



RETIREMENT PLAN NEWS

SEPTEMBER/OCTOBER 2004

Allocating Plan Expenses in 2004

When the Employee Benefit Security Administration (EBSA) issued Field Advisory Bulletin (FAB) 2003-3 last year, the IRS was taken by surprise. The Service needed time to review and address the provisions dealing with the allocation of plan expenses that were included in the guidance. In particular, the IRS wanted to look at the EBSA's position to allow the allocation of administrative expenses to terminated participants but not to active plan participants. The EBSA had also reversed its long standing prohibition of the allocation of qualified domestic relations order (QDRO) expenses to the affected participant's account in the Bulletin.

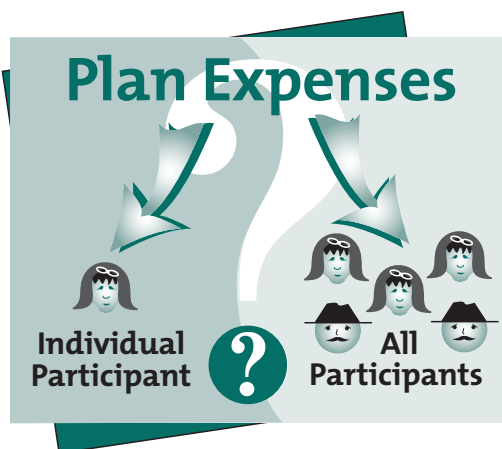
The IRS did not publicly disagree with any of the other provisions of FAB 2003-3 at that time, but they cautioned against following the guidance until they could examine the issue of whether the guidance caused a "substantial detriment" of a participant's ability to exercise his or her statutory rights.

IRS Revenue Ruling 2004-10 (February 13, 2004) announced that the IRS is now in full agreement with the EBSA on the allocation of the above administrative expenses to affected participants, *provided* the allocation method is reasonable.

Allocations Must Be Disclosed

Following is a recap of the changes brought by FAB 2003-3 and a list of expenses that may — and may not — be charged to a plan. The plan document must permit the

allocation of fees and expenses to participants. Keep in mind that Department of Labor (DOL) regulations require that, before the allocation of plan expenses to participants can be imposed, it must be disclosed in either a Summary Plan Description (SPD) or a Summary of Material Modifications (SMM).





FAB 2003-3: General Guidance

FAB 2003-3 notes that plan sponsors and fiduciaries have considerable discretion in determining, as a matter of plan provision or administrative policy, how expenses will be allocated among the employer, the participants, and the beneficiaries. The Bulletin concludes that a method of allocating expenses, as set forth in the plan document, effectively becomes a part of the benefit entitlements under the plan, and fiduciaries are generally required to follow those provisions.

If plan documents are silent or ambiguous on the subject, *plan fiduciaries must act prudently and solely in the interests of participants in determining how to allocate expenses.* These general principles apply to methods of allocating expenses among plan participants as a whole, as well as allocating specific expenses to individual participants.

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HIGHLIGHTS

-  **Automatic Enrollment Rules**
-  **Husband and Wife Sole Proprietors = Controlled Group?**

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Retirement Plan Services

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The Bulletin focuses on the allocation of expenses among participants, but does not provide a list of permitted expenses that may be charged to a plan. However, the allocation of those expenses *specifically addressed* in the FAB — with the support of the IRS — is clearly allowed.

Expenses That May Be Charged to an Individual's Account

In general, a participant's account may be charged for specific expenses relating to the services that a particular individual receives, such as:

- Administrative expenses for hardship distributions.
- Expense of calculating benefits payable under different distribution options, such as joint and survivor annuity, lump-sum, single life annuity, etc.
- Plan administration expenses to vested participants who are separated from service. This may be accomplished without regard to whether the accounts of active participants are charged such expenses (the employer may cover the administrative expenses of active participants) and without regard to whether vested, separated participants have the option of withdrawing or rolling over the funds.
- Charges for distributing benefits (both lump-sum and installment) to the participant.
- Expenses involved in determining if a domestic relations order (DRO) or a medical child support order (MCSO) is qualified (creating a QDRO or QMCSO). This is a reversal of the DOL's prior position on QDRO expenses as stated in Advisory Opinion 94-32A. The "alternate payee(s)" in a QMCSO may also be assessed a proportionate share of the expenses.

Allocating Expenses Among All Plan Participants

The Bulletin further details methods of allocating expenses among all participants. These methods include:

Pro rata allocation. Expenses are allocated based on the value of the assets in each individual account. This is defined as a permissibly equitable method of allocating expenses among participants.

Per capita allocation. Expenses are allocated on an equal dollar or percentage basis to each participant or beneficiary, regardless of the value of the assets in an individual's account.

Under the FAB guidelines, the *per capita* method may be used for allocating certain fixed administrative plan expenses, such as recordkeeping, certain legal fees, auditing, annual reporting, claims processing, and similar administrative expenses.

Fees that are based on account balances, such as investment management fees, should be charged on a *pro rata* basis because a *per capita* charge has the appearance of being arbitrary. However, if investment advice services are available to individual participants, such services may be charged on either a *pro rata* or *per capita* basis, regardless of the actual utilization by particular participants.

Reasonable Plan Expenses for Former Employees

The IRS revenue ruling now clearly permits a plan to charge reasonable plan administrative expenses to the accounts of former employees and their beneficiaries on a *pro rata* basis — or on another reasonable basis that satisfies the requirements of ERISA Title I — even though the accounts of current employees are not charged.

Caveat: Not all allocation methods are acceptable, however. The following is an unreasonable allocation formula by IRS standards:

Allocating the expenses of active employees *pro rata* to the accounts of both active *and* former employees, while allocating the expenses of former employees

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Automatic Enrollment Rules Clarified


The IRS recently released a General Information Letter addressing — and generally enhancing — the automatic enrollment rules for 401(k) and 403(b) plans.

Automatic enrollment is a plan design method approved in 1998 by the IRS under which a new plan participant is deemed to have agreed to defer a stated percentage of compensation under the terms of the plan document (unless the participant elects to defer a different amount, including zero).

A follow-up ruling (Revenue Ruling 2000-8 released in 2000) permitted a plan to apply automatic enrollment provisions to current plan participants who make elective deferrals that fail to meet the minimum annual threshold stated in the plan document.

The General Information Letter expands and clarifies the application of the automatic enrollment rules as follows:

1. The percentage selected in the plan document may be any amount that is otherwise permitted under the terms of the plan (thus, it is not limited to 3%, as stated in Revenue Ruling 98-30).
2. The plan may provide a schedule of automatic deferrals that will change over time. Example: 3% for the initial five years of participation and 5% thereafter.
3. The application of the percentage will automatically apply to compensation increases (including raises and bonuses).

In all cases, the plan document (including the Summary Plan Description) must clearly state *and* explain the automatic enrollment rules, including the option to totally elect out of deferring into the plan. 



Husband and Wife Sole Proprietors — When Does a Controlled Group Exist?

Under the family attribution rules of Internal Revenue Code Section 318(a), spouses are considered to own each other's stock. What one spouse owns, the other is deemed to own. However, if a husband and wife are sole proprietors with distinctly different occupations — let's say one is a dentist and the other an author — are their businesses considered to be part of a "controlled group" under the family attribution rules?

As in most situations involving qualified retirement plans, the answer is "it depends." If the couple owned stock in the same corporation or had some other ownership interest in a non-corporate business entity, each spouse would be deemed to own the ownership interest of the other. For example, if the husband owned 50% of a business and the wife owned 30% of that same business, their joint ownership would be considered to be 80%. Alternatively, if the husband owned 9% of the business and the wife owned nothing, under the family attribution rules, the wife would be deemed to also own 9% of the business.

Exception to the Rules

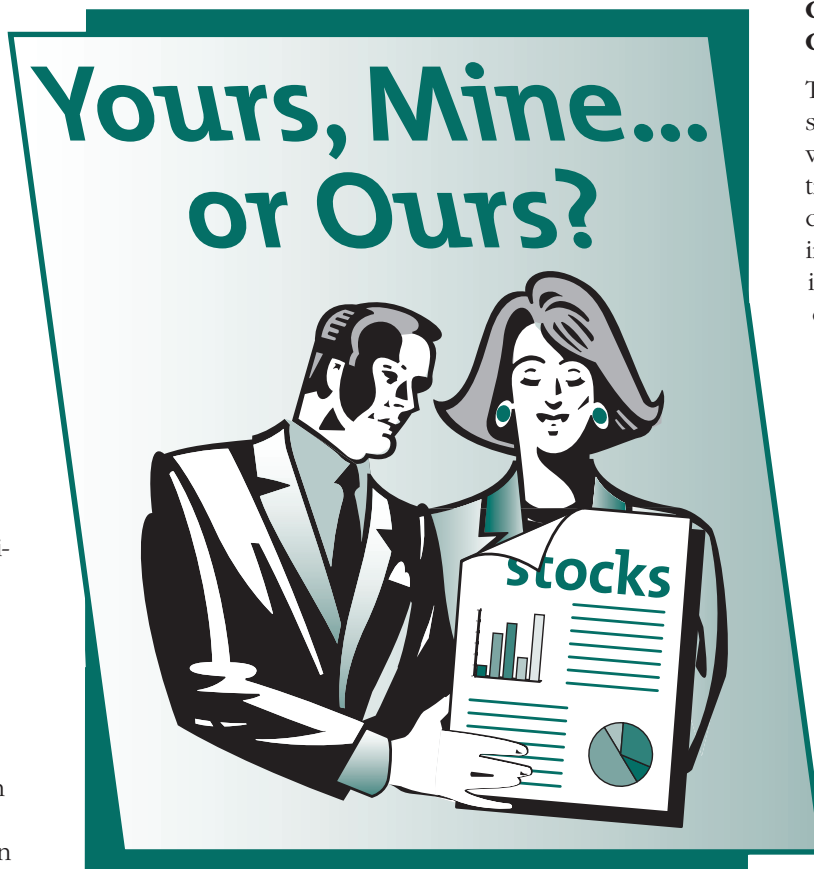
The attribution of ownership will have significant impact in determining the status of spouses under retirement plan law. For example, because the husband's ownership of 9% in the latter example is also attributed to his wife, they would both be considered highly compensated employees *and* key employees since they would satisfy the more than 5% ownership rule of each definition.

There is an exception when the husband and wife are sole proprietors in unrelated businesses. In such a situation, ownership will not be attributed between the spouses *provided* the following conditions contained in Code Section 1563(e)(5) are met:

- Each spouse has no ownership interest in the other's business entity;
- Neither spouse participates in the management of the other's business entity, nor is either spouse employed by the other spouse;

- Not more than 50% of either business entity's gross income is derived from passive income such as royalties, rents, dividends, interest, and annuities; and
- There is no restriction on the right of the spouse to dispose of the business' stock.


Assuming the foregoing conditions are satisfied, ownership attribution will not occur. Each spouse will be able to maintain separate retirement plans without the need to aggregate those plans to satisfy the coverage and other nondiscrimination requirements.



Controlled Group Concept

There are certain family situations, however, that will trigger family attribution rules and bring the controlled group concept into play. For example, if the individuals have a child under age 21, even if a divorce or legal separation has intervened, a controlled group will be deemed to exist because common ownership is attributed through the child, despite the four conditions above being met. This unexpected ownership attribution will continue to apply until the minor child attains the age of majority under Code Section 318(a), age 21.

Caveat: The spousal exception may not apply in community property states.

State rather than federal law usually determines property rights stemming from marital status. The above exception to the controlled group rules does not appear to apply in the ten or so states that have community property laws. However, if the community property is relinquished, or if the community property law permits the business ownership to be treated as separate property, the exception may apply. In community property states, it is suggested that an ERISA attorney familiar with that state's law be consulted. 

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only to the former employees' accounts, is not reasonable because the former employees would bear more than an equitable portion of plan expenses.

Fees and Expenses That May Be Charged to a Qualified Retirement Plan

Under the DOL and IRS rulings, the following costs may be passed through to plan participants:

- Determination letter expenses for initial plan qualification.
- Plan fees from accounting, actuarial, and appraisal services (including the annual valuation of trust assets and independent appraisal of employer stock).
- Certain attorney fees.
- Investment advisory and management fees.
- Third party administrator fees.
- Trustee and/or custodian fees.
- Reporting and disclosure costs.
- Costs of amending plan for required regulatory changes.
- Required bonding.
- QDRO and QMCSO determination.
- Claims processing and payment (including check writing, distribution processing, hardship withdrawal, and benefit calculations).


Fees and Expenses That May Not Be Charged to a Qualified Retirement Plan

These expenses, also known as *setlor* expenses, are the responsibility of the employer and therefore may *not* be assessed against plan assets:

- Plan design and implementation costs.
- Legal costs for corporate issues involved in establishing a plan.
- The cost of amending a plan for voluntary reasons (rather than to satisfy required regulatory amendments), such as changing a plan's allocation or benefit formula.
- Plan termination costs *other than* those due to the implementation of the termination. For example, acceptable expenses would include the filing of the final Form 5500 and the liquidation of investments.
- Cost of bringing the plan back into compliance under Employee Plans Compliance Resolution System (EPCRS).
- Excise taxes and the cost of preparing Form 5330 to pay them.

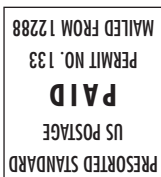
Conclusion

With this guidance from the DOL and IRS, employers now have clear authority to charge fees for participant distributions and to allocate administrative fees to terminated participants without jeopardizing the qualified status of their plans. Remember that, before fees may be charged, they must be disclosed to participants and beneficiaries in either an SPD or SMM.

As part of its retirement plan education program, the DOL has issued a 16-page booklet on retirement plan expenses that may be allocated to the plan. Three categories of fees are outlined: plan administration, investment, and individual service. This generic yet well-organized booklet will help employers understand the general concept of retirement plan fees. The booklet "Understanding Retirement Plan Fees and Expenses" may be found on the DOL website at www.dol.gov/ebsa/pdf/undrstndgrtrmmt.pdf. 

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Retirement Plan Services

