401(k) Plan Provisions That Are Good Ideas

By Ary Rosenbaum, Esq.

I recently wrote an article regarding which 401(k) plan provisions are bad ideas. The provisions I listed were listed because I thought that they were plan features that could easily cause administrative errors that could threaten the tax qualification of the Plan and its trust. Now, I will take the positive side and mention plan provisions that 401(k) plans should have.

When it comes to 401(k) plans, so much is said about plan expenses, review of funds, investment policy statements, and fiduciary liability. What is forgotten about 401(k) plans is that in addition to being a retirement plan, it is also an employee benefit. So a 401(k) plan with features that encourage participation and accessibility to save for retirement is an employee benefit that could attract potential employees and retain current employees. The features that I think should be added to 401(k) plans if they currently aren't current provisions would cost plan sponsors very little in administration fees and nothing in added contributions. Therefore, there will be no discussions of certain plan design features that increase employer contributions to plan participants like safe harbor or cross-tested/new comparability form of a profit sharing contribution. The only costs would be to amend the plan document. Here are my suggestions, which can rev-up a 401(k) plan:

Eligibility to Defer with Little or No Service Requirement: We have a retirement crisis in this country. Social Security is on track to run out of money in the future unless benefits are slashed and the retirement age is increased. Many private employers and some public employers either have phased out employer provided pension plans or have cut back future benefits. Individual retirement accounts and 401(k) plans are now being used to shoulder the burden of funding an individual's retirement. While I understand why employers require a Year of Service to give participants a profit sharing or matching contribution, there is very little reason why plan sponsors should require a Year of Service for participants to be able to make salary deferral contributions in a 401(k) plan. The reason is because even if a plan sponsor would require no service or six months of service as an eligibility requirement for deferrals, the otherwise excludible rule would allow salary deferral testing (the ADP test) to be conducted as if the salary deferral eligibility was age 21 and a Year of Service. The only downsides are that administrative costs would be increased because third party administration firms typically have a per participant charge and there is a concern with employee turnover that there will be many small account balances of former participants in the plan. The reasons those downsides can be dismissed is because most 401(k) plans have their administration fees paid by the participants' account balances and there are mechanisms to rid 401(k) plans of small account balances of $5,000 or less belonging to plan participants who are former employees. In addition, allowing participants to start deferring income from their date of hire will increase plan assets, which may lower costs as a percentage of assets because of the economies of scale. The ability to allow participants to defer quickly is a statement that the employer is encouraging retirement savings and it becomes a rather attractive benefit to entice potential employees and to retain current employees.

Roth 401(k) Feature: Since 2006, 401(k) plans can add a Roth feature that allow participants to defer some or all of their salary deferrals for the year on an after tax basis. By doing so, a participant could get those deferrals and the earnings from those deferrals on a tax free basis upon retirement. The Roth feature has no effect on 401(k) limits or 401(k) testing, so other than notifying the payroll company that deferrals are going to be made on an after tax basis, it is treated the same as the regular pre-tax deferral. Yet a majority of plans don't have that feature. Why? Participants should have the option on whether they want their deferrals on a pre or post tax basis. Options that have no negligible effect on a retirement plan are good.

In-Service Distributions: Other than a hardship distribution, it is a disqualifying plan provision to allow active participants to receive a distribution of their salary deferrals prior to the attainment at age 59 ½. In addition, distributions after the attainment of age 59 ½ will not incur the early distribution penalty which incurs a 10% excise tax. There should be no reason why plan participants should not be able to take out a portion or all of their account balance upon turning age 59 ½ or attaining the retirement age under the Plan, It is their money and since they are near the age of retirement, they should have the opportunity to take that money in cash or transfer it to their own individual retirement account.

Loans and Hardship Distributions: In an ideal world, 401(k) plans would be for retirement savings only. However, we live in the real world and there are reasons why participants may need to tap their 401(k) account funds. A plan loan is an attractive way to borrow money at a reasonable rate of interest that also acts as a participant directed investment. Hardship distributions are for important reasons like burial expenses, medical expenses, educational expenses, to prevent a foreclosure, or other life important events. While many believe that participants shouldn't tap their accounts in these instances, we should allow participants to have the free will to make those choices when they really need to.

Automatic Enrollment: When I first heard of automatic enrollment in 1999, it was called negative election and I thought it was something out of the Soviet Union. The reason for my red baiting was clear. Negative elections were merely designed as a cheap gimmick to artificially improve the ADP/salary deferral discrimination test by forcing participants to defer who didn't affirmatively opt out of deferring. The reason that it was a gimmick because there was no liability protection for plan sponsors to invest that money if the plan was a participant directed plan and these participants didn't affirmatively elect to participate. So plan sponsors would simply park that money into money market funds that accrued very little earnings and rate of return. Legislative changes have made automatic enrollment more than a gimmick with the advent of the qualified default investment alternative (QDIA) which allows the plan sponsor to have liability protection if they place these deferrals into a qualified, default investment (all plans should have a QDIA added to their plan). Automatic enrollment can also develop into a Qualified Automatic Contribution Arrangement (QACA) that offers a form of a safe harbor contribution that has a vesting schedule and is less costly than the normal fully vested version. In addition to helping the ADP results, automatic enrollment increases the retirement savings of participants and it has increased participation. It will also increase the asset of the size, which as discussed earlier, may help reduce administrative expense as a percentage of plan assets. Combined with great investment education to participants provided by the financial advisor, I believe automatic enrollment can turn people who automatically defer to people that will voluntarily defer. Increasing retirement savings for all plan participants is a good thing. While many companies fear the backlash from automatically enrolled participants who complain that a portion of their pay has been automatically deducted, having these participants to opt out is fairly simple.

While plan sponsors have been forced to concentrate on potential liability from participant lawsuits in connection with plan expenses and participant directed investments, plan sponsors should never lose sight of the fact that 401(k) plans are employer provided benefits that were developed to recruit and maintain employees. So when possible, plan sponsors should consider the provisions I listed that will enhance their plans ate very little cost. They will make up those negligible costs in the long run through employee retention and recruitment.

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