

401(k) Checkup: Elective Deferrals

January 2, 2024

PRACTICES Employee Benefits and Executive Compensation

It is a good idea to periodically review your 401(k) plan's provisions and administrative procedures to ensure that the plan's terms comply with all applicable legal requirements and that the administrative procedures comport with the terms of the plan as well as applicable legal requirements. Plan sponsors should focus on the following items when reviewing a 401(k) plan's elective deferral provisions and procedures:

- **How are elective deferrals determined?** Some plans allow participants to defer a flat dollar amount each pay period, while others base deferrals on a percentage of compensation. Some plans permit both. While administrators are allowed a certain degree of flexibility in designing the plan's elective deferral provisions, it is important that the plan is administered in accordance with its terms. To that end, plan sponsors should review the plan's elective deferral forms and/or electronic election procedures to confirm they conform with the terms of the plan.
- **How are off-cycle payments treated?** Regardless of whether deferrals are based on a percentage of compensation or a flat-dollar amount, unless a plan's terms specify otherwise, deferrals must be deducted from all payments, even those made off-cycle. Sponsors should ensure they have the administrative procedures in place to withhold deferrals from any off-cycle payments if that is required by the plan.
- **How are bonus payments treated?** Similarly, unless a plan excludes bonus payments from compensation used to calculate elective deferrals, or unless there are specific plan provisions that treat bonus payments separately, elective deferrals generally need to be withheld from bonus payments. Some plans permit participants to make separate deferral elections with respect to bonus payments. Plan sponsors should ensure that they understand the plan's elective deferral provisions as they apply to bonus payments, and that, regardless of what the plan provides, it is administered in accordance with its terms.
- **How is compensation determined for purposes of calculating elective deferrals?** A common operational failure involves improperly including or excluding certain compensation components (e.g., bonuses, commissions, overtime, fringe benefits, etc.) from the compensation used to calculate elective deferrals. Most plans have complicated compensation definitions, and it is important that plan sponsors and administrators understand the plan's definition and how the plan sponsor's various compensation components fit within it. Plan sponsors also should periodically review their various compensation components to ensure that if any new components have been added, they have been analyzed to determine whether they fall within the plan's definition of compensation, and if so, whether deferrals are being properly withheld.
- **Are automatic enrollment and escalation provisions being properly administered?** Many plans provide for automatic enrollment, and some also provide for automatic escalation of automatic deferral percentages. Plan sponsors should review automatic enrollment

provisions to ensure that all eligible employees are being automatically enrolled at the time provided in the plan (for example, the first payroll period following 30 days of employment). If the plan provides for automatic escalation, ensure that those provisions are being properly applied at the correct time (*i.e.*, at the beginning of the plan year or the participant's anniversary date). Plan sponsors may also want to consider increasing the maximum automatic escalation percentage.

Sponsors should contact their plan's counsel and the plan's third party administrator if they have any questions about their plan's elective deferral provisions and whether they are being properly administered. If there have been any documental or operational errors with the plan's elective deferral provisions, corrective measures are likely available under the IRS's voluntary correction program.