

**The WAGNER LAW GROUP
A PROFESSIONAL CORPORATION**

**Retirement Alliance, Inc.
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Roundtable Q&As**

Tax Reform

Q. *With the size of the deficit a contentious political issue for the November election and the fiscal cliff looming in December, I suspect that the tax incentives for retirement plans will likely change in the near future. What are key pending legislative proposals that will affect the tax treatment of retirement plans?*

A. 401(k) Tax Advantages. The amount of tax revenue forgone on account of retirement plans is very large and this makes 401(k) plans an easy target for revenue raising initiatives. Retirement saving through a 401(k) plan is tax-advantaged because the government generally taxes neither the original plan contributions nor the investment returns on those contributions until they are paid as benefits. Since the budget process looks at revenues and expenditures within a ten-year window, and the payment of most retirement benefits occurs outside that window, the amount of taxes forgone because of 401(k) contributions tends to be viewed as a permanent expenditure. As pressure builds to control the federal deficit, legislative proposals will be considered to reduce the tax cost of the retirement plan expenditure.

Current Limitations. The tax code already contains various limitations on 401(k) plan contributions that could be adjusted for the purpose of reducing tax expenditures (which, by the way, is another name for a tax increase). For example, in the case of 401(k) plans, the maximum amount of annual contributions from all sources for any employee is currently \$50,000, and the limit increases to \$55,500 if the employee is at least 50 years old. The limit on annual contributions includes elective deferrals by participants which themselves are capped at \$17,000. Another limitation subject to being reduced by legislation is the cap on the plan sponsor's deduction for contributions to a 401(k) plan equal to 25% of the compensation otherwise paid during the taxable year to the plan's participants. Further, compensation in excess of \$250,000 cannot be considered in calculating contributions to a participant's plan account. Over the years, Congress has raised or lowered these amounts depending on the needs of the time. However, the most threatening tax reform proposals would not simply adjust the current limits. Rather, the new tax reform proposals would fundamentally change the way the limits are calculated.

20/20 Cap. Consider, for example, the so-called 20/20 Cap proposed in December 2010 by the National Commission on Fiscal Responsibility and Reform. The 20/20 Cap would limit the maximum excludable contribution to a defined contribution plan to the lesser of \$20,000 or 20% of income. This proposal applies to both employee elective deferrals as well as nontaxable employer contributions. The 20/20 Cap is hard on high earners; if you earn \$100,000 per year, the most that can be put into your 401(k) account is \$20,000.

Refundable Tax Credit. Brookings Institution has also designed a much-discussed refundable tax credit proposal that would shift the demographics of those receiving the tax benefits of the retirement plan tax expenditure from a perceived slant favoring highly compensated employees. Under this tax reform proposal, all employer and employee contributions would be included in gross income without any deductions and exclusions. In their place, a flat-rate refundable tax credit would be deposited directly into a plan participant's retirement savings account. Although the current contribution limits would not change, the refundable tax credit would benefit low earners at the expense of the more highly compensated. Critics have noted that this would seriously diminish the incentive many employers have to maintain qualified plans.

28% Tax Benefit Cap. The Obama Administration's FY 2013 budget proposed to limit the tax value of any particular tax deductions and exclusions to 28 percent of the specified item's amount in order to increase taxable income that would otherwise be subject to the 35% tax rate. Although this is not an entirely new proposal, what is new is the inclusion of 401(k) contributions (as well as health care contributions), regardless of who makes them, in the list of affected tax exclusions. Thus, a taxpayer subject to the top 35% tax rate would pay a 7 percent tax (35% - 28%) on the value of any 401(k) contributions. Under this proposal, those receiving the highest contributions to their 401(k) accounts could be subject to an additional \$3,885 in tax liability. Critics of the Administration's proposal were quick to point out that it contains an element of double taxation in that the same plan contributions would be taxed again when withdrawn from the plan.

Conclusion. The 20/20 Cap, refundable tax credit, Administration's 28% tax value cap, and other tax reform proposals represent a fundamental reduction of the incentives for maintaining a qualified plan. Such cutbacks in the tax incentives for retirement plans seem to be the order of the day and have the potential to reduce the role of employers and to shrink the system.

Re-Enrollment Default Investments: Bidwell v. University Medical Center

- Q.** *Many recordkeepers offer re-enrollment services that require participants to provide new or updated investment instructions for their accounts. Employees who fail to re-enroll are defaulted into a qualified default investment alternative ("QDIA"). Recordkeepers have relied on the preamble to the QDIA regulations as legal authority to support the re-enrollment default investments. Please explain how a recent court decision will support the practice of re-enrollment default investments.*
- A. Preamble to QDIA Regs.** As you noted, the preamble to the QDIA regulations explains that "it is the view of the Department that nothing in the final regulation limits the application of the fiduciary relief to investments made only on behalf of participants who are automatically enrolled in their plan." The preamble then explains that the QDIA regulations also apply to the failure of a participant to provide investment direction following the elimination of an

investment alternative or change in service provider (*i.e.*, plan conversions) as well as any other failure of a participant to provide investment instruction. When a participant has “the opportunity to direct the investment of assets in his or her account, but does not direct the investment of such assets, plan fiduciaries may avail themselves of the relief provided” by the QDIA regulations so long as all of its conditions have been satisfied.¹

5th Circuit *Bidwell* Case. In its June 29, 2012 decision in *Bidwell v. University Medical Center*, the U.S. Court of Appeals for the Sixth Circuit relied on the QDIA regulations and its preamble to provide relief for an employer that implemented default investments following a re-enrollment. The facts in *Bidwell* are as noteworthy as the court’s legal analysis.

Facts. In 2008, the employer changed the default investment under its 403(b) plan from a stable value fund to a target date fund. The employer instructed the recordkeeper to send a notice of the change by first-class mail to all participants who were 100% invested in the stable value fund. The notice also advised these participants that their investments would be moved to the target date fund unless the participants gave instructions otherwise by a specified deadline. Two participants who had affirmatively elected to invest in the stable value fund did not respond by the deadline and were defaulted into the target date fund. When these participants received their next quarterly statement, they directed their investments back into the stable value fund. In the interim, one participant suffered an \$85,000 investment loss; the other participant incurred a \$16,900 investment loss. They filed claims for reimbursement with the plan administrator. After the plan administrator and federal district court rejected the claims, the participants appealed to the 6th Circuit.

Arguments. On appeal, the participants argued that QDIA regulations should not shield the employer from claims of plan participants who had affirmatively elected to invest in the stable value fund. In other words, because they affirmatively elected into the stable value fund, they had a right to have their investment remain within the stable value fund until they explicitly directed otherwise. In relying upon the preamble to the QDIA regulations, the 6th Circuit said: “In essence, the DOL explained that, upon proper notice, participants who previously elected an investment vehicle can become non-electing plan participants by failing to respond. As a result, the plan administrator can direct those participants’ investments in accordance with the plan’s default investment policies and with the benefit of the [QDIA fiduciary liability] protections.” The 6th Circuit also rejected the participants’ argument that the QDIA regulations did not apply to a transfer of funds but only a failure to provide instructions with respect to contributions. Although the participants alleged that they did not receive a QDIA notice, they did not allege that the employer’s delivery method was inadequate. In any event, the 6th Circuit noted that it is not the actual receipt of notice that is relevant, but the acts of the fiduciary in attempting to ensure that notice is delivered. In this

¹ Preamble to final QDIA regulations at 72 Fed. Reg. 60452, 60453 (2007). The preamble also explains that QDIA regulations may also apply when a participant fails to provide investment instructions following a rollover or when the plan administrator has determined that a participant’s investment directions are inadequate (*e.g.*, if the investment election form does not exist, is illegible or does not provide the information necessary for an effective election).

case, it was reasonable for the employer to rely on the dependability of the first-class-mail system.

Impact. Although the Sixth Circuit's decision is binding in only Kentucky, Michigan, Ohio and Tennessee, it is likely that courts in other jurisdictions will cite it favorably.

408b-2 and 404a-5 Disclosure Aftermath

Q. *What should financial advisors be telling their plan sponsor clients now that the 408b-2 and 404a-5 disclosures have been made?*

A. Disclosure Failures. If a service provider has failed to provide the required 408b-2 disclosures to the plan sponsor, the plan's fee payment to the service provided can be a prohibited transaction. However, a plan sponsor can obtain relief from the prohibited transaction penalties by taking steps to cure a known disclosure failure. First, the plan sponsor must make a written request for information, and the delinquent service provider is obliged to respond within 90 days. If the service provider refuses or is unable to respond to the request for information, the plan sponsor must notify DOL no later than 120 days after requesting information, and decide whether to terminate the service arrangement. On July 18th, the DOL has announced that plan sponsors can provide it notice online.² In addition, if the requested information relates to future services and is not disclosed promptly after the end of the 90-day period, the plan sponsor is obliged to terminate the service arrangement—consistent with the duty of prudence—as expeditiously as possible.

Fee Reasonableness Now Becomes Key Issue. All plan sponsors have a specific duty to assure that the plan's fees for investment and administrative services are reasonable. Now that ERISA Section 408(b)(2) requires investment vendors and recordkeepers to provide comprehensive fee information plan sponsors have a corresponding responsibility to review and understand this information. Thus, as a practical matter, the fiduciary bar is being raised for plan sponsors to evaluate the reasonableness of the service provider's compensation. One of the keys to making a proper evaluation is establishing a prudent fee review process, which will most likely require plan sponsors to ask for additional information beyond what is included in a service provider's 408(b)(2) fee disclosures.

Fee Policy Statement. It is now standard practice for plans to maintain an investment policy statement or IPS. Like an IPS, plan sponsors should seriously consider establishing and adopting a fee policy statement or FPS. The written procedures maintained in a formal FPS can give plan sponsors the procedural discipline necessary to conduct a proper view of a plan's fees and services. The plan's FPS should be customized to the plan's circumstances

² See July 18, 2012 EBSA News at <http://www.dol.gov/ebsa/newsroom/2012/EBSA071812.html>. The online notice website is at <http://www.dol.gov/ebsa/regs/feedisclosurefailurenotice.html>.

and objectives, and the FPS's procedures should complement the plan's IPS procedures. That is to say, the plan's review under the IPS should be coordinated with the plan's review under the FPS. And like an IPS, a solid FPS can help plan fiduciaries demonstrate that they are acting with the procedural prudence required under the law.

Value Proposition. Rather than seeking a service provider with low fees, plan sponsors should seek out the service provider with the best "value proposition." In order to evaluate the reasonableness of the service provider's fees, the plan fiduciary should make appropriate inquiries about the service offering. Is the service provider genuinely committed to helping both the plan sponsor and the plan participants on an ongoing basis? If so, is the service provider willing to make that commitment in writing? Consistent with DOL's guidance, a service provider's fees should always be evaluated in light of the services provided. Plan fiduciaries should make an effort to work with service providers that are open and forthcoming about the types of services they offer and the fees for such services.

Fee Disclosures to Participants. If a plan sponsor has fee-related concerns because of the reaction of participants to the fee disclosures, the plan sponsors may need assistance in meeting or communicating with participants in order to clarify the investment and fee information with educational materials. The plan sponsor may need assistance in enhancing its fiduciary review process.

Plan Sponsor's Fiduciary Duty to Determine Actual Fee

Q. *Can you provide an example of a situation where a plan sponsor would have a fiduciary duty to probe beyond a recordkeeper's 408(b)(2) fee disclosures?*

A. Duty of Prudence. The 408b-2 regulations³ explicitly state that a service provider's duty to disclose fees under the 408b-2 regulations is independent of a plan sponsor's duty of prudence under ERISA's fiduciary responsibility rules. In the preamble of the 408b-2 regulations, the DOL has explained that this independent duty of prudence means:

- The disclosure rules should be construed broadly to ensure that plan sponsors review service arrangements based on comprehensive information.⁴
- If a plan sponsor needs assistance in understanding any information furnished by a service provider, as a matter of prudence, the plan sponsor should request assistance, either from the service provider or elsewhere.⁵
- If the 408b-2 disclosure rules do not require a service provider to disclose particular information, but the plan sponsor needs the information to make an informed decision

³ 29 CFR 408b-2(c)(1)(i) ("The requirements of this paragraph (c)(1) are independent of fiduciary obligations under section 404 of the Act.").

⁴ Preamble at 77 Fed. Reg. 5632, 5634 (Feb. 3, 2012).

⁵ Preamble at 77 Fed. Reg. 5632, 5636 (Feb. 3, 2012).

when selecting or monitoring the service provider, and the service provider is unwilling or unable to provide the information, then the duty of prudence may preclude the plan sponsor from continuing (or entering into) the service arrangement.⁶

Example. Let's examine the plan sponsor's duty of prudence with respect to a recordkeeper that discloses it may receive 5 basis points from investment vendors as indirect compensation and that a portion of the indirect compensation may be offset against the direct fees paid by the plan sponsor or the plan. Although the recordkeeper discloses the direct fee, the recordkeeper explains that it does not have sufficient information to disclose, in advance, whether or how much indirect compensation that it may receive in a particular year because it is based on, among other things, the total amount of assets invested by all of its clients with the investment vendors. The recordkeeper has complied with its 408b-2 fee disclosure obligation, but the plan sponsor does not know how much compensation the recordkeeper will actually receive for its services.

Duty of Prudence. For a plan sponsor to understand how much compensation the recordkeeper will actually receive, the plan sponsor would—at the end of year— have to:

- determine the amount of the offset against the direct fee and, thus, the net direct fee;
- ask the recordkeeper how much indirect compensation it received that was attributable to the plan;
- subtract the offset from the indirect compensation attributable to the plan in order to determine how much of the indirect compensation the recordkeeper has kept instead of offsetting against the direct fee;
- add the indirect fee kept by the recordkeeper to the net direct fee to determine the recordkeeper's total fee.

Of course, this assumes that the plan sponsor understands that the recordkeeper is not using all of the indirect compensation to offset the direct fee. This example raises two questions: do plan sponsors have the knowledge and persistence to follow-up with a recordkeeper in order to determine the recordkeeper's actual compensation for its services; and if not, will the plan sponsors fulfill the duty of prudence to seek assistance.

Asset Allocation Models As Designated Investment Alternatives (“DIAs”)

Q. *When are asset allocation models subject to the participant disclosure requirements for DIAs (i.e., performance, benchmarking and expense ratio disclosures for annual comparative chart)?*

A. Asset allocation models can be offered in three different forms:

- Educational models providing non-personalized investment education to participants;

⁶ Preamble at 77 Fed. Reg. 5632, 5634 (Feb. 3, 2012).

- Non-discretionary models providing investment advice to participants who have the discretion to determine whether or not to implement the advice; and
- Discretionary models that initially allocate, and subsequently rebalance, the participant's assets among the plan's investment alternatives according to the participant's risk profile.

Educational and Nondiscretionary Models. The participant disclosure requirements apply to DIAs—investment alternatives into which participants may direct the investment of assets held in their individual accounts. Educational and nondiscretionary models are clearly not DIAs. Rather, these models assist participants in choosing the DIAs into which they will allocate the assets in their accounts. As a result, the performance, benchmarking, and expense ratio disclosure requirements for DIAs do not apply to educational and nondiscretionary models.

Discretionary Models. Discretionary models for a plan are also not treated as separate DIAs requirements so long as the components of the models are solely DIAs under the plan. However, if a discretionary model includes investments that are not DIAs under the plan, the model itself must be treated as a DIA subject to the performance, benchmarking, expense ratio disclosures. Similarly, if choosing a model requires a plan participant to invest in an entity (*e.g.*, unitized portfolio) that, itself, invests in some combination of the plan's DIAs, the model would also be a DIA.

Models v. DIA Explanation. For all asset allocation models, the plan must clearly explain how the model functions.⁷ For educational, nondiscretionary, and discretionary models that are not DIAs, the DOL also requires the plan to explain clearly how the model differs from the plan's DIAs.

Voluntary DIA Treatment. As noted above, when educational, nondiscretionary, and discretionary models are simply a means of allocating account assets, they need not be treated as DIAs. However, the DOL will allow plans to voluntarily treat the models as DIAs in the annual comparative chart for performance, benchmarking and expense ratio disclosures. In addition, with respect to the performance data for models, appropriate additional information may be provided as long as the information is not inaccurate or misleading. See the “Performance Disclosure Issues” below.

Performance Disclosure Issues. An issue arises as to how the required performance information (*i.e.*, average annual total return for 1-, 5- and 10-calendar year periods or for the life of the DIA, if shorter) for models should be disclosed. As noted above, the DOL does not prohibit supplementing this information with historical performance data for a hypothetical model portfolio or a composite of historical client accounts. Thus, financial advisors providing models should consider developing an appropriate disclosure approach that incorporates such historical performance data. Financial advisors that are investment advisers registered under the Investment Advisers Act of 1940 (Advisers Act) would need to

⁷ FAB 2012-02R , Q&A 28 (July 30, 2012).

present any hypothetical model results or composite performance data in accordance with Rule 206(4)-1(a)(5) of the Advisers Act and the 1986 no-action letter that the SEC issued to Clover Capital Management, Inc.

QDIAs. The participant disclosure rules for the asset allocation models described above are generally consistent with the QDIA rules. For example, education and nondiscretionary models are not considered DIAs under the participant disclosure rules as explained above. Consistently, these models cannot be QDIAs because the participant has the discretion to make the asset allocation decisions, not the trustee, plan sponsor or investment manager.⁸ Another example, a discretionary model whose investments are not restricted to DIAs available under the plan would be subject to the participant disclosure rules as explained above. Consistently, this type of discretionary model also could be a QDIA as a stand-alone product.⁹ The significant anomaly is a discretionary model whose investments are restricted to DIAs under the plan. This type of discretionary model would not be mandatorily subject to the participant disclosure rules as explained above. However, this type of discretionary model could be a QDIA (*e.g.*, target date fund). Notwithstanding the anomalous regulatory result, competitive market pressure is likely to compel QDIAs using discretionary models to voluntarily comply with the participant disclosure rules.

Brokerage Accounts

Q. In light of the DOL's original and revised guidance on offering brokerage accounts under 401(k) plans, what should plan sponsors be concerned about?

A. There is no bright line test for determining whether the proper fiduciary review of brokerage accounts has been undertaken, or whether “sufficient information” has been disclosed. It will be a facts and circumstances analysis, case by case. However, financial advisors should help their plan sponsor clients maintain good documentation of efforts to satisfy the unique rules applicable to brokerage windows.

Original FAB. On May 7th, the DOL issued a Field Advice Bulletin (“FAB”) that was intended to primarily clarify the participant disclosure requirements.¹⁰ Nevertheless, the FAB included a question and answer (“Q&A”) that imposed an “affirmative obligation” on a plan sponsor to examine the investments available within brokerage account and determine

⁸ 29 CFR 404c-5(e)(3)(i)(A).

⁹ Preamble to 29 CFR 404c-5(e)(4)(i) (“The reference to ‘an investment fund product or model portfolio’ is intended to make clear that this alternative [*i.e.*, target date fund] might be a ‘stand alone’ product or a ‘fund of funds’ comprised of various investment options otherwise available under the plan for participant investments.” 72 Federal Register 60451, 60461 (10-24-2007).

¹⁰ FAB 2012-02 (May 7, 2012). DOL’s participant disclosure regulations are published at 29 CFR 2550.404a-5 with conforming changes to the ERISA Section 404(c) regulations at 29 CFR 2550.404c-1.

whether any should be treated as a designated investment alternative (“DIA”). The Q&A was controversial and the retirement industry persuaded the DOL to revise it.

Revised FAB. On June 30th, the DOL revised the FAB to eliminate the “affirmative obligation” duty to examine the investments available within brokerage account.¹¹ However, the revised FAB explains that the general ERISA duties of prudence and loyalty would require consideration of the nature and quality of services provided in connection with the brokerage account. In addition, a plan’s failure to offer any DIA (as a means to avoid the disclosure rules for DIAs) would “raise questions” under those ERISA fiduciary duties. The DOL intends to further examine the fiduciary obligations of plan sponsors with brokerage accounts.

Implications. In light of the revised FAB, here are some of the more important points for financial advisors to remember when assisting their plan sponsor clients:

- Where a plan sponsor has determined a brokerage account would be a prudent investment option for the participants, financial advisors should assist with the implementation.
- Even though brokerage windows are not subject to the specific DIA disclosure requirements (*e.g.*, benchmarking or performance data), financial advisors should be prepared to help with the following general disclosure requirements for brokerage accounts offered by a plan:
 - A general description of the brokerage account that includes how investment instructions are to be provided, special restrictions or limitations if any, how the brokerage window is different from the plan’s DIA, and to whom questions may be directed.
 - Detailed fee and expense information that is chargeable to the participant’s account rather than on a plan-wide basis, including commissions and per-trade charges.
 - Preparation of quarterly fee statements that include a description of the related services.
- Financial advisors should be careful to provide accurate brokerage account information requested by their plan sponsor clients. Although the plan sponsor is ultimately responsible for compliance with the participant disclosures, the plan sponsor is not liable where there has been reasonable and good faith reliance on information provided by service providers.

Capturing IRA Rollovers

Q. *How can a financial advisor accept rollover assets from 401(k) participants when the financial advisor serves as an investment advice fiduciary for the plan sponsor?*

¹¹ FAB 2012-02R (July 30, 2012).

- A. A fiduciary advisor can accept rollover assets from participants where the financial advisor has been engaged as a non-fiduciary advisor when the rollover-related services are offered to the participant.

Rationale. With regard to the same retirement plan, a financial advisor may serve as a fiduciary in some instances (*e.g.*, advising the plan sponsor) and as a non-fiduciary in other instances (*e.g.*, educating a plan participant). A financial advisor who offers rollover-related services to participants in a non-fiduciary capacity is not subject to the ERISA restrictions that otherwise apply to those services delivered to the plan in a fiduciary capacity. In determining whether a financial advisor is acting in a fiduciary capacity when communicating with participants, three factors come into play.

- (i) whether financial advisor's communications take place in a plan setting;
- (ii) whether the financial advisor is using plan-related authority in making the communication; and
- (iii) whether the communication is primarily related to the plan.

With these three factors in mind, the following steps should be taken to demonstrate the financial advisor is acting in a non-fiduciary capacity in offering rollover services to participants.

Communication Setting. A financial advisor's communications regarding the rollover services should be made in a non-plan related setting. Therefore, the financial advisor should not discuss, promote, or offer rollover services at any plan meetings conducted by the plan sponsor. At these plan meetings, the financial advisor cannot discuss the advisability of taking a plan distribution or rolling over funds to an IRA. However, the financial advisor can discuss the availability of rollover distribution features in a plan as an element of plan education, and to follow up at one-on-one meetings with plan participants on certain rollover topics.

Plan Sponsor's Role. The plan sponsor should confirm in writing (*e.g.*, investment advisor agreement or confirmation letter) that the financial advisor's rollover services are unrelated to any services it provides to the plan sponsor or plan. Consistent with this understanding, the plan sponsor should not endorse or encourage the use of the financial advisor's rollover services.

Participant's Role. The financial advisor must not suggest in any way that the participant is obligated to work with the financial advisor. Rather, the participant must understand that the rollover services are not associated with the plan and the financial advisor is not offering the rollover services in a fiduciary capacity. To confirm this understanding, the participant should sign an acknowledgment form.

Non-Plan Assets. ERISA would not apply to a participant's assets held outside the plan sponsor's plan. Thus, a financial advisor serving as an investment advice fiduciary for the

plan sponsor could accept and manage the non-plan assets. For this purpose, the participant's outside assets would include assets held in an IRA or another employer's retirement plan.

Pending Changes. Notwithstanding the controversy that its initial proposal generated, the DOL is anticipated to expand the definition of investment advice fiduciary. In connection with that proposal, the DOL has requested comments on whether "investment advice" should include recommendations related to taking plan distributions. Thus, it is possible that the final regulation may change the conditions under which a financial advisor may accept rollover assets from 401(k) participants when the financial advisor serves as an investment advice fiduciary for the plan sponsor.

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