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Deadline for Filing 2020 Form 5500 Approaching

The IRS requires that plan administrators of plans with a 12/31 plan year end date file their annual Form 5500 before 7/31 each year. 5500s filed after this date will incur additional fees in order to file with an extension. If your plan's 5500 has not yet been filed, please confirm all necessary annual census data and asset information has been submitted to RetireWell for processing.

Expense and Revenue Sharing Allocation Issues in Connection With Retirement Plans

By Anthony L. Scialabba, Esq.

This article addresses the Department of Labor ("DOL") that exists that concerns expense and revenue sharing allocations in connection with participants of retirement plans. As a 401k plan fiduciary best practice, the issues set forth in this e-mail should be considered by plan fiduciary boards.

I. Allocation of Plan Expenses

The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), contains no provisions specifically addressing how plan expenses may be allocated. However, the DOL has issued Field Assistance Bulletin 2003-03 ("FAB") that provides guidance with regard to this matter.

FAB 2003-03 states that the following ERISA statutes are applicable in an "expense allocation" determination. These laws are that fiduciaries of a retirement plan shall discharge their duties with respect to a plan: in accordance with the terms of the plan ("Plan Terms Rule"), in a prudent manner ("Prudence Rule"), and solely in the interest of the participants and beneficiaries ("Exclusive Benefit Rule"). In addition, the DOL states that plan sponsors and fiduciaries have considerable discretion in determining how

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plan expenses will be allocated among participants and beneficiaries in connection with a plan's design and administration. In general, the DOL asserts that with regard to a particular method of allocating plan expenses, fiduciaries can evaluate the benefit to participants and allocate expenses in any manner that reasonably reflects that benefit. However, fiduciaries must engage in a process to make that decision and must consider the impact that a decision to adopt an allocation method will have on the plan participants as a part of this process.

Two methods that are predominately utilized to allocate expenses are the "Pro Rata Method" and the "Per Capita Method". Under the Pro Rata Method, the plan administrator allocates these expenses either proportionally based on the value of the participant account balances. Under this method, the amount of plan expenses is divided by a fraction: the denominator is the amount of all participant account balances and the numerator is the value of a specific participant's account balance. After the fraction is applied to the expenses, the participant will receive an allocation of expenses as a result of the division.

Under the Per Capita Method, expenses are based on the number of Participants in the Plan. Under this method, the amount of plan expenses is shared equally by the number of all participants in a plan.

The FAB provides that in analyzing formulas for allocating expenses among all plan participants, the instruments governing the plan must be examined first. Where the method of allocating expenses is set forth in the plan documents, the Plan Terms Rule requires fiduciaries to follow the prescribed method of allocation.

Sometimes a retirement plan may not clearly indicate which allocation method to apply. For example, a plan may state:

The Plan Administrator will determine the proper method for allocating expenses in accordance with such rules as the Plan Administrator deems appropriate under the circumstances.

When the plan documents are silent or ambiguous concerning the issue of allocating plan expenses, the FAB notes that fiduciaries must select the method(s) for allocating plan expenses. In this regard, the DOL asserts that a plan fiduciary must be prudent in the selection of the method of expense allocation and a fiduciary's decision must satisfy the Exclusive Benefit Rule.

The Prudence Rule requires, at a minimum, a fiduciary to engage in a process that examines the competing interests of various classes of the plan's participants and the effects of various expense allocation methods on those interests. With regard to satisfying the Exclusive Benefit Rule, the government notes that a method of allocating expenses would not fail this rule merely because the selected method disfavors one class of participants, so long as a rational basis exists for the selected method. However, if a method of allocation has no reasonable relationship to the services furnished or available to an individual account, there could be a breach of both the Prudence Rule and the Exclusive Benefit Rule in selecting the allocation method.

It is important to note that the Per Capita Method is generally more adverse to participants with smaller account balances. This is because participants with smaller account balances must generally pay the same amount of expenses as participants with larger account balances. Thus, the utilization of this method with regard to the participants with smaller account balance could cause them to have employee morale issues.

The adversity caused by the application of the Per Capita Method could be the reason why the DOL states in the FAB that a Pro Rata Method would usually be an equitable method of allocation of expenses

among participants. In fact, the FAB states that certain expenses which are charged on the basis of account balances should probably be allocated on a Pro Rata Method. For example, the FAB sets forth that investment management expenses should be allocated on a Pro Rata Method. Thus, the Pro Rata Method is used more often used to allocate plan expenses than the Per Capita Method.

Although the DOL generally prefers that plan expenses should be allocated on a Pro Rata basis, the government provides that a Per Capita Method of allocating expenses among individual accounts may also constitute a reasonable method of allocating certain fixed administrative expenses of the plan, such as recordkeeping, legal, auditing, annual reporting, claims processing and similar administrative expenses.

Finally, it is important to note that in addition to the Pro Rata Method and the Per Capita Method, there are other ways in which expenses can be allocated. However, the degree to which this can be done depends on the ability of the record keeper which services the plan.

II. Allocation of Revenue Sharing

In general, revenue sharing involves payments made by a mutual fund, or its investment manager or affiliates, to a recordkeeper for participant-directed plans (e.g., 401(k) plans) for keeping track of the ownership of the mutual fund's shares and other shareholder services. The payment is made because the mutual fund's responsibility to market funds (i.e., "12b-1" fees), to provide shareholder services (i.e., shareholder servicing fees) and to maintain share ownership records (i.e., sub-transfer agency fees) is reduced when a recordkeeper makes a fund available on its platform. Thus, this savings is "shared" with the recordkeeper.

Revenue sharing emanates from money paid from either a mutual fund's expense ratio, or by a fund's investment manager, distribution company, or transfer agent from their revenue. On one level, revenue sharing may be perceived as generally being paid by the mutual fund. However, the source is in reality the money in the mutual fund. Thus, the participants of a plan who invest in the fund ultimately bear much or all of the expense.

ERISA does not contain any rules that directly concern the allocation of revenue sharing. However, the Act does provide that fiduciaries of a retirement plan must comply with the Prudence Rule and Exclusive Benefit Rule when operating the plan.

With regard to the application of the exclusive benefit rule in connection with revenue sharing, a per capita allocation of revenue sharing generally favors participants with smaller account balances. Plans that have "fiduciary/participants" often tend to have larger plan account balances with regard to such participants. Thus, the utilization of a per capita allocation of revenue sharing could be viewed as being less likely to cause a conflict of interests with participants who also happen to be fiduciaries.

In addition to ERISA, the DOL has not issued guidance on the allocation of revenue sharing. However, as mentioned above, it has provided guidance on the allocation of plan expenses in FAB 2003-03. This guidance concern allocations in a retirement plan. Thus, the concepts set forth in the FAB may be used by analogy for providing guidance in the situation concerning the allocation of revenue sharing. Similar to the situation involving the allocation of plan expenses, it is important to note that in addition to a pro rata method and a per capita method, there are other ways in which revenue sharing can be allocated. However, the degree to which this can be done depends on the ability of the record keeper which services the plan.

It is important to note that if the investment funds in 401k plans generate revenue sharing, it is often first utilized to pay for the record keeping expenses of a record keeper. Any amount of revenue sharing in excess of these expenses is transferred into an expense account in connection with a plan. This amount can be subsequently used to pay for administrative expenses concerning the plan at issue.

III. Conclusion

Most record keepers allocate plan expenses in compliance with the DOL guidance. Thus, typically, the guidance will not require any changes to be made to the administration of the plans. However, as mentioned above, there is uncertainty as to how revenue sharing should be allocated. In addition, plan fiduciary boards may not merely abdicate its responsibility to allocate plan expenses or revenue sharing to a record keeper. There is always a duty imposed on the fiduciaries to monitor the record keeper of the plan. Thus, as a 401k plan fiduciary best practice, at a minimum, the issues set forth in this article should be considered by plan fiduciary boards and a process for selecting a methodology to make allocations which takes into account the impact on participants should be adopted.

A Summary of the Controlled Group of Employers Rules

By Anthony L. Scialabba, Esq.

The Internal Revenue Code of 1986, as amended ("Code"), generally provides that for purposes of the "tax qualification" requirements of the Code all employees of all companies which are members of a "controlled group of employers" are treated as employed by a single employer. In addition, the Code generally provides that a controlled group of employers can be a "brother-sister controlled group" and "parent-subsidiary controlled group". The following discusses these rules.

A. Brother-sister Controlled Group

A Brother-sister Controlled Group will exist between two or more organizations if the following requirements are satisfied: (1) the same five or fewer persons who are individuals own a "controlling interest" in each organization; and (2) after taking into account the ownership of each such person, only to the extent such ownership is identical with respect to each such organization, such persons are in "effective control" of each organization. In determining whether a Brother-sister Controlled Group exists, certain attribution rules are applied.

After the attribution rules of the Code are applied, the next step in determining whether a Brother-sister Controlled Group exists is to determine if the same five or fewer persons who are individuals own a controlling interest in each organization. A controlling interest is defined as ownership of at least 80 percent of the total value of the entity.

An example of the application of the controlling interest rule is as follows. Assume Company ABC is owned 33 percent each by individuals A, B and C. Further assume that Company XYZ is owned 25 percent each by individuals A, B, C and D. When the controlling interest test is applied to the facts of this example; individuals A, B and C only own 75 percent of XYZ Company. Thus, the controlling interest test is failed.

In addition to a controlling interest in one or more organizations, a Brother-sister Controlled Group also requires the same persons who own such controlling interests to be in effective control of such organizations. Under the Code, effective control of a business entity is defined as such individuals owning

more than 50 percent of the total value of the entity. The same individuals whose ownership is considered in determining a controlling interest must be the same individuals whose ownership is considered for purposes of determining effective control of a business entity. In addition, the ownership interest of each individual that is taken into account for purposes of determining effective control is limited to the extent that such individual's ownership interest is identical with respect to each organization.

An example of the application of the effective control test is as follows. Assume Company ABC, from the example above, is now owned 10 percent by individual A, 10 percent by individual B and 80 percent by individual C. Further assume that Company XYZ is owned 45 percent by individual A, 40 percent by individual B, 10 percent by individual C and 5 percent by individual D. When the controlling interest test is applied to the facts of this example; individuals A, B and C own 100 percent of ABC Company and 95 percent of XYZ Company. Thus, the controlling interest test is satisfied. However, when their lowest percentage interest owned in either entity is examined; individual A owns 10 percent, individual B owns 10 percent and individual C owns 10 percent. This totals to 30 percent. Since 30 percent does not exceed 50 percent, the effective control test is failed.

B. Parent-subsidiary Controlled Group Rules

The Parent-subsidiary Controlled Group rules requires one company to own directly or indirectly 80 percent or more of another company. In determining whether this group exists, the same attribution rules are applied that concern a Brother-sister Controlled Group.

An example of a Parent-subsidiary Controlled Group is as follows. Assume Company A owns 85 percent of Company B. In this example, a company directly owns 80 percent or more of another company. Thus, a Parent-subsidiary Controlled Group exists between Company A and Company B.

Another example of a Parent-subsidiary Controlled Group is as follows. Assume Company A owns 70 percent of Company B. Further assume that Company A owns 100 percent of Company C and Company C owns the remaining 30 percent of Company B. In this example, Company A indirectly owns 100 percent of Company B because of Company C's ownership by Company A and Company C's ownership of Company B.

If you have any questions regarding Expense and Revenue Sharing Allocation Issues or the Controlled Group of Employers rules, please contact us at RetireWell Administrators, Inc.

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