The Choices You Make, That Can Land You In Trouble As A 401(k) Plan Sponsor

By Ary Rosenbaum, Esq.

Our lives are the sum of our choices, at least that is what the trailer for the next Mission Impossible moving is telling me. When I was a kid, I would read these Choose Your Own Adventure books where the story and outcome were dependent on choices you made at specific plot points of the book. Just like the movie trailer said, our lives are the sum of our choices and many 401(k) plan sponsors are in hot water over plan choices they made, mainly in plan design and plan providers that could have negative ramifications later on.

Not caring who the TPA is

Since I live near New York City, I believe I will look out for the best medical provider available. I believe when it comes you your health, your chances are better with the best medical providers out there. My mother was insistent on finding the doctor closest to my house. Looking back at what my pediatrician did with my allergy shots and what my orthodontist did with my overcrowded mouth, that wasn't the right choice. I feel the same way when 401(k) plan sponsors pick a Third Party Administrator (TPA) for any reason, other than competence. The most important provider you can have is a TPA because they do most of the work and most of the errors and headaches you can have from your plan come from their errors if they do a terrible job. Don't pick a TPA just because they're in the neighborhood, or they're the cheapest. Also, don't pick the TPA just because they are connected with your bank or your payroll provider. You need to pick a TPA that will charge a reasonable fee for a great service. Focus on a TPA that understands how to do a competent job on the recordkeeping side. That means fewer errors in compliance testing and they're also probably going to be good at plan design, which is essential for a TPA to help you when you expand or contract. A TPA that knows plan design can help you along the way to make sure that the plan designs still fit your business needs and adjust if it doesn't.

The headaches of salary deferral deposits

The bulk of 401(k) plan assets are funded by the salary deferrals of your employees. It stands to reason that if it's their money, it should be invested in the investment options that a participant selects as soon as possible. Years ago, plan sponsors followed a Department of Labor (DOL) safe harbor that said they could deposit employee salary deferrals into the 401(k) plan as long as it was done by the 15th business day of the following month. The only problem is that DOL reinterpreted the safe harbor a while back and essentially said that you need to deposit salary deferrals as quickly as possible. That's because we no longer have to rely on checks in the mail to fund the salary deferrals. So you must understand that you have to get your deferrals into the plan's trust as soon as possible, essentially just a few days after taking out the deferrals through payroll. The reason you need to deposit the deferrals as quickly as possible is that late deferral deposits are a question on Form 5500, so any late deposits must be corrected using the DOL's voluntary compliance program unless you want the DOL to audit you based on your yes answer to the late deposits. The DOL will will now allow a plan sponsor to self-correct without a voluntary compliance program application if it's fixed timely. It is one of the easiest and most frequent plan errors. I've always said that no plan sponsor is ever late with depositing salary deferrals just once. That means a 401(k) plan sponsor that is late once will always be late until they develop practices and procedures to make sure it doesn't happen.

The Definition of Compensation

In an ideal world, every 401(k) plan sponsor would use W-2 Compensation for their plan's operation and document.

We don't live in an ideal world. Many 401(k) plan sponsors just don't want to make employer contributions on some forms of taxable income, such as bonuses, commissions, overtime, taxable fringe benefits, and car allowances. I understand they want to save a couple of bucks in employer contributions. However, for the want of saving a few shekels, errors come about. Outside of the late deposit of deferrals, the most frequent 401(k) error I see these days, deals with the definition of Compensation. How does this happen? Simple, the 401(k) plan document doesn't mirror the intent and practice of the 401(k) plan sponsor. Usually, the plan document doesn't omit the forms of W-2 Compensation that the 401(k) plan sponsor was under the assumption was practice and operation. 401(k) plan documents operate by the rules of the Internal Revenue Code and ERISA to be qualified for favorable tax treatment of contributions and retirement income. One cardinal rule is that a 401(k) plan must operate according to the terms of the plan document. So if the 401(k) plan includes a part of W-2 Compensation that the plan sponsor intended to exclude, the plan document controls. I've come across plan sponsors that have excluded bonuses from compensation for purposes of employer contributions and salary deferrals and get told that they have to fix the error through corrective contributions coming out of their wallets. The bill to fix this error through corrective contributions can be costly to the 401(k) plan sponsor. While I recommend that you use all forms of W-2 Compensation available for salary deferrals and employer contributions, I'm not paying for it, you are. So if you want to exclude some forms of compensation for 401(k) plan purposes, make sure the plan document is consistent with actual or intended, plan operation. If not, a bill to fix it with corrective contributions is coming.

The eligibility issue

Eligibility has always been a headache, but now it's a bigger headache. Thanks to changes in the law, long-time, part-time employees who complete 500 hours or more for two consecutive years are now eligible to defer in your 401(k) plan. Make sure you're following the law, otherwise you may have to make corrective contributions for a missed deferral opportunity. In addition, make sure your eligibility requirements and list of ineligible employees are consistent between the plan document and plan operation. I've had too many issues where a 401(k) plan sponsors improperly excluded and sometimes, improperly included, a group of employees in their 401(k) plan.

Not keeping tabs on documents and filings

I had a great law school professor named Bernie Corr. He was great, even though my grade in his Civil Procedure class was not. I made up for it, in his Bankruptcy classes. During one class, he joked that the Bankruptcy Code is amended from time to time, to create paydays for Bankruptcy attorneys. I'm sure a cynic would say that IRS requirements for timely amendments and restatements were so ERISA attorneys like me, can get extra work. That being said, the requirements are set by the Internal Revenue Code. So whether I do the plan documents and amendments or your TPA, it's got to be done. The problem with not doing them means the plan is out of compliance. It can get your plan disqualified, which means that you lose the tax deductions for employer contributions made in the last 3 years and participants have to recognize the immediate income of their retirement account balance. More than likely, if the IRS discovers this problem on audit, they will allow you to fix the error and pay a hefty penalty. If you find out you're missing an amendment and/or restatement, you have to correct this, through the Internal Revenue Service Voluntary Compliance Program (VCP) and pay the program fee. In terms of catastrophic errors, failing to file a 5500 or failing to file on time is at the top of the list. The current DOL penalty for a late Form 5500 is $2,739 per day. That penalty is uncapped. If you are late, you should file the 5500 through the Delinquent Filer Voluntary Compliance Program (DFVCP) where there's a $4,000 maximum penalty if you file at the same time. The problem is I've seen 401(k) plan sponsors make mistakes by not checking the DFVCP box on the 5500 or forgetting to pay the penalty and still getting a bill from the DOL for $150,000. The penalties can be crippling, but it's an adventure that plan sponsors have unwillingly taken by being late or failing to file, or failing to meet the terms of the forgiving DFVCP program.

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