YEAR END
2017

Employee Benefits Update

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Deciding what to do with orphaned 401(k) plan accounts

With employees changing jobs more frequently than they once did and Baby Boomers hitting retirement age, it's common for 401(k) plans to include a significant number of orphan accounts. If your plan has a lot of them, it might be time to think about whether it's time to actively pursue these accounts. The answer depends in part on how your plan charges administrative fees and the value of these orphan accounts.

Analyze costs

Orphan accounts are accounts of 401(k) plan participants who are no longer employees. It's not uncommon for 10% of a plan's participant census to consist of terminated employees, and, depending on the employer, the percentage could be much larger.

This demands that you consider the administrative costs. On the one hand, the bigger the asset pool, the lower the per-capita charges. If the collective value of those former employees' accounts is significant, the possible upside is that all participants are benefiting from lower administrative and asset management charges because they're based on a scale according to total plan assets.

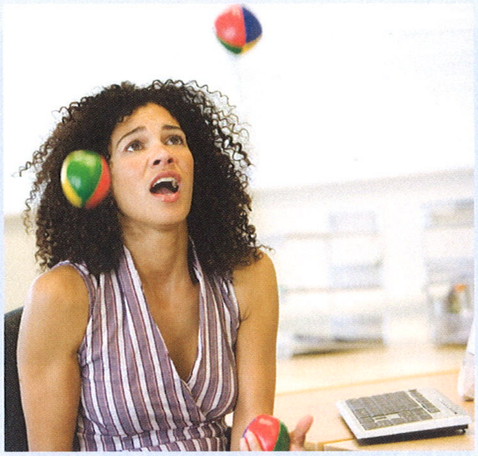
On the other hand, suppose those orphan accounts don't add up to enough dollars to push your plan into a lower fee bracket. Fees charged against participant accounts based on the size of their accounts could effectively be penalizing those participants for incremental administrative costs incurred on behalf of people no longer working for the company.

Under ERISA, you can distribute accounts with balances up to $1,000 directly to the former participant if your plan document permits it.

Similarly, if you, as the employer, are subsidizing any of the plan's administrative charges, doing so for former employees might not be considered an effective use of your organization's dollars. And in addition to hard dollar expenses, you'll want to consider the indirect cost of added staff time devoted to administrative or compliance tasks associated with those accounts.

Orphan 401(k) accounts require fiduciary juggling act

Plan sponsors have a fiduciary responsibility to all plan participants. However, the process of determining what to do with orphan accounts requires a delicate balancing act on the part of plan sponsors.



For example, if former employees feel that they were strong-armed into making a rollover, and wind up with an IRA that has higher fees, you could face accusations of violating your fiduciary duty to those former participants. One way to lower that risk is to outsource the process to another custodian service that specializes in this activity.

In the final analysis, your fiduciary duty is to all your plan participants, whether they're active employees, former employees who have moved on to other jobs, beneficiaries or retirees. Be sure to weigh the pros and cons of your policy from the perspectives of these groups before deciding which approach to take.

What kind of administrative tasks? For one, you'll need to be sure those former employees receive 404(a)(5) fee disclosure forms, along with other routine disclosure documents. You'll also need to regularly update IRS Form 8955-SSA, listing terminated participants. Even if you have a third-party administrator performing those tasks, you're still paying for it.

Make a policy

So, if orphan accounts are needlessly driving up plan costs, what can you do about it? The first step is formalizing a policy. For example, you might decide to focus on former employees who left the company before retirement, instead of retirees. This may just be a prioritization issue, however, because you can't discriminate against any set of participants. (See "Orphan 401(k) accounts require fiduciary juggling act" above.)

Other policy decisions include whether to set a dollar threshold on the size of the orphan account. Under ERISA, you can distribute accounts with balances up to $1,000 directly to the former participant without obtaining their permission if your plan document permits it. And for accounts with balances up to $5,000, you can, again without obtaining the former participant's permission, transfer the funds to an IRA that you establish on his or her behalf.

For larger orphan accounts, you don't have that option. You can, however, contact the former employees (assuming you can track them down) and remind them of the option to roll their funds into an IRA or a new employer's plan or keep them in the current plan.

They may prefer to move the funds to an IRA to gain more control over how to invest those funds. But other former employees may leave their accounts with your plan because they like the way it's invested.

Keep in mind that, if you completely lose track of former employees, there's the possibility those funds can be taken over by your state.

Start now

Orphan accounts could be helping or hurting your administrative costs. Find out which it is, and then review your options with your employee benefits specialist to determine what's best for your plan. □

Why adding a Roth 401(k) option could boost employee savings

A decade after they first became available, Roth 401(k) plans are now offered by many employers. Employees are also getting on board — particularly the younger ones — even without fully understanding how they work, a Harvard study suggests.

Roth 401(k) vs. Roth IRA vs. traditional 401(k)

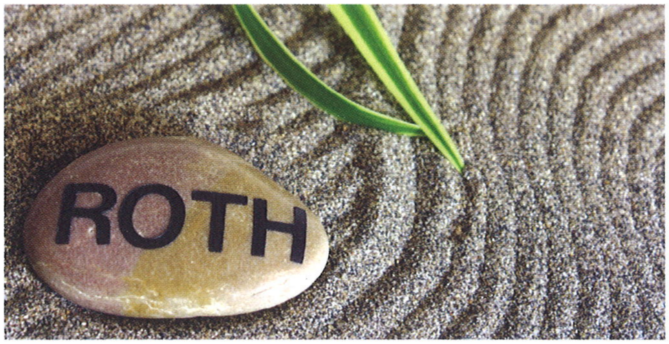
Roth 401(k) plans operate on the same principle as their older cousin, the Roth IRA: Participants make contributions on an after-tax basis, but qualified distributions are tax-free. (Any employer-matching contributions, however, are pretax and must flow into a separate account.)

Roth 401(k)s have an advantage over Roth IRAs for highly paid employees: Participation eligibility isn't capped by income. The only cap is the annual 402(g) limit imposed by the IRS for employee deferrals.

An advantage of a Roth 401(k) over a standard 401(k) is that participants can avoid required minimum distributions (RMDs) after age 70½ by rolling their Roth balance into a Roth IRA. This allows those dollars to accumulate tax-free indefinitely, and be passed on to heirs, if participants choose.

Can participants borrow money from their Roth IRA? The short answer: Not really. Unlike many employer-sponsored retirement plans like 401(k) plans that allow participant loans, there's no such thing as an "IRA loan."

Finally, in the opposite scenario (a participant wants to access funds sooner), the Roth 401(k) has another advantage over a traditional 401(k): Before age 59½, Roth 401(k) participants can tap into principal amounts contributed to their account (but not investment returns) without a 10% early withdrawal penalty. They must, however, have been in the plan for at least five years to take advantage of that opportunity.



Employee participation

Roth 401(k)s make more sense financially for some employees than others; offering employees both kinds of 401(k)s leaves it up to them to decide which is better. T. Rowe Price, for example, reports that 61% of employers in its client database offered a Roth option in 2016 — a 10% jump from 2015. According to T. Rowe Price's data, the percentage of 401(k) participants with access to Roth 401(k)s who then made contributions to a Roth 401(k) was about 6% in 2016, down from 7% in 2015. However, this drop may be explained by the 10% increase in availability of the Roth option from 2015; many employees haven't had a chance to warm up to the new option yet.

More detailed research from Alight Solutions, a consulting firm, indicates that, when the participation rate data is sliced by age bracket among employees who have access to a Roth 401(k) plan, the numbers are more impressive. For example, it found that in 2016 close to 20% of employees in the 20 to 29 age bracket who have the option to take advantage of the Roth option do so. Participation rates drop for each successive older age bracket, down to around 11% for employees in the 40 to 59 age range, and 7% for the 60-plus cohort.

That pattern suggests that some participants could be following general advice offered with respect to who is best suited to take advantage of a Roth. According to conventional wisdom, younger employees are in lower tax brackets because they tend to earn less than older participants. That means that the opportunity cost of missing out on making their 401(k) contributions on a pretax basis is lower than it would be for someone in a higher tax bracket.

For example, it would cost a single-filer employee with a federal marginal tax rate of 15% only $750 in forgone federal income tax savings to contribute $5,000 to a Roth 401(k), and nearly twice that amount ($1,400) for a single filer in the 28% tax bracket.

Employee knowledge

But are employees performing this kind of analysis? The conclusion of a recent study by Harvard University researchers suggests that perhaps they aren't, which in turn also suggests that Roth 401(k)s are a particularly good option to put in front of employees.

According to the Harvard study, when participants switched to a Roth 401(k), they maintained the same deferral rates they had been using with the conventional 401(k) plan. If the employees who made that switch had analyzed the implications of doing so, they would have realized that, by making their 401(k) deferrals on an after-tax basis, they could afford to reduce their deferrals, and wind up at retirement with the same amount of money. How? Because those funds wouldn't be reduced by taxes when they took their distributions in retirement.

"Our survey experiment provides suggestive evidence that employee confusion about and neglect of the tax properties of Roth balances … prevent contribution rates from falling following a Roth introduction," the study concludes. The upshot is that "the total amount of retirement consumption being purchased via the 401(k) increases after the Roth is made available."

Smart saving

Adding a Roth option to your 401(k) may help your employees to effectively save more than they otherwise would have. That's a win for everyone. □

Compliance Alert

Upcoming compliance deadlines:

12/1 Deadline for 401(k) and (m) safe harbor notice, annual qualified default investment alternative (QDIA) notice, and qualified automatic contribution arrangement (QACA) notice (can be made up to 90 days before the start of the plan year)

12/15 Extended deadline to distribute the Summary Annual Report for plans that filed Form 5500 by October 15 (calendar year plans)

12/29* Deadline for making corrective distributions for failed 2016 actual deferral percentage (ADP) and actual contribution percentage (ACP) tests with a 10% excise tax penalty, as well as for making a qualified nonelective contribution (QNEC)

12/29* Deadline for making required minimum distributions for 2017

12/29* Deadline for making a prospective amendment to add or remove safe harbor status for the 2018 plan year

12/29* Deadline for making a prospective amendment to add automatic enrollment (eligible automatic contribution arrangement (EACA) and QACA only) for the 2018 plan year (must give participants notice at least 30 days prior to the effective date)

1/31 2017 Forms 1099 are due to participants

** The original due date of December 31, 2017, falls on a Sunday. The IRS historically hasn't extended due dates for required disclosures, contributions or distributions.*

How high can you go?

Participants willing to accept higher default deferral rates

It's generally accepted that 3% isn't a very ambitious 401(k) plan deferral rate, and won't get many employees where they need to be financially as they approach retirement unless they enjoy miraculously high average investment returns. Most employees will need a figure closer to 10%, or even more, depending on how old they are when they begin to get serious about retirement saving.

Yet 3% has traditionally been the most common default deferral rate used by plans that auto-enroll participants. That's changing, however.

No revolt

Many plan sponsors have feared that, if they get too ambitious with the auto-deferral rate, employees will balk, and simply opt out of the plan, leaving them worse off than they otherwise would have been. Anecdotal evidence, supplemented by survey data, suggests that this fear is overblown.

For example, according to the money-manager newspaper *Pensions & Investments*, an auto dealership in the Midwest that raised its auto-enroll default deferral to 6% from 3% at the beginning of 2016 reported that its employees didn't revolt. The company's maximum deferral rate eligible for a 50% match is 6%, a fact that might have kept some employees from objecting.

Number crunching

Large 401(k) recordkeepers regularly crunch the numbers on deferral rates and other data from all the accounts they service and publish them. They also look at the impact of raising the default deferral rates for auto-enrolled participants. Although their data don't always match, they tend to be similar, particularly with respect to trends.

For example, Wells Fargo's Institutional Retirement and Trust unit determined that there's no difference in auto-enrolled participant opt-out rates whether the deferral rate is 3% or 6%. (The opt-out rate for both was about 11%.)

Meanwhile, T. Rowe Price reports that in 2011 only 17% of the plans it administered with auto-enrollment had default deferral rates of 6% and above. By 2016, it had risen to 33%. That's just a hair under the 34% prevalence of the once dominant 3% default deferral rate (used by half of the firm's clients in 2011). In other words, if those trends have kept up, this year the most popular deferral rate among its clients will be 6%.

At Vanguard, the trends are the same, although in 2016 the percentage of plan sponsors using at least a 6% auto-enroll default deferral rate was only 20%, with 45% still using the traditional 3% rate. Fidelity has reported similar current rates: 18% use 6% deferral rates, and 48% use 3%.

Research shows that employers that auto-enroll participants have better luck getting them to accept auto-increases in their deferral rates.

More research

Companies that are fully comfortable with auto-enrollment don't limit the practice to new employees. Some extend auto-enrollment to eligible employees who aren't participating (such as if they were hired before auto-enrollment began or employees opted out after being auto-enrolled in the previous enrollment cycle). Others include auto-increases to deferral rates for active participants whose deferral rate is lower than the default rate.

Research also shows that employers that auto-enroll participants have better luck getting them to accept auto-increases in their deferral rates. Among T. Rowe Price clients, for example, two-thirds of participants in plans with an auto-enroll go along with auto-increases in deferral rates. But when auto-increase formulas are used for participants who weren't auto-enrolled, only 12% stick with that program.

What next

And remember: Auto-enrollment often helps plans pass average deferral percentage (ADP) testing because the average deferral rate for nonhighly compensated employees will increase. Is a higher auto-enrollment deferral rate right for your plan and its participants? Discuss it with your benefits specialist and don't forget to sweeten the pot with matching contributions. ☐

Reimbursement road map for sponsor services

When retirement plan sponsors perform administrative services on behalf of the plan, they can be reimbursed by the plan for those services. However, meticulous expense documentation is essential, as a recent case illustrates.

Determining reimbursement

For a plan sponsor to receive reimbursement for services it has rendered to the plan, the sponsor must satisfy ERISA regulations. This means that the transaction must:

Satisfy the standards for a "prohibited transactions" exemption. The basic ERISA prohibited transaction that must be avoided is "self-dealing."

Meet ERISA's prudence standards for plan fiduciaries. Regulations allow a fiduciary like the plan sponsor to be reimbursed for "direct expenses properly and actually incurred in the performance of such services." They also must be "reasonable."

Fiduciary standards are applicable to just about any substantive actions a plan sponsor can take with respect to a plan, except "settlor" tasks, such as changing the level of employer contributions to participant accounts, amending the plan document, or even terminating the plan.

Documenting expenses

What these standards mean is defined by courts when disputes arise. In *Perez v. City National Corporation*, the U.S. Department of Labor argued — and a court agreed — that City National's reimbursement for services rendered to its ERISA plan didn't provide sufficient documentation. Its calculation of "direct expenses" was based on averages and estimates.

That methodology, the court concluded, could have resulted in over- or undercharges to the plan. Instead, the court ruled, the company should have "kept contemporaneous time records [such as timesheets] so that it could calculate actual costs" of its administrative services to the plan.

Finding reasonableness

Even when expenses are meticulously documented, they must be reasonable. But how is reasonableness determined? Generally, courts decide reasonableness on a case-by-case basis.

To avoid discrepancies and meet your fiduciary burden, be sure to properly document any expenses you intend to seek reimbursement for from the plan, and review any fees you charge to the plan for reasonableness. ☐

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Our Story

We are committed to the success of our clients. As one of the largest California-based accounting and consulting firms, we have worked with plan sponsors and other fiduciaries to ensure their plans are fully compliant, for over 30 years.

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