Great 401(k) Participant Features That Can Cause You Headaches

By Ary Rosenbaum, Esq.

A 401(k) plan is one of the great employee benefits. Within a 401(k) Plan, some options are truly beneficial to plan participants when it comes to increasing retirement savings or allowing access for a participant's benefit. The problem with these options is that if you and/or your plan provider keep your eye off the ball, then there may be a compliance headache coming your way. The road to hell is paved with good intentions and certainly when 401(k) plan features that benefit employees cause compliance grief.

Automatic Enrollment

Automatic enrollment is one of the best features of a 401(k) plan since it was added to the Internal Revenue Code in 2006. Previously called a Negative Election, it will withhold a percentage of a participant's compensation as a salary deferral if the plan participant didn't affirmatively opt out of deferring by noting as such in their deferral election form. I like the automatic enrollment because it gets people to defer, which helps their retirement savings and may help the plan's actual deferral percentage discrimination test. The problem with the automatic enrollment that could blow up in your face is when you fault to implement the automatic enrollment feature and don't take out the deferrals from participants' paychecks, as mandated by the plan document. If you don't fix the problem as soon as possible (and you likely won't), you will have to fix the plan by making corrective contributions out of your pocketbook. There is nothing worse than making a corrective contribution instead of the participant making salary deferral contributions under an automatic enrollment feature.

Matching Contributions

One of the best features for plan participants out there is a matching contribution where they get a contribution tied to the deferral they put in from their paycheck. What we call "free money" for deferring, it's a great encouragement for participants to actively participate by deferring their salary. The problem with matching contributions is based on the time of funding and any caps that you would place on matching contributions. The limit is the maximum you will match, which is limited to the percentage of deferrals you will match up to a specific percentage of compensation. An example is when you agree to match 50% of the salary deferrals up to 4% of compensation. Where it causes problems is if you decide to match on a payroll period basis, but the limits on matching are tied to an annual amount. Why the problem? Matching payroll by payroll will lead to one issue, the issue that participants may change their deferral rate now and then. It may be due to fluctuation based on how much they could defer or the fact that they max out their salary deferral before December 31st. Whatever the reason for the fluctuation, it's a problem when the matching contribution is tied to an annual compensation limit. Since payroll periods fluctuate and an annual limit does that, it may force you to make a true-up contribution to meet that annual match limit. The same could hold if you make the matching contribution on an end-of-year basis and your matching contribution is tied to a compensation that isn't annual, such as monthly or payroll period. In English, the way you match should be the way you put in a match limit. It needs to be consistent, otherwise, you may have to fork over more money or make some corrections to fit the terms of the plan document.

Participant direction of investments

Allowing participants to direct their investments within a 4011(k) plan was done to limit your liability as a plan sponsor. The problem is you may not be aware of your requirements under ERISA §404(c) which requires you to follow a fiduciary process to achieve that liability protection from participant losses from their investment. As a plan sponsor, you must have a process to select and replace plan investments. You also need to provide enough information for participants to make informed investment decisions, such as providing investment education. Without following a prudent fiduciary

process, you will still end up being liable for something you were supposed to get liability protection for losses sustained by participants when they direct their investment.

Loans

On paper, allowing participant loans is one of the beneficial participant features because it allows plan participants to access their account balance for a loan when they need the money. Loans act as a participant-directed investment if the plan offers participant investment direction. Loans are for a maximum five-year term (unless a home loan) and must receive payment at least quarterly. Otherwise, the loans default, and the plan participant is supposed to receive a Form 1099 representing a taxable deemed distribution, In terms of plan error, errors resulting from plan loans are at the top of the list and these errors usually involve the plan loan becoming defaulted because of the failure to properly make a payment towards the loan quarterly. Usually, it's the fault of the plan sponsor and/or the TPA and it's not fun to tell a participant that they have a taxable distribution for a loan default that wasn't of their making, sometimes years after it happened. The reason this happens usually is when a plan offers unlimited plan loans. There might be plan participants with 7-10 outstanding loans and the TPA may forget to make a payment to one or more loans, which may cause a default. The road to hell is paved with good intentions and there is nothing worse than having huge compliance problems because you offered plan loans. As a plan sponsor, you should only offer one loan outstanding at a time. You can certainly allow participants the right to refinance or reconsolidate plan loans, but there should be only one loan outstanding at a time. Also, you should require a $1,000 loan minimum. There is nothing worse than charging a participant $50 to $100 to take out a $500 loan. Offer a loan program, but don't offer a payday loan program. Offer one loan outstanding and a $1,000 loan minimum to minimize the potential for compliance errors. Also, make sure you have the backup from a participant to offer the 30-year home residence loan.

Hardship distributions

While many plan sponsors abhor the idea of hardship distributions, I see nothing wrong with allowing plan participants the opportunity to access their 401(k) account balance in times of heavy financial need. There are times such as medical expenses and funeral expenses when a participant may need quick access to large amounts of money. The problem with hardship distributions is the compliance end. There is a safe harbor criterion for hardship distributions and it's something you should follow. Also, you can't take participants' words that they have a heavy and immediate financial need for that hardship distribution. They must provide written evidence and you must vet that written evidence to make sure that the request meets a definition of hardship. While the fairly new hardship regulations does allow you to take the participants' word that they qualify, I'm concerned an audit could claim you had imputed knowledge that the request was improper. Over the past few years, the Internal Revenue Service (IRS) has advised its agents to review hardship requests during a plan audit especially when a participant makes multiple hardship requests. That is why I still would request backup for requests. There is nothing wrong with offering hardship distributions, what's wrong if you don't document these requests with written proof. Otherwise, you're turning the 401(k) plan into an ATM and that won't pass muster with the IRS.

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