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Gavel to Gavel: A few tips for 401 (k) plan sponsors

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Whoever said "don't sweat the small stuff" never was responsible for administering a company's 401(k) plan. With so much at stake for both the employees and the companies who sponsor them, retirement plans are, by their very nature, complicated documents. And it's sometimes the smallest things – like not following a plan's written definition of "compensation" – that can expose the company sponsor to significant financial and legal liability.

Unfortunately, compensation definitions can be extremely complicated. For example, does the plan's definition of "compensation" include bonuses or overtime pay? What about any deferred compensation or other benefits provided to the employee? Because of these complexities, the use of inaccurate compensation amounts in plan operations is one of the most common errors.

An employer can avoid certain penalties by identifying these errors through internal audits and taking advantage of IRS programs allowing self-correction of past miscalculations. A key factor in determining whether you are eligible for self-corrections not requiring approval from the IRS, and therefore lower penalties, is how quickly you identify and correct the error. This, coupled with the reduced risk of prolonged failures, creates a cost-saving incentive to employers adopting certain precautions and taking immediate action to correct any errors.

Periodic "Compensation" Audits: With the rise of pre-approved plans, more and more plan sponsors are choosing to rely on adoption agreements, summary plan descriptions, or other similarly abbreviated descriptions of a plan's key provisions as their primary resource for plan operations. As a result, it is not unusual for a plan sponsor to have never reviewed the compensation definition contained in the actual plan document, which increases the chances that the plan's operations are inconsistent with the plan's terms. And while the summary materials should contain the key provisions of the plan, the language in the plan document controls.

A best practice for plan sponsors is to conduct an annual audit of the plan's operations in comparison to the plan's definition of compensation. Such an audit should identify the plan document's compensation definition(s) and confirm its consistency with the plan's calculations. This process can be streamlined by taking a random sampling of participants, calculating what their deferrals and allocations should be under the plan's terms, and comparing it to the actual deferrals and allocations made.

Here's an example of a common error. Compensation under your plan is defined to include overtime pay. Participant A has elected to defer 5 percent of his compensation to his 401(k) account. During an audit, you discover that your calculations did not include his overtime pay as compensation. The general correction principle is to restore the plan to the position it would have been in had the failure not occurred. As a result, the company will likely be required to make a corrective contribution to Participant A's account, adjusted for earnings from the date of the failure, plus a matching contribution, if applicable.

Simplify When Possible: To complicate matters further, amounts considered compensation for one plan purpose may be excluded for another plan purpose. Consequently, even after conducting the review discussed above, errors may arise from simple miscalculations. To minimize this risk, assess whether a less complicated definition of compensation is available and if one definition can be used for multiple purposes. Regardless of the definition, though, calculation errors can be avoided by properly training and educating the people administering the plan's terms.

Communicating With Key Players: Plan compliance is ultimately the plan sponsor's responsibility. However, most plans are administered by several different individuals, including employees of the sponsor and outside vendors and professionals. A lack of good communication among all of these parties can easily result in errors not only occurring, but going undetected for a long period of time.

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LINKS

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