# The 401(k) Plan Provisions That Can Land You In Harm's Way

By Ary Rosenbaum, Esq.

When setting up a 401(k) plan document as a plan sponsor, you have a lot of choices in plan provisions. Depending on the plan documents you're using, there are problems thousands and thousands of different combinations. The problem with plan provisions at times is that some choices might cause more problems than they're worth because of the tendency of them causing compliance headaches. This article is about some of the plan provision choices that could give you heartburn as a 401(k) plan sponsor.

**Immediate eligibility or eligibility less than a year of service**

Most 401(k) plans I've handled require some sort of eligibility service before allowing employees to become participants in the plan. You can't have an eligibility provision longer than a Year of Service and you can't have an age requirement greater than 21. Many plans out there have an eligibility provision of less than a year of service with many plans having immediate eligibility. Having been an employee once, I like eligibility provisions of less than a year. The problem with eligibility provisions of less than a year is based on your demographics. If you have an eligibility provision of less than a year, the problem is that might inadvertently be bringing in part-time employees into the plan that you never intended to cover. Whether you have part-timers or not, a huge turnover of employees could result in many small account balances when you have a liberal eligibility provision. Unwittingly creating a lot of participants with a liberal eligibility provision also could lead you to be having to require to get an audit for your plan earlier. Getting an audit from an accountant when the participant headcount hits 100 (120 under the 80-120 rule) costs a lot of money that you or the plan has to shell out. When considering any type of eligibility provision, measure the desire to cover employees as an employee benefit versus the demographics of your employee population. Otherwise, you might inadvertently headaches for you in running your plan.

**Immediate entry date**

Once an employee completes the eligibility requirement to become a participant, they still don't become a participant until they enter the plan on the entry date. Most plans offer dual entry (usually January 1 and July 1), quarterly entry, or monthly entry. Some plans offer immediate entry once the eligibility requirements are met and this is the biggest mistake you make. More entry dates mean you have to track more days when employees become eligible to enter the plan. When you use quarterly dates, you have to track four days where people can become participants. When you use immediate entry dates, then you essentially have to track 365 days where employees become eligible. The problem with so many entry dates is that you're bound to miss when employees can become participants and that could be a compliance headache when it's months before you realize your mistake. If it takes months and months to realize your error, you've deprived these employees of deferring their salary towards the 401(k) plan which might require you to make corrective contributions. You have enough on your plate as an employer, so you don't need to track 365 possible days when employees can be eligible to participate in a 401(k) plan.

**Compensation issues**

One of the biggest compliances errors that I've noticed for 401(k) plans deals with the plan's definition of compensation form purposes of plan recognition and contributions. The problem is that the plan document may recognize one form of compensation, but in practice, the plan sponsor does something else. This usually happens when the compensation definition includes something such as a bonus or taxable fringe benefits, but the plan fails to allow participants to defer or receive compensation on these sources of compensation. If you're compensating employees for bonuses and taxable reimbursements in something than a regular payroll, you might be making a mistake since you must conform the administration of your plan

to the terms of the plan document. It's important that whatever you decide for the definition of compensation is in your plan document, you need to be doing that in practice. One of the biggest problems with the compensation issue is that it's undetected for years. I will never forget a plan sponsor many years ago that for 20 years didn't recognize bonuses as part of compensation even though the plan document did. Thousands and thousands of dollars in corrective contributions plus earnings had to come out of the plan sponsor's pocket.

**That dreaded loan provision**

Most 401(k) plans offer loans to plan participants because they want to allow plan participants to borrow against their account balance when they need money for one reason or another. While I understand that plan sponsors want participants to have access to their retirement savings in matters of financial emergency or need, there are some choices within the loan provision that you make that usually lead to compliance headaches. The number one problem I find with a 401(k) plan's loan provision is when they offer an unlimited number of plan loans. I believe that a 401(k) plan sponsor should only offer one loan outstanding per participant at any time. You don't need to be in the payday loan business. Most importantly, multiple plans outstanding per participants often leads to headaches when the plan's third-party administrator (TPA) fails to have loans paid off in a timely fashion and that leads to default in one or more loans. By only offering one loan outstanding at the time, the plan's TPA is less likely to make a mistake. Also, you should always have a $1,000 minimum loan amount. Again, you're running a 401(k) plan, not a payday loan business.

**Hardships**

Another way for plan participants to access their 401(k) account for immediate need is when the plan offers hardship distributions. I understand the plan sponsor's need to offer it, I just think there are choices out there that make it more of a problem than it's worth. Hardship distributions should only be limited to vested account balances, I can't recall the last time I ever saw a plan that offered hardship distributions from account balances that weren't vested. Also, there should be a $1,000 minimum for hardship distributions because any amount less really can't be classified as a hardship.

**Involuntary cashouts**

The involuntary cash-out provisions mean that when a participant has less than the involuntary cashout limit, then upon termination, the plan sponsor could cash the participants out after the participants failed to move the money out. The limit used to be $3,500, that was increased by law in 1997 to $5,000. In 2005, there was another change in the law. Plan sponsors could decrease the cashout limit to $1,000 or keep the limit at $5,000. However, if plan sponsors kept the limit at $5,000, then all distributions between $1,000 and $5,000 under the cash out had to be done through an automatic rollover. Most plans that I worked on at the time I was a TPA attorney was to lower the threshold to $1,000 because most plan sponsors didn't want to go through the trouble of opening up automatic rollover individual retirement accounts (IRAs). Since it's rather easy to open up with the automatic rollover companies that are around, I think it's better to cash out former employees when you can, so I would keep the cash out limit at $5,000 as well as exclude rollovers these former participants brought to the plan in figuring out the threshold limit.

**Forfeitures**

There are too many 401(k) plan sponsors that are using forfeitures as some sort of war chest without allocating it the way the plan document states every year. Whether your plan says forfeitures are re-allocated or used to reduce employer contributions, you must allocate these forfeitures from the non-vested portion of a former participant's account balance annually. By holding on to forfeitures instead of allocating it annually, you'd be violating the terms of your plan document and you might be depriving current participants of the benefit intended for them if forfeitures are re-allocated. If your forfeitures call for you to reduce the employer contribution by forfeitures, you're paying more to the plan in employer contributions than you have to. Also, pretty much all forfeiture provisions do allow you to use them to pay administrative expenses. You'll land in a world of hurt and unnecessary expenses if you don't abide by your plan's forfeitures provisions.

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