

# 401(k) Plan Provisions That Are Bad Ideas

By Ary Rosenbaum, Esq.

Smith and Wesson Mountain Bikes. Life Savers Soda. Colgate Kitchen Entrees. Arch Deluxe. Heaven's Gate. The Adventures of Pluto Nash. History is littered with historic flops and bad ideas. When it comes to retirement plan design, plan provisions don't look like such a bad idea as a toothpaste manufacturer selling ready-made meals. Based on my 14 and a half years in the retirement industry, there are numerous plan features that can land you in a whole lot of trouble as a retirement plan sponsor because it creates unnecessary plan errors. So this article is about trying to inform you which retirement plan provisions are bad ideas that you should avoid.

## Unlimited Plan Loans and Loan Repayment besides Payroll

In an ideal world, retirement plans would be retirement savings vehicles that plan participants wouldn't touch until death, disability, retirement, attainment of age 59 1/2, and termination of employment. Unfortunately, we don't live in an ideal world and plan participants borrow funds from their 401(k) account that will be their directed investment because they need their money for purposes that will not trigger any taxable event or excise taxes.

While most 401(k) plans offer plan loans, there are some features that plan loan provisions should not have. The first is allowing unlimited loans. I have seen 401(k) plans where participants have five to seven plan loans outstanding. What's the problem? Many TPAs are confused with how to pay off multiple loans at the same time when a loan repayment is deducted from a participant's paycheck. I have seen firsthand when a 401(k) administrator would direct payments

toward most of the loans, but forget one. The problem? Since payments were not made for half the year, the loan should have been in default and the participant should have received a 1099 form for a taxable deemed distribution representing the defaulted loan balance. This error was not caught by the administrator or the plan auditor, but was discovered by an Internal Revenue Service agent on an audit. To avoid the error, plan sponsors should have



a limit of one loan outstanding at all times as a loan provision which would eliminate all the issues that would emanate from allowing multiple loans because it's far easier for a 401(k) administrator to apply a payment towards one loan, instead of five to seven loans.

When it comes to repayment, I would also not allow any other form of repayment besides payroll. 401(k) plan sponsors and TPAs are not banks and there should be a uniform payment of all loans. 401(k) plan loans should not be treated as some sort of bank holiday or vacation

club savings accounts. Plan sponsors and TPAs don't need the headache or accepting checks or ACH or cash payments and worrying whether they will manually lower the loan amount because of the issues of reporting as well as the fact that 401(k) loans come with a fixed pre-payment schedule dictated by their promissory note. Any prepayments will throw off that schedule and could possibly confuse the TPA as to how much of the loan was actually paid off and what would happen if the plan sponsor accepted payments from the participant, but the plan sponsor failed to inform the TPA? Don't ask for trouble, one loan outstanding at a time and payments through payroll only will facilitate the proper administration of a 401(k) plan. In addition, a provision should also be placed in the plan that a participant's termination causes an automatic default because a plan sponsor and TPA shouldn't be tracking down a former employee for loan repayments or trying to figure out how to rollover a loan.

## Stated Matching Provisions

While matching contributions under a 401(k) plan are supposed to be discretionary, for some reason or another, many plan sponsors feel the need to make that matching required by creating a stated match. A stated match is where the plan sponsor states the full formula in the plan document of what their match will be such as 50% of a participant's salary deferrals, up to 5% of the participant's annual compensation.

Why is a stated match a problem? If business falters or business improves; any change to the matching formula will require a plan amendment. Also if the plan sponsor makes the matching contribution after the end of the plan year (the deadline

is the plan's sponsor tax filing due date include extensions) and determines that they don't have enough money for the match, the problem is that the last day to amend the plan to eliminate the stated match was the last day of the plan year (usually December 31). Aside from some collective bargaining requirement, there is no need for a stated match provision. A simple resolution by the plan sponsor with the matching provision by their tax due date is sufficient notice to plan participants without having to put that provision in the plan document and summary plan description.

### The Match True Up

In my example of a matching contribution in the previous section, it was based on a limit on annual compensation. What happens if the plan sponsor actually makes the contribution on a more frequent basis, such as monthly or payroll? Since participants start deferring, max out the annual deferral limit, and change the rate of their deferral throughout the year, the plan sponsor would actually have to true up the matching contribution at the end of the year to meet that annual compensation limit. If the true up is not done, then the plan sponsor has not followed the terms of their plan document and risk the tax qualification of the plan.

The Match True-Up situation usually arises when the plan sponsor actually makes the matching contribution on a time basis that contradicts the compensation limit they use. So if a matching provision limits matching on payroll compensation and the plan sponsor makes the contribution annually, many errors by TPAs may be made. The same is true if the matching compensation limits deferrals on annual compensation and they make the contributions on a payroll basis. The way to avoid is rather simple, the plan sponsor should always deposit the matching contributions on the same time basis they actually limit compensation for matching contribution purposes.

### Self-Directed Brokerage Accounts

Many 401(k) plans, especially profes-

sional organizations offer self directed brokerage accounts to plan participants. The problem is that most plan participants fare far worse in their brokerage accounts than participants that limit their investments to the fund menu and there are hidden liabilities for the plan sponsor in offering them. Self directed brokerage accounts may incur higher plan fees since self directed brokerage accounts won't pay revenue sharing fees to the TPA to defray



costs and a plan advisor may charge a higher fee if those accounts are not under their domain because more assets under management lowers the advisor's fee.

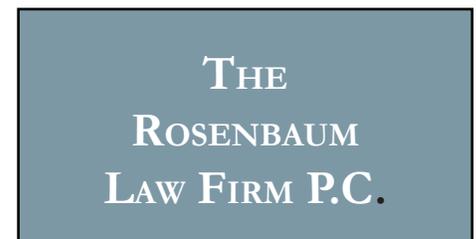
One hidden liability is often when the plan sponsor fails to offer self directed brokerage accounts to all plan participants, possibly violating the rule against discrimination against non-highly compensated participants in what is known as benefits, rights, and features. I believe that if a plan sponsor doesn't have the participants sign a hold harmless agreement, not to sue the plan fiduciaries for any losses in a self directed brokerage account, a participant can sue plan fiduciaries for losses they sustained in their account because plan sponsors and trustees are fiduciaries for all of the assets of the plan, so they must actually review the investments made under these accounts. Is there a dram shop rule for self-directed brokerage accounts? I don't think any plan sponsor wants to know.

### Payments Other Than Lump Sum in Cash

Plan distributions from a 401(k) plan to former participants should be simple to void any administrative headaches. They should be distributed in one lump sum in cash. There are instances where distributions must be made in an annuity form (where the joint and survivor annuity rules apply) or to meet minimum distribution requirements. Plan sponsors may incur higher fees for carrying former participants who still have account balances, so there

is a financial reason to pay them off once and for all. Another reason is that I have seen situations where installment payments to former participants are missed.

Payments to plan participants should also be made in cash only; the TPA and plan sponsor should not add the extra burden of going through the process of allowing in-kind transfers. It facilitates administration and cuts down on potential error by allowing the TPA to liquidate the account into cash and mailing the check to the participant or the participant's rollover account. Distributions from a 401(k) plan are difficult enough where I have seen countless errors where former participants were paid more than they were entitled to, so why add to the potential problems and errors by adding multiple payments options?



Copyright, 2013 The Rosenbaum Law Firm P.C.  
All rights reserved.  
Attorney Advertising. Prior results do not guarantee similar outcome.

**The Rosenbaum Law Firm P.C.**  
734 Franklin Avenue, Suite 302  
Garden City, New York 11530  
(516) 594-1557

<http://www.therosenbaumlawfirm.com>  
Follow us on Twitter @rosenbaumlaw