BENEFIT BYLINES

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REGULATORY UPDATE

2015 and the beginning of 2016 have been quiet with respect to Federal pension legislation. While there have been on-going discussions regarding so-called “pension reform” at the committee level in both the House and Senate, the political gridlock in Washington has created an environment where nothing moves forward. In contrast, there has been significant activity on the regulatory front. The IRS and DOL have issued proposals that could significantly impact employers, individual investors, and the financial services industry. Further, an increasing number of states are looking into and, in some instances implementing, state-sponsored IRA and retirement/savings programs that compete against private sector arrangements. Clearly, regulatory initiatives are a necessary by-product of federal law. Many of them can be quite helpful (see article beginning on next page discussing positive developments for sponsors of safe harbor contribution plans). What is significant and perhaps disconcerting is the degree to which regulatory initiatives have replaced legislative actions and the extent to which some of these initiatives could change the way IRAs and employer-sponsored retirement plans are designed, administered, and marketed. Further, soon-to-be-finalized regulations from the DOL are likely to change the way investment providers and advisors interact with their clients.

This issue of Benefit Bylines is devoted exclusively to highlighting these initiatives. However, please keep in mind that a comprehensive discussion of any specific proposal is beyond the scope of this newsletter.

Background/Perspective

Historically, Congress has passed legislation impacting private retirement plans almost every year. Not surprisingly, some changes have been received positively by plan sponsors and industry professionals whereas others have not. Under ERISA, the IRS, Department of Labor (DOL) and the Pension Benefit Guaranty Corporation (PBGC) are the three primary Federal agencies tasked with interpreting pension law and providing guidance to plan sponsors and participants. This is accomplished primarily through the issuance of regulations, interpretive bulletins and notices. Many of the rules associated with retirement plans originate with Federal tax legislation which are interpreted and enforced by the IRS. This makes sense given the substantial impact that tax-deferred contributions made by individuals and businesses to retirement accounts have on revenues received by the Federal government. Pursuant to ERISA, the primary focus of the DOL is to protect overall employee benefit rights, and the primary focus of the PBGC is to protect the benefits due to defined benefit plan participants through a quasi-governmental insurance program. The system that is in place is cumbersome and anything but perfect. Nonetheless, despite being voluntary, the private retirement system has performed pretty well since the passage of ERISA in 1974. This is evidenced by the fact that approximately 70% to 85% of full-time workers nationwide are covered by some type of tax favored retirement/ savings plan and that assets held in private retirement plans exceed $18 trillion.*

* As of year-end 2011. Source: Board of Governors of the Federal Reserve System 4th quarter 2013 reporting. ▪

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DOL FIDUCIARY/CONFLICT OF INTEREST PROPOSAL STIRS CONTROVERSY

The Office of Management and Budget (OMB) is in the process of reviewing rules proposed by the DOL that would result in sweeping changes in the way IRAs and employer-sponsored retirement plans subject to ERISA are sold and serviced. The proposed rules change the definition of "investment fiduciary" and impose strict rules intended to avoid conflicts of interest on the part of investment brokers and advisors. It is anticipated that the "final" rule will be issued within weeks, if not days.

The DOL first took up this issue more than 5 years ago with a stated objective to ensure that financial professionals and institutions serve the best interests of their customers. While there is widespread agreement as to the merits of this goal, there continues to be substantial pushback from the investment industry, members of Congress, and other parties with respect to the approach the DOL has taken, as set forth in 500 pages of proposed regulations.

Republicans in Congress, including House Speaker Paul Ryan, as well as a handful of Democrats, have expressed strong opposition to the new regulations. Opponents argue that they are too complex, enormously expensive to implement, and counter-productive to the interests of investors. They further maintain that the costs incurred to comply with the regulations far outweigh the benefits and the intended beneficiaries of the fiduciary proposals, i.e. small investors, will suffer because it will no longer be profitable to service small accounts. The DOL has stated publicly that the final regulation will address some of the concerns expressed in the numerous comments it has received. However, the investment industry is anticipating that the final regulation will include most of the strict fiduciary standards and compliance challenges set forth in earlier proposals.

Not surprisingly, this has become a political issue in this election year. With encouragement from the Obama Administration, the DOL expedited its delivery of the latest revised fiduciary regulation to the OMB on January 28, 2016. This was a critical date because the OMB has up to 90 days to conduct its review. Then, pursuant to the Congressional Review Act of 1996, Congress has 60 legislative days to reject regulations it dislikes. If Congress rejects the regulation, President Obama can and would veto that action. However, if the 60-day congressional review period extends beyond Obama's term of office, the next President (if he were a Republican) would likely not issue a veto.

Observation

If you are an ABP retirement plan client, you may not have previously been aware of the DOL's fiduciary advice/conflict of interest proposals. However, you will almost certainly be hearing more about them in coming days and weeks after regulations are finalized by the DOL and further debated by Congress. If you are a broker or financial advisor, it is likely that you are anxious to learn about the final regulations so that you can develop appropriate strategies to comply with them while representing the best interests of your clients.▪

IRS GRANTS ADDITIONAL FLEXIBILITY TO SPONSORS OF SAFE HARBOR PLANS

On January 29, 2016, the IRS issued Notice 2016-16. This notice provides welcome flexibility for employers who sponsor 401(k) plans with safe harbor contribution provisions.

Background

A substantial number of ABP's 401(k) plan clients have elected to include a safe harbor contribution provision in their plans. By committing in advance of each plan year to make either a safe harbor matching or non-elective contribution, the employer "buys" a pass on the required, and possibly very problematic, ADP/ACP nondiscrimination testing for the year. This enables owners and highly-compensated employees to maximize their elective deferral contributions for the year, irrespective of how much, or usually how little, non-highly compensated employees elect to contribute. An employer's safe harbor contribution election is also a good deal for non-highly compensated employees because it often results in them receiving a higher rate of employer contributions than they would likely qualify for in a non-safe harbor plan.

The Problem

Historically, the IRS has taken the informal position that employers who make safe harbor elections are prohibited from implementing mid-year changes/amendments to their plans except under very limited circumstances. The formal guidance provided by the IRS includes only a small list of examples of mid-year changes that can be made to safe harbor plans. However, there are many other reasons for employers to make mid-year changes that are not on the IRS list that have nothing to do with the safe harbor election. For example, amending the plan mid-year to add an age 59 1/2 in-service withdrawal provision has no impact on the employer's safe harbor election. Nonetheless, when questioned at industry conferences, IRS officials have unofficially and informally warned the audiences that mid-year amendments of this nature are likely not permissible. Many industry practitioners, including ABP, have encouraged plan sponsors to apply a common-sense approach when considering mid-year amendments addressing plan provisions that are un-related to safe harbor provisions. However, the stance taken by the IRS has unnecessarily put sponsors and their advisors in uncomfortable situations where there has been the opportunity or need for mid-year amendments for reasons not specifically included in the IRS "short-list".

IRS Relief

After considerable lobbying by ASPPA and other organizations representing small businesses, the IRS finally provided relief this past January. Notice 2016-16 expands the number of circumstances under which mid-year plan amendments can be made by employers who sponsor safe harbor plans. It accomplishes this by replacing the short list of permissible mid-year changes with a short list of prohibited changes. To the IRS' credit, the list of circumstances under which mid-year changes are prohibited under the latest guidance passes a test of reasonableness by reason of having a direct or indirect relationship to the employer's safe harbor election for the year.

Final Note

Many plan sponsors operate their plans for years without the need to make mid-year amendments. However, the change in position set forth in IRS Notice 2016-16 provides welcome flexibility for employers who make safe harbor contribution elections if mid-year changes to their plans are appropriate. Please contact a member of ABP's professional staff if you or a client is contemplating a mid-year change for a safe harbor plan. We would be happy to help you determine if that type of change being considered is permitted and to guide you through the amendment process. ▪

DOL GUIDANCE FAVORS STATE-RUN RETIREMENT PLANS OVER PRIVATE SECTOR ARRANGEMENTS

The Winter 2016 edition of Benefit Bylines included separate articles discussing initiatives being made by both the Federal Government and a number of states that compete against IRAs and traditional retirement plans historically marketed through the private sector.

The new, federally-sponsored myRA program is intended to encourage individuals who are not participating in an employer-sponsored retirement plan to begin saving through an after-tax Roth type of IRA account. According to governmental officials, myRAs do not really compete against the private sector because the individuals to whom they are being marketed (first time savers with small accounts) cannot be serviced profitably by financial institutions and advisors. This argument does, in fact, have merit. However, what is disturbing is that an increasing number of states have established or are looking to establish their own payroll deduction IRA programs. In some instances, the resulting program is basically a traditional retirement program that would compete against plans currently offered through the private sector.

To add fuel to the fire, last November the Department of Labor issued a proposed rule that would specifically authorize states to sponsor payroll deduction IRA savings plans with auto enrollment provisions. Currently, several states, including California, Illinois, and Oregon, require that employers who do not provide retirement programs for their workers participate in the state sponsored payroll deduction automatic IRA enrollment plan. The administration previously instructed the DOL to provide guidance supporting these and future state initiatives. The administration believes state-sponsored savings plans are socially desirable but they raise concerns under current Federal law which preempts states from jurisdiction over plans that are subject to ERISA. Under the proposed guidance, to obtain a safe harbor exemption from ERISA, states would be required to:

1. Establish and administer the program under state law and require certain private sector employers to participate,
2. Be responsible for investing employee savings, or selecting investment options from which employees can choose, and for the security of payroll deductions and employee account, and
3. Create and enforce employee notice requirements which detail the participant's rights under the program.

Although the state run arrangements would include auto-enrollment provisions, individual employees would have the right to opt out of participating. The DOL's proposal, if implemented, would exempt state run plans from the provisions of ERISA while still requiring a virtually identical IRA offered through the private sector to fully comply. That just seems blatantly unfair.

In a separate interpretive bulletin, the DOL also described 3 categories of more traditional retirement programs potentially involving employer contributions that would be subject to ERISA but sponsored by individual states. These include state run Marketplaces (that connect employers to investments offered by the private sector), state administered Prototype Plans, and state Multiple Employer Plans (MEPs). While the plans themselves would be subject to ERISA, the states that sponsor them would not be. In coming up with this proposal, the DOL has ventured into even more problematic territory with respect to working around the state pre-emption requirements of ERISA. In fact, DOL Secretary Thomas E. Perez has acknowledged that the courts may disagree with the DOL's conclusion on this issue.

In commenting on this DOL initiative, Brian Graff, CEO of The American Retirement Association/ASPPA, said that it "creates an un-level playing field, and uses regulation to give state-run alternatives an unfair and unwarranted competitive advantage in the retirement plan marketplace". While supporting the need for more retirement access by workers, the Investment Company Institute (ICI) argued that such access "should be provided through national legislation that builds on the current voluntary system, not through a confusing patchwork of state programs". ▪

PROPOSED CHANGES WOULD IMPACT CLASS ALLOCATION (CROSS-TESTED) PLANS

In a companion article in this edition of Benefit Bylines, we discuss welcome relief provided by the IRS for employers who sponsor 401(k) plans with safe harbor contribution provisions. Ironically, on that same day (January 29, 2016), the IRS surprised almost everyone by issuing a proposal that would negatively impact plans that include class allocation contribution features.

Background

The opportunity to allocate nonelective (profit sharing) contributions among participants based on employment classes is a highly popular design technique. It provides the opportunity to allocate a larger portion of limited employer dollars among key employees than would otherwise be possible under other allocation formulas. Each year, the intended allocation among participants must be tested to demonstrate that it does not discriminate in favor of highly-compensated employees. Testing involves actuarial based calculations methodology developed by the IRS. Currently, the discrimination testing methodology prescribed by the IRS is objective in that it is numbers-driven and not based on subjective evaluations.

Out of the Blue

As noted above, the IRS surprised everyone on January 29th when it published a notice advising that it was considering revisions to its own nondiscrimination testing rules that have been in place for a number of years. In many instances, applying the newly proposed testing rules will result in the need to make larger employer contributions than is currently required to maintain the same level of benefits for owners and highly-compensated employees. Another disturbing aspect of the surprise IRS proposal is that it creates a new "reasonable classification" standard for establishing rate groups for purposes of discrimination testing. The reasonable classifications would be determined based on "facts and circumstances" which adds a level of uncertainty and risk that does not currently exist under the IRS' prescribed methodology.

Time to Lobby Again

Less than a decade ago, the IRS undertook a similar initiative and proposed significant, detrimental changes to class-based designs. The American Society of Pension Professionals and Actuaries (ASPPA) organized a grass-roots campaign designed to demonstrate the benefits of class-based allocation plans to Congress and the IRS. ABP participated in that campaign as did many of our clients at that time. As part of the process, ABP analyzed our clients' plans to determine who was benefitting. What we discovered was that, in general, employers who sponsored plans with class allocation provisions not only provided higher contributions for highly-compensated employees, but also provided substantially higher contributions to non-highly compensated participants, when compared to plans that did not utilize class allocation features. Many other TPAs nationwide were able to demonstrate similar results with respect to their clients. The combination of these demonstrations and thousands of letters from plan sponsors achieved positive results. Congress was swayed and instructed the IRS to withdraw their proposal.

ASPPA has not yet finalized a strategy for addressing the latest IRS proposal impacting class-allocation plans. However, we suspect that an analysis of ABP client plans would produce similar results to those determined a decade ago, e.g. that rank and file employees receive substantial employer contributions when covered by plans that apply a class allocation formula. We will keep you posted as to future developments. Again, keep in mind that this is merely a proposal from the IRS. Until further notice, the current nondiscrimination testing rules for class allocation plans remain in effect. ▪

CLOSING EDITORIAL COMMENTS

Last year, the U.S. Bureau of Labor Statistics reported that retirement benefits were available to 76% of private industry full-time workers and 37% of part-time workers, for a combined **availability rate** of 66%. The same report revealed that 59% of full-time workers and 39% of part-time workers were actually participating in an employer-sponsored plan, resulting in a combined **participation rate** of 49%. Not unexpectedly, availability and participation rates vary materially by job category and from one industry to the next. An argument can be made that the availability of retirement benefits to as many as 76% of full-time private industry workers is a positive development, particularly when one considers the fact that ERISA does not require employers to offer any type of retirement plan at all. However, critics of the status quo make a compelling argument that having less than 50% of all private sector workers actually participating in an employer-sponsored retirement/savings plan is unacceptable.

At least some aspects of the regulatory proposals/actions discussed herein appear to reach beyond what historically has been viewed as respective roles of the IRS and DOL (e.g., to interpret and provide guidance for laws passed by Congress). These initiatives, at least in part, reflect the Administration's frustration with a polarized Congress and a desire to "get something done" in its final year. As a practical matter, most regulatory initiatives passed by one Administration can be modified or withdrawn by the next. Further, the next session of Congress is not necessarily bound by actions of its predecessors. So, the final disposition of at least some of the initiatives discussed herein will likely not be determined until after November's Federal elections.

It is hard to dispute that the low level of retirement savings in the U.S. is a growing problem that needs to be addressed. However, in ABP's view, the solution is not for the Federal Government to punt the problem to the states because Congress can't get its act together. It does not make sense to embark on a path of developing 50 or more different state-sponsored programs covering private workers when similar programs exist in the private sector with delivery systems already in place.

The private retirement system is expected to provide a major, if not primary, source of retirement security for millions of workers. Employers who voluntarily adopt retirement plans covering their employees must comply with complex rules set forth in ERISA and thousands of pages of guidance published by the IRS, DOL and also the PBGC, for many employers who sponsor defined benefit pension plans. Although far from perfect, the private retirement system has performed well, despite what many view as excessive red tape imposed by the Federal government. Imagine how the private retirement system might be able to expand and bring more workers under its umbrella if some of the regulatory burdens were lifted and replaced with meaningful incentives. ▪

Associated Benefit Planners, Ltd.

Associated Benefit Planners, Ltd. (ABP) is an independent consultant and third party administrator (TPA). We specialize in the design and administration of employer-sponsored retirement/savings plans, including 401(k) arrangements. ABP also provides plan document and compliance support for Section 125 Plans and Employee Welfare Plans, operating on a fee-for-service basis.

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