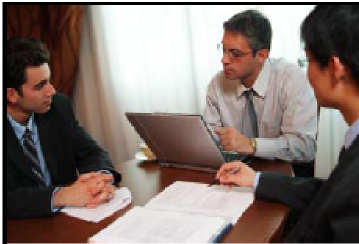

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401(k) Challenges in Troubled Economic Times

Companies that sponsor 401(k) plans always need to pay close attention to the proper operation of these plans, since they are governed by complex tax and labor law and regulations. The need for close attention to the plan is especially important now because troubled economic times and difficult investment markets are affecting almost all 401(k) plans. We have outlined seven important steps you can take to minimize the risk of costly financial consequences relating to your 401(k) plan's investments, contributions, compliance testing, and in-house operations.

1. **Review your plan's investment options from a fiduciary perspective.**
   - Make sure your plan has an Investment Policy Statement that lists your criteria for selecting and monitoring the menu of investment options offered to participants. This is a crucial part of protecting the employer and trustees from fiduciary liability for investment losses incurred by participants during this declining market.
   - Meet with your plan's investment advisor at least annually to monitor the performance of the plan's investment options compared to appropriate benchmarks and compared to the terms of your Investment Policy Statement. Keep minutes of these meetings and document the reasons for your decisions to select, keep or change any of the plan's investment options.
   - Manage the plan's investments in a manner that provides maximum fiduciary protection for the employer and the trustees under ERISA Sec. 404(c).
2. **Review the affordability of employer contributions under your plan.**
   - Look at your budget to see if you can afford the level of employer contributions (matching and/or profit sharing) that are either specified in your plan document or that your employees are expecting to receive.
   - If your plan has a fixed contribution rate stated in the plan document, you must consider your company's ability to fund the required cost. If you are uncertain about your ability to meet that obligation this year, discuss with your plan advisors what options you have to reduce, suspend, or eliminate the required contribution. If employer contribution changes can and need to be made, make the changes sooner rather than later in the year in order to get the most impact from the change.
   - If the contribution rate stated in the plan document is a discretionary amount determined by the employer each year, you will not need a plan amendment to reduce, suspend, or eliminate the contribution for this year. However, you would still need to communicate with employees if you are reducing a contribution rate you had previously announced or that employees would otherwise be expecting to receive.
3. **Consider the effect of contribution changes on your plan's annual compliance tests.**
   - If you reduce or suspend the employer matching contribution, some employees may reduce or suspend their salary deferrals. Lower salary deferral participation by non-highly compensated employees (NHCEs) may make the plan fail the ADP and/or ACP tests that limit salary deferrals or matching contributions for highly compensated employees (HCEs). Communicate with your plan's affected HCEs so they will be aware that they will be affected by these limits.
   - If you reduce or suspend a safe harbor matching contribution during the year, the plan will lose its safe harbor status for the entire year and must be subject to ADP and ACP testing that year. Again, let your HCEs know that they will now be subject to limits on their salary deferrals and/or matching contributions.

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- If your plan is a top-heavy plan (a plan in which 60% of more of the benefits belong to owners or certain officers of the business), any salary deferral contributions made by owners or officers of the company during the year could trigger a mandatory top-heavy minimum employer contribution for that year. Check with the service provider who does the plan's annual compliance testing to see if your plan could face a mandatory top-heavy minimum employer contribution this year.

4. **Maintain timely deposits of employee salary deferrals.**
   - Do not ever be tempted to delay the deposit of your employees' salary deferrals (and/or loan payments) when cash flow is tight. U.S. Department of Labor regulations require that these amounts be deposited into the plan as soon as administratively possible after the date they are withheld from payroll, which is usually just a matter of days, not weeks.
   - Late deposits of employees' deferrals and/or loan payments must be reported to the Department of Labor on the annual Form 5500 and will subject your company to penalties as well as the cost of restoring lost earnings to affected participants' accounts.

5. **Expect more frequent requests for plan loans and/or hardship withdrawals.**
   - Due to the severe effect of the economy on many individuals and their families, more participants than usual may be requesting loans or hardship withdrawals from your plan.
   - Check the terms of your plan document to see if your plan allows loans and/or hardship withdrawals and, if allowable, what administrative or legal limits apply to such transactions.
   - Make sure participants provide documentation to prove they have the type of hardship circumstance that can allow them to take an in-service hardship withdrawal from the plan. Keep this documentation in the plan's files in case your plan is audited by the IRS or DOL on these transactions.
   - Some employees may stop making their loan repayments to the plan and default on the remaining loan balance. These loan defaults must be reported to the IRS as a deemed taxable distribution from the plan to the employee. You must notify your plan service providers whenever a loan default occurs, so they can prepare the necessary Form 1099-R that year.
   - Apply your plan's rules on loans and hardship withdrawals to all participants in a uniform, non-discriminatory manner.

6. **Watch out for special vesting rules that can be triggered by layoffs.**
   - If your company lays off a significant portion of the employees eligible to participate in the 401(k) plan, the plan would be treated as having had a "partial termination", which would result in the laid-off employees becoming 100% vested under the plan.
   - The determination of whether a partial termination has occurred is based on facts and circumstances, but in general a layoff of at least 20% of the eligible plan participants during one year would be treated as a partial termination.
   - If your company will be laying off any employees who are eligible to participate in the 401(k) plan (including those who are eligible but do not have an account balance in the plan), talk to the service provider who does the annual compliance testing for your plan to determine whether the anticipated number of layoffs is likely to trigger the partial termination rules.

7. **Establish a policy for interim valuations of any pooled investment accounts.**
   - If your 401(k) plan has any pooled accounts that are not valued on a daily basis at the participant level, consider establishing a policy to determine under what circumstances the plan would automatically require an interim valuation of the pooled account before paying out benefits to terminated participants.
   - The sudden and dramatic decline of many investments during the second half of 2008 showed that the lack of such an interim valuation policy could result in a plan having to pay out a benefit to a terminated participant without adjusting for significant investment losses that had occurred since the most recent valuation of the pooled account.