How 401(k) Plan Sponsors Can Avoid Turning Their Plan Into A Disaster

By Ary Rosenbaum, Esq.

I'm a movie fan especially a fan of movies from the 1970s. One genre of movies made famous during the 1970s was the disaster movie. The Poseidon Adventure, Airport, and The Towering Inferno led to a great successful genre until it was killed off by The Swarm, Beyond The Poseidon Adventure, and When Time Ran Out (all Irwin Allen productions by the way). Retirement plan sponsors cant afford to have their retirement plan become a disaster, especially when they are responsible to clean up the mess. This article is about disasters that a 401(k) plan can turn into and how to avoid it.

The missed 5500

One of the crimes I'll never understand is taxpayers who are prosecuted for not filing their taxes. If you have a social security number and don't file, the Internal Revenue Service (IRS) will find you eventually. The same can be said for the 401(k) plan that doesn't file one or many Form 5500s. A failure to file a Form 5500 is one of the biggest plan errors out there and is the result when the third party administrator (TPA) fails to draft one and the plan sponsor forgets they needed to electronically file one. Plan sponsors who sponsor a 401(k) plan with at least one employee or have no employees, but $250,000 in assets, should know that an annual Form 5500 is due every July 31st or October 15th (if an extension was filed). So it's imperative that every 401(k) plan sponsor keeps it in the back of their mind that they have to file a return every year. While there are voluntary correction programs that offer low penalties for late filings, a failure to file a return that is caught by the IRS and Department of Labor (DOL) can lead to a fine as high as $2,097 per day.

Late deferrals

Another big mistake is when 401(k) plan sponsors fail to properly deposit participant salary deferrals in a timely fashion. For many years, plan sponsors relied on language in the Treasury regulations that plan sponsors should deposit deferrals no late than the 15th day of the following month. The problem was that a few years back, the DOL interpreted the regulation as requiring plan sponsors to deposit their deferrals as soon as possible. As soon as possible always means to me as soon as possible and no later than the next payroll. Too many plan sponsors relied on that 15th day of the following month language and it's a costly error because of what a plan sponsor has to do to correct the problem especially filing with the DOL's voluntary compliance program. It's such a big topic that whether a plan has late deferrals is a question on Form 5500. If a plan sponsor admits there were late deferrals and didn't file with the DOL's voluntary compliance program, the DOL will contact the plan sponsor and it's also a red flag for a potential plan audit. It's an error to avoid, so plan sponsors should make sure there is a process in place to timely deposit salary deferrals.

Forgetting about those who are eligible

Eligibility to participate is one of the most important components of a 401(k) plan and it's one of the first things that a plan sponsor could forget. The problem is that it can be costly. The big mistake is forgetting which participants are eligible and not given an opportunity to defer. While most eligible employees won't actively participate in a 401(k) plan by deferring, they still need the opportunity to defer. If these participants aren't given an opportunity to defer, the plan sponsor may have to make a corrective contribution to fix that error. While it doesn't seem fair for the plan sponsor to have to make a fully vested employer contribution for a participant who wasn't going to defer, there is always a price to pay for not following the terms of the plan. Plan sponsors shouldn't just depend on their TPA to tell them who should be eligible, they need to keep track themselves to avoid a situation where they have to make contributions for people who weren't going to defer anyway

Paying too much in fees

Thanks to fee disclosure regulations, 401(k) plan sponsors are advised as to

how much they directly and/or indirectly pay their plan providers. It's important because a plan sponsor has the fiduciary duty to only pay reasonable plan expenses. Too many plan sponsors take the fee disclosures that they receive from their plan providers and stick it in the back of the drawer. A plan sponsor needs to benchmark the fees they're being charged to make sure that the fees charges are reasonable for the services provided. While larger plans are the main targets for plan litigation, smaller plans should make sure they're benchmarking fees because I've seen DOL audits ask about fee benchmarking and plan provider reviews. So if the DOL asks for it., it's important for the plan sponsor to handle their fiduciary duty diligently.

Compliance testing is where the errors are

Annually, the TPA performs compliance testing to make sure that the 401(k) plan doesn't discriminate in favor of highly compensated employees. The problem with compliance testing is that errors can be made and they usually aren't detected unless there is an IRS audit or the TPA has been replaced. So it can be years before these types of errors are detected. If it's caught many years later down the line, the cost of correcting through employer contributions can be costly through the IRS' voluntary compliance program. If errors are discovered on audit, the voluntary compliance program is closed and penalties may be levied. Since this is one of the big areas where plan sponsors can have their plan turn into a disaster, it may make sense for the plan to undergo a review of testing by hiring an ERISA attorney or independent retirement plan consultant. I have a plan review called the Retirement Plan Tune-Up that I have been hawking for $750 for the last 7 years to see how healthy the plan is and that the testing is done correctly.

Avoiding prohibited transactions

The 401(k) plan is for the exclusive benefit for plan participants. It's not something that should be used to directly or indirectly the plan sponsor. So the plan sponsor should avoid using the plan to make transactions that benefit them or other plan fiduciaries, so they should avoid any transaction that the DOL and IRS consider prohibited transactions. So the business owner shouldn't hire their spouse as the plan's financial advisor or use the plan to buy a building that the plan sponsor will use as an office. In addition, the hiring of plan providers should be done through an impartial process, so that means not hiring a bank as a plan provider because they will increase the plan sponsor's credit line. Everything a plan sponsor does in the management of the Plan should be fair and rational.

The peril of participant-directed plans

A 401(k) plan sponsors won't be liable for the losses incurred by participants if the plan is participant directed as long as the plan sponsor fulfills their fiduciary duty. That means developing a process for the selection and replacement of investment options, as well as providing investment education to plan participants. Of course, the plan sponsor needs to hire a financial advisor to either manage or assist in managing the process. As of late, the DOL has been asking about whether a plan has an investment policy statement even though it's not legally required, so I think it's imperative that a plan sponsor has one. The whole point of offering a participant-directed plan is to limit liability, so it makes sense for plan sponsors to take advantage of that limited liability by doing their job.

Plan theft

Theft of plan assets by employees and by plan providers happen. They are rare, but it happens. Plan sponsors should make sure that plan assets are in the custody of a well known and regulated custodian. In addition, they should always review the plan trust's statement to confirm deposits and withdrawals to insure that plan assets aren't being stolen. I see too many times where someone in the employ of the plan sponsor or serving in an executive position using the plan as their own personal piggy bank. While plan provider theft isn't rampant it has happened. While an ERISA bond covers theft by plan fiduciaries, it does of little help if the theft is greater than the insured value of the bond. People steal from a plan when the plan sponsor isn't looking.

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