WORKING WITH PLAN SPONSORS

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Making Participants Out of Employees Via Eligibility

A strategic approach to defining eligibility provisions in 401(k) plans can boost take-up rates.

BY NOAH BUCK

As consultants to our plan sponsor clients, we are often asked for guidance on plan design. In the last decade, plan design discussions on 401(k) plans have often centered on automatic plan features, which is due to the higher participation and savings rates they create for our clients' workforces. But beyond the hype of automatic plan features, there are other topics within plan design — sometimes overlooked — that are meaningful and impactful to participants and plan sponsors. One of those topics is plan eligibility.

The eligibility rules of a 401(k) plan have significant implications for plan sponsors. These rules can affect benefit costs, talent recruitment and retention, administrative complexity and plan compliance. As consultants, we can help plan sponsors take a strategic approach to defining eligibility provisions in their 401(k) plans, with consideration given to various plan objectives and statutory requirements.

THE PARAMETERS

It's typical for plan sponsors to define the eligible population as their common law workforces, with specific provisions to exclude certain employees such as nonresident aliens with no U.S.-source income, union or nonunion employees, commissioned employees or leased employees. Plan sponsors may also exclude certain job categories as long as these provisions are not a means to sidestep the minimum statutory age and service requirements outlined below. A plan's eligibility rules are subject to coverage testing under Code Section 410(b) to ensure they are not discriminatory against non-highly compensated employees.

In general, a qualified 401(k) plan's eligibility rules cannot be stricter than the minimum statutory requirements in the Code, which are age 21 and one year of service. A plan can always be more liberal than these minimum statutory requirements. For example, a plan can set eligibility requirements at age 18 and no service requirement.

The year-of-service requirement can be based on elapsed time or it can be hours-based. If hours-based, the plan sponsor can require an employee to work as many as 1,000 hours in a 12-month period in order to satisfy eligibility. Section 410(a)(4) mandates that plan sponsors allow these employees to enter the plan no later than the earlier of: (1) the first day of the plan year following the satisfaction of eligibility; or (2) six months following the satisfaction of eligibility.

Under the aforementioned parameters, the longest a plan sponsor can typically make an eligible employee wait to satisfy eligibility and enter a plan is between 12 and 18 months. Consider the following extreme example: John Doe works for a company that requires a year with 1,000 hours of service before entering on the first day of the subsequent plan year in January or six months later in July. He is hired in January 2015 and works 1,000 hours in his first 12 months. John enters the plan in July 2016, or approximately 18 months after he was hired.

STRATEGY

To what degree is the plan used to attract and retain talent?

A law firm does not want highly sought-after recruits joining a competing law firm down the road because they can enter the competing firm's retirement plan sooner. Employers relying partially on their 401(k) plans for recruitment should consider that quicker and easier access to the plan will be more attractive to those in their prospective talent pools.

Are eligibility and entry date provisions cost-efficient with respect to turnover and vesting?

An organization's turnover rate and average employee tenure are important to consider. A restaurant chain employing high-turnover wait staff will save cost and administrative energy by requiring employees to work six months before entering the plan instead of requiring one month.

It's also important to consider the plan's vesting provisions. If the plan has immediate vesting, the employer matching contributions — meant to supplement long-term retirement savings — could be going right out the door to short-term employees who are allowed to enter the plan too quickly. Employers should consider structuring eligibility and plan entry provisions so employer contributions are more likely to stay in-house with longer-term employees.

What's the best enrollment experience for employees?

Aside from the actual benefit provided to employees, an organization can also be strategic with its enrollment experience. It can be difficult to engage employees on their benefits. An organization may want to take advantage of the employee engagement that exists when new employees are signing up for other benefits, and align the 401(k) eligibility provisions accordingly. If newly hired employees sign up for medical, dental, life insurance and other benefits within the first few weeks of employment, it may be easier for them to elect a savings rate in the 401(k) plan at the same time. Employees asked to satisfy a longer 401(k) eligibility requirement may no longer have benefits at the front of their minds a few months down the road.

The enrollment experience needs to be carefully considered by organizations using automatic enrollment. Specifically, your clients may find it prudent to enroll employees after at least one to three months of service. This cushion of time allows plan communications and education to take hold with employees, and it affords them a reasonable opt-out period. Employees being automatically enrolled too quickly may feel rushed, and — if it's an eligible automatic contribution arrangement (EACA) plan — may request refunds.

How easy is the administration?

Administrative errors in a 401(k) plan can be costly to our clients, and for that reason there's value in keeping the rules clear and simple. Plan sponsors should avoid gray areas or knowledge gaps with respect to the administration of eligible employees. For example, if hourly employees are excluded from the plan, can the organization's recordkeeper or payroll team clearly identify the hourly employees? Automated processes to assign eligibility based on clear and consistent data are preferable to manual processes that are prone to oversight.

Are dual eligibility provisions a good fit?

An organization may want to let some employees enter the plan right away, but require others to meet a more stringent eligibility requirement (assuming coverage testing will pass). For example, an organization with both salaried and hourly employees might require hourly employees to fulfill a longer eligibility period if this category of employees has a higher turnover rate or shorter average tenure.

Similarly, a plan sponsor may allow immediate plan entry with respect to 401(k) deferrals, but assign a longer eligibly period for employer matching contributions. Some plans with immediate vesting can extend the eligibility period for employer contributions for as long as two years.

Will the plan pass coverage testing?

Some exclusions do not affect coverage testing, such as the exclusion of those not meeting the age and service requirements, nonresident aliens, union employees and some newly terminated employees. However, it's important for our clients to tread carefully when venturing outside of these standard exclusions or when setting up dual eligibility provisions. For example, an exclusion of a certain job category (*e.g.*, "hourly employees," or "employees working in the Atlanta office") can cause the plan to fail coverage testing, resulting in corrective contributions to the plan. Nondiscrimination testing should be completed each year to validate a plan's eligibility provisions, and projected testing is recommended ahead of significant plan design changes.

CONCLUSION

Plan eligibility provisions within 401(k) plans can have a significant impact on our clients and their employees. Injecting strategy into this area can help our clients contain benefit costs, recruit and retain talent, simplify administration, and stay in compliance with the law. PC

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