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401(k) Plans

Make 401(k) Easy on Yourself

How to keep your 401(k) streamlined without effectively increasing the contribution cost of the plan.

BY MICHELLE G. MURPHY

Michelle G. Murphy, ERPA, QPA, QKC is President of Blue Benefits Consulting, Inc., a third-party administrator focused on qualified retirement plans. In addition to management and oversight of locations in Indiana and Ohio and a growing remote staff, she enjoys working with clients on effective plan design, and is responsible for business growth and sales. Mickie is a member of the American Society of Pension Professionals & Actuaries (ASPPA).

With the enactment of SECURE 2.0, there is much talk about new regulations, lack of needed guidance, and the additional complexities the new provisions will bring to the administration of a 401(k) plan. However, 401(k) plans have always had built-in complexity and can become a nightmare for administration if particular options are selected. This discussion is about simplifying plan administration by choosing better administration options for the plan and participants.

Participant Eligibility—All for One and One for All

When a participant becomes eligible to enter a 401(k) and then what entry date is used can be one of the most confusing things to discuss with an employer setting up a new 401(k) plan. And, if it is confusing for the employer, it is also confusing for the employee. Getting the entry date wrong or missing the notification for enrollment for an employee can mean penalties for the employer for missed contributions and lost opportunity costs. As part of our initial plan design discussions, I usually start by asking if the employer has other benefits being provided to employees, such as health insurance. If so, we can talk about using a common eligibility period. Then we discuss turnover, who they are trying to benefit, and how different enrollment dates will affect the process. Frequently, we come back to using a common entry date to simplify the administration for the employer and ongoing maintenance of the plan.

Some years ago, I inherited a 401(k) plan that was designed by a controller handling the benefits for a growing employer. They had created separate eligibility requirements for no less than four contribution sources and it made me insane. This falls under the category of "just because you can, does not mean you should!" Of course, it was never correct, and it was never what they expected, because the software did not calculate the different eligibilities the way the employer thought it would. What's more, the added complexity made no significant difference to the benefit the employees received. It certainly was not worth the additional time and grief of the controller or the pension consultant doing the work. After several years and the departure of that particular controller, we were able to convince the owner it was not necessary and changed the plan to have a single eligibility process, and all were much happier with the plan design. While there are certainly times where it may make sense to create a longer eligibility requirement for a profit-sharing contribution over a shorter salary deferral and match requirement, it may be that contribution formulas could accommodate a similar end goal without adding multiple eligibility requirements.

Compensation—Gross

Everyone enjoys payday, but very few understand compensation used for 401(k) plans and how it affects contribution calculations. Compensation used for contribution calculations is defined in the plan document. Understanding the nuances of the different standard definitions requires some skill for a plan compliance administrator, much more so for an employer not accustomed to worrying with such things. When one starts excluding compensation for different purposes, there may be needless complexity involved. The easiest and most understandable compensation will be to use gross compensation. The dollar amount may be pulled from a payroll report and can be explained that it is what an employee is paid before any deductions. Exclusions of certain compensations require additional testing and perhaps making additional contributions to correct failed testing. The easier the definition is for the employer to understand, the fewer mistakes to be made by all involved.

The second most common correction we make (after late or missed contribution deposits, which leads the pack of errors) is the correction for using incorrect compensation for contribution calculations, such as excluding bonuses, or NOT excluding bonuses from salary deferrals when the document says otherwise. Including all pay in salary deferral calculations makes it easy for everyone involved in the calculation.

LTPT—Who's In and When?

In 2024, the obligation to include Long-Term Part-Time (LTPT) employees in the 401(k) plan for salary deferral purposes will take effect.

The original LTPT legislation was put in place by the first SECURE Act (generally referred to these days as SECURE 1.0), requiring that we begin looking at employees who worked at least 500 hours per year for three consecutive years beginning 2021 and permit them to participate in salary deferrals in the year following. That first year is 2024. SECURE 2.0 reduced the number of years required from three to two, but that doesn't begin until 2025. So, we will have one year at the old three-year requirement, and then begin the two-year requirement a year later.

How exactly will we handle all of the things that go with this? The Treasury Department is charged with providing guidance on the details that are missing from the legislation, and we are still waiting for that information. Until then, if the plan does not already include LTPT employees, to simplify the process for next year, you should gather all of the census data annually for *all* employees, so it is a matter of using the data when it is needed.

For plans that already permit all employees to participate at 90 days or immediately, there will be no need to be concerned with the LTPT inclusions and the provisions that go with it. It is already simplified.

Contributions

Simplification of eligibility requirements can also lead to simplification of contribution allocations.

Whether all employees participate immediately or there is a full Year of Service wait, it is well understood that safe harbor contributions can make life easier. Whether the standard match or non-elective formula is used in plan design is generally dependent on whether profit sharing contributions are intended, or even whether a cash balance plan has layered on top of the 401(k) plan, which usually would make a non-elective formula most efficient. For larger plans or plans with less ability to make additional contributions, the matching formula will frequently be the best design. Plans utilizing a match will be most straightforward for calculation and employer understanding if either matched each payroll without a year-end true up, or if only calculated at the year-end and deposited at one time. Participants get the benefit of weighted earnings if match is calculated and deposited each pay period. Annual calculation gives the benefit of catching full compensation (and any exclusions or complexities necessary to a particular employer circumstance) and can save making corrections later. And we will add the caveat here that there will always be that plan for which the best solution is to provide the payroll match and do a true up calculation at year end in order to maximize employees who front load contributions, thus mucking up the payroll calculation. (As an aside here, if you are using a safe harbor matching contribution and you are allocating it quarterly or more often, the regulations require that the contribution actually be deposited by no later than the end of the following quarter.)

Auto-Enrollment Escalated

Finally, there may be a new star in the safe harbor contribution world, as SECURE 2.0 mandates both auto-enrollment and auto-escalation for new plans written after the law was enacted by January 1, 2025. The levels of auto-enrollment and auto-escalation look a lot like qualified automatic contribution arrangements (QACAs), which have been around for some time. Where we have seen little use of the QACA safe harbor provisions in the past, perhaps it will become a simplification method in and of itself, with the two-year vesting schedule (especially when we use immediate entry to the plan) and the maximum 3.5 percent match at 6 percent or more of deferral. By auto-enrolling at 10 percent of pay, the employer can avoid auto-escalation, use a 3.5 percent match rather than the standard safe harbor 4 percent minimum, and satisfy multiple nondiscrimination tests. If employees were permitted to participate in the plan immediately or at 90 days (where many health and welfare plans are enrolled), and gross compensation is used for contribution calculations, the 401(k) plan would operate with relative ease and possibly have a lower cost than a standard safe harbor match plan, depending on participation.

While we work the complexities of SECURE 2.0—and really, the entire retirement plan system—we should also look for ways to make our clients and their plans as painless to operate, both for their benefit and for the practitioners managing them, while also trying to meet their objectives. Managing to do both is the value we should all strive to provide to our clients. ■