Features That Turn Your 401(k) Plan Into A 401(k) Disco

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There is a difference between throwbacks vs. vintage clothing. A throwback is a sports uniform styled to resemble the uniforms that a team wore in the past. Vintage clothing are actual clothing garments from another era. I wear throwback jerseys from Mitchell & Ness and I just think wearing the actual old uniforms that a former player wore is kind of icky since I never wore hand me downs as a kids (I was the only boy in the family). Regardless of whether it's throwback or vintage, a 401(k) plan with archaic provisions and features isn't something to revere, it's something to abhor since the plan sponsor could potentially be on the hook for liability or have a plan that isn't used to its fullest potential to help plan participants. So this article is about 401(k) provisions and features that make a plan look like a disco and a disco today isn't something that is in style.

Limits on salary deferrals for participants

Prior to 2002, there was interesting dilemma for employers that sponsored a 401(k) plan. They were limited to deducting 15% of compensation of plan participants as an employer contribution to a 401(k) plan. The problem is that when it came to that deduction limit, salary deferral contributions made by a participant counted towards that limit. In 2002, that was changed so an employer could deduct 25% of compensation as an employer contribution and salary deferral contributions no longer counted toward the limy. So many 401(k) plans changed their previous salary deferral limits by eliminating the percentage cap on what participants could defer from their income. So it's surprising that many 401(k) plans out there still limit participant deferrals to perhaps maybe 10-15% of compensation. While a limit on highly compensated employees may defer might make sense (so the plan can pass compliance testing), a limit for all participants makes no sense. That limit was so early millennium.

Not allowing participants to receive distributions prior to retirement

When 401(k) plans started popping up about 30+ years ago, they were treated like pension plans in terms of design and features. One feature that many of these early 401(k) plans had was a provision that would be found in defined benefit plans. So many of these 401(k) plans had a provision that restricted participants from receiving a distribution of their account balance until they actually retired, whether they still worked for the employer or not. That provision made sense for defined benefit plans when the employer was fully funding the participant's benefit and any distribution of benefit could actuarially affect the funding of the plan that the plan sponsor needed to favorably maintain. It makes no sense for a 401(k) plan to have such a provision because it's a defined contribution plan and the bulk of most participant account balances consist of their own salary deferrals. Unlike a defined benefit plan, the participant has their own account balance and whatever theirs is theirs with no need for actuarial calculations. In addition, why would a plan sponsor want to still maintain the account balances of participants who are former employees? Former employees still have rights of participants including notice requirements, updated summary plan descriptions, and many of the other rights that current employees that are participants also have. Why keep the money belonging to some who no longer work there because I always say that former employees will sue a plan sponsor a lot more frequently than current employees. Why have a headache when you don't need one? A plan participant should be able to receive a distribution of their account balance upon termination of employment, disability, or upon attaining age 59 ½.

A Plan where the trustee directs the investments

This provision will probably get the most criticism, but that's what happens when you take a stance. Before the technology allowed for daily valuation and before the proliferation of mutual funds, most 401(k) plans where valued on an annual basis and trustees directed plan investments like other retirement plans. Thanks to the proliferation of the Internet and the high returns of the stock market of the late 1990's made participant directed daily valued 401(k) plans a big thing. It also helped that ERISA §404(c) gives plan sponsors liability protection if the participants direct their investments after getting enough information to make investment decisions. While trustee directed plans will usually use the expertise of investment advisors, they still offer far less liability protection than a participant directed plan. While trustee directed plans would probably offer a higher rate of return overall than participant directed plans, they also offer a lot more liability exposure. While people will state that ERISA §404(c) is often misinterpreted in liability protection especially if investment options for participants aren't reviewed and that participants don't get enough guidance in helping them make investment decision. That's all true, all of it. However, over the past few years, plan sponsors have been more diligent in their role in managing the fiduciary process by reviewing plan investments and giving plan sponsors enough investment education and/or advice for them to make informed investment decisions. In addition, small to medium sized plans are still less likely to face a lawsuit from a plan participant than a larger one. So the threats of litigation from a plan participant over investment losses are probably less likely in a participant directed plan than a trustee directed plan. That's just my two cents.

The stated matching provision

The stated matching provision is what it says it is. It's a matching provision where the plan sponsor states in their plan document and summary plan description (SPD) how much they will actually match deferrals as part of a matching contribution. What's the problem? Most of the time, nothing. Some of the time, a lot more than nothing. I don't like the stated matching provision because it takes what was supposed to be a discretionary contribution (the matching contribution) and makes it mandatory like a pension plan requires. I've been in this business almost 17 years and have been through two huge recessions, why force a plan sponsor to state a matching provision that the business climate may force them to cut back on? The problem is that if the 401(k) plan matches salary deferrals and requires no hours of employment in their stated matching provision, they are basically precluded to eliminating and/or decreasing the matching provision until the following plan year. So a plan sponsor maybe on the hook for a matching provision that they can no longer afford or will further put them in the red. What if business is so good and the plan sponsor wants to increase matching contributions? It's the same problem. I always prefer a discretionary matching provision where the plan sponsor will announce through a resolution and notice to participants how much they will contribute in the form of a matching contribution. That gives plan sponsor a lot of leeway in determining whether they can afford to make a contribution and how much if they can. It also avoids the need to consult with an ERISA attorney to see if a stated matching provision needs to be amended or not. In my opinion, the only reason you should ever have a stated matching provision is if it must be stated because of the terms of a collective bargaining agreement where union employees are participants in the 401(k) plan.

Plans with expired service provider contracts

Thanks to fee disclosure regulations that required transparency of fees, plan administration expenses has decreased as a percentage of assets. Yet there are so many 401(k) plans out there that actually have contracts with their service providers that date back to the year of the flood when pricing was a lot less favorable to plan sponsors. So many plan sponsors are unwittingly paying higher plan expenses just because they haven't bothered to renew their service provider contracts and haven't bothered to benchmark their fees to see if there is a better deal out there. So many 401(k) plans are paying through the nose in fees just because the plan sponsor is breaching their fiduciary duty by not paying reasonable plan expenses.

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