Buyer's Guide: 401(k) Plans

This Buyer's Guide offers information on choosing a 401(k) plan for your company.

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As a business owner or manager, you want to attract and retain high-quality employees. But reality dictates that small firms can't always offer the perks that larger firms have at their disposal. One area where smaller businesses can find it easier to compete with larger businesses, however, is 401(k) plans.

Why 401(k) plans?

Let's face it: Americans can no longer rely on the prospect of retiring on Social Security. As a result, more and more of them are turning to 401(k) plans. In fact, according to the PCSA (Profit Sharing/401(k) Council of America), Americans have more than $1.5 trillion invested in 401(k) plans.

So if you want to stay competitive in attracting talented employees, you'll want to seriously consider making a 401(k) plan part of your employee benefits package.

What is a 401(k) plan?

A 401(k) plan allows employees to save for their own retirement. This type of plan was named for section 401(k) of the Internal Revenue Code, which permits employees of qualifying companies to set aside tax-deferred funds with each paycheck.

The plan provides employees with a great amount of flexibility - they can regularly change how much they wish to contribute to their plan, and they usually have several options for choosing how their savings will be invested over time. So unlike a traditional pension plan, a 401(k) plans does not specify from the onset how much money an employee will receive upon retirement.

As en employer, it is your responsibility, and the plan provider who offers the 401(k), to do all the legwork in setting up the plan. The employee is left simply to decide which percentage he wants deducted from each paycheck, and how he wants to invest it.

The amount of the employee's contribution and how it will be invested is up to the employee, as long as he stays within the limits of the plan and the law. Employees can legally contribute up to 15% of their annual earnings as long as the amount does not exceed the legal cap of $10,000.

Contributions are pre-tax, meaning the employer deducts the amount from the employee's salary before calculating income taxes. In fact, it is because the deduction is pre-tax that the IRS sets a limit on employee contributions. The limit is to ensure that the highly paid employees in your company don't abuse the tax advantages of the plan.

An employer's role

As an employer, you'll be faced with some important decision when setting up your 401(k) plan. The two most important ones are choosing the investment options that will be available to your employees, and deciding whether or not to match employee contributions.

Investment choices. Perhaps the most attractive feature of 401(k) plans to employees is the investment opportunities it can provide them. With 401(k) plans, employees have the opportunity to significantly grow their savings with various investment options.

Most employers hire a mutual fund, insurance company, or bank to assist with the record keeping of the retirement plan. But you'll often find that in order for your plan provider to offer you those services, you must agree to offer funds only from their portfolio of funds.

If that sounds unfair to you, you can hire a third-party administrator (TPA) to help with the record keeping and administration of the plan. TPAs have generally formed alliances with fund companies, which allow them to earn commissions, rebates or other incentives for directing clients to use funds from "partner" fund companies.

There are also brokerage firms, as well as some mutual fund companies, that do allow your employees to choose from any funds they like (yes, this means any fund in the whole world). The drawback, though, is that too large an assortment of funds will require significant time and energy on your part. And having too much to choose from can also greatly confuse employees and prevent them from enrolling in the plan as soon as they should.

As an employer, it's your responsibility to take the time to investigate fund options that provide manageable choices to your employees. So if you need guidance on what funds to choose, check out Section 404(c) of the Employee Retirement Income Security Act.

Though it doesn't tell you which funds to choose, it does offer definitions of what's acceptable. These guidelines, when followed, can reduce the financial responsibility of the employer for investment performance.

According to guidelines in the 404(c), an employer must offer a "broad range of investment alternatives." In order to achieve that specification, you'll want be able to present your employees with a diverse range of investment funds that have different risk and return characteristics. By diversifying their contributions into funds with varying levels of risk and return, employees can minimize the overall risk of the portfolio.

Matching contributions. You have a number of options when it comes to contributing. You can contribute a flat monthly fee to each participant's account, contribute a certain percentage of an employee's salary, or fully match the amount your employee decides to contribute (which is currently limited by the U.S. government to 15% of the employee's total gross salary).

Matching an employee's contribution is the most popular way of contributing to an employee's plan. Matching an employee's own contribution simply means that you agree to kick in additional money for every dollar the employee contributes to his own plan, usually within limits that you've set.

Many businesses match employee contributions, either fully or partially. Though you're not legally obligated to match contributions, it's a very popular feature with employees, needless to say.

You can set the formula of how much you want to match.

The standard match for companies is 50% up to 6%. That means for every dollar your employee contributes up to 6% of their pay, you will contribute fifty cents, increasing your employees returns by 50%.

Most companies match between twenty-five cents and fifty cents on the dollar. Larger companies with larger budgets will often have "full matches," which means for every dollar an employee puts in, they'll fully match each dollar, sometimes for the entire allotted 15%.

If you do decide to contribute, you can do so on a vesting schedule. That means your contributions become property of the employee over time.

A vesting schedule is a tactic used by employers to encourage employee retention. For example, if your employees are 100% vested from the moment they enroll in the plan, this means that they can quit any time and can walk away with any of the money you've contributed thus far.

If you put them on a vesting schedule, say of four years, the money that you've contributed gradually becomes theirs over time. If they quit after the third year, they might receive only 75% of what you've contributed. They won't be 100% vested until the four years is up.

Plan providers

There are thousands of providers you can turn to get a 401(k) plan. Providers can be insurance companies, mutual fund companies, financial services companies, or third-party administrators. Despite some variations, whether it is fees or investment options, these providers offer very similar 401(k) plans.
The main distinction is whether a plan provider (or vendor) is billed as a full-service provider, or as an unbundled provider.

Full service providers offer the entire range of administrative services and the investments to a plan sponsor. Also referred to as "bundled plan providers," think of full service providers as a one-stop source for a 401(k) plan. The majority of small to mid-size businesses turn to full service providers to get a 401(k) plan.

Types of full service providers are mutual fund companies, banks, insurance companies, and third-party administrators (TPAs). These make up the bulk of full service providers, but online services, payroll providers and HR outsourcing firms may also fall into the realm.

Also keep in mind that some full service providers actually outsource to other parties. For example, you may turn to a TPA for a plan and get all of your needs there. But the TPA may outsource to a mutual fund company in order to offer those funds to you.

The advantage of a bundled plan is that you get everything you need from one spot. The big downside is that you don't have many options within the plan. For example, if you go with a mutual fund company, you may have to invest in their funds. With a TPA, you may have a larger variety of investment options from different fund companies, but you still have to stick to what they offer as far as services and fees.

So if your provider has this restriction, needless to say, make sure you are satisfied with the majority of funds that they offer.

You can use a combination of in-house staff and independent service providers to design a 401(k) plan. For example, you can have an in-house HR professional to handle record keeping, while turning to an outside vendor to handle investment management or compliance testing.

Unbundled plans offer flexibility since the plan is designed on your terms. Unfortunately, the only way to keep administrative costs to a minimum is to work on them in-house. That would require a great deal of resources -- probably another one or two extra salaried employees.

As a small business you'll most likely turn to a vendor that offers a bundled plan. Although they differ in name, insurance companies, TPAs, and banks will offer similar plans at comparable pricing.

Some mutual fund companies will only offer their funds, which reduces flexibility but mutual funds are the most popular investment choice for 401(k) plans. Mutual fund companies like Fidelity Investment, The Vanguard Group, and Oppenheimer are also popular picks simply because the well-known name can increase participation by employees. Banks usually offer plans tailored towards larger companies.

Shopping tips

Here are several tips to keep in mind when shopping around for a 401(k) plan provider.

Vendor experience: How long have they been in business? What types of clients do they typically serve? You may want to see if they have clients that have plans similar to what you would like to set up.

Service: Take into account their overall service. This includes consistent and timely reporting and investment success. On the client side, make sure that they have representatives available 24/7, or a Web site where employees can turn.
Education: What sort of mediums do they use to educate (i.e., software, seminars, printed material, online material)? How thorough is the training? Remember, this may be the first time many of your employees are participating in a 401(k) plan.

Record keeping and administration: This should be part of your plan, whether your vendor handles it or out sources it. A 401(k) vendor should have access to the latest technology to handle this in a timely and accurate manner.

Plan compliance: Although your vendor won't act as your lawyer, they should assist you when it comes to 401(k) laws and regulations. When asked, they should voice that they fully support Employee Retirement Income Security Act (ERISA).

Fees: There will be a number of fees associated with any plan. The fees should be outlined and broken down and you should receive a document that outlines them for easy understanding and reference.

Pricing

How much will a plan cost you?

How much a plan costs is too broad of a range to pin down, since it depends on a number of variables. But there are standard fees and expenses that make up the total cost of a plan.

Set-up fees. You only have to deal with set-up fees once. It covers the cost of establishing the plan and accounts for transferring an account if you had a prior vendor, entering participants' data, and preparing the actual document that details your plan.

Most small businesses pay somewhere around $1000 for this, but the Department of Labor sets the range at $500-$3000 (big range, but it depends on how much work has to go into establishing your individual plan). It is usually a set fee in addition to a per participant fee.

Administrative fees. These are recurring fees that cover the costs of record keeping, compliance testing, loan processing, withdrawals, etc. A big chunk of administrative fees is made up of record keeping fees, which cover individual account maintenance.

Investment Management fees. These recurring fees account for a large portion of your overall fees and expenses - generally up to 80%. These fees cover the buying and selling of stocks and the research that goes into it.

Communication fees. These fees will pay for an important part of your plan - the training and education of your employees about their 401(k) plan. It also covers services like Internet access or call center. It is usually a one-time fee of about $500 and could include a per-participant fee.

These are standard expenses that make up the total cost of a plan, but your plan may have additional fees as well. Other expenses could include special services (additional training, a toll-free help number, etc.).

Make sure you know how these fees are charged, especially the recurring fees and expenses. They may be charged to you or to your employee's individual account. For example, investment management fees are commonly deducted from participant’s accounts while administrative fees are charged to and covered by the employer.

Total costs of plans are hard to pin down. But, in 1998 the Department of Labor did a study on the cost of 401(k) plans. They came up with benchmark figures for the top 17 third-party administrators (TPA) in the country. The annual fees and expenses for a business with 100 employees and $2 million in assets range from $11,400-$42,800.

Annual fees and expenses attached to online 401(k) services are a bit cheaper. They range between $700-$2000. Per-participant fees are many times not applicable, if so expect to pay $20 per year.

Cost Control. Controlling your costs requires extensive price comparison while you are shopping for a plan and close monitoring of the plan after it's in place. Pay particular attention to the broad range of fees that your vendor will charge now and in the future.

Something as simple as communicating with your employees can reduce your costs. Find out what they want from a 401(k) plan. If you decide to dish out extra service fees for Internet access and a toll-free number just to find out later that they aren't interested in that, it's a waste of money.

Saving your business money could include cutting back on contributions, or not contributing at all. But your main goal is getting employees to contribute, and cutting back in this area could cut back on participation. You should look to cut back and make additions where it's in yours, and your employees, best interest.