More on Paying Administrative Expenses

**SITUATION:** As a money-saving measure, Employer would like to charge the costs of administering former employees’ 401(k) plan accounts directly to those participants’ accounts, but continue to pay the costs of administering current employees’ accounts.

**QUESTION:** Can Employer do this without violating the pension and tax laws?

**ANSWER:** Yes. In guidance issued last year,* the U.S. Department of Labor (DOL) said that a defined contribution retirement plan could charge the costs of administering the accounts of former employees directly to those participants’ accounts, even if the employer paid the costs of administering current employees’ accounts.

And a subsequent IRS Revenue Ruling** confirms that a plan may charge reasonable plan administrative expenses (such as investment management fees) to the accounts of former employees and their beneficiaries on a pro rata basis — or another reasonable basis that satisfies the pension law (ERISA) — even if the accounts of current employees are not charged.

**DISCUSSION:** The pension law’s requirements govern whether a particular administrative expense can be paid from plan assets. If a plan provision specifies an allocation method, then that method must be used. If the plan doesn’t specify or is ambiguous, the plan sponsor, in its role as a fiduciary, must determine the allocation within ERISA’s basic fiduciary duty requirements.

When allocating expenses among all participants, the *pro rata* method (unequal allocation based on the assets in individual accounts) is equitable in most cases. The *per capita* method (equal allocation to each account regardless of the assets) also may be reasonable, especially for fixed administrative expenses, such as recordkeeping, legal, and similar expenses.

ERISA doesn’t specifically mandate how expenses incurred in administering accounts of separated vested participants are to be allocated. However, the IRS initially had concerns that automatically charging these expenses to former employees’ accounts might impose a “significant detriment” on participants who do not consent to distributions.

Tax law generally provides that, if the present value of a participant’s vested benefit exceeds $5,000, the plan cannot distribute the benefit without the participant’s consent. IRS regulations further state that consent to a distribution is not valid if, under the plan, a *significant detriment* is imposed on any participant who does not consent to the distribution.

The IRS concluded that a pro rata, or other reasonable, allocation of investment management and other administrative fees is *not* a significant detriment to departing employees leaving their money in the plan. The plan participants would be charged similar fees in the marketplace for a comparable investment outside of an employer-sponsored plan.

For example, a former employee would be charged such fees by an IRA trustee, if the participant had chosen to roll over his or her distribution rather than leave it in the employer’s plan. Thus, the IRS saw no problem in charging the fees only to former employees.

**COMMENT:** According to the IRS, not all allocation methods are acceptable. For example, allocating the expenses of active employees pro rata to the accounts of active and former employees, while allocating the expenses of former employees only to the former employees’ accounts, is not reasonable because the former employees would be bearing more than an equitable portion of the plan’s expenses.


Choosing a safe harbor 401(k) plan design provides employers with several advantages. For one, annual nondiscrimination testing no longer needs to be performed on pretax salary deferrals and employer matching contributions. In addition, safe harbor 401(k) plans that meet certain requirements are exempt from the pension law’s top-heavy rules. The IRS recently published new guidance on these requirements.

A plan is considered top heavy if the value of benefits accrued by key employees is more than 60% of the value of the benefits accrued by all employees. When a plan is top heavy, the employer has to make mandatory minimum contributions to nonkey employees’ accounts. Not making these required contributions can jeopardize a plan’s tax-exempt status.

**Safe Harbor Exemption**

A 401(k) plan that allows only elective deferrals and matching contributions that satisfy the safe harbor design provisions is exempt from the top-heavy rules. With this safe harbor design, the employer generally makes dollar-for-dollar matching contributions on elective deferrals of up to 3% of compensation and matches deferrals between 3% and 5% of compensation at a rate of 50 cents on the dollar. The employer cannot match contributions of highly compensated employees at a rate greater than the match rate for nonhighly compensated employees.

**New Guidance**

In a recent ruling,* the IRS looked at a safe harbor plan design that allows newly hired employees to begin deferring compensation to the plan immediately. However, employees are not eligible for employer matching contributions until they have completed one year of service. The IRS ruled that the plan is not eligible for the top-heavy exemption because it does not satisfy the safe harbor requirements for employer matching contributions. Newly hired nonhighly compensated employees are not eligible to receive the same level of contributions as longer term highly compensated employees.

This ruling can have a significant impact on the plan and the employer if the plan is top heavy. When a plan is top heavy, the employer generally has to make minimum contributions to nonkey employees’ accounts equal to at least 3% of their compensation (or, if less, the highest contribution percentage of any key employee in the plan).

So, for example, in the situation the IRS considered, longer term nonkey employees who were not deferring to the plan would be eligible for the top-heavy minimum contribution. Those who were deferring less than the plan’s top-heavy minimum (usually 3%) would be eligible to receive the difference, up to 3% of their compensation. The employer would be responsible for the additional contributions.

Employers who have 401(k) plans with deferral eligibility periods that are different from their plans’ eligibility period for employer matching contributions may want to reconsider their eligibility periods if they want to take advantage of the safe harbor top-heavy exemption.


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**Owner-employees Granted Plan Protections**

Good news for owners of small businesses. The U.S. Supreme Court recently held that the working owner of a business that sponsors a retirement plan for one or more employees other than the owner and his or her spouse has the same rights and benefits under the plan as the other employees.* The fact that the plan had other participants was a key issue in the decision.

Among other protections, this ruling extends to these owners the bankruptcy law exclusion for interests in qualified retirement plans. Previously, lower courts had found that the retirement plan assets of sole proprietors and sole shareholders were not protected from creditors under the pension law (ERISA) because the owners were employers, not employees.

The Supreme Court said that a working owner of a business can be both an employee and the employer/plan sponsor. Thus, the Court concluded, an owner can be a full participant in a company-sponsored retirement plan and enjoy all plan-related benefits and protections — as long as the owner and his or her spouse are not the only employees covered by the plan.

In the past, the IRS conducted the majority of 401(k) retirement savings plan audits. Recently, though, the U.S. Department of Labor (DOL) has become a major player in the audit arena. Below we discuss the examination process and what an employer can do to be prepared for a DOL audit.

The Process

Unlike the IRS, the DOL doesn’t conduct random audits, so when an employer receives a notice from the DOL’s Employee Benefits Security Administration (EBSA) that its plan has been selected for audit, the DOL is looking for something specific. It may be acting on complaints from plan participants, a government referral, a referral from a service provider, or items “red flagged” by its computer programs.

A list of requested documents usually accompanies the EBSA’s notice. This list generally includes:

- The plan document and amendments
- IRS Form 5500 for the past three years
- Summary Annual Report provided to participants for the past three years
- Distribution forms provided to participants
- The fidelity bond for the plan required under the pension law (ERISA)
- Financial statements
- A list of the plan’s investments
- The plan’s investment policy
- Minutes of meetings of the trustee or investment committee showing how investment decisions are made
- Information about the plan’s policies with respect to the voting of proxies

DOL’s Voluntary Fiduciary Correction (VFC) Program

The VFC Program lets plan fiduciaries, such as plan sponsors, identify and correct certain transactions that are breaches or potential breaches of fiduciary duty. The fiduciary reports the problem(s) to the DOL’s Employee Benefits Security Administration (EBSA) and demonstrates that the problem has been corrected. In response, the EBSA issues a VFC Program No Action Letter stating that the EBSA will take no further action or impose any penalty against the fiduciary concerning the breach(es) reported and corrected.

IRS’s Employee Plans Compliance Resolution System (EPCRS)

The Self-Correction Program (SCP) allows the sponsor of an IRS-approved plan to identify and correct operational failures in its plan without notifying the IRS or paying any fee.

The Voluntary Correction Program (VCP) permits a plan sponsor to submit corrections of various types of qualification failures to the IRS for approval, pay a limited fee, and receive a compliance statement from the IRS.

The Audit Closing Agreement Program (Audit CAP) is for plans that are already under examination and includes the payment of a monetary sanction. Plan sponsors correct failures identified during the audit.

Audit Targets

What areas does the DOL typically target in its audits? Some current “hot” investigation issues are:

- Timeliness of deposits of participant deferrals
- Employer stock issues

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Deposit Deadlines and Form 5500

What constitutes timely deposit of 401(k) deferrals and other employee plan contributions continues to be a point of confusion for some employers. The current IRS Form 5500 (Annual Return/Report of Employee Benefit Plan) offers some helpful guidance.

For starters, the Form 5500 instructions for the 2003 plan year clearly indicate that an employer is in violation of the rules for timely deposit if the employer remits employee contributions by the latest date allowed when doing so earlier was possible.

The U.S. Department of Labor (DOL) requires employee plan contributions to be deposited no later than the earliest date on which they can reasonably be segregated from the employer’s general assets, but in no event later than (1) the 15th business day of the month following the month in which the employee contribution amounts are received by the employer or (2) the 15th business day of the month following the month in which such amounts would otherwise have been payable to the employee in cash (for withheld deferrals).

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