How an Employer Can Rev-Up Their 401(k) Plan at Low Or No Cost

By Ary Rosenbaum, Esq.

After I got my driver's license, my very first car was a 1985 Oldsmobile Delta 88. The car had a powerful V8 engine, large plush bench seats, a tape deck radio that no longer worked, and a bumper that was an actual bumper and not a piece of plastic. While I loved that first car, it lacked many of the amenities of today like satellite radio, anti-lock brakes, an I-Pod dock, and air bags. There are a lot of 401(k) plans that are like an Oldsmobile Delta 88, lacking many of the amenities that have been developed in the 401(k) industry. 401(k) plans are not only a vehicle for retirement savings for employees; they can be seen as an important employee retention tool if the employer takes their job as plan sponsor seriously. Many of these amenities can be added to an existing 401(k) plan with little or no additional cost.

Adding A Roth 401(k) Feature

One of the most positive developments within 401(k) plans has been the addition of the Roth 401(k) feature for the plans that decided to implement it. The Roth 401(k) feature simply allows a participant to designate some or all of their deferrals on an after tax basis, allowing for tax free distributions at distribution if certain requirements are met. There should be no added cost to adding this feature (except for a plan amendment), it simply is an addition to an existing plan. A majority of plans have still failed to add this feature and there should be no reason why because it doesn't complicate plan compliance and participants should have the opportunity to decide whether to defer some or all of their salary deferrals as after-tax and enjoy that tax free growth. Also, the addition of a Roth 401(k) feature allows eligible plan participants (those older than 59 ½ or normal retirement age) to convert their pre-tax salary deferrals into Roth deferrals after taxes are paid.

Adding Automatic Enrollment

While many plan sponsors bristle at the thought of adding an automatic enrollment feature which defers a participant's income automatically if a participant fails to affirmatively waive participation in the salary deferral component of the plan because of possible complaints, I think it is a positive addition. Automatic enrollment artificially increases plan deferral participation which can help with required plan discrimination testing as well as increasing plan asset size, which can decrease the cost of administering the plan. It also makes a statement that the employer is interested in the welfare of their employees by having them set aside a portion of their income for retirement. Through encouragement by the employer and investment education by the plan advisor, it is the hope that these automatically deferring participants may be converted into active deferring participants.

Eliminate Eligibility Requirements for Salary deferrals

This may be the most unpopular suggestion in this article because having immediate eligibility may increase plan costs because the plan may have multiple accounts sitting in the trust account belonging to former employees who quickly terminated employment after their date of hire. While that may be true, employers should understand that immediate eligibility for salary deferrals is an attractive employee recruitment and retention tool. When I have interviewed for jobs in the past, a one year of service eligibility requirements has been a a strike against taking a job offer. Immediate eligibility for deferrals doesn't preclude the employee from having a year of service requirement for employer contributions and it won't affect discrimination testing on salary deferrals because under the otherwise excludible rule, testing will be completed as if the plan had an age 21 and a year of service requirement for salary deferrals. Employers often forget than a 401(k) plan is an actual employee benefit and immediate eligibility for salary deferrals is an attractive benefit for any potential or new employee.

Reviewing the Investment Selection Process

Whether the plan is participant or trustee directed, it is incumbent on the plan sponsor to review the investment selection process and whether it complies with ERISA to limit liability. This process requires the retention of a financial advisor, development of an investment policy statement (IPS), selection and review of plan investments based on the IPS, memorializing any decisions taken by the plan fiduciaries in the selection and review of investment options, and employee investment education (if the plan investments are directed by participants). It is often surprising how many plans don't have an IPS, or a financial advisor, or a review of investments to see it complies with the IPS. Heck I worked at a law firm who had a 401(k) plan with all of those deficiencies before I advised them to clean up that potential liability disaster.

Prune an Excessive Fund Line-Up

When it comes to having investment options for participant directed 401(k) plans, many advisors and plan sponsors believe that more is more. Studies suggest that less is actually more because plan participation for salary deferrals is depressed with participant directed plans with large fund menus because it overwhelms participants. I have seen plans with 28 and even 50 different mutual fund options on a single plan menu, which has to confuse plan participants. There should be no reason why a plan has 3 large cap growth funds. Too many fund choices have also been shown to spur participants to invest more in less riskier investments which may negatively affect their asset allocation and their retirement savings. Why have 28 mutual funds in the fund lineup when 12 can do the trick?

Review Plan Fees

It is a breach of a plan fiduciary's duty of prudence to pay fees that are unreasonable for plan administration and investments. It is required for plan sponsors to understand the fees that plan participants pay and determine whether those fees are reasonable for the services involved and what is available in the marketplace. With fee disclosure regulations coming into effect in July 2011, all plan sponsors will be advised by their plan providers as to what fees are being charged and what compensation that these providers will receive. Therefore, plan sponsors have no excuse not to review plan fees and inquire with competing plan providers to determine whether the fees are reasonable. This past year, a Federal District Court in California determined that a plan sponsor breached their duty of prudence by using retail share classes of mutual funds, when less expensive institutional share classes of the very same funds were available. Plan costs have been an important discussion over the last few years because of the demands for required disclosure and because so many plan sponsors have been sued by participants for excessive fees.

Complete an Annual Review of the Plan

Retirement plans are like automobiles (another car reference), they need constant maintenance to run to its optimum capability. Too many plan sponsors have a "drawer" mentality when they take their plan, put it in the back of the drawer and forget about it. A 401(k) plan should be reviewed annually to determine whether the fees being charges are reasonable, whether the investments are still proper according to the IPS, whether the plan still fits the needs of the sponsor and participants, as well as determining whether the plan documents and the plan's administration is compliant with ERISA and the Internal Revenue Code. While plan sponsors may consider this review cost prohibitive, there are many financial advisors, TPAs, retirement plan consultants, and ERISA attorneys (including this one) who can perform that service at a reasonable fee.

It is required for a plan sponsor to keep their 401(k) plan in tip-top shape. They should consistently review and update their plan as needed. 401(k) plans are an employee benefit and one of the ways to improve that benefit is to rev up the plan with some of the new amenities and features available today at low or no cost. A plan sponsor with a 1985 Oldsmobile Delta 88 of a 401(k) plan in 2011 will find out the hard way why their plan should have been like a 2011 Ford Mustang by paying large lawsuit settlements to plan participants.

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