DEFINITI

INSIGHTS

Common Mistakes Plan Sponsors Make in Retirement Plan Administration

We know from working with thousands of retirement plan sponsors nationwide that they have many things on their plates. They often carry responsibilities outside of overseeing the retirement benefit, such as working as a Human Resources representative or even running the entire company.

A plan sponsor has fiduciary responsibility for the company's retirement plan, including acting in the interest of plan participants and their beneficiaries and following the plan document to a "T." With this obligation on their shoulders — and regardless of any other responsibilities they carry at work — plan sponsors must be aware of mistake-prone areas.

13 Mistakes in Retirement Plan Oversight

Mistakes can and do happen in retirement plan administration. It's the plan sponsor's responsibility to quickly find and fix anything they discover and establish a plan to avoid mistakes happening again in the future. These mistakes can result in penalties, liability and, in some situations, disqualification of the retirement plan.

If you're new to the retirement plan sponsor role or manage people who may not be as familiar with plan administration, here are a baker's dozen mistakes Definiti commonly sees and best practices for stopping problems before they occur.

1. Plan Document Isn't Updated

The Internal Revenue Service (IRS) requires 401(k) and other qualified retirement plans to have a formal, written plan document that complies with the Internal Revenue Code (IRC). When tax laws change, as they regularly do, it's the retirement plan sponsor's responsibility to update the plan document promptly. Plan fiduciaries must adhere to the IRS's firm deadlines for critical plan amendments, including those mandated by the IRS and those driven by the company's own changes to the employee benefit.

If you didn't amend your plan document after a recent internal change or missed an IRS-mandated deadline, corrective action may be needed. (See the IRS's options for its self-correction program and other correction options.)

Best practice: The IRS recommends annually reviewing your plan document to ensure you comply with its terms.

2. Failure to Operate Per the Plan's Terms

Not following the retirement plan's terms is another common mistake. Since a plan sponsor often partners with other parties, such as a third-party administrator (TPA) or internal employees with plan-related responsibilities, anyone the sponsor designates to assist with this employee benefit needs to understand the plan document and be made aware of changes made to it.

If a plan sponsor changes the way it operates the plan, adding automatic enrollment for new hires, for example, the change must be communicated to every individual who provides service to the retirement plan.

Best practice: Establish a communication process to let everyone with administrative or managerial responsibilities for the 401(k) know of plan changes on a timely basis.

3. Compensation Definition Not Followed

According to the IRS, one of the most common mistakes employers make when administrating their 401(k) or other retirement plan is using the incorrect definition of compensation when allocating plan contributions to participants.

Since compensation is the main component in determining employee deferrals, match amounts and employer profit-sharing calculations, it's critical for plan sponsors to review the plan adoption agreement and know the compensation definition listed there. Your plan document may exclude certain forms of compensation — for example, bonuses, commissions, accrued paid time off, etc.

Best practice: Know the language in the plan adoption agreement regarding any excluded compensation, and regularly review plan election forms to see if they are consistent with plan terms.

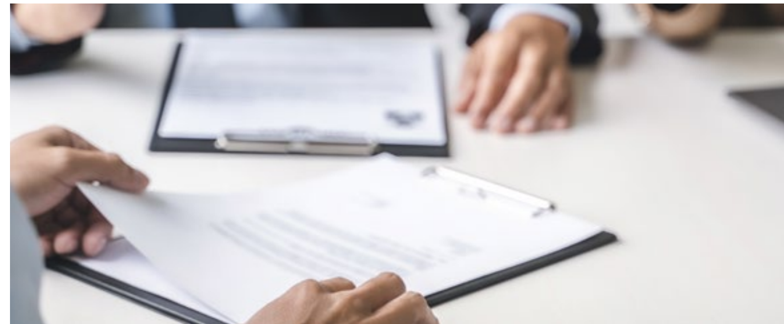
4. Employer Matching Contribution Errors

Incorrectly calculating hours of service or plan entry dates are two areas that often result in incorrect or missed matching contributions to employees.

The timing of the matching contributions matters, too. For example, if your retirement plan document states the matching contribution is deposited on a per payroll basis and you have been depositing those contributions annually, this mistake must be corrected.

Additionally, failing to follow the definition of compensation can cause errors in calculating the match.
(Refer to point 3.)

Best practice: Review the plan document for information about correct matching contribution formulas, the definition of compensation and the timing of when matching contributions should be made.



13 Common Retirement Plan Mistakes

1. Plan Document Isn't Updated
2. Failure to Operate Per the Plan Terms
3. Compensation Definition Not Followed
4. Employer Matching Contributions Errors
5. Nondiscrimination Tests Failure
6. Failure to Notify Eligible Employees
7. Noncompliance With 402(g)
8. Late Deferral Deposits
9. Participant Loan Don't Meet Requirements
10. Hardship Distribution Issues
11. Required Contributions Not Made for Top-heavy Plans
12. Not Filing Form 5500
13. Failure to Send SAR or Annual Notices

IRS's "Key Employee" Definition

To determine if a plan is top-heavy, you must first identify key employees — that is, any employee (including former or deceased employees), who at any time during the plan year was:

- An officer making over $215,000 for 2023 ($200,000 for 2022; $185,000 for 2021 and for 2020; $180,000 for 2019);
- A 5% owner of the business (a 5% owner is someone who owns more than 5% of the business), or
- An employee owning more than 1% of the business and making over $150,000 for the plan year.

A non-key employee is everyone else.

5. Failure to Satisfy Nondiscrimination Testing

The IRS wants to ensure 401(k) plans are fair to employees, business owners and officers alike when saving for retirement.

The three main nondiscrimination tests are:

- **Actual Deferral Percentage (ADP)** – Compares elective deferrals (both pre-tax and Roth deferrals, but not catch-up contributions) of the highly compensated employees to nonhighly compensated employees
- **Actual Contribution Percentage (ACP)** – Compares elective deferrals of the highly compensated and nonhighly compensated employees but divides each participant's matching and after-tax contributions by the participant's compensation
- **Top-heavy** – Divides the amount of plan assets of owners and the most highly paid employees (i.e., the "key employees") by all employees' plan assets to make sure key employees' ownership of assets is not more than 60%

If one of these tests fails, the plan sponsor must take a corrective action, which is often to do a refund to highly compensated employees.

Best practice: Know the process for making any needed corrections due to a failed nondiscrimination test and the deadline, so you don't incur additional costs to the plan if the date is not met.

6. Failure to Notify Eligible Employees

Eligible new hires need to be notified of their opportunity to enroll in your retirement plan. They should receive enrollment materials, including required notices, information on the qualified default investment alternative (QDIA) and a copy of the Summary Plan Description (SPD).

To avoid missed deferral opportunities for participants, it's critical to know the eligibility requirements in the plan, such as hours worked or the period of time tied to eligibility and administer them accordingly.

Best practice: Have an established process in place for how you identify eligible employees and how you will distribute the required enrollment materials.

7. Noncompliance With 402(g)

IRC Section 402(g) limits the amount of elective deferrals a plan participant can exclude from their annual taxable income. The limit on elective deferrals is updated each year. (Refer to the Annual Compensation and Contribution Limits on Definiti's website for specifics.)

Elective deferrals include both pre-tax deferrals and designated Roth contributions. In general, all elective deferrals made by an individual to every retirement plan they participate in will determine if the employee exceeded the 402(g) limits. Any plan they participate in is subject to disqualification if an employee has elective deferrals above the 402(g) limit.

Best practice: Ensure that no participant's elective deferrals exceed the limit by comparing the amount deferred to the 402(g) limit.

8. Late Deferral Deposits

The Department of Labor (DOL) requires employers to promptly deposit deferrals to participant accounts via the plan's recordkeeper. Late deposits result in additional contributions to compensate participants for any lost investment gains.

Best practice: Establish written procedures for your deferral deposits to ensure they're timely and monitor deposits ongoing. If you use a payroll provider, coordinate efforts so they submit employee deferrals as soon as possible.

9. Participant Loans Don't Meet Plan Requirements

Not all retirement plans offer loans to participants, but many do. Participants may see plan loans as desirable if they focus solely on the "pay yourself back, with interest" aspect. But like a consumer loan, there are rules for borrowing money, a loan application process, and a legal agreement for the loan the explains the repayment schedule, interest rate, how repayment is made, what happens to the loan if the employee leaves the company.

(Read the IRS's Retirement Plans FAQs Regarding Loans for guidelines it sets for plan loans.)

Best practice: If your plan offers loans, review your loan policy to fully understand this feature, including determining if your plan allows for more than one loan at a time. Make sure your participants know the plusses and minuses of retirement plan loans.

10. Hardship Distribution Issues

A hardship withdrawal is another type of optional provision in a retirement plan. Hardship withdrawals are on the rise, according to an Empower Institute report, with withdrawals up by 24% last year.

Hardship distributions are limited to the amount of the employee's elective deferrals and are designed for immediate and heavy financial need, which the IRS states are:

- Medical care expenses previously incurred by the employee, the employee's spouse or any dependents of the employee, or if necessary, for these persons to obtain medical care.
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments).
- Payment of tuition, related educational fees, and room and board expenses for the next 12 months of post-secondary education for the employee, the employee's spouse, children or dependents.
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or mortgage foreclosure on that residence.
- Funeral expenses for the employee's deceased parent, spouse, etc.
- Certain expenses relating to the repair of damage to the employee's principal residence.

Best practice: Understand your plan's obligation to obtain documentation supporting the hardship and the amount a participant requests. (Note: There are other types of loan provisions; see our recent At Long Last, SECURE 2.0 Is Here article for information on loan provisions for federally declared disasters.)

11. Required Minimum Contributions Not Made for Top-heavy Plans

The IRS's top-heavy rule helps ensure lower-paid employees receive the maximum benefit if the plan is top-heavy. If a retirement plan is top-heavy, the employer must contribute up to 3% of compensation for all non-key employees still employed on the last day of the plan year. As we mentioned earlier in point 5 (Nondiscrimination Tests Failure), a plan is top-heavy when the total value of the plan assets of key employees is greater than 60% of the total value of plan assets.

If a 401(k) is top-heavy and the required minimum contribution is missed, the plan sponsor must make a corrective contribution that includes lost earnings to non-key employees. The contribution is generally 3% of compensation, adjusted for plan earnings through the date of correction.

Best practice: Determine if your plan is top-heavy by testing it annually and remember to correctly identify company owners and their family members. [Note: Certain safe harbor 401(k) plans aren't subject to the top-heavy rules, which is one of this plan types many benefits.]

12. Not Filing Form 5500

The IRS, DOL and Pension Benefit Guaranty Corporation developed the Form 5500 to report on the qualification of the retirement plan, its financial condition, investments and the operations of the plan. A plan sponsor or its fiduciary partner must file the 5500 by the last day of the seventh

month after the plan year ends (e.g., that's July 31 for a calendar-year plan).

Late filing of the Form 5500 (or not filing it at all) is a common mistake we see retirement plan sponsors make. Missing the deadline can result in substantial penalties from the IRS and DOL.

Best practice: Keep track of the filing deadline for your plan, and don't assume an administrative partner is handling the filing unless you're confident they are doing so.

13. Failure to Send Summary Annual Report or Annual Notices

The final common mistake is related to required notices for plan participants. These include the Summary Annual Report or SAR, which is associated with Form 5500 and serves as a summary of that form. The SAR must be distributed to plan participants nine months after the plan year or within two months after the Form 5500's filing.

Other key notices for the majority of retirement plans include:

- Summary Plan Description or SPD describing participants' rights, benefits and responsibilities under the plan in understandable language
- Enrollment materials, including beneficiary designation and salary deferral election forms
- Automatic enrollment notice if the plan offers this feature
- Individual benefits statement

There are other notices tied to participant events and plan events. Visit the IRS's notices help page for specifics on each type.

Best practice: Understand the required notices participants must receive for your retirement plan and schedule the deadlines for sending out those communications.

Who Benefits From Hiring a 3(16) Fiduciary?

Often, it is the plan sponsor who is experiencing any (or all) of these concerns:

- Has limited staff and needs help monitoring activities such as payroll, notices, eligibility and enrollment
- Is newer to the world of retirement plans and needs to bring in additional expertise
- Is concerned with the volume of compliance responsibilities and fiduciary risk/liability
- Experiences a high employee turnover rate
- An excessive amount of participant loans from the plan
- May have failed compliance testing in the past
- Submitted a corrective filing for a Department of Labor issue

Find out why two of our clients, a manufacturer and construction company, chose to outsource their plan administration to The Fiduciary Studio here.

We’re Here to Help

Most errors made in retirement plan management have little or nothing to do with the investments or the investment manager. They involve daily plan administrative tasks.

Plan sponsors who want to minimize their fiduciary risk and ensure errors are avoided have a great option: They can hire a comprehensive 3(16) administrator to serve as a co-fiduciary to the plan.

The 3(16) administrator will monitor, review and execute many of these administrative tasks to ensure they are error-free. The 3(16) administrator can even review and sign the Form 5500 on the plan sponsor’s behalf.

The Fiduciary Studio, a wholly owned subsidiary of Definiti, helps keep retirement plans compliant. Its comprehensive services minimize the risks associated with compliance activities while allowing plan sponsors to focus on operating their business. Companies large and small and from various industries rely on The Fiduciary Studio’s 3(16) fiduciary services.

Do you need someone to help carry much of the load of your plan sponsor responsibilities? Or are you a financial advisor who wants to learn more about how Definiti and The Fiduciary Studio work together to help your clients? Let’s start the conversion — call 1-(888)-912-3653 or email sales@definiti-llc.com.

This material has been prepared for informational purposes only, and is not intended to provide legal, tax or investment advice. Any tax-related discussion contained in this material is not intended or written to be used, and cannot be used, for (i) avoiding any tax penalties, or (ii) promoting, marketing or recommending to any other party any transaction or matter addressed herein. This material does not provide fiduciary recommendations concerning investments or investment management; it is not individualized to the needs of any specific benefit plan or retirement investor, nor is it directed to any recipient in connection with a specific investment or investment management decision. Please consult your independent legal counsel and/or professional tax advisor regarding any legal or tax issues raised in this material.

This information is intended to provide general information on matters of interest in the area of qualified retirement plans and is distributed with the understanding that the publisher and distributor are not rendering legal, tax or other professional advice. Readers should not act or rely on any information in this article without first seeking the advice of an independent tax advisor such as an attorney or CPA.