The 401(k) "Engine" Lights For Plan Sponsors

By Ary Rosenbaum, Esq.

Cars these days will show you a light anytime there is a problem with it. Since where I live, there is a lot of construction, and checking the tire pressure light seems to be a monthly thing. Unfortunately, as a 401(k) plan sponsor, you don't have a check engine light or tire pressure light, but there are warnings that your 401(k) plan may have issues. The problem is that you have to be proactive and look under the "hood" of your 401(k) plan. This article is all about the "warning" lights in your plan that you need to check.

Late deposit of salary deferrals

For years, we relied on a definition of depositing salary deferrals, that allowed a safe harbor for plan sponsors that was quite generous. The safe harbor allows plan sponsors to make salary deposit deferrals by the 15th day of the following month. The reason for that generous safe harbor was that it was drafted in a time before the Internet when salary deferral deposits were made by check, sent in the mail, and 5 days clearing for non-local checks. Thanks to web transactions on the Internet using ACH (Automated Clearing House) debits, there really was no need for such a long deadline for plan sponsors to deposit deferrals. The Department of Labor (DOL) agreed with that thinking, by reinterpreting that safe harbor regulation. The new DOL regulations said salary deferral deposits need to be deposited as soon as possible. That usually meant as little as 3 business days because the DOL didn't think participants should have to wait to invest their retirement savings and that plan sponsors should take advantage of that float. In connection with the DOL clamping down on the regulation interpretation, the Form 5550 files for retirement plan ask a question on whether late deposits have been made to the plan. If you are late and you answer yes (under penalties of perjury), it may increase your chances of a DOL or an Internal Revenue Service (IRS) audit. In addition, if you self-correct and don't apply to the DOL's Voluntary Fiduciary Compliance Program, you may hear from the DOL with a suggestion that you should have made with the application. The problem with late deposits is that if you are late once, you will be late more often since almost all plan sponsors that are late, are consistently late. If you are late, look at your payroll process and correct any deficiencies that may cause you to be late in depositing salary deferrals.

Definition of Compensation

Next to the late deposit of salary deferrals, the biggest error I see with 401(k) plans is administering a different definition of Compensation, than what is listed in the plan document. If you think a bonus is excluded from the definition of Compensation and the plan is administered that way while the plan document includes it, you have a major problem. The plan document controls your plan, so if you didn't allow deferrals or make contributions when it says you have to, you will have to make corrective contributions for a missed deferral opportunity and employer contributions plus earnings. I recently had a client who had to make a $40,000 corrective contribution because they didn't administer the plan correctly by excluding bonuses and overtime from the plan document's definition of Compensation. The best way to avoid this issue is using my theory of plan provision construction which I call K.I.S.S. (Keep it Simple, Stupid). I believe excluding any part of pay from a W-2 or Section 415 definition of Compensation is creating a potential problem with plan administration. While I understand you may not want to offer employer contributions for stuff like bonuses, commissions, and taxable fringe benefits, being cute in your definition of Compensation creates the potential for mayhem in plan administration. I understand why you still may want to draft a definition of Compensation with exclusions, but I recommend that regardless of the definition, check what you're doing and what the plan document says, and that it's consistent with the practice and plan document definition.

Failed compliance testing

Retirement plans that intend to be consid-

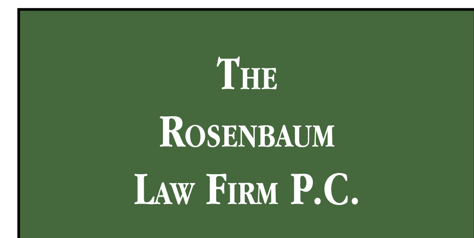
ered qualified under the Internal Revenue Code have to go through a lot of compliance testing to prevent discrimination in favor of highly compensated employees. For a 401(k) plan, you have coverage testing, discrimination testing for salary deferrals and matching contributions, and the Top Heavy Test. Based on your definitions of Compensation, profit-sharing contributions, benefits, rights, and features, you may have additional testing. If you have issues with passing a compliance test, it's a concern. A failed test requires corrective actions, that may necessitate additional employer contributions, refunds, or some add-back of employees in a fail-safe action. Regardless of the action, a failed test is an issue that needs to be corrected and might require some design changes, to avoid future failures because one testing failure usually means a failure the following year. One of the best changes to happen to 401(k) plans in the last 25 years is the addition of the Safe Harbor plan design. By requiring 401(k) plan sponsors to make mandatory contributions to employees, a plan will be deemed to have satisfied the discrimination testing for deferrals, matching contributions, and Top Heavy. Making contributions such as a Safe Harbor or QNEC (Qualified Non-Elective Contribution) contributions for a failed salary deferral contribution test (called the Actual Deferral Percentage (ADP) test) might be more popular than making taxable deferral refunds to Highly Compensated Employees. If you have issues with non-highly compensated employees making salary deferrals, you may also consider adding an Automatic Enrollment feature, that requires employees to opt-out if they don't want to make salary deferrals. Regardless of the failure, it's a warning sign that something in your plan's design isn't working. A plan design needs to meet your needs and your employee demographics. Otherwise, it will be an annual compliance failure and an annual headache.

Participant education

One of the biggest conceptions of offering participant-directed investments under ERISA §404(c) is that you are guaranteed to be held harmless from liability for any losses sustained by participants. There are no guarantees in life and ERISA §404(c). To get that liability protection under ERISA §404(c), you're required to do something. You're required to maintain a prudent fiduciary process that provides enough information for participants to make informed investment decisions. That sounds like a mouthful, but not hard to maintain that process. You need to hire a good financial advisor who is well-experienced in understanding the prudent fiduciary process. That means an advisor who handles many participant-directed 401(k) plans. That means they understand the need to develop an Investment Policy Statement (IPS) that is used to select and replace investment options. It also means frequent meetings with you to document the fiduciary process and adherence to the IPS. One other important factor is to have regularly scheduled 401(k) enrollment and investment education meetings, that should be tied to the entry date for new participants in the plan. Giving participants a summary plan description, enrollment form, and some Morningstar profiles on mutual funds isn't enough. You need an advisor who will at the very least, give general investment education. Obviously, participants do better when advisors provide specific investment advice as to investments, based on each individual participant's retirement needs and risk tolerance.

Loans

I don't like loans in 401(k) plans and the only reason is the mistakes made with them. The mistake made with plan loans is the failure to properly pay down a loan with participant salary deferrals on a timely basis. That mistake is usually made on the plan sponsor side, where they fail to properly pay a loan that goes into default because a payment wasn't made for about 90 days. A delinquent loan is a taxable distribution to a participant and that is a little annoying to them when it isn't their fault. If you have a loan provision, make sure there is only one outstanding loan allowed at any time, as well as check your processes with your payroll provider and third-party administrator that plan loan repayments are made.



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