Great 401(k) Plan Features That Can Be A Hit Or A Miss

By Ary Rosenbaum, Esq.

When you're buying a new car, there are so many available features on a car model that can make your head spin. There are some features you need like power steering and power brakes, but there are some features that you just don't really need. The same can be said about starting a 401(k) plan, there are so many different features that you need to consider and some that you don't because you should never forget that a 401(k) plan is supposed to be a way to recruit and retain employees. Some features go a long way in helping that out than others. So this article is about 401(k) plan features that a plan sponsor should consider adding to a 401(k) plan.

Eligibility

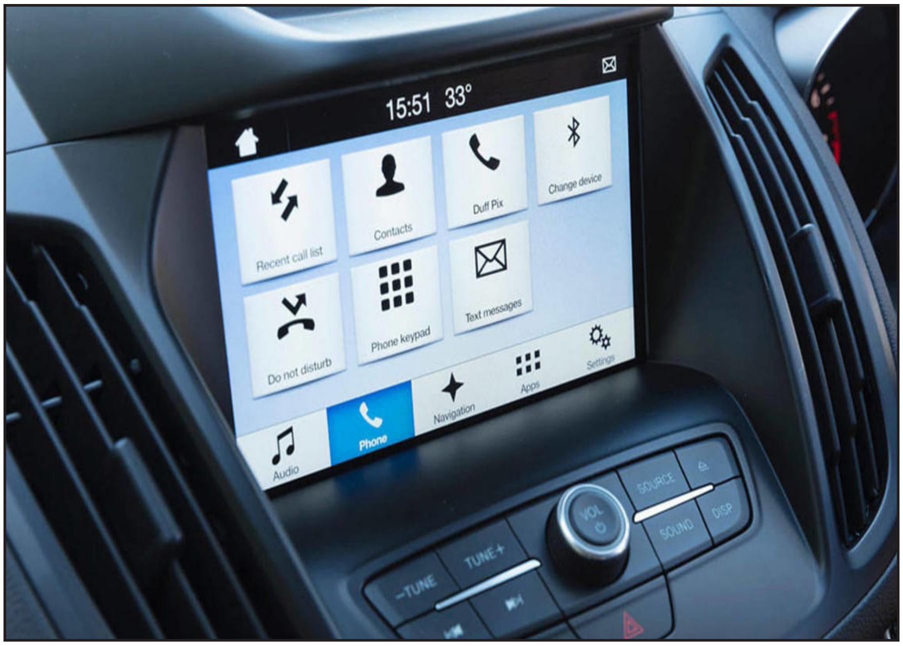
For 401(k) plans and eligibility, the question is whether plan sponsors should offer immediate eligibility or the maximum one-year of service wait for employees or somewhere in between. While I loved the idea of immediate eligibility, that's just my opinion and may be inconsistent with the demographic needs of the plan sponsor. Immediate eligibility brings in all employees including part-time employees that the plan sponsor may never have intended to cover under their 401(k) plan especially if they have a large staff of part-time employees. Immediate eligibility may also be a bad idea if there is constant turnover in the employee base, especially with people who just started employment. Too much turnover and bringing in too many part-time employees can cause headaches by creating a lot of small account balances for terminated employees. In addition, bringing in too many employees into the plan can also create havoc for the plan sponsor by requiring employer contributions to employees that they never intended to give contributions to. So the decision on what type of eligibility and whether it should vary for employer contributions (by requiring more time than salary deferrals is dependent on each employer and their demographic needs and reality.

Vesting

Vesting like eligibility can be immediate where participants can be fully vested in their employer contributions immediately. As always, salary deferral and safe harbor contributions (more on that later) are fully vested at all times. Vesting that is immediate is a nice feature for participants because they won't forfeit employer contributions no matter when they leave. A vesting schedule such as the 6-year graded schedule can be a great feature for the plan sponsor because it acts as an incentive for good employees to stay and can help the plan sponsor out since a lot of turnover will create forfeitures. Vesting can also be a moot issue if the plan sponsor has never made employer contributions and never will, which happens with a lot of 401(k) plans. Like with eligibility, I believe that vesting is dependent on the demographics of the plan sponsors as well as whether they offer employer contributions or not.

Automatic Enrollment

Automatic enrollment allows a plan sponsor to automatically deduct elective deferrals from a plan participant's wages unless the participant makes an election not to contribute or to contribute a different amount. Automatic enrollment has been around for almost 20 years when the Internal Revenue Service (IRS) approved it, but didn't catch on until 2006 when it finally became part of the code and offered fiduciary relief. People in the business were very hesitant about using automatic enrollment because they thought that employees who were automatically enrolled would be upset that deductions were made against their wages, but that wasn't the case. Automatic enrollment is a great feature, especially for the plan sponsor that have issues with the deferral rate of non-highly compensated employees. Automatic enrollment can be coupled with a more cost-effective safe harbor design that will allow the plan



to automatically pass their compliance tests. Automatic enrollment isn’t the best fit for every plan sponsor. Plans that have no testing issues on their deferrals may have no need for automatic enrollment. Automatic enrollment can also have the negative aspect of creating more account balances of participants that are lower and become a bigger issue when these participants terminate. If the plan sponsor offers a match, it may increase their contribution costs of they offer automatic enrollment. A plan that also has a good deferral rate from non-highly compensated employees that is in excess of the usual automatic enrollment amount don’t need it as well. Automatic enrollment is a great feature that can act as a Band-Aid for the plans that need the help, but not a good fit for those plans that don’.

Loans

Loans are an important plan provision because it allows plan participants the ability to borrow against their 401(k) balance when they need the money such as when buying a home. While giving plan participants access to their money is a great idea, it does have a lot of issues that question whether plan sponsors should offer it or not. Loans are an exception from the prohibited transaction rules under Section 4975 of the Internal Revenue Code. It requires loans to be paid within a 5-year period (except for loans to purchase a principal residence) and that payments are made quarterly. Loans that are defaulted are treated as deemed taxable distributions. The problems with loans usually involved the repayment of plan loans. Mistakes made in plan administration may have the loans defaulted if payments aren’t made because of errors created on the plan sponsor or third party administrator (TPA) side. Offering participants to take out multiple loans exacerbate the problem. I’ve seen plans where participants have nine outstanding loans and it’s a recordkeeping disaster waiting to happen when some loans are being paid down and some are not. In addition, having participants take loans in an amount of less than $1,000 creates too much paperwork and recordkeeping that isn’t worth the amount of the loan. Loans aren’t the best feature for every plan sponsor, but any plan that offers it should only offer loans one at a time and with a $1,000 minimum.

Hardship Distributions

If plan participants still need money after maximizing the plan’s loan provision if there is, they can seek a hardship distribution if their 401(k) plan offers it. While giving participants access to a hardship distribution may alleviate their financial needs, many plan sponsors don’t want because like with loans, they don’t want their plan turned into an automatic teller machine. In addition, plan sponsors have the fiduciary duty to determine whether the participants have qualified for the hardship distribution. The participant who sent me a hardship distribution on prison stationery wasn’t entitled to use a hardship distribution to pay someone he owed money to on the outside (that did happen). The IRS on audits is reviewing hardship distribution requests especially for those participants who have made multiple requests. Also, hardship distributions do involve early, taxable distributions (with penalty) to plan participants that negatively affect the plan’s asset size which may hurt the plan’s expense cost because plans with more assets pay less in fees, percentage-wise.

In-service distributions at age 59 ½ or later

Like with hardship distributions, a great feature is allowing in-service distributions for plan participants who are still working and have attained age 59 ½ or normal retirement age. It allows these participants access to their account balance and take a distribution in cash or a tax-free rollover to an individual retirement account. The only drawback is that these participants tend to have more money in the plan and depletion of those assets might affect the pricing of the entire plan for administration and recordkeeping purposes.

Safe harbor contributions

More than 20 years ago, 401(k) plans that had issues with failed discrimination tests either had to make corrective contributions or in the case of failed deferral tests, make refunds to highly compensated employees. Plans that opted for the safe harbor contribution amount would avoid these tests by automatically satisfying them if they made fully vested safe harbor contributions. This option is a great feature for the 401(k) plans that need the correction and can afford it. For those plans that don’t have potential compliance tests and those that do have these issues, but can’t afford the contributions, a safe harbor plan design makes no sense. While I love the safe harbor plan design, I never bring it up with plan sponsors that don’t need it and I’m cautious with those plan sponsors I know will have a tough time in affording it.

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