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Employee Benefits Update

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Small employers on notice

Fiduciary focus important for any size employer

One recent lawsuit alleging fiduciary duty violations caught the attention of many in the employee benefits business. The filing received considerable attention in legal circles not because of the nature of the charges, but instead because it involved a small employer. A string of large employers have faced similar charges and ultimately compensated participants. Even though the plaintiffs later withdrew their complaint, let's take a closer look at why the filing of this case matters.

The case

Employees of LaMettry's Collision Inc. filed — and then later dropped — a class action suit against their employer charging that key executives had breached their fiduciary duty by allowing the company's $9.2 million, 114-active-participant plan to pay excessive administrative, investment and recordkeeping fees at their expense. Noteworthy is that only the company's CEO and CFO — both plan trustees — were named as defendants, and not the plan's recordkeeper, its brokerage or the advisor representative. Charging them would have required proving that they too held fiduciary duty to plan participants — an assertion that would have been difficult to prove.

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The plan's investment options include approximately 11 mutual funds, seven pooled separate accounts and a guaranteed investment contract offered by the broker.

According to the complaint, the retail-priced investment options selected by defendants "likely offered no additional services at all compared to equivalent or lower fee institutional funds." The asset-based fees for two of the retail-class shares of two funds identified were 1.17% and 1.3%, vs. 0.73% and 0.69%, respectively, for the institutional-share classes of those funds.

The complaint alleged that the defendants had failed to consider the lower-fee funds and actively monitor the selected funds' fees compared to the lower-fee funds. In addition, the lack of any additional value or services in exchange for the higher fees charged by the selected funds caused plan participants to pay hundreds of thousands of dollars in excessive fees.

Recordkeeping concerns

The plaintiffs' lawsuit also charged that the plan overpaid for recordkeeping services. The complaint stated that recordkeeping is necessary for every defined-contribution plan and that prudent fiduciaries must solicit requests for proposals from companies that provide recordkeeping services to control plan costs.

How to allocate recordkeeping fees equitably among participants?

With heightened attention focused on plan costs, how can plan sponsors prevent participants from experiencing "excessive" recordkeeping fees? Sponsors have several choices when allocating fees:

Employer funds. The simplest choice — but most costly to sponsors — is to pay recordkeeping fees from employer funds. With that approach, whether fees are "reasonable" is moot from the participants' perspective. However, this approach is only used by about 20% of sponsors, according to a survey by Fidelity Investments.

Revenue-sharing agreements. When participants bear some or all of the cost of recordkeeping fees, it's important not only that they be reasonably priced, but that they be shared equitably. Ask recordkeepers to use revenue-sharing fees they receive from asset managers to offset recordkeeping charges that would otherwise be levied against participant accounts.

However, some funds, particularly actively managed stock funds, share more revenue with recordkeepers than others. To avoid having revenue-sharing arrangements disproportionately benefit participants with investments in high-revenue-sharing funds, have the recordkeeper apply aggregate revenue-sharing amounts equally among all participants.

R6 share agreements. Yet another approach is to limit plan investments to "R6 shares." This is an emerging class of funds that are lower in cost but don't share revenue with recordkeepers. While this simplifies accounting for recordkeeping charges against individual participant accounts, those costs still exist, and must be paid in some other fashion.

The plan was paying a 1.22% asset-based fee for recordkeeping services, resulting in a $113,000 annual charge. The plaintiffs claimed that if instead those services had been charged on a competitive per-participant annual fee basis, plan participants would have been in better shape.

The complaint also faulted the defendants for failing to disclose revenue-sharing fees paid by asset managers to the recordkeeper. Finally, the plaintiffs questioned the plan's paying of an umbrella administrative fee averaging 0.58% for which, the complaint charged, participants received little to no value. This fee amounted to an annual cost of over $50,000.

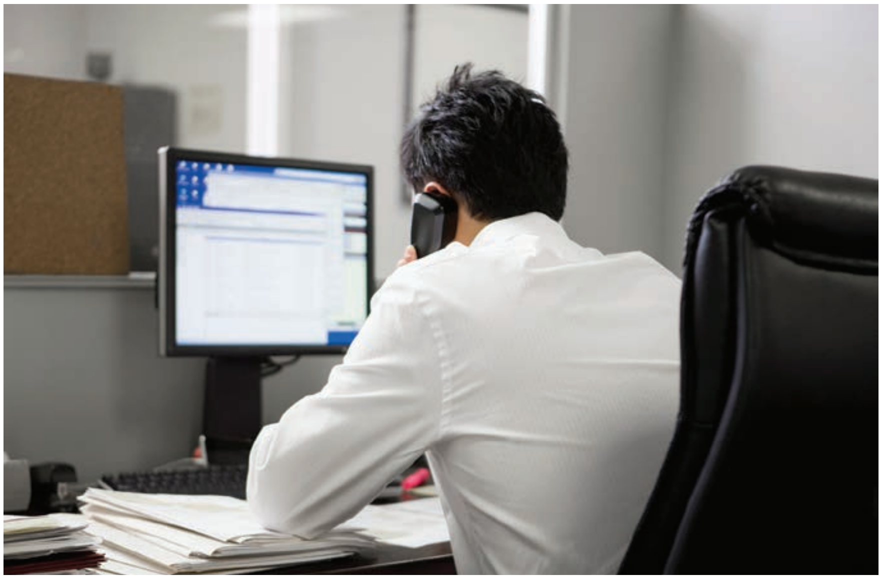
ERISA's fiduciary standards as litigated over the years place great emphasis on the process by which fiduciaries arrive at their decisions. The plaintiffs zeroed in on that issue, charging that the CEO and CFO "did not have a prudent process — or any process — for the consideration, selection, evaluation, or active monitoring of these funds or their fees with respect to alternatives, including lower fee funds."

On notice

The fact that plaintiffs' attorneys were prepared to take on a class action case against a smaller retirement plan puts small employers on notice that they too face defending themselves in such a case if they haven't taken essential precautionary steps. Because the case was dropped "without prejudice" it could, in theory, be resurrected. While this is unlikely, the lesson of the filing is clear: All employers no matter their size need to follow all fiduciary rules. ☐

IRS places high priority on retirement plan internal controls

When IRS examiners check under the hood of many retirement plans, they often find a lack of sufficient internal controls. The consequences can be severe — even if an IRS audit doesn't turn up any other problems. The worst-case scenario? Theft of plan assets that's financially damaging to participants and your company, and can also lead to plan disqualification.



Internal controls and IRS audits

Plan sponsors often fall short with their internal controls, the IRS warns, because of a misunderstanding of their obligations vs. those handled by service providers. The IRS cautions that hiring a service provider doesn't relieve sponsors of their responsibility to keep their plan in compliance.

If an audit uncovers inadequate internal controls, your plan can become ineligible to use the IRS's self-correction program.

If an audit uncovers inadequate internal controls, your plan can become ineligible to use the IRS's self-correction program (SCP). The SCP allows plans to fix insignificant operational errors at any time and preserve the plan's tax-favored status without paying any fees.

In addition, when an IRS auditor determines that internal controls are weak, the auditor will conduct a more detailed audit than would otherwise have occurred. What's more, if that closer look leads to the discovery of errors, the lack of adequate internal controls weakens your leverage to negotiate a favorable audit closing agreement with the IRS, such as a less-onerous penalty to resolve the case.

Internal control categories

The AICPA's Employee Benefit Plan Audit Quality Center deems internal controls as "a process affected by plan management and other personnel charged with governance, and designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting. A plan's policies, procedures, organizational design and physical barriers are all part of the internal controls process."

The key components of a comprehensive internal control system are:

Segregation of Duties (SoD). This is fundamental to all internal control systems and includes the way your company's invoices and receivables are processed, paid and accounted for. According to the AICPA, SoD "is based on shared responsibilities of a key process that disperses the critical functions of that process to more than one person or department. Without this separation in key processes, fraud and error risks are far less manageable." SoD includes asset custody, authorization or approval of transactions, transaction reporting and reconciling, and security of participant data.

Reporting and reconciliation of plan assets, contributions and distributions. This includes ensuring the accuracy of participant benefit statements and asset valuation and the proper bonding of plan assets. Plans must reconcile cash disbursement records and match individual participant records to data reported by the asset custodian. Finally, ensure the timeliness and accuracy of required regulatory filings and the proper recording of investment transactions, income and expenses.

Oversight of outsourced functions. Review the performance of your service providers against your service agreements and determine the causes of any deviations. In addition, review service providers' own internal control procedures. Those are compiled in standardized reporting formats under the AICPA's Service Organization Control (SOC) Report 1 and SOC 2. The former covers the service provider's financial controls, whereas the latter addresses controls pertinent to operations and compliance. You can hire an independent auditor to review outsourced services. But as with any other outsourced service, a system must be in place to vet that auditor.

Keys to control

When reviewing internal controls for your plan or the controls of a service provider, there are many considerations. At a minimum, be sure that:

- Participant enrollment is consistent with plan documents,
- Contributions satisfy required amounts and are within regulatory limits, and
- Employer and employee contributions to employee accounts are made on a timely basis.

In addition, review hardship withdrawal requests for compliance with regulatory standards prior to disbursement. Implement and follow a documented process for approving participant loans and ensuring that payments are being made according to amortization schedules. Maintain records of correspondence with participants and former participants and periodically compare signatures on endorsed checks to original signatures on file. Finally, have a system in place to locate former participants with residual account balances who fall off the radar.

It's up to you

The saying "an ounce of prevention is worth a pound of cure" applies to your internal controls. Effective internal controls and annual reviews can help prevent costly mistakes that can jeopardize your plan's tax-favored status. Take the time to review and update yours now.

Compliance Alert

Upcoming compliance deadlines:

10/3* Deadline for establishing a new safe harbor 401(k) plan

10/3* Deadline for setting up a SIMPLE for 2016

10/17* Extended deadline for filing 2015 Form 5500

10/17* Deadline for funding employer profit sharing contributions and employer matching contributions

10/17* Extended deadline for filing 2015 Form 8955-SSA

10/17* Extended deadline for filing 2015 individual tax returns

10/17* PBGC Comprehensive Premium filing and payment deadline

11/1 2016 SIMPLE notice due to current participants

** This date reflects an extension of the normal deadline, which falls over the weekend this year.*

Fair Labor Standards Act update

New employee exempt status threshold rules affect retirement plans

Dramatic changes to the Fair Labor Standards Act (FLSA) that take effect on December 1, 2016, could have implications for your retirement plan. The changes affect what forms of compensation you use to calculate employer contributions to your qualified retirement plan and determine highly compensated employee (HCE) status.

Exemption changes

Since 2004, the rules automatically deemed employees earning above $455 for a 40-hour week ($23,660 annualized) exempt from overtime pay requirements (time-and-a-half for weekly hours exceeding 40). Now, that threshold is jumping to $913 per week (annualized at $47,476).

In addition, the HCE definition for purposes of automatic exempt status is rising from $100,000 in annual income to $134,004. These amounts will be automatically adjusted for inflation at three-year intervals, beginning in 2020.

Bonus standards

A maximum of 10% of income for exempt status determination can come from commissions and nondiscretionary bonuses (those automatically paid if they meet certain job-related quotas). However, employers must pay these additional amounts at least on a quarterly basis. Thus, if you currently pay nondiscretionary bonuses to employees whose income is close to but under the income thresholds less frequently than quarterly, switching to a quarterly payout schedule could shift such employees into exempt status, and thus not entitled to overtime pay.

If you currently make annual contributions to employees' retirement accounts based on a percentage of their pay (either in addition to or in lieu of matching contributions), you could see your costs going up. The impact will depend on how you respond to the higher minimum wage threshold.

For example, assume you make a 3% nonelective annual contribution and have several employees whose current salaries are $30,000. They'd no longer qualify as exempt. Let's say that, with overtime included, they now earn an average of $40,000, and you will be paying an additional $300 in nonelective annual contributions per employee, not to mention an additional $10,000 in wages per employee.

Alternative responses

So what should you do? You can:

- Try to limit those employees' hours to 40 per week and pay overtime as needed, or
- Raise those employees' salaries to or above the new $47,467 threshold, avoiding the necessity of paying overtime.

If you're not including overtime pay in the 3% nonelective contribution, the size of your contribution wouldn't change in the first scenario, but would rise in the second. And if you include overtime pay in the 3% contribution calculation and decide simply to start paying overtime instead of raising wages, as noted, your 3% contributions will go up.

Also consider whether the net increase would be greater than what you could face if you increase base pay, even if it isn't large. Finally, if you opt to not raise salaries, and you don't include overtime pay in the 3% contribution calculation and nonexempt employees are receiving a lower proportion of total nonelective contributions throughout the year, the share going to exempt HCEs will rise, possibly triggering discrimination testing failures.

Now's the time

Check with your benefits specialist to make sure your plan won't be affected by the new FLSA rules. Remember that decisions about benefit formula design and forms of compensation should look beyond the dollars. Be sure to weigh employee perception and motivational factors. ◻

Hybrid pension plan interest credit rule amendment deadline nears

The deadline for hybrid pension sponsors to adopt plan amendments bringing them into compliance with key provisions of final IRS hybrid plan regulations is fast approaching: January 1, 2017 (January 1, 2019 for collectively bargained plans). The deadline applies specifically to transitional amendments to satisfy the regulations' market rate-of-return rule.

What plans are affected?

The final regulations apply to defined benefit (DB) plans that use a lump-sum-based benefit formula, instead of one expressed as an annuity based on participant earnings and length of service. These plans include cash balance, pension equity and others that have formulas similar to a lump-sum-based formula.

If you're a sponsor of a traditional DB plan and are considering converting to a hybrid plan, the new regulations affect you as well.

What do the regulations require?

The new regulations generally require that interest credit rates used by hybrid plans not exceed a market rate of return. The goal is to prevent hybrid plan sponsors from estimating the value of notional participant "accounts" benefits too optimistically. Doing so could put plan participants at risk if they base their retirement planning using those estimates, the plan's underlying investment performance ultimately falls short and the plan sponsor cannot make up the difference.

The regulations define the conditions under which hybrid plan sponsors can amend their noncompliant plans without triggering "anticutback rules" under the tax code. (Anticutback rules prevent plan sponsors from reducing previously promised benefits.) Plan sponsors should consult the regulations' methods for addressing particular compliance failures.

What should you do?

Review the final rules to see if your plan is affected. In particular, check to make sure your plan's interest credit rate meets the statutory requirements. If you haven't done so already, contact your benefits advisor to complete any plan amendments if necessary. ◻