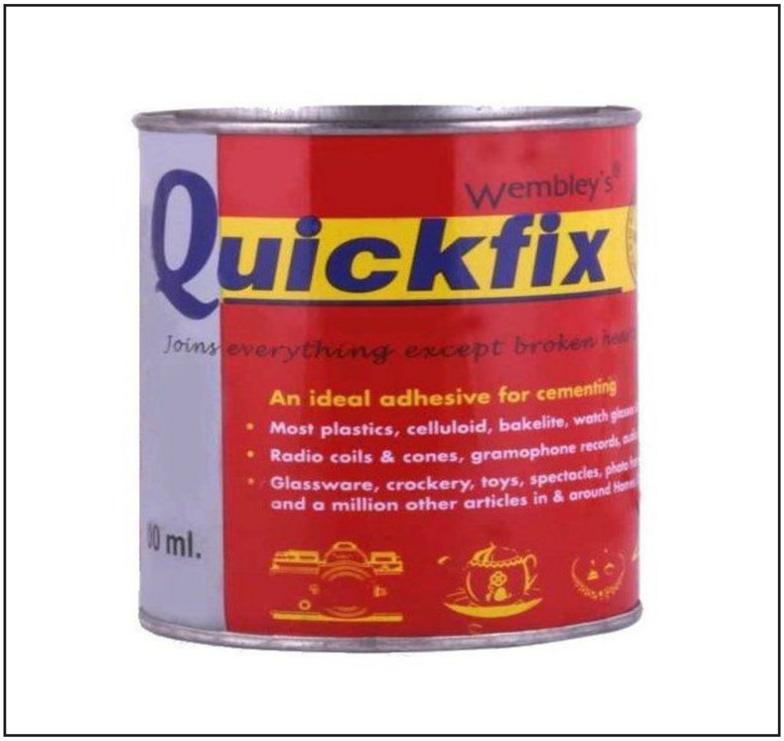
One of those best barometers of the health of a 401(k) plan is the deferral rate of plan participants. A low rate indicates that a plan usually has a major problem, as long as the bulk of the employees don't make minimum wage (which means no matter what, they're not going to be able to afford to defer for retirement.) An automatic enrollment feature that automatically takes out a certain deferral percentage out of participant's paychecks who don't affirmatively opt out is often used to deal with a low deferral percentage rate. A low deferral percentage rate for lower paid employees is a concern because it may impact the deferral rate of highly compensated employees because the plan must pass a deferral, compliance test. A lower rate for the rank and file will require a lower deferral rate for the highly compensated employees which may be in the form of a taxed deferral refund. Automatic enrollment isn't the only fix fo9r a low deferral percentage rate. Sometimes, there is poor communication between the participants and the plan sponsors as it pertains to plan investments. A poor engagement process through enrollment/plan education meetings may be the reason for a low deferral rate. Studies have shown that 401(k) plans with too many investment options actually depresses the plan's deferral percentage rate because too many fund choices lead to participant confusion. So rather than just implement an automatic enrollment feature, it might be wise to review the fiduciary process of the plan to see if there is a disconnect between the participants and the plan. Something as simple as injecting some life into the plan enrollment/education meetings might be enough. The problem with any quick fix here is that most plan sponsors and plan providers don't identify a low participation rate as a glaring problem.

Failed actual deferral percentage test

As discussed, a 401(k) plan has to go through a deferral test called the actual deferral percentage test (ADP). In a nutshell, in the ADP test, to pass the test, the ADP of the Highly Compensated Employee may not exceed the ADP of the Non-Highly Compensated Employees by more than 2 percentage points. To correct this problem, the plan has to refund the Highly Compensated Employees deferrals in the amounts needed to pass or the plan sponsor must make a qualified non-elective contribution to the non-highly compensated employees. If the plan consistently fails the ADP test, a plan sponsor could make a quick fix going forward and select a safe harbor status for the 401(k) plan. By being a safe harbor, the plan is required to make 100% vested contributions to participants annually and will be considered as passing the test. There is also a cheaper, less vested safe harbor contribution available in connection with an automatic enrollment feature. Regardless of the safe harbor, it can be an easy headache-free alternative for 401(k) plan sponsor who consistently fails the ADP test and has the pockets to make a required contribution.

Compliance errors

The problem with compliance errors is they are often only detected many years later where it's costlier to fix, especially when it's caught on a government audit. Getting caught on an audit before the 401(k) plan sponsor can self-correct will be more expensive because of penalties issued by the government rather than just the costs of self-correction. There are so many things involved with 401(k) plans that errors fo happen, how many errors is the problem. A 401(k) plan sponsor needs to identify the errors in their 401(k) plan and find out who is at fault. Many times, it's the fault of the third-party administrator (TPA). The difference between a good TPA



and a bad TPA are the number of errors as better TPAs make fewer mistakes. However, not all errors are the result of the TPA. Many times, it's the error of the plan sponsor as they may provide incorrect data or incorrect information to the TPA. For example, problems with controlled and affiliated service groups may arise because the plan sponsor was less than forthcoming with the TPA's questions. So it's important for the plan sponsor to be clear as to who made the error and what adjustments need to be made. If the plan sponsor is responsible, they need to put procedures in place to make sure the incorrect information is no longer given. If the fault lies with the TPA, the plan sponsor needs to identify the severity of the errors and the frequency of overall compliance errors and make a judgment call. In my opinion, a TPA that makes too many errors for the plan sponsor is a liability concern because they're putting the plan sponsor at risk for liability.

Timely deposit of deferrals

The biggest and most frequent 401(k) error is something that can't be pinned on the TPA or any other provider. That error is the untimely deposit of 401(k) participant salary deferrals. For far too long, plan sponsors were under the impression they had a safe harbor for salary deferral deposits if they could get it in by the 15th day of the following month. The Department of Labor (DOL) reinterpreted that regulation for all of us and said that plan sponsor need to get salary deferrals in as soon as possible, which could be as little as 3 days. This has been such an important compliance checkpoint for the DOL, that late deposit of salary deferrals is a question on Form 5500. If a plan sponsor admits they made a late deferral (which they should, under penalties of perjury), they will be contacted by the DOL if the DOL doesn't find the plan sponsor's application to their voluntary fiduciary compliance program. The problem with late deferrals is that it's usually not a one and done error by the plan sponsor. If they've been late before with deferral deposits, they will do it again. The quick fix for the plan sponsor is to identify the moving parts of their plan when it comes to payroll and the 401(k) and develop a procedure that is followed that requires the timely deposit of deferrals. While depositing salary deferrals should be easy, thanks to direct deposit, it's not the case when a plan sponsor has multiple locations of employees and sometimes, multiple payrolls.

Missing former participants

Another compliance priority for the DOL is missing former participants. When employees leave, they should be encouraged to take their 401(k) assets with them. Plan sponsors don't need the headache in dealing with former employees because of the liability associated with 401(k) plans including something as simple as proving notices. The problem is that past a certain amount ($1,000 or $5,000 usually), plan sponsors need a participant's consent to remove their account from the plan. So if a former employee doesn't take their money initially after termination, that account usually sits in the plan for many years to come, usually until the 401(k) plan is terminated. Missing former participants are not only a problem for the liability aspect of it, but they might be costly because it might affect the need for a plan audit (if the plan hits the magic number of participants for an audit 100-120 participants) or some other charge that current employees must pay. Over time, former employees can't be located one way or the other and it becomes additional work because the DOL doesn't want these employees to be missing. Rather than just allowing former employees to being missing former participants, it's important for the plan sponsor to develop a procedure with the TPA to make sure that employees are encouraged to take their 401(k) account with them and at least annually, remind them they have this account and that it's a good idea for them to roll it over to another plan or an individual retirement account. Allowing former employees to be missing participants and hold their assets doesn't do the 401(k) plan sponsors any good.

Wrong definition of compensation

Another big error these days is plan sponsors using one definition of compensation for purposes of 401(k) contributions and the plan document saying something else. It's a problem because the plan sponsors aren't operating their 401(k) plan to its terms. But it also might be costly if the plan sponsor has to make corrective contributions for a portion of compensation they never intended to recognize and there is a mistake in the plan document. To avoid this frequent error, the plan sponsor must communicate annually with the TPA on the portions of compensation they want to exclude for contributions and make sure that the language for the exclusion is actually in the plan document's compensation definition.

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