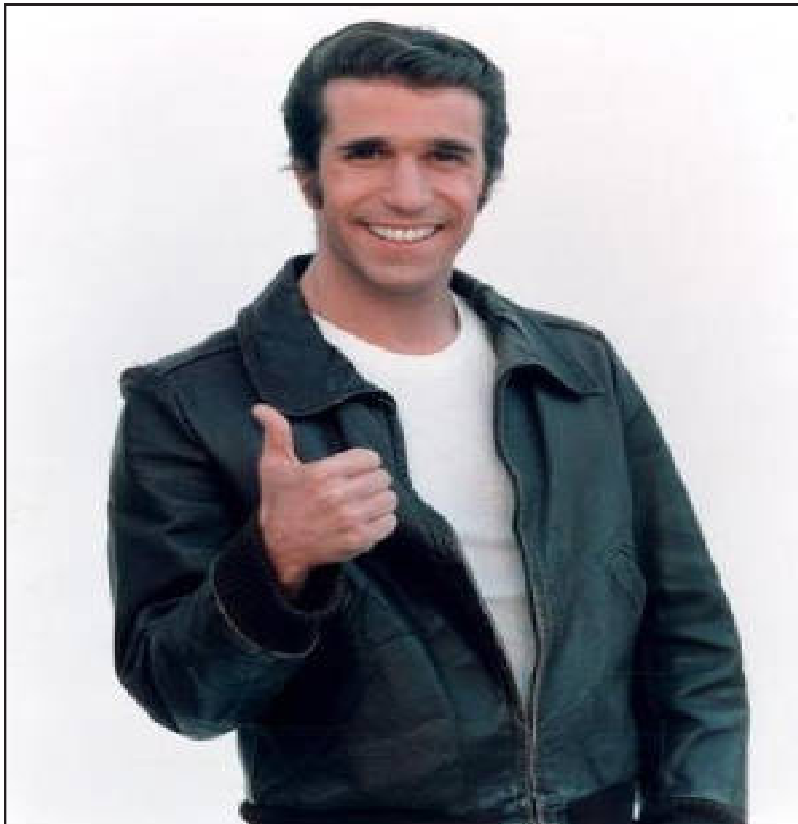
Problems A 401(k) Plan Sponsor May Not Be Aware Of Because They Think Everything is OK

By Ary Rosenbaum, Esq.

I knew a family member who would never go to the doctor for preventative care. She always reasoned that if she went to a doctor, that meant she was sick. That meant that her goal was avoiding the doctor at all costs. It's silly that someone would avoid going to the doctor because many illnesses and diseases don't show symptoms for a while. I've known people who died way too early because they didn't seek out medical attention until it was too late. While not on the same level as life or death, plan sponsors act that way about their retirement plan. They only seek guidance and help after the errors have happened because they have a false sense of security about their plan, because their current providers tell them it's OK. So this article is about the many hidden problems that plan sponsors may discover about their plans after the errors have gone untreated for quite some time just because they didn't seek the preventative care a plan review would have taken care of.



When the errors are usually discovered

Plan sponsors tend to have this false sense of security because their plan providers, especially their third party administrator, tell them everything is OK. Sometimes the plan provider has hidden the error, but most times they are unaware of it themselves. So the plan provider may tell the plan sponsor everything is fine without really knowing. With this false sense of security, the plan sponsor will forego an independent review. So that means plan errors may be discovered many years later when they decide to finally change the provider and it's discovered by the new provider in transition or through an Internal Revenue Service or Department of Labor audit.

Missing plan documents and amendments

The running joke about amending and restating plan documents every few years is to keep ERISA attorneys like me in business. Seriously, there are many changes in the law and the Internal Revenue Code time after time, so the Internal Revenue Service (IRS) will require plan sponsors to restate (redo) their retirement plan every six years and may ask them to add a tack on amendment very 1-2 years. The problem with these many changes is that there's bound to be an amendment or restatement that may be missing. Sometimes, the amendments and restatements have been done but the plan sponsor failed to properly sign them. Regardless of whether the amendments or restatements weren't done or weren't signed, this is a huge compliance error when detected. If an incumbent plan provider or a new provider detects the error, this serious error needs to be corrected through the IRS' voluntary compliance program. If this error is detected on an IRS audit, the penalty will be thousands and the legal fee to add missing amendments and plan documents will add thousands to the bill as well. So this glaring error can just be easily discovered through a simple plan review, but too many plan sponsors take it for granted that their plan is in order.

Not operating the plan according to its terms

Even if a plan sponsor has all their plan documents, one big problem is when the plan is not operated according to its terms. It's a requirement that a retirement plan has a written document, yet it's surprising how many times the plan isn't operating according to its terms. These provisions may deal with eligibility, contributions, vesting, or something as simple as not annually allocating plan forfeitures. Many times this error happens because when a TPA gets a plan document from a client, they may put the terms of the plan incorrectly on the system since they may only rely on what's on the computer than what's in the Plan document. This problem needs to be corrected either through self-correction or the IRS' voluntary compliance program depending on the error. Of course, getting errors like this caught on an IRS audit will

cost and hurt a lot more. A passive plan sponsor is not going to discover this type of error on their own.

Incorrect or missing compliance tests

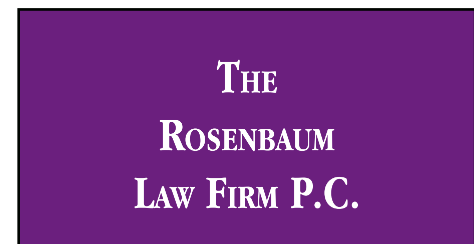
One of the big hallmarks of solid retirement plan administration is that the compliance tests are actually done and done correctly. Those are the best laid plans of mice and men. In reality, many compliance tests are either done incorrectly or not done at all. In order to maintain qualified status under the Internal Revenue Code, a retirement plan has to go through annual compliance tests in order to show that the plan doesn't discriminate in favor of highly compensated employees. Tests such as coverage, actual deferral percentage test (ADP), actual contribution test (ACP), and top-heavy test are just some of the compliance tests that a plan may have to complete annually. Many times, a simple test such as coverage (which needs to show that non-highly compensated aren't discriminated in being covered under the plan) may not be completed by the TPA just because they forgot, which is a big issue if the plan would have failed. I remember working on a union staff 401(k) plan where a big index fund bundled provider thought that the plan offered a safe harbor contribution and didn't have to satisfy an ADP and ACP test. The problem was the plan offered no safe harbor contributions, so the plan sponsor had to hire an outside TPA to perform the tests that they luckily passed. Even if compliance tests are done, sometimes they are done incorrectly. This may happen because the TPA may have coded some employees incorrectly as non-highly compensated employees when they should be coded as highly compensated employees, which happens often because the TPA neglected to complete a stock attribution analysis. If the TPA fails to identify or if the plan sponsors neglect to tell them about affiliated companies that have common ownership that should be treated as part of the company that sponsors the plan, a huge coverage nightmare is waiting to be discovered. Errors to fix compliance tests can be costly especially when an employer contribution may be the only way to correct when it's discovered years later. They can be corrected through the IRS' voluntary compliance program or through self correction at times. If caught on an IRS audit, the costs and penalties will be higher. If a plan sponsor failed to cover employees of affiliated companies that they should have because they are part of a controlled group or affiliated service group, the plan could be disqualified. Disqualification is costly when the tax deductions of employer contributions are reversed and plan participants have immediate taxation of their retirement plan benefits. Again, these are errors that are waiting to be discovered, but they won't be when the plan sponsor takes it for granted that everything is running smoothly.

Not providing the required notices

Plan participants have the right and are required to get certain notices about their Plan. They could be something as simple as the summary plan description or a safe harbor notice or a fee disclosure about the costs of their plan. A plan sponsor may not be aware that these notices should go out and if a TPA isn't good about the nuts and bolts of plan administration, this could be a problem. While the IRS isn't really interested in the plan participants getting the notices they're supposed to get, the Department of Labor (DOL) is. Whether a participant contacts the DOL or the DOL audits the plan, having them involved isn't any fun.

Problems in the fiduciary process.

Not only are plan administration errors something that can cause plan sponsor headaches, but so can errors in the fiduciary process of the plan. This may happen because a plan doesn't have a financial advisor serving the plan or a financial advisor who isn't doing their job. There are many errors that can be made on the investment side of the plan. Something as simple as not properly educating plan participants about the investments in the plan (if it's participant directed) or offering retail share classes of mutual funds when less expensive institutional share classes are available can cause headaches for plan sponsors. Unlike errors on the administration side of the Plan, the IRS isn't interested in these types of errors. However, the DOL and ERISA litigators are.



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