<u>DOL Issues Significant New Guidance on Plan Expenses</u>

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Establishing and operating an employee benefit plan costs money. A plan's expenses can be paid directly by the employer or they can be paid from the assets of the plan. Although employers typically fund plans and thus indirectly "pay" even when expenses are paid from plan assets, the legal implications of using plan assets to pay expenses are significant and the rules for doing so are strict. The November-December issue of the Legal Report contained an article outlining those rules. Since then, the U.S. Department of Labor ("DOL") has issued significant new guidance on the issue. The DOL guidance comes at a time when many employers, particularly those with overfunded defined benefit plans, are interested in getting the most mileage possible out of the plan's excess assets. In addition, many sponsors of defined contribution plans are determining that the business bottom line requires that they consider shifting some of the costs of maintaining the plan to the plan and its participants. Although we will briefly set out all of the rules applicable to the payment of plan expenses, this article will focus mainly on two of them – (1) the prohibition on the payment of "settlor" expenses, as modified by the new DOL guidance, and (2) the "but for" test, an "old" rule that has caused particular difficulties for employers seeking to expense reimbursements from plan assets.

The Plan Expense Tests

The decision to pay expenses from the assets of a plan is a fiduciary decision subject to the fiduciary rules under ERISA. The plan fiduciary must make the following determinations before causing a plan to purchase goods or services with plan assets:

1. The plan document does not prohibit the payment of the expense.
2. The goods or services (and related expense) are related to the fiduciary's administration of the plan and not to "settlor" decisions.
3. The expenditure is a prudent one and the amount is reasonable.
4. If the "service provider" is a "party in interest" (e.g., a party related to the plan in certain ways), the services arrangement meets the conditions of an ERISA exemption (e.g., the terms of the services arrangement are reasonable).
5. If the services are provided by a plan fiduciary (e.g., the employer), the amount paid to the fiduciary from the plan is limited to the fiduciary's "direct expenses."

The Development of the Distinction between "Fiduciary" and "Settlor" Expenses

In traditional trust law parlance, a "settlor" is the party who designs, establishes and funds a trust, while the "fiduciary" administers the trust in accordance with the terms adopted by the settlor. DOL has adopted this terminology for ERISA plans. Thus, an employer setting the terms of its employee benefit plan is a "settlor," but when the employer administers the plan, it is a "fiduciary." "Settlor" decisions are not subject to ERISA's fiduciary duties. Examples of "settlor" decisions include decisions regarding the establishment, amendment or termination of a plan. DOL has also consistently taken the position that while expenses associated with a fiduciary's administration of a plan may be paid from the assets of the plan, expenses related to "settlor" decisions must be borne by the employer.

Based on this traditional analysis, determining whether an expense was a "fiduciary" or a "settlor" expense was relatively straightforward. However, in 1997, DOL issued Advisory Opinion 97-03 (Jan. 23, 1997) ("1997 Opinion") which appeared to require an additional layer of analysis when determining whether an expense was payable from the plan's assets. The 1997 Opinion appeared to hold that, because an employer benefits from the plan's compliance with the tax qualification rules, the costs of compliance, such as non-discrimination testing, must be allocated between the employer and the plan. Thus, DOL seemed to say that an expense clearly related to the fiduciary's administration of the plan could not be fully charged to the plan because the expenditure also "benefited" the employer. To make matters worse, DOL also said that a plan would need a fiduciary independent of the employer to determine how much of the expense could be charged to the plan.

Many employers were unaware of or ignored the far reaching implications of the 1997 Opinion. However, in 2000, DOL's Kansas City regional office began to rely on the 1997 Opinion to pursue investigations of plans in the midwest. The Kansas City office reportedly challenged all kinds of expenses historically viewed as "fiduciary" simply because they could be said to also "benefit" the employer. These included the cost of "glossy" or non-legally required benefit descriptions, non-discrimination testing, IRS determination letters and outsourcing expenses.

DOL's Issues New Guidance on Inauguration Eve

In response to these activities, and to rumors that other DOL regional offices were likely to take similar positions in enforcement actions, employer groups discussed plan expense issues with DOL's Washington office and with congressional staff. Recognizing the need for further guidance to address the employers concerns, on January 19, 2001, DOL issued Advisory Opinion 01-01A and an analysis of five hypothetical circumstances involving plan expense issues (collectively "the 2001 Guidance"). According to DOL, the 2001 Guidance is intended to both help employers comply with, and help DOL's regional offices enforce, the plan expense rules. In the 2001 Guidance, DOL -

- reaffirmed the traditional principle that fiduciary expenses are eligible for payment from plan assets and settlor expenses are not, and provided a roadmap for identifying each;

- denied that the 1997 Opinion requires a sharing of fiduciary administrative (non-settlor) expenses between the employer and the plan merely because the expenses might benefit the employer as well as the plan;
- recognized that, under U.S. Supreme Court precedent, an employer may receive incidental benefits as a result of offering an employee benefit plan without violating ERISA's fiduciary provisions; and
- apparently retreated from the requirement of an independent fiduciary.

DOL's Hypotheticals Address Specific Types of Expenses

In the hypotheticals addressed in the 2001 Guidance, DOL specifically states that the costs of providing the following services could be viewed as "fiduciary" rather than "settlor" expenses and thus eligible for payment from a plan's assets:

- Mandatory participant disclosures, including the summary plan description and the summary annual report, as well as disclosures required upon request of participants, such as benefit statements and certain plan information;
- "Extra" participant communications that are helpful but not legally required, such as automatic annual benefit statements, annual benefit descriptions, and descriptions of benefit "windows;"
- Benefits estimates, benefit calculations, and actuarial and other calculations necessary to implement a spin-off or merger decision;
- Maintenance of the tax qualification of the current plan of benefits, including non-discrimination testing, and application for an IRS determination letter;
- Drafting of plan amendments to maintain the tax qualified status of the plan or to comply with other applicable federal law, such as ERISA; and
- Third party administration expenses, including "start up" and ongoing expenses.

In addition, although not specifically mentioned in the 2001 Guidance, many other expenses may be eligible for plan payment based on the principles articulated there. These include the costs of governmental reporting (e.g., Form 5500), enrollment and claims processing, plan and participant recordkeeping (including audited financials), and investment management.

DOL has indicated in its 2001 Guidance that the following expenses are "settlor" expenses that may not be paid from the assets of the plan –

- Plan design studies or calculations made in advance of the establishment or amendment of the plan, such as studies of the feasibility of a retirement window or a plan merger;
- Drafting discretionary plan amendments;
- Determination of FASB 87, 88, 106 and 112 liabilities and expenses for the employer's financial accounting; and
- Conducting union negotiations in advance of a plan amendment.

Drafting Plan Documents and Amendments

Prior to DOL's issuance of the 1997 Opinion, many employers permitted their plans to pay lawyers or consultants for drafting amendments to the plan documents, regardless of the substance of the amendment or the reason for its adoption. The 1997 Opinion confused matters in that DOL asserted that the cost of some amendments had to be allocated between the plan and the employer.

The 2001 Guidance clarifies DOL's position on the payment from plan assets of the costs of drafting amendments. According to DOL -

- a plan may pay drafting costs for any "legally required" amendment;
- a plan may pay for the cost of drafting an amendment even if the employer had discretion is choosing among several options for amending, so long as some amendment was "legally required;"
- the employer must pay for drafting all "discretionary" amendments; and
- a plan may not pay for drafting an amendment that permits the plan to pay plan expenses where the employer was previously required to pay those expenses.

In one respect, the 2001 Guidance is positive. DOL would permit a plan to pay the full cost of "legally required" amendments, without requiring that these costs be allocated between employer and plan based on the relative "benefits" to each. On the other hand, because it permits no portion of "discretionary" amendment costs to be paid from plan assets, DOL has effectively required that employers pay for most amendments. In today's regulatory climate, most amendments being considered by employers would be classified as "discretionary" and not legally required. These days, the IRS is liberalizing existing qualification rules rather than adding new mandatory ones. For example, many employers are implementing the GUST amendments, which are a set of amendments that generally allow the plan to track recent changes in the tax laws. While many of the GUST amendments, such as the adoption of GATT interest and mortality assumptions, are required and therefore are payable by the plan, other amendments are optional, such as the change in the cashout maximum from $3,500 to $5,000. Under the 2001 Guidance, changes the employer is not required to make, although clearly related to a qualification requirement, are not payable by the plan. Thus, under the 2001 Guidance, employers will have to determine which plan amendments are mandatory and which are discretionary, and allocate costs accordingly.

Participant Communication Expenses

In the last year or two, DOL regional offices have taken aggressive positions suggesting that the use of plan assets to pay for sophisticated or optional participant communications was problematic or that the cost of certain types of plan communications had to be shared between the plan and the employer based on the extent to which each benefited from the communication (e.g., "glossy" benefit statements or SPDs).

In the 2001 guidance, DOL rejected this miserly approach and instead endeavored to encourage all forms of plan communications. It specifically acknowledged that communicating plan information to plan participants is "an important plan activity" and set out the following principles for determining when the cost of these communications is properly payable from the plan's assets –

- The plan can clearly pay for all legally mandated disclosure (e.g., SPD, SARs);

- If prudent, the fiduciary may cause the plan to pay for communications in addition to those legally required;

- The fact that a communication relating to the plan also incidentally benefits the employer does not preclude the plan's payment of the expense;

- The plan fiduciary will be given "substantial latitude" is determining the "method, form and style" of the communications provided to participants;

- The fiduciary's decisions as to the type of communication should be carefully justified and documented and the costs appropriately allocated as necessary (e.g., if a plan communication relates to more than one plan or includes non-plan information).

DOL provided the following useful example. An employer annually prepares and distributes benefits booklets. The booklets include information on benefits provided under several ERISA plans as well as a few pages of non-plan information (e.g., a description of the employer's fitness center and picnic). Even though a plan is not required by ERISA to provide annual booklets to participants, DOL concluded that plan could pay for the booklets nonetheless, but it noted that the cost attributable to the non-plan information could not be paid for by the plan and that the balance must be allocated between the various ERISA plans covered by the document. Significantly, DOL did not suggest that an independent fiduciary was needed to perform the allocation.

In another example provided by DOL, an employer added an early retirement window to its pension plan for the purpose of obtaining a reduction in its workforce. The plan fiduciary communicated the components of the window to the plan's participants for their consideration.

DOL concluded that the cost of the communications could be a reasonable expense of the plan even though the communications might be viewed as furthering the objective of the employer to induce employees to opt for early retirement.

Expenses of Outsourcing of Plan Administration

Prior to the issuance of the 2001 Guidance, one of DOL's regional office had reportedly challenged a plan's payment of the expenses associated with outsourcing plan administration, arguing that the decision to outsource benefited the employer. This created much concern in the employer community as many employers who historically performed day-to-day administration in house (at no cost to the plan) have considered transferring those responsibilities to third party providers. Fortunately, in the 2001 Guidance, DOL specifically confirmed that a plan that is administered "in house" need not always be administered that way. An employer that has borne some or all of the costs of its plan's administration may prospectively shift those costs to the plan, so long as the plan document does not prohibit it from doing so. As to outsourcing in particular, DOL noted that a plan could pay both the start-up fees and the ongoing administrative fees charged by a third party provider where the fees paid for services necessary to administer the plan.

Other "Plan Expense" Tests Must Be Considered

The 2001 Guidance provides much needed help to employers who must decide whether an expense is a "settlor" or "fiduciary" expense. It provides a clear roadmap for resolving this question. However, the "plan expense" analysis does not stop with the characterization of an expense as a "fiduciary" expense. As summarized at the beginning of this article, before plan assets may be used to pay "fiduciary" expenses, several other tests may be applicable as well.

We review one of those tests - the “but for” test - in greater detail here because it is has historically been misunderstood by many employers.

The “but for” test is applicable where an employer decides to use its own employees and resources to perform administrative services for the plan. If the employer seeks to be reimbursed by the plan for the cost of performing these services, such as employee salaries, it must meet a strict test articulated in DOL regulations. This is because, although it may seem automatic, deciding that the employer will perform administrative services for a plan and how much the plan will pay for those services is a fiduciary decision. When the employer makes this decision, it is subject to conflict of interest rules that prohibit a fiduciary (e.g., a employer) from “choosing itself” to provide services to the plan unless the amount paid by the plan for those services is no more than the fiduciary’s “direct expenses.” Thus, if an employer acting as fiduciary decides to provide services to its plan, its ability to be reimbursed for the cost of those services will be limited to its “direct expenses.”

Some employers mistakenly believe that the “direct expense” of providing a plan service is, in all cases, equal to the employer’s out-of-pocket cost in providing that service. For example, if an HR specialist devotes 20% of her time to processing pension claims, some employers charge 20% of her compensation to the plan without further inquiry. Unfortunately, DOL regulations under ERISA § 408(c)(2) and later advisory opinions make it clear that this common sense approach is incorrect, or at the least, incomplete. In addition to identifying the compensation attributable to time spent on plan business by its employee, the employer must also satisfy the ‘but for” test. That is, it must be able to conclude that it would not have incurred the compensation expense had it not provided the services to the plan. To do this, the employer might reason that it would either eliminate the employee's position entirely or reduce the employee's compensation if the employer decided not to provide services to the plan.

Going back to our example in which the HR specialist spends 20% of her time on plan business and 80% on non-plan personnel matters, the employer must ask itself whether the specialist's job would be eliminated or her salary reduced if she were not required to perform the plan services. Where an employee spends a relatively small portion of her time on plan work, this may be difficult to demonstrate. In many such cases it is likely that if the plan work were outsourced, the employer would continue to pay the specialist the same salary and her non-plan duties would simply expand to fill up her time.

If the HR specialist instead spent 80% of her time on plan administration, the employer might more easily conclude that it would eliminate the specialist's position if the plan duties were outsourced (reassigning the 20% non-plan work to others). If the employer could come to this factual conclusion, it could charge 80% of the specialist's compensation to the plan. Obviously, where the specialist is "dedicated" to plan administration (e.g., devotes 100% of her time), the "but for" test is much easier to satisfy.

It is very important to keep in mind that there is no percentage of time spent on plan work that allows the employer to avoid answering the "but for" test. In every case, whether the percentage of time spent on plan work is 10% or 100%, the employer must be able to affirmatively conclude that it would not have incurred the compensation expense if the employer were not performing services for the plan. In addition, to support the expenses charged to the plan, it is very important to record the time spent on plan business on a relatively contemporaneous basis and document the "but for" analysis.

Where an employer provides in house administrative services to multiple plans or assigns multiple employees to plan work, it should be possible to apply the "but for" test on an **aggregate** basis. For example, if four employees in the HR department each spend 25% of their time on administering the plan, the employer might reasonably conclude that, if the plan work were outsourced, it could consolidate these positions and eliminate one of them. (Again, whether is true is this is a factual question for the employer and will depend on its particular circumstances.). Similarly, in Advisory Opinion 86-001A (Jan. 2, 1986), DOL indicated that multiple plans can be aggregated for purposes of the "but for" test. Thus, if an employee spends 60% of his time processing claims for the employer's defined benefit plan and 40% processing 401(k) plan loans, the employer might reasonably conclude that "but for" the provision of services to the two plans in the aggregate, the employee's job would be eliminated. In that case, the employee's entire compensation would be allocated between the two plans on some reasonable basis.

Conclusion

In many respects, the 2001 Guidance was a relief to employers who had been confused and concerned as a result of DOL's 1997 Opinion and the 2000 enforcement efforts. The 2001 Guidance provides a framework for the identification of appropriate "fiduciary" expenses, rejecting the requirement that administrative expenses that benefit the employer as well as the plan must be "allocated" according to the relative benefits afforded to each. While DOL's position on discretionary plan amendments is disappointing, the Guidance provides certainty in many respects and therefore reduces risk for employers trying to identify the types of expenses payable from plan assets. Now that the confusion as to "settlor" vs. "fiduciary" expenses has been diffused, employers should take care to consider all of the tests applicable to the payment of expenses from plan assets, including the "but for" test where in house services are provided.