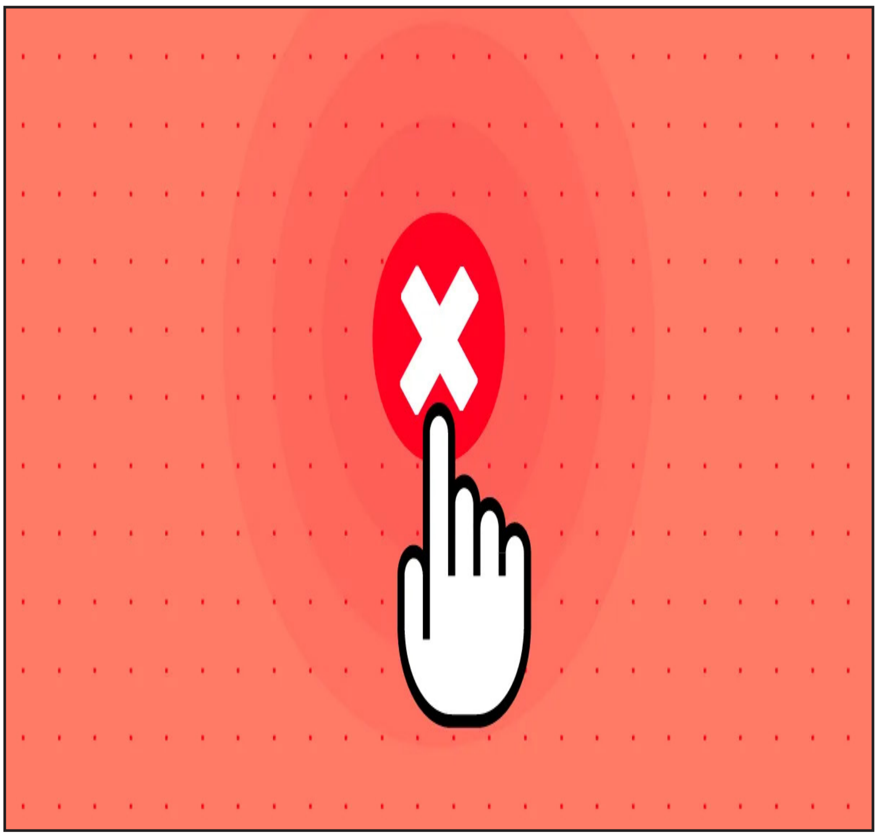
The Most 401(k) Plan Errors We See Today

By Ary Rosenbaum, Esq.

401(k) plans are like intricate, complex, machines. There are many moving parts, in dealing with participants, plan sponsors, and Third Party Administrators (TPAs). That means errors happen. However, as an ERISA attorney, there are some errors that I see, so many times these days.

Late deposit of salary deferrals

For years, we relied on a definition of depositing salary deferrals, that allowed a safe harbor for plan sponsors that was quite generous. The safe harbor allows plan sponsors to make salary deposit deferrals by the 15th day of the following month. The reason for that generous safe harbor was that it was drafted in a time before the Internet when salary deferral deposits were made by check, sent in the mail, and 5 days clearing for non-local checks. Thanks to web transactions on the Internet using ACH (Automated Clearing House) debits, there was no need for such a long deadline for plan sponsors to deposit deferrals. The Department of Labor (DOL) agreed with that thinking, by reinterpreting that safe harbor regulation. The new DOL interpretation (it's more than 10 years old) said salary deferral deposits need to be deposited as soon as possible. That usually meant as little as 3 business days because the DOL didn't think participants should have to wait to invest their retirement savings and that plan sponsors should take advantage of that float. In connection with the DOL clamping down on the regulation interpretation, the Form 5550 files for the retirement plan ask whether late deposits have been made to the plan. If you are late and answer yes (under penalties of perjury), it may increase your chances of a DOL or an Internal Revenue Service (IRS) audit. In addition, if you self-correct and don't apply to the DOL's Voluntary Fiduciary Compliance Program, you may hear from the DOL with a suggestion that you should have made with the application or notify them of your self-correction. The problem with late deposits is that if you are late once, you will be late more often since almost all plan sponsors that are late, are consistently late. If you are late, look at your payroll process and correct any deficiencies that may cause you to be late in depositing salary deferrals.



Definition of Compensation

Next to the late deposit of salary deferrals, the biggest error I see with 401(k) plans these days is administering a different definition of Compensation, than what is listed in the plan document. If you think a bonus is excluded from the definition of Compensation and the plan is administered that way while the plan document includes it, you have a major problem. The plan document controls your plan, so if you didn't allow deferrals or make contributions when it says you have to, you will have to make corrective contributions for a missed deferral opportunity and employer contributions plus earnings. I recently had a client who had to make a $40,000 corrective contribution because they didn't administer the plan correctly by excluding bonuses and overtime from the plan document's definition of Compensation. The best way to avoid this issue is using my theory of plan provision construction which I call K.I.S.S. (Keep it Simple, Stupid). I believe excluding any part of pay from a W-2 or Section 415 definition of Compensation creates a potential problem with plan administration. While I understand you may not want to offer employer contributions for stuff like bonuses, commissions, and taxable fringe benefits, being cute in your definition of Compensation creates the potential for mayhem in plan administration. I understand why you still may want to draft a definition of Compensation with exclusions, but I recommend that regardless of the definition, check what you're doing and what the plan document says, and that it's consistent with the practice and plan document definition.

Eligibility and the missed deferral opportunity

Another huge problem is eligibility and identifying employees who are eligible to participate in the 401(k) plan. Every retirement plan has eligibility requirements that an employee must complete to be a plan participant. Some 401(k) plans have immediate eligibility, some require 1,000 hours within a year of employment. Regardless of the eligibility, plan sponsors need to make sure that eligibility requirements are tracked to make sure that employees become participants when the plan documents say they can become a participants. 401(k) plan sponsors need to make sure that plan operation is done according to the plan document terms. In addition, failure to include eligible employees as plan participants may require the employer to make corrective employer contributions (plus earnings) whether they're for employer contributions or what is known as a missed deferral opportunity. Failure to include eligible employees as participants over time may require the plan sponsor to fork over a corrective contribution for the time that these employees didn't have the opportunity to make deferral contributions. The problem is that these corrective contributions must be made to all affected employees whether they were planning to make salary deferral contributions or not. While a major responsibility of a TPA is to track eligibility, many errors occur because of non-reporting by the plan sponsors. If the 401(k) plan sponsor tracks eligibility on their side correctly, it eliminates the potential for errors that may cost them money in terms of corrective contributions. An added wrinkle to this problem is the addition of the Long Term, Part-Time Employee situation. It's a fairly new law that allows long-time, part-time employees who have completed 2 years where they have completed 500 or more hours of service to become eligible to defer in the salary deferral component of the 401(k) plan. These employees will not be eligible for employer contributions if they require 1,000 hours of service for eligibility. The problem is that plan documents won't be updated for this change for now, so plan sponsors may not be aware of this law change.

Automatic Enrollment

If the plan has an automatic enrollment feature or has to have one since it's a new plan after the passage of SECURE 2.0, plan sponsors need to make sure that they implement the feature. That means automatically enrolling participants to defer into the plan if they have not opted out of this feature. While I think automatic enrollment is a great idea since it increases retirement plan coverage, it has been creating a whole host of errors because plan sponsors are forgetting to utilize it.

Plan Loan Defaults

I like 401(k) loans, but I hate the errors associated with them. There are too many 401(k) plans out there that offer unlimited plan loans to participants and that leads to a lot of compliance errors. When a participant takes out a loan, they need to make at least quarterly payments for the loan to be allowed and not considered a prohibited transaction. I think offering multiple plan loans is almost being a novice who juggles, eventually, something is going to drop. If a participant fails to make a quarterly payment to a loan, it will be in default which creates a taxable deemed distribution. A participant shouldn't be penalized for someone else's mistakes, so this error is going to have to be corrected to avoid a taxable event for the participant. Too many times, the plan sponsor or the TPA will forget to make payments on one loan, out of many. That's why plans should only allow one loan outstanding at all times with a $1,000 minimum loan. You're in the business of sponsoring a 401(k) plan, nor running a payday loan service. Even if loan defaults aren't caused by an error by you or the TPA, I do think it's a concern because I think loan defaults are a strike against the plan. There has been a discussion that the DOL and/or IRS may make a change to Form 5500 and ask plan sponsors the amounts of any loan defaults.

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