Paying the Administrative Fees of a Qualified Plan

By Ilene H. Ferenczy

In today's economy, plan sponsors are less likely to pay all costs of plan administration, leaving the plans themselves to pick up a greater share of such expenses. Fiduciaries now have a greater duty to determine the expenses properly paid out of plan assets.

Historically, sponsors of qualified plans commonly paid all the costs of administering the plan, leaving the plan funds to be available entirely for providing benefits. In a tighter economy, with larger retirement plans that are more complex to administer, sponsors are looking to the plans to pick up a greater share of their own expenses.

At times, the plan sponsor simply permits the plan to pay third-party providers directly for the fees they charge in relation to the plan. In certain circumstances, the qualified plan reimburses the plan sponsor (or other fiduciary) for the expenses it incurs in administering the plan. This article addresses the standards for a plan to pay expenses at all, as well as what must occur in order for the plan to pay the plan sponsor, the plan administrator, or other fiduciaries for such expenses.

What Does the Plan Say About the Payment of Expenses?

Both the Internal Revenue Service (IRS) and Department of Labor (DOL) require that a plan be administered according to its terms. In particular, ERISA Section 404(a)(1)(D) requires fiduciaries to discharge their duties in accordance with the plan's terms. In DOL Opinion Letter 97-03A, the DOL notes that "evaluating the propriety of the payment by a plan of particular expenses first requires an examination of the language of the plan documents."

DOL Opinion Letter 97-03A further articulates the DOL's position that, if the plan is silent as to whether it can pay plan expenses, the plan *may* do so. The letter also provides that a plan can be amended to provide for the payment of expenses when the plan previously prohibited such payment. Although the DOL letter does not specifically state this, it is more prudent for a new amendment permitting the payment of expenses to apply only to those expenses incurred after the amendment is adopted. [*See also,* DOL Opn. Ltr. 2001-01A, Hypothetical Answer 6] If the amendment is retroactive, there is at least an argument that it reduces the earnings allocation that the participants' accounts have already earned, thereby violating the anti-cutback rules of the Code and ERISA. [IRC § 411(d)(6); ERISA § 204(g)]

Is the Payment of Plan Expenses Prudent?

The decision to use plan assets to pay for expenses is a fiduciary decision. In a letter to a practitioner in 1987, the DOL noted: "In evaluating the propriety of the payment of plan assets for certain expenses, plan

Ilene H. Ferenczy is a partner specializing in employee benefits issues at the Atlanta law firm of Law Offices of Ilene H. Ferenczy, LLC. She authored *Employee Benefits in Mergers and Acquisitions,* an Aspen Publishers publication.

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fiduciaries must first consider the general fiduciary responsibility provisions of Section 403 and 404 of ERISA." [PWBA Letter to Kirk Maldonado dated March 2, 1987]

Under ERISA, a fiduciary is anyone who:

1. Exercises any discretionary authority or discretionary control respecting management of the plan or exercises any authority or control respecting management or disposition of the plan's assets;
2. Renders investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of the plan or has any authority or responsibility to do so; or
3. Has any discretionary authority or discretionary responsibility in the administration of the plan. The named fiduciary under the plan is always a fiduciary under ERISA.

[ERISA § 3(21)]

Under ERISA the plan administrator and the plan trustee are generally fiduciaries. If the plan sponsor is also the plan administrator, it is also a fiduciary when it acts in that capacity.

Besides providing that the fiduciaries have the responsibility to manage and control the plan's assets, Section 403 prohibits the inurement of assets to the benefit of the employer. Plan assets must be used for the exclusive benefit of plan participants and beneficiaries or to defray the expenses of plan administration. [ERISA § 403(c)(1)] In addition, Section 404 of ERISA provides in relevant part that fiduciaries must discharge their duties with respect to the plan solely in the interests of participants and beneficiaries and:

1. For the exclusive purpose of providing benefits to the participants or beneficiaries or defraying reasonable plan administrative expenses;
2. With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in like capacity and familiar with such matters would use in a similar situation; and
3. In accordance with the plan documents to the extent that they are consistent with ERISA.

These rules have been applied in the expense arena to require that the expenses be appropriately charged to the plan (*i.e.*, are not "settlor" expenses) and that the amount to be paid from plan assets be reasonable.

What Is a Settlor Expense and How Does It Differ from a Plan Expense?

The DOL has noted that there are certain expenses that relate to the plan, but are appropriately paid for by the employer. These expenses relate to the design or establishment, modification, or termination of the plan, or to the analysis of options in relation to their impact on the employer, rather than on plan participants. These expenses are considered to benefit the employer primarily, rather than the participants. [PWBA Letter to Kirk Maldonado dated March 2, 1987] The word "settlor" comes from trust law, which is one of the bases of ERISA, and means the person or entity that establishes the trust. In an employee plan situation, the settlor is the employer, unless the plan is established by a union or other employee organization.

The DOL has specifically ruled that expenses related to the following are settlor expenses and *not* payable by the plan:

1. Plan design or amendment;
2. Documenting a plan or amendment (except for amendments needed to keep the plan in compliance with legal changes);
3. Documentation of a plan termination;
4. The decision to adopt, amend, or terminate a plan, including the development of illustrations to reflect the impact of a plan amendment (*e.g.*, benefit studies, actuarial analyses);
5. Union negotiations about plan provisions;
6. The development of financial accounting reports or footnotes for the employer's financial statements (*e.g.*, FASB statements);
7. Plan amendment to permit the payment of expenses from plan assets;

On the other hand, the DOL has also ruled that expenses related to the following may be appropriately paid by the plan:

1. Amendment of a plan to conform to changes in the law;
2. Implementation of a decision to adopt, amend, or terminate a plan;
3. Activities related to maintaining compliance with the law, such as nondiscrimination testing and filing the plan for a favorable determination letter;
4. Determinations of the amounts of benefits for

employees, even if in connection with the implementation of a termination or spin-off; and

5. Employee communications, including calculation of benefits for purposes of determining who is eligible for and the amount of a window benefit, even if the need for communication was occasioned by a plan design change. For example, the costs of revised nondiscrimination testing required because the plan was amended to increase benefits are payable from plan assets. Similarly, expenses to prepare a new SPD because the employer wanted to aggregate several plans into one booklet were payable by the plan.

[DOL Opn. Ltr. 97-03A; DOL Opn. Ltr. 2001-01A] If an expense does not fall comfortably in one of these categories, it may need to be evaluated to determine whether it relates to a settlor or a plan function. The criteria for this choice should be the facts and circumstances of the situation: the extent to which the function was performed for the benefit of the participants and beneficiaries of the plan, as opposed to the benefit of the employer.

It is important to remember at all times that the decision whether an expense is appropriately paid by the plan is a fiduciary act. The fiduciary who decides incorrectly can be found to have breached fiduciary duties and can be personally responsible for making the plan whole. In truly gray areas, the safer course of action is to have the employer pay the cost. Furthermore, the criteria and analysis that the fiduciary undergoes in making its decision should be documented; often proper and reasoned contemplation is more important than the ultimate decision when fiduciary liability is being assessed by courts.

Are the Expenses to Be Paid Reasonable?

Any expenses paid from the trust must be reasonable in amount. To the extent that a third-party service provider is involved, the fiduciaries must determine whether the fees or expenses are reasonable. Furthermore, if the plan and the service provider enter into a contract or agreement governing the expenses, the contract or agreement must be reasonable. This is purely a facts-and-circumstances analysis, based on the marketplace for the provision of the services involved and the value of the services to the plan.

This area is the subject of much consternation. It may be next to impossible for an individual fiduciary to identify the amount of funds being paid to a service provider, because many of these payments take place indirectly. A service provider may receive direct payments from the plan, commissions from the investments of the plan, as well as 12b-1 fees and sub-T.A. fees generated by mutual funds. Many of these payments are made by the mutual fund company directly to the service provider, and may occur without the knowledge of the plan administrator. It is not uncommon for plan administrators to believe administrative services are provided for free in exchange for simply investing the plan assets with a given family of funds, when in fact these hidden fees are being paid.

If the fiduciary responsible for hiring the service providers does not know and cannot easily discover the amount of fees being paid on the plan's behalf, how can it possibly assess its reasonableness? This is the current conundrum facing many sponsors and administrators.

How is this problem resolved? At the least, it is incumbent upon the fiduciary to question a service provider about compensation that it is collecting by virtue of the services it provides to the plan. Furthermore, mutual fund prospectuses should be reviewed to identify expense charges. Last, a fiduciary may retain the services of a new variety of consultant that specializes in determining and assessing the various hidden fees being paid to providers. This latter course may be the most prudent, although the sponsor or administrator should first determine whether the fee consultant has any axes to grind in doing his or her work: Is the consultant working for a fee, or is he or she motivated by trying to take the investment business (and some fraction of the commissions and overrides) from the current service providers?

Someone must compare those fees to the actual service or product being provided to determine what the plan is getting for its money. This means that the sponsor or plan administrator (or an advisor hired for this purpose) must understand the standard fee structures in providing the relevant services, and assess whether the amounts paid by the plan are reasonable.

Is the Service Provider a Party-in-Interest?

If the person or entity providing services to the plan is a party-in-interest, the provision of the services—and the payment of expenses relating to those services—may give rise to a prohibited transaction.

ERISA Section 406(a)(1)(C) prohibits the furnishing of goods, services, or facilities between the plan and a party-in-interest. Section 406(a)(1)(D) prohibits the transfer to, or use by or for the benefit of, a party-

in-interest, of any assets of the plan. These two sections prohibit both a party-in-interest from providing services to the plan and the plan from paying the party-in-interest for such services.

ERISA Section 3(14) defines who is a party-in-interest. Under this section, the employer of covered employees, fiduciaries, and the plan administrator are all parties-in-interest; therefore, any payments made to the plan sponsor, a fiduciary, or the plan administrator are potential prohibited transactions.

ERISA contains two statutory exemptions from the prohibited transaction rules that may permit the transactions between the plan sponsor or administrator and the plans to take place:

1. Section 408(b)(2) permits a party-in-interest to enter into a reasonable contract or arrangement with the plan to provide office space or legal, accounting, or other services "necessary for the establishment and operation of the plan, if no more than reasonable compensation is paid therefore."
2. Section 408(c)(2) permits a fiduciary to receive "any reasonable compensation for services rendered or for the reimbursement of expenses properly and reasonably incurred" in the performance of duties for the plan. The section further notes that no full-time employee of an employer may then be paid compensation from the plan, except for the reimbursement of expenses properly and actually incurred.

These two sections permit the party-in-interest to provide services or incur expenses on behalf of the plan, and to be reimbursed for those services and expenses, but only if the various requirements of the exemption are met. If these requirements are not met, the exemption does not apply, and the plan has engaged in a prohibited transaction.

It is important to note at the outset that the exemption under ERISA Section 408(b)(2) is not an exemption from the self-dealing rules under ERISA Section 406(b). [DOL Reg. § 2550.408b-2(a)] Under that section, fiduciaries are prohibited from dealing with the assets of the plan in their own interest or for their own account and from taking a position in any transaction that is adverse to the plan. If the fiduciary itself is providing services to the plan for compensation, that can be seen as self-dealing or taking an adverse position to the plan. Therefore, it is important that any decision to pay the party-in-interest for costs it incurs on behalf of the plan be handled appropriately. It may be necessary (or at least advisable) for the employer to engage a third-party fiduciary or a disinterested trustee to review such expenses and to determine when they are appropriately paid or reimbursed. [For a discussion of a possibly different interpretation of these self-dealing rules by the Eighth Circuit Court of Appeal, *see* Ferrera, "Eighth Circuit Sets Precedent on Standing and Statutory Exemption for Fiduciary Self-Dealing," *Journal of Pension Benefits*, Autumn 2002]

Is the Service Being Provided Necessary for the Establishment or Operation of the Plan?

The only criteria the DOL and its regulations have provided in relation to whether the services are necessary is whether the services are "appropriate and helpful to the plan in carrying out the purpose for which the plan is established or maintained." [DOL Reg. § 2550.408b-2(b)]

Based on the dearth of guidance, it is likely that the settlor expense versus plan expense analysis discussed previously is appropriate for this purpose. If an expense is an appropriate plan expense, it is likely to be helpful to the plan in carrying out its purpose.

Are the Expenses Being Incurred Pursuant to a Reasonable Contract or Arrangement?

The prohibited transaction exemption applies only if the party-in-interest enters into a contract or reasonable arrangement with the plan for the provision of services. While neither the Code nor the regulations requires a written agreement, it is difficult to prove the terms of the agreement (and its reasonableness) without a written document. Any such agreement should be reduced to writing to protect the parties-in-interest and the plan fiduciary from claims that the arrangement is prohibited.

Under the applicable DOL regulations, an arrangement between the plan and a party-in-interest is not reasonable unless the plan may terminate the contract within a relatively short period of time without penalty. [DOL Reg. § 2550.408b-2(c)] The point of this provision is to prevent the plan from being locked into an agreement that has become disadvantageous for it. The regulations do not articulate what is a "short period of time," and this term is likely to change depending on the type of contract at issue. Nonetheless, anything that commits the plan to do something for any significant period of time that has become ineffectual, burdensome, or unfair it is likely to be suspect.

The party-in-interest provider may charge a reasonable minimal fee where warranted for reasonably foreseeable expenses related to the termination of the contract. For example, the regulations permit an employer to recoup start-up expenses relating to the provision of services to the plan. Similarly, a party-in-interest leasing office space to the plan can charge the plan a reasonable foreseeable expense if it terminates the lease early, such as the cost to re-let the office space. The written agreement between the plan and the party-in-interest should specify the terms and outline and explain any fees associated with an early termination and their relation to the foreseeable costs of the termination.

Is the Party-in-Interest Receiving Only Reasonable Compensation for Its Services?

Generally, only "reasonable compensation" may be paid for the services rendered by the party-in-interest to the plan. This is a facts-and-circumstances analysis. The regulations specifically note that any compensation that would be considered to be "excess compensation" under the regulations to Code Section 162 (and, therefore, would not be an ordinary and necessary business expense) is not reasonable compensation.

In addition to analyzing whether the fees and expenses charged to the plan are "reasonable," the plan fiduciary analyzing the reasonableness engenders additional obligations if the recipient of the compensation is also a fiduciary. This is clearly the case when the recipient is the employer.

ERISA and the DOL regulations provide that an individual who is employed full-time by the employer cannot receive compensation for his or her services for the plan. [ERISA § 408(c)(2); DOL Reg. § 2550.408c-2(b)(2)] This does not preclude the employer from passing on to the plan the expenses for that employee's compensation in certain circumstances to the extent that the employee has performed services for the plan. Those circumstances are discussed further later.

Nonetheless, the DOL regulations and rulings are clear that the reimbursement to a fiduciary for expenses incurred in administering the plan cannot exceed the "direct expenses" incurred. [DOL Reg. § 2550.408c-2(b)(3)] This means several things:

1. The employer or fiduciary cannot make a profit from the plan. This is particularly important when a company is providing services to the plan that it also provides to third parties. To the extent that the fees normally charged for that service include a profit margin, that margin cannot be charged to the plan.

Suppose, for example, that TPA Services, Inc. (TSI) provides third-party administration services to qualified plans of other companies. When TSI establishes a plan for its own employees, it uses one of those employees to administer its own plan. If TSI charges the plan for those services, it should be for less than it charges unrelated clients—at least, assuming that TSI is making a profit by providing this service to its normal clients.

2. The expense must have been incurred solely as a result of the provision of services to the plan, i.e., the "but for" test. No expense is reimbursable if it would have been sustained even if the plan was not there. This is called the "but for" test for plan expenses: If the expense would not have been incurred *but for* the plan's existence, the expense is a direct expense.

The "but for" rule precludes the reimbursement of expenses or compensation for company employees who simply lend some time to the plan. The various DOL rulings on point include recitations of the fact that, had the plan not been there, the employees involved would be laid off or reassigned to totally different positions. The administration of the plan must be a significant part of the employee's job. [DOL Opn. Ltr. 93-06A, DOL Opn. Ltr. 89-09A, DOL Opn. Ltr. 83-20A, PWBA Letter to Marcia Wagner dated 9/13/96]

For example, suppose that TSI (from the previous example) has an administrative employee who provides annual plan administration services to 50 plans. If TSI's own plan is one of those 50, it is unlikely that its existence is the criteria for whether this employee has a job. As a result, the employee's compensation or expenses incurred could not be charged to the plan.

On the other hand, suppose that TSI is a national firm that employs a thousand workers. Administering TSI's own plan is a full-time job, and the employee who does this work administers no other plans. If TSI did not self-administer its plan, this employee would be let go or would be reassigned to a totally different task. In that situation, the employee's compensation could likely be paid by the plan.

Similarly, the "but for" test precludes the charging to the plan of expenses associated with equipment or software that would be used by the company in any event (for example, the word processing, spreadsheet, or accounting programs that are commonly used company-wide). On the other hand, if software is purchased solely for purposes of administering the plan (for example, pension software purchased by a widget

company for use *only* by its internal administrator in performing services for its own plan), the cost of the software would be reimbursable.

3. The plan may not reimburse the employer for overhead. The DOL regulations specifically preclude the payment of overhead costs by the plan. [DOL Reg. § 2550.408c-2(b)(3)] Unfortunately, neither the regulations nor other guidance defines "overhead." (It is simply stated as one of the given facts in the various rulings that no "overhead" will be charged to the plan.) Therefore, this represents a gray area for which there is no hard-and-fast rule that can be followed. Expenses that may fall within this definition should be examined closely, and documentation of the analysis should be kept in case the decision is challenged by a participant or the DOL.

Overhead appears to represent an allocation of an expense to a function that is not directly related to the incursion of the expense by the function. For example, if the department administering the plan is allocated a pro-rata share of electricity, oil, gas, and other utility expenses, that is overhead, because it is not necessarily true that the administrators used that much of the utilities. Similarly, if a department is allocated an expense for computer technical support that is not related to the use of the tech group by the administrators, that is likely to be an allocation of overhead.

Rent is a more complex issue, particularly because ERISA specifically permits the reasonable arrangement under which the plan leases office space from the employer. Again, it appears that, if there is a dedicated space that would not be used but for the plan's existence, it is not overhead. On the other hand, if there is a large office building and the rental charges are allocated among all departments, those charges are overhead.

Are the Expenses Properly Allocated to the Plan?

Only expenses incurred in relationship to a given plan may be charged to the plan. [DOL Opn. Ltr. 93-06A] If services are rendered in connection with several plans, records must be kept that divide the charges among the plans.

There is some guidance that permits a pro-rata allocation of services when they are provided to a common trust and relate equally to all the assets in the trust. This includes, for example, investment services to a master trust. In that circumstance, the DOL permitted the expenses to be allocated pro-rata to account balances within the trust. [*Id.*]

When employees work on several plans, the DOL rulings all indicate in the facts that records were kept *contemporaneously with the provision of services* as to the plan for which the services were provided. Similarly, phone logs were kept, charging various phone calls to the related plans, as were supply logs. [*See, e.g.*, DOL Opn. Ltr. 89-09A]

It becomes difficult to determine the proper way to allocate certain types of office supplies, such as staplers or computers, to the plans. While such allocations could be made based on the time that the employee worked for that plan during the period, that is not practical for devices such as staplers or hole punchers. It makes more sense to consider such expenses as overhead. On the other hand, when several reams of paper are used to print statements for a given plan, that paper can reasonably be charged off to the plan as a direct expense of the plan.

Conclusion

Needless to say, the payment of expenses by the plan, particularly if such payment is being made to a party-in-interest, can be fraught with danger. The decision to pay such expenses is a fiduciary act, requiring proper research and analysis, as well as proper documentation of this process. In all likelihood, a good rule of thumb is that, if there is any doubt as to whether an expense is properly paid by the plan, it should not be. ■