Paying Employee Benefit Plan Expenses

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This Note describes the types of expenses that may and may not be paid from the assets of an employee benefit plan. It also explains the requirements that must be met before expenses can be paid from plan assets, the methods for allocating expenses between plans and among plan participants and the consequences of paying improper expenses from plan assets.

Establishing and operating an employee benefit plan costs money. The expenses of administering a plan may be paid directly by the plan sponsor or, if certain rules are observed, they may be paid from the assets of the plan. However, the legal implications of using plan assets to pay expenses are significant and the rules for doing so are strict.

For various reasons, some employers are interested in providing for plan expenses as well as benefits from the assets of a plan. Also, some sponsors of defined contribution plans find that the business bottom line requires that they consider shifting some of the costs of administering the plan to the plan and its participants.

This Note explains:

- The types of expenses that may and may not be paid from plan assets.
- The requirements that must be met before expenses can be paid from plan assets.
- Methods for allocating expenses between plans and among plan participants.
- The consequences of improperly paying expenses from plan assets.

For a useful chart that outlines expenses that may and may not be paid from plan assets, see *Paying Employee Benefit Plan Expenses Chart (http://us.practicallaw.com/0-503-5315)*.

PLAN EXPENSES TEST

The assets of a plan subject to the Employee Retirement Income Security Act of 1974 (ERISA) may be used for two purposes:

- To pay benefits to participants and beneficiaries.
- To pay the reasonable expenses of administering the plan.

The decision to pay expenses from plan assets is a fiduciary decision subject to the fiduciary duty rules of ERISA (see *Practice Note, ERISA Fiduciary Duties: Overview (http://us.practicallaw.com/5-504-0060)*). The plan fiduciary must make the following determinations before using plan assets to pay the costs of services provided to the plan:

- The plan document permits (or does not prohibit) the payment of the expense (see *Plan Documents*).
- The goods, services and associated expenses relate to fiduciary and not to settlor decisions (see *Distinction Between Fiduciary and Settlor Activities and Expenses*).
- The expenditure is prudent and the amount is reasonable (see *Reasonableness of Expense*).

If the service is provided by a party related to the plan (known in ERISA as a party in interest), the services arrangement must meet the conditions of an ERISA prohibited transaction exemption (see *Services Provided by a Party in Interest*). In addition, if the services are provided by the plan fiduciary responsible for selecting the service provider (for example, the employer), the amount paid to the fiduciary from the plan must be limited to the fiduciary's direct expenses (see *Services Provided by a Plan Fiduciary*).

Plan Documents

The plan document should specify whether expenses may be paid from plan assets. If the plan document is silent regarding the payment of administrative expenses, these expenses may be paid from the plan's assets. However, if the plan document provides that the employer must pay the plan's expenses, the plan's assets may not be used to pay these expenses because it would involve an impermissible use of plan assets to satisfy the employer's obligation. If the plan document contains this type of requirement, all is not lost. As long as the plan document reserves to the employer the right to amend the plan, the employer may adopt an amendment prospectively permitting expenses to be paid from the assets of the plan. A typical plan provision provides that the expenses of the plan shall be paid from the plan assets unless paid by the employer and that the employer may advance expenses and benefits on the plan's behalf and be reimbursed from the plan's assets for those advances. If there is a chance that the employer advances will not be reimbursed within 60 days, a written, no-interest loan agreement is required between the employer and the plan.

In an individual account plan, such as a 401(k) or other defined contribution plan, the plan documents may also set out the method for allocating expenses paid by the plan to participants' accounts. If the allocation method is described in the plan, it is considered a settlor decision and the fiduciaries must follow it (see *Distinction Between Fiduciary and Settlor Activities and Expenses*). However, if the plan is silent or ambiguous, the fiduciaries must select a reasonable allocation method (see *Allocating Expenses Among Participant Accounts in a Defined Contribution Plan*).

Distinction Between Fiduciary and Settlor Activities and Expenses

ERISA does not require an employer to establish an employee benefit plan and generally does not dictate the design of the benefits provided by the plan. Therefore, subject to certain legal requirements, plan sponsors can establish, amend or terminate a plan as they wish. These types of activities are called settlor functions.

While the settlor establishes and designs the plan, the plan's fiduciary administers the plan according to its terms and the requirements of the law. ERISA contemplates that employers can play both roles. Therefore, when an employer chooses the terms of its employee benefit plan, it is acting as a settlor, but when it administers the plan, it is acting as a fiduciary.

The settlor decisions that an employer makes are not subject to ERISA's fiduciary standards (see *Practice Note, ERISA Fiduciary Duties: Overview (http://us.practicallaw.com/5-504-0060)*) and expenses associated with those settlor activities cannot be paid from plan assets. Instead, settlor expenses must be paid by the employer.

Settlor Expenses Not Eligible for Payment from Plan Assets

Settlor functions include decisions regarding the establishment, amendment or termination of a plan. Examples of settlor expenses that may *not* be paid from plan assets include expenses relating to:

- Plan design studies or calculations made before establishing or amending a plan, such as the feasibility of a retirement window or plan merger.
- Drafting discretionary plan amendments (see *Drafting Plan Documents and Amendments*).
- Determination of liabilities and expenses under Financial Accounting Standards Board (FASB) ASC 715 (previously FASB Statements 87, 88, 106 and 112) for the employer's financial accounting.
- Conducting union negotiations before a plan amendment.

If the expenses related to an activity are paid by the plan, the fiduciary cannot later argue that the activity was a settlor function not subject to fiduciary standards. Also, if legal expenses are paid from the assets, it will be difficult for the recipient of the advice to argue that the advice was not received in its fiduciary capacity, which could affect the extent to which that advice may be protected as attorney-client privileged communication.

Expenses Eligible for Payment from Plan Assets

Examples of expenses that are generally eligible for payment from plan assets include:

- Mandatory participant disclosures, including the summary plan description (SPD), summary of material modifications (SMM), summary annual report (SAR), required benefit statements and disclosures required on request of participants (see *Participant Communication Expenses*).
- Extra participant communications that are helpful but not legally required, such as descriptions of benefit windows.
- Benefit estimates, benefit calculations and actuarial and other calculations necessary to implement a plan spin-off or merger decision.
- Compliance costs for maintaining the tax-qualified status of a plan, including nondiscrimination testing and applying for an IRS determination letter (see *Practice Note, Applying for an IRS Determination Letter (http://us.practicallaw.com/9-501-4610)*).
- Drafting of plan amendments necessary to maintain the tax-qualified status of the plan or to comply with other applicable federal law such as ERISA (see *Drafting Plan Documents and Amendments*).
- Third-party administration expenses, including start-up and ongoing expenses if the fees are paid for services necessary to administer the plan.
- PBGC premiums.
- ERISA bond (see *Practice Note, ERISA Bonding Requirements (http://us.practicallaw.com/9-503-3454)*).
- Fiduciary liability insurance for the fiduciaries or the plan only if the policy permits recourse by the insurer against the fiduciary in cases of a loss owing to breach of fiduciary obligations.
- Expenses relating to implementing a plan termination such as:
  - a plan audit;
  - legally mandated annual reports;
  - required benefit statements and disclosures;
  - calculation of benefits; and
  - participant communications, including participant benefit statements in connection with termination.

Other expenses that may also be eligible for payment from plan assets include:

- Governmental reporting (such as Form 5500).
- Enrollment and claims processing.
- Plan and participant recordkeeping (including preparation of audited financial statements).
- Investment management, consulting and advice.

Drafting Plan Documents and Amendments

The legal and other costs associated with amending a plan document can be significant. In evaluating whether these costs may be paid from a plan's assets, the Department of Labor (DOL) distinguishes between mandatory and discretionary amendments.

To determine which plan amendments are mandatory and which are discretionary (and allocate costs accordingly), fiduciaries should consider the following:

- A plan may pay the drafting costs for any legally required amendment.
- A plan may pay the costs of drafting an amendment even if the employer had discretion in choosing among several options for amending, as long as some amendment was legally required.
- The employer generally must pay for drafting all discretionary amendments, including amendments that relieve the employer of the obligation to pay plan expenses.

In practice, it is likely that most plan amendments would be considered discretionary amendments, the cost of which cannot be paid from the plan under the DOL's guidance. However, though it is unclear that the DOL would agree, some plan fiduciaries take the position that drafting any amendment involves the fiduciary implementation of a settlor decision, and the related costs are properly payable by the plan.

Participant Communication Expenses

Communicating plan information to plan participants is an important plan activity. When determining whether the cost of the communications is properly payable from plan assets, consider the following principles:

- The plan may pay for all legally mandated disclosures (such as the SPD, SMM and SAR).
- A plan fiduciary may determine that it is in the best interests of the plan's participants to provide communications in addition to those that are legally required.
- Even if a communication relating to the plan also incidentally benefits the employer, the associated expense may still be paid by the plan.
- A plan fiduciary has substantial latitude to determine the method, form and style of the communications provided to participants. However, the fiduciary's decisions should be carefully justified and documented, and the costs appropriately allocated as necessary (for example, if a plan communication relates to more than one plan or includes non-plan information).

For examples, see *Box, Examples of Participant Communication Expenses*.

Reasonableness of Expense

The amount of an expense paid from plan assets must be reasonable in light of the services provided to the plan. The plan fiduciary must understand all of the direct or indirect compensation the service provider will receive in connection with the plan services (see *Practice Note, Service Provider Disclosure Requirements for Pension Plans (http://us.practicallaw.com/7-508-2407)*). Furthermore, the plan fiduciary must thoroughly understand the services that will be provided. When selecting a service provider, the plan fiduciary should also understand how the proposed fees and services compare to others available in the marketplace.

SERVICES PROVIDED BY A PARTY IN INTEREST

Any ongoing arrangement for services to a plan should satisfy the requirements under the "reasonable services" exemption to the prohibited transaction rules. This is because any provider of services to the plan is considered a party in interest as soon as it begins providing services. These requirements include:

- The service must be necessary for the operation of the plan.
- The service must be furnished under a contract or an arrangement that is reasonable (see *Practice Note, Service Provider Disclosure Requirements for Pension Plans (http://us.practicallaw.com/7-508-2407)*).
- The plan may pay no more than reasonable compensation for the service.

If these requirements are not met, the service arrangement will be a prohibited transaction and the fiduciary will be liable for violation of fiduciary duty (see *Practice Note, ERISA Fiduciary Duties: Overview: Avoiding Prohibited Transactions (http://us.practicallaw.com/5-504-0060)*).

A service is considered necessary for the plan's operation if it is appropriate and helpful in carrying out the purposes for which the plan is established or maintained.

The requirements for services provided by a party in interest must be reviewed each time the service provider is scheduled to be rehired to perform the same or additional services for the plan.

If the services are provided by the employer sponsoring the plan (or other fiduciary responsible for selecting the service provider), an additional requirement applies (see *Services Provided by a Plan Fiduciary*).

SERVICES PROVIDED BY A PLAN FIDUCIARY

A fiduciary, such as the employer, may decide to provide administrative services to its plan. However, that fiduciary will have a conflict of interest if it wishes to be paid for those services from the assets of the plan. In short, a fiduciary may not choose itself (or an affiliate) to provide services to the plan for a fee unless an exemption to the prohibited transaction rules is met (see *Practice Note, ERISA Fiduciary Duties: Overview: Avoiding Prohibited Transactions (http://us.practicallaw.com/5-504-0060)*). However, the fiduciary may be reimbursed by the plan for the fiduciary's direct expense in providing the service (*ERISA § 408(c)(2)*).

Direct expenses do not include:

- Any expense that the employer would have incurred even if the employer had not provided the service to the plan.
- Overhead 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, such as a percentage of the salary of an employee who works on plan matters. Unfortunately, the DOL has made clear that this common sense approach is incorrect, or at the least, incomplete. In addition to identifying the percentage of time an employee spends on plan business (and the compensation allocable to that time), the employer must also ensure that the "but for" test is satisfied. The employer must be able to conclude that it would not have incurred the employee's compensation expenses if the employer did not provide 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.

Where an employee spends a relatively small portion of her time on plan work, this may be difficult to demonstrate. In many of these cases, it is likely that if the plan work were outsourced, the employer would continue to employ the employee and pay the employee the same salary and her non-plan duties would simply expand to fill up her time. Obviously, where the employee is dedicated to plan work (for example, devotes 100% of her time), the "but for" test is much easier to satisfy. Employers should 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 (through its employees) were not performing services for the plan.

In addition, to support the expenses charged to the plan, it is important to record the time spent on plan business on a relatively contemporaneous basis and document the "but for" analysis. For two examples, see *Box, Analysis of Employees' Time Spent Providing Services to Employer Plans.*

ALLOCATING EXPENSES

Allocating Expenses Among Plans

Where an employer maintains more than one plan and hires a service provider to provide services to all of the employer's plans, each plan must pay only those expenses properly incurred by it and may not pay expenses properly allocable to another plan, even if maintained by the same employer.

Allocating Expenses Among Participant Accounts in a Defined Contribution Plan

The method for allocating expenses among participants in a defined contribution plan can be set out in the plan document. However, if the plan is silent on how expenses should be allocated, the plan fiduciary must prudently select a method consistent with its general fiduciary duties. A fiduciary has considerable discretion to determine how to allocate plan expenses among participant accounts. However, a fiduciary must weigh the competing interests of various classes of plan participants and the effects of the various allocation methods on those interests. A method of allocation can favor one class of participants over another, if the fiduciary has a reasonable basis for choosing the allocation method. In addition, different types of expenses can be allocated using different methods.

Plan fiduciaries use several common methods of allocation:

- **Pro rata method.** The pro rata method allocates a portion of plan expenses to each individual account based on the amount of assets in each account. This method may be reasonable where fees or charges to the plan are determined on the basis of account balances (for example, investment management fees).
- **Per capita method.** This method charges expenses equally to each account without regard to the assets in each individual account. This may be a reasonable method of allocating certain fixed administrative expenses of the plan (such as record keeping, legal, auditing, annual reporting and claims processing expenses).
- **Individual account assessments.** Under this method, certain expenses may be properly chargeable to the account of the individual participant for whom the expense was incurred. These include fees associated with:
  - the participant's hardship withdrawals;
  - the participant's benefit distribution (such as check writing fees);
  - a qualified domestic relations order or qualified medical child support order determination requested by the participant (see *Practice Note, Qualified Domestic Relations Orders: Overview (http://us.practicallaw.com/0-501-1197)* and *Standard Document, Procedures for Identifying Qualified Medical Child Support Orders (http://us.practicallaw.com/2-502-1850)*);
  - loan processing; and
  - locating the participant.

DISCLOSURE OF PLAN EXPENSES

The SPD must include a summary of any fees or charges that a participant or beneficiary must pay to receive benefits (*DOL Reg. § 2520.102-3(l)*; see *SPD Compliance Chart for ERISA Plans (http://us.practicallaw.com/8-506-0985)*).

There are additional disclosure requirements under DOL regulations that apply to participant-directed plans. The regulations require plan sponsors and service providers to develop and issue documents disclosing fees and investment-related information to eligible employees, participants and beneficiaries. The information may be provided through an SPD so long as the initial disclosure and required update timing requirements and comparative format requirement under the regulations are satisfied (see *Practice Note, Disclosure Requirements for Participant-Directed Defined Contribution Plans (http://us.practicallaw.com/7-506-5295)*).

CONSEQUENCES OF USING PLAN ASSETS TO PAY IMPROPER EXPENSES

Using the plan's assets to pay expenses that the plan is not permitted to pay can have serious consequences for the plan and the fiduciary causing the payment:

- The fiduciary would be exposed to liability for breach of the fiduciary duties of prudence and loyalty (see *Practice Note, ERISA Fiduciary Duties: Overview: Duty of Prudence (http://us.practicallaw.com/5-504-0060)* and *Duty of Loyalty (http://us.practicallaw.com/5-504-0060)*).
- The fiduciary or service provider, or both, could be exposed to liability under ERISA for engaging in a prohibited transaction and, in the case of a qualified plan, could be subject to an excise tax under the IRC (see *Practice Note, Prohibited Transactions and Exemptions under ERISA and the IRC (http://us.practicallaw.com/9-526-8386)*).
- The payment might violate the IRC's exclusive benefit requirement possibly resulting in plan disqualification (see *Practice Note, ERISA Fiduciary Duties: Overview: Duty of Loyalty (http://us.practicallaw.com/5-504-0060)*).

Examples of Participant Communication Expenses

EXAMPLE 1

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 (such as a description of the employer's fitness center and picnic). Even though a plan is not required under ERISA to provide annual benefits booklets to participants, the plans may pay for the booklets but the cost attributable to the non-plan information must be paid by the employer. The cost associated with the plan-related information must be allocated among the various plans covered by the document.

EXAMPLE 2

An employer added an early retirement window to its employee pension benefit plan to obtain a reduction in its workforce. The plan fiduciary communicated the components of the window to the participants for their consideration. The cost of the communications is a reasonable expense of the plan even though the communications furthered the objective of the employer to induce employees to opt for early retirement.

Analysis of Employees' Time Spent Providing Services to Employer Plans

EXAMPLE 1

An HR specialist devotes 20% of her time to processing pension claims and 80% on non-pension related personnel matters. Her employer cannot simply charge 20% of her compensation to the plan without further inquiry. Instead, the employer must determine whether it would have incurred the compensation expense "but for" providing services to the plan. The employer must decide 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 cases, 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.

EXAMPLE 2

An HR specialist devotes 80% of his time on plan administration and 20% on personnel matters. In this case, the employer might more easily conclude that it would eliminate the specialist's position if plan duties were outsourced because the 20% non-plan work could be assigned to others. If the employer could come to this conclusion, it could charge 80% of the specialist's compensation to the plan.

For more information, search for the following resources on our website.

Practice Note: Overview

- Employee Benefits Law: Overview (http://us.practicallaw.com/9-506-5906)
- ERISA Fiduciary Duties: Overview (http://us.practicallaw.com/5-504-0060)
- Qualified Domestic Relations Orders: Overview (http://us.practicallaw.com/0-501-1197)
- Retirement Plan Determination Letters Toolkit (http://us.practicallaw.com/7-501-3923)

Practice Notes

- ERISA Bonding Requirements (http://us.practicallaw.com/9-503-3454)
- Insurance for ERISA Fiduciaries (http://us.practicallaw.com/2-517-5994)
- Negotiating ERISA Service Provider Agreements (http://us.practicallaw.com/8-517-8904)
- Prohibited Transactions and Exemptions under ERISA and the IRC (http://us.practicallaw.com/9-526-8386)
- Service Provider Disclosure Requirements for Pension Plans (http://us.practicallaw.com/7-508-2407)
- Voluntary Fiduciary Correction Program (VFCP) (http://us.practicallaw.com/4-523-2663)

Standard Document

- Procedures for Identifying a Qualified Domestic Relations Order (http://us.practicallaw.com/3-501-1855)

Checklists

- Drafting Qualified Retirement Plans Checklist (http://us.practicallaw.com/7-518-1879)
- Paying Employee Benefit Plan Expenses Chart (http://us.practicallaw.com/0-503-5315)
- SPD Compliance Chart for ERISA Plans (http://us.practicallaw.com/8-506-0985)
- Suggested Agenda Items for Plan Investment and Administration Committee Meetings Checklist (http://us.practicallaw.com/5-503-0457)

For the links to the documents referenced in this note, please visit our online version at http://us.practicallaw.com/4-504-8434