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Employee Benefits Update

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Make the change

IRS expands midyear safe harbor plan changes

Sponsors of safe harbor 401(k) plans now have more flexibility to make "midyear" changes to their plans, thanks to a policy change announced by the IRS. The changes, outlined in IRS Notice 2016-16, took effect January 29.

Safe harbor basics

Safe harbor plans enable plan sponsors to automatically satisfy the annual actual deferral percentage and actual contribution percentage (ADP/ACP) discrimination tests. This can be helpful to plans with lackluster participation by non-highly compensated employees. Without a safe harbor provision in the plan — and the plan fails the ADP/ACP tests — some of the salary deferrals that highly compensated employees set aside in their 401(k) accounts is returned to them as taxable income so the plan can pass the ADP and ACP tests.

The safe harbor regulations require either a minimum matching contribution formula (100% of the first 3% of pay and 50% of the next 2%, or alternatively a 100% match on at least 4% of pay) or a nonelective employer contribution (at least 3% of the employer contribution to all eligible participants regardless of whether they defer). But the safe harbor regulations offer some flexibility with respect to other plan design options. That flexibility can now be taken advantage of, subject to certain limitations.

Midyear updates

"Midyear" doesn't necessarily mean precisely six months into the plan year. Rather, midyear changes are those that are effective:

- During a plan year, but not effective as of the beginning of the plan year, or
- As of the beginning of the plan year, but adopted after the beginning of the plan year.

There are several midyear changes already addressed in the regulations that have their own regulatory requirements and restrictions. Notice 2016-16 *doesn't* apply to these changes and they remain subject to their specific regulatory requirements:

- Midyear adoption of a new safe harbor plan,
- Adoption of a short plan year or a midyear change in the plan year,
- Midyear reduction or suspension of safe harbor contributions,
- Midyear plan termination, or
- Use of the "maybe" notice to change to safe harbor status.

Impermissible changes

While the IRS has loosened the rules for some midyear safe harbor plan changes, it doesn't apply to all changes. Plan sponsors cannot make midyear changes to:

1. Increase the number of completed years of service required for an employee to have a nonforfeitable right to the employee's account balance attributable to safe harbor contributions under a qualified automatic contribution arrangement (QACA) pursuant to the safe harbor regulations,

2. Reduce or narrow the number of employees eligible to receive safe harbor contributions,
3. Change the type of safe harbor plan — for example, from a traditional 401(k) safe harbor plan to a QACA 401(k) safe harbor plan, or
4. Modify or add a formula used to determine matching contributions (or the definition of compensation used to determine matching contributions) if the change increases the amount of matching contributions or allows discretionary matching contributions.

The restriction in #2 above doesn't apply to an otherwise permissible change under eligibility service crediting rules or entry date rules made with respect to employees who aren't already eligible (as of the date the change is either made effective or is adopted) to receive safe harbor contributions under the plan. Plan sponsors should consult Notice 2016-16 for more technical explanations of and exceptions to these areas.

Required notice and examples

If a plan sponsor intends to make a midyear change to a safe harbor plan, Notice 2016-16 sets out two participant notification requirements. First, the plan sponsor must provide a notice describing the change and its effective date to each employee within a reasonable period (at least 30 days and not more than 90 days) before the change's effective date. Second, employees who receive the notice must be given a reasonable opportunity to change their cash or deferred election.

Notice 2016-16 features several examples illustrating when certain midyear plan amendments are and aren't permissible. An employer sponsoring a traditional 401(k) safe harbor plan doesn't violate the rules when it makes a midyear plan amendment to increase future safe harbor nonelective contributions from 3% to 4% for all eligible employees. As noted above, the employer must provide employees an updated notice that describes the increased contribution percentage *and* give employees a reasonable opportunity before the effective date of the midyear change to make or change their election.

In the second example offered, instead of increasing the nonelective contribution, the sponsor was planning to do the opposite: lowering it from 4% to 3%. That wouldn't be permitted, even though a 3% nonelective contribution rate would be permissible if the amendment were made effective as of the beginning of the plan year.

Learn more

Notice 2016-16 contains technical caveats and limitations too numerous to describe in this article. However, sponsors of safe harbor plans, guided by ERISA experts, might find it worthwhile to exploit the new flexibility it describes. □

Compliance Alert

Upcoming compliance deadlines:

6/30 Deadline for processing corrective distributions for failed actual deferral percentage / actual contribution percentage (ADP/ACP) tests from plans with eligible automatic contribution arrangement (EACA) without 10% excise tax

7/28 Summary of material modifications is due (210 days after the end of the plan year in which the amendment was adopted)

8/1* Form 5500 is due for calendar year plans or a request for an extension on Form 5558

8/1* Form 5330 to report excise tax on prohibited transactions and excess 401(k) plan contributions is due

8/1* Form 8955-SSA for calendar year plans to report separated participants with a deferred vested benefit

** These dates reflect an extension of the normal deadline, which falls over the weekend this year.*

Court dismisses excessive fee charge

When parties are considered fiduciaries

A U.S. Court of Appeals has denied a 401(k) plan sponsor's effort to recover funds from its administrator based on an accusation that it had charged participants "excessive" fees. The court, in *McCaffree Financial Corp. v. Principal Life Insurance Company*, rejected the plaintiff's arguments.

Just the facts

McCaffree and Principal entered into a contract in which Principal provided investment options and associated services to McCaffree employees participating in McCaffree's retirement plan. The contract assessed administrative fees at two levels: 1) for separate accounts containing Principal's own mutual funds, and 2) the administrative charges embedded in the mutual funds themselves.

Courts assessing ERISA claims must determine whether a person was acting as a fiduciary when taking the action subject to the complaint.

Five years after entering into this contract, McCaffree filed a class-action lawsuit against Principal. According to McCaffree's theory, because each Principal mutual fund charged its own layer of fees, the additional separate account fees were unnecessary and excessive. The trial court dismissed the claim, finding that Principal wasn't acting as a fiduciary when it negotiated fees with McCaffree.

Fiduciary status criteria

The outcome of the case hinged on whether Principal was indeed a fiduciary with respect to the issues raised

in the case. Under ERISA, for an entity that's not explicitly named as a fiduciary to hold that status, courts consider the extent to which a party:

- Exercises any discretionary authority or control over the management of the plan and its assets,
- Offers investment advice for a fee to the plan or its assets, and
- Has discretionary authority over plan administration.

Courts assessing ERISA claims must determine whether a person was acting as a fiduciary when taking the action subject to the complaint. In other words, there must be "a nexus between the alleged basis for fiduciary responsibility and the wrongdoing alleged in the complaint." Thus, McCaffree had to prove that Principal had been acting in a fiduciary capacity when it established the fee structure.

Arm's length agreement

Perhaps the biggest shortcoming in McCaffree's case is that it had agreed to Principal's clearly described fee structure when McCaffree signed its contract with Principal five years earlier. "A service provider's adherence to its agreement with a plan administrator does not implicate any fiduciary duty where the parties negotiated and agreed to the terms of that agreement in an arm's length bargaining process," the court held.

Under the service agreement, Principal maintained discretionary authority to increase separate account management fees and adjust amounts charged to participants. McCaffree cited that power as evidence that Principal had fiduciary status. The court disagreed, finding that McCaffree failed to plead any connection between this discretion and the complaint's excessive fee allegations.

Careful scrutiny

With this decision, three U.S. Courts of Appeals have held that adherence to a properly negotiated agreement doesn't implicate a service provider's fiduciary duty. Thus, plan sponsors must carefully scrutinize fee structures during contract negotiations, a responsibility they should already be taking seriously. ◻

Studies support pairing auto-escalation with auto-enrollment

Auto-enrolling 401(k) plan participants without also incorporating an auto-escalation feature might be a counterproductive exercise. J.P. Morgan Asset Management survey data suggests that average 401(k) plan deferral rates have been trending downward even though more employers are adopting auto-enrollment. The apparent culprit: low auto-deferral rates.

Stats tell the story

From 2012 to 2014, the average annual contribution rate was 7.2%. This is down slightly from the 7.4% average in the prior two-year period, and well below the 8% average during 2007 to 2008.

Even though 45% of surveyed employers auto-enroll new participants, just 31% have auto-escalation features built in. One interesting note from the study: For plans with at least $200 million in assets, the numbers are considerably higher — 62% of these high-asset plans have automatic enrollment and 48% use auto-escalation clauses.

The most common auto-enrollment default deferral rate is only 3%, according to the most recent Defined Contribution Institutional Investment Association (DCIIA) survey. Participants who defaulted into such a low deferral rate generally don't increase it significantly. With typical annual auto-increase increments of only 1%, it'll take new employees several years to begin deferring at reasonable levels, and many more to reach the 15% that DCIIA sees as ideal.

The DCIIA survey reveals impressive deferral rates for plans that both auto-enroll and auto-escalate participants. "Plan sponsors who offer both automatic enrollment and automatic contribution escalation have over twice as many participants with retirement savings rates over 15% (14% of respondents) as those that don't offer both (6% of respondents)," according to the survey.

Change is in the air

So why don't plan sponsors implement these features? According to the survey, plan sponsors with less than $50 million in plan assets were concerned about complaints from participants (28%) and feared it would be seen as paternalistic (18%). And a whopping 31% have never considered using it.

But the DCIIA study concluded that, when properly implemented, automatic features can make a positive difference. Contact your benefits specialist to learn how to use both auto-enrollment and auto-escalation clauses to help benefit your employees. □

DOL liberalizes views on economically targeted investments

The U.S. Department of Labor (DOL) has reversed guidance it issued in 2008 with respect to retirement plans' allocating funds to economically targeted investments (ETIs) that consider environmental, social and governance (ESG) factors. It's an about-face for the DOL, and one that plan sponsors should review.

Former guidance

The DOL defines ETIs as "any investment that is selected, in part, for its collateral benefits, apart from the investment return to the employee benefit plan investor." Interpretive Bulletin (IB) 2015-01 is intended to reassure retirement plan trustees that they have some latitude to invest in ETIs (or give plan participants the opportunity to do so) without violating their fiduciary obligations to participants. The DOL restores the position it had maintained since 1994 until changing it in 2008.

The original 1994 guidance stated that nothing in ERISA's fiduciary standards prevented ETIs if their expected rate of return was "commensurate" with that expected from alternative investments with similar risk characteristics. In addition, ETIs had to be appropriate investments for the plan in terms of diversification and the plan's investment policy. The standard was nicknamed the "all things being equal test."

Tougher stance

The 1994 standard was later replaced by IB 2008-1. This guidance clarified that fiduciary consideration of collateral, noneconomic factors in selecting plan investments should be rare. It also reminded sponsors to document their decision in a manner that demonstrated compliance with ERISA's fiduciary standards. This guidance essentially stalled ETI investing by retirement plans.

Looking back, the DOL believes its 2008 interpretation unduly discouraged fiduciaries from considering ETIs and ESG factors. IB 2015-1 goes beyond the "all things being equal" standard of IB 1994-1 for fiduciaries considering ETIs.

According to IB 2015-1, plan fiduciaries should consider all factors that potentially influence risk and return. Such factors include environmental, social and governance issues that may have a direct relationship to the economic value of the plan's investment.

For example, in theory, a public company that has strong governance systems in place, and an active board of directors that doesn't always vote according to the CEO's wishes, might, in the long run, outperform another company with weak governance. According to the DOL, fiduciaries can be open to considering such an argument.

Greener pastures

The same could be true of companies with strong environmental track records. For example, such a company might outperform a competitor with a long history of litigation and penalties for environmental violations because of the hard costs and adverse reputational impacts associated with poor environmental stewardship.

ESG factors can be more than "tie-breakers" when all traditional investment criteria suggest that two possible investments have equal prospects of success. In fact, according to the 2015 guidance, these factors "are proper components of the fiduciary's analysis of the economic merits of competing investment choices."

Similarly, fiduciaries don't have to treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they consider environmental, social or other such factors. At the same time, however, when a fiduciary prudently concludes that an investment is justified based solely on the investment's economic merits, there's no need to evaluate ETI goals as tie-breakers.

Finally, IB 2015-1 essentially annulled IB 2008-1's implication that documentation of the justification for choosing an ETI need be particularly rigorous. Now, the DOL won't construe consideration of ETIs or ESG criteria as requiring additional documentation or evaluation beyond that required by fiduciary standards applicable to plan investments generally.

What now for plan fiduciaries?

Traditionally, the largest economically targeted investment (ETI) investors have been large public pension funds and charitable endowments. This makes sense because of the strong philosophic support for "socially responsible" investing within those communities.

As a practical matter, the U.S. Department of Labor's (DOL's) Interpretive Bulletin (IB) 2015-1 doesn't require plan fiduciaries to do anything new with respect to ETIs. Plans that haven't incorporated ETI options for plan participants, or used investment managers for other plan funds that hold ETIs, have no greater obligation to do so today than before the DOL's guidance.

Plan sponsors should weigh the decision to add ETI-based funds as investment options within a 401(k) plan in light of plan fiduciaries' general views about the merits, or lack thereof, of maximizing the number of participants' investment choices. Plan fiduciaries must decide whether a particular fund or investment satisfies ERISA fiduciary requirements based on all the facts and circumstances of the individual situation.

Looking ahead

With the DOL no longer appearing to frown on ETIs, are they right for your retirement plan? Before you decide, make sure to consult with your benefits specialist and make the decision using the same fiduciary standards as you would for all other investment decisions. □