Defining Expense Accounts

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What They Are

What IS a Plan Expense Account, also known as an ERISA Account, ERISA Budgets Account, or Revenue-Sharing Account, to name a few? Simply put, it's an account within the Plan to which your Plan's recordkeeper makes deposits to be used by the plan administrator. The plan sponsor can use these funds to pay eligible plan operating expenses. Eligible plan operating expenses can be any non-settlor fees permitted by the plan, including but not limited to, communications and education costs, adviser fees, nondiscrimination testing, and plan audits. Anything that is a permissible payment may be paid by plan assets can be paid out of the expense account because these accounts are typically considered plan assets. Plan Expense Accounts have gained increased prominence in qualified retirement plans. As the size of the average defined contribution plan grows, and plan sponsors become more aware of their obligations to monitor fee reasonableness, sponsors have gained the ability to leverage their asset bases to reduce marginal plan costs. Employers have successfully negotiated lower expense investments, reduced servicing fees, and asked the vendors to create Plan Expense Accounts.

As the Department of Labor and plaintiff's attorneys continues to make headlines about the need for plan sponsors and participants alike to understand retirement plan and investment product fees, fiduciaries have come to understand the diseconomies of scale in the current defined contribution system. The fiduciary community has become more cognizant of their obligation to understand what is being paid to service providers, both direct and indirect, and to negotiate what is reasonable. In the years ahead, plan sponsors will be forced to ask whether the escalating revenues generated by larger asset bases cause compensation for retirement services to exceed the bounds of reasonableness.

Who Are They For

Initially, Plan Expense Accounts were available solely to defined contribution plans with large asset bases. However, an aging workforce has led to a significant increase in the average account balances at all plan sizes. Plan Expense Accounts become a critical tool not solely for larger plan sponsors, but perhaps more importantly, for sponsors with above average account balances, without regard to total plan size. The critical issue is how much revenue your plan investments generate and the unique servicing requirements of your plan.

This is where an experienced retirement plan consultant can help you identify and benchmark your plan's fees and service obligations to assist in the negotiation of a Plan Expense Account.

How They Work

Excess fees are a result of a fixed percentage of assets being paid to vendors for services to the plan. When defined contribution plans invest in mutual funds, many (although not all) funds pay revenue sharing to the vendor, often in the form of 12b-1 fees or sub-transfer agent fees. However, as assets grow, the rate of these payments remains fixed, leaving the sponsor with little economy of scale. Over time, plan sponsors discovered that the vendors were receiving compensation in excess of their service burden, which resulted in the need to create the Plan Expense Account. A Plan Expense Account is a straightforward way to capture excess revenue that is above and beyond what is needed for actual plan administration and recordkeeping.

Consider a plan with $20 million in total assets that uses 25 basis points of revenue-sharing to pay its recordkeeper—$50,000 annually. If, over time, those same plan assets grew to $60 million, that 25 basis points of revenue-sharing would now produce $150,000 in revenue for the recordkeeper. Yet, the recordkeeper's costs almost certainly would not have grown commensurately. Because much of the work related to servicing these plans is done up front during the conversion process, arguably plan costs reduce over time.

As a result of the growth of assets in defined contribution plans and fiduciaries' need for full fee disclosure, fiduciaries are realizing the diseconomy of scale in the current defined contribution system. As fiduciaries become more cognizant of their obligation to understand what is being paid to service providers, both directly and indirectly, and to determine what is reasonable, Plan Expense Accounts will become more common.

Why Do They Exist

For investments, high fees tend to fall into two categories. The first is the expense ratio of one or more of the mutual funds is high. That can easily happen as a plan grows. For example, one share class may be appropriate for a small plan, but as the plan grows, a lower-priced share class of the same investment product may be more appropriate. Plan sponsors and their advisers need to be attentive to this issue or their defined contribution plans could inadvertently be paying higher fees than is necessary, thereby reducing participant returns and their ability to accumulate wealth.

The second area of additional fees involves so-called "wrap" fees. While wrap fees are not by nature inappropriate, they can become burdensome. To properly evaluate these fees, the first step for a plan sponsor is to learn the total annual fees. The second step is to obtain information on the charges for similar plans (e.g., plans with similar assets and numbers of participants). The competitive marketplace does a good job of establishing reasonable prices and a Request for Proposal can be an excellent way of benchmarking your own plan's fees. However, understanding and uncovering these fees may require expert advice.

With regard to the plan provider/recordkeeper, cost of service typically varies based on the number of participants, and client service expectations. This cost of service has very little correlation to the amount of plan assets, however, plan providers are often—perhaps almost universally—the recipients of payments, such as 12b-1 fees, sub-transfer agency fees and/or shareholder servicing fees, which are based on a percentage of assets. While costs are fixed, part or all of the revenue is based on a percentage of assets. It is just a matter of time before a plan grows large enough that the plan, and its participants, are overpaying for services. Conversely, in many instances plan providers may price cases assuming little or no profitability in the early years of a contract in order to win business that, over time, will become very profitable.

Unfortunately, only the largest of plans have the leverage necessary to determine the specific cost of plan servicing and to negotiate their fee agreements with that knowledge. In those cases, once a provider has recouped its operating costs, plus a reasonable profit, the balance of the revenue sharing should be restored to the plan. When the balance is restored, it is often done as a cash payment into the plan, through a vehicle sometimes referred to as an "ERISA Budget Account" or an "Expense Recapture Account." That money is then available to pay other expenses of the plan or to be allocated to the participants. Either way, it ultimately improves the benefits for the participants and that is a fiduciary's primary objective.

How They Are Handled

Permissible Payments

The concept of Plan Expense Accounts is not discussed anywhere in the text of ERISA, but what is discussed and what has been precisely laid out by the Department of Labor (DOL), is a detailing of what expenses may be paid from plan assets and how "excess" funds may be reallocated to participant accounts. The Plan Expense Account simply facilitates the use of revenues generated by plan assets that exceed the cost of administration to pay other legitimate plan administrative expenses, including, but not limited to, communications and education costs, adviser fees, and nondiscrimination testing. What cannot be paid from plan assets or the ERISA budget set-aside, however, are so-called "settlor expenses." These must be paid by the employer and include costs associated with establishing, designing, and terminating plans. The DOL prohibits using plan assets for settlor expenses, which are generally deemed to be for the benefit of the employer, not the plan. The DOL prohibits using plan assets for the benefit of the plan sponsor.

Plans can handle the excess revenues being used in a Plan Expense Account in two distinct ways. One method is to deposit the money into the plan as an "Allocated Account." During the course of the plan year, those monies can be used to pay expenses that are prudent and appropriate for the plan to pay out of plan assets. Any money in that ERISA Account that has not been expended at year's end must be paid back to participants. The most common method of dealing with the funds remaining at year end is to allocate the amounts pro rata to participants based on their account balances on the last day of the year (for example, the account balances on December 31 for a calendar-year plan). Excess revenues deposited to Allocated Accounts cannot be carried over into the next calendar year.

Alternatively, excess revenues can be left on account with the recordkeeper as a credit that the plan can tap into at any time to pay for expenses. In this scenario, the recordkeeper creates a bookkeeping account on its records and allows the plan sponsor to use that money for plan expenses—often without any time limit. As this suggests, the credit amounts are typically not allocated to participants at the end of the year. In some cases, the credit amounts are ultimately forfeited back to the recordkeeper (for example, if they are not used by the time the plan transfers to another recordkeeper) or they are deposited into the plan (for example, if the plan sponsor demands the deposit of those amounts). Of course, in neither method may the deposits or credits be used for the benefit of the plan sponsor.

When the amounts are deposited into a plan, they are obviously plan assets. But, are the amounts also plan assets when they are recorded as credits on the books of the recordkeeper? The answer may be that they are not when the recordkeeper can keep the credits. However, when the plan can demand the payment of the credit to or for the benefit of the plan and its participants, without limit or restriction, they probably are, because ERISA determines whether something is a plan asset by applying ordinary notions of property rights.

The conclusion is significant—for example, the determination will impact whether the account must be included in the accountant's audit of the plan, must be allocated to participants each year, and so on. In 2013, the DOL released guidance in the form of Advisory Opinion 2013-03A exploring the question of whether revenue sharing payments constitute "plan assets" under ERISA. Needless to say, consult your attorney on this one.

How Long to Accumulate This Money

I often am asked how long can we keep money in the Plan Expense Account. The answer depends on if the money is considered a Plan asset. If you have determined that the money is a Plan asset, the rules state that Plan assets must be allocated during the plan year in which the forfeiture is incurred. In Revenue Ruling 80-155, the IRS takes the position that a defined contribution plan will not be qualified unless all funds are allocated to participants' accounts in accordance with a definite formula defined in the plan. Therefore, a plan may not carry over Plan assets to subsequent plan years, as doing so would contradict the rule requiring all money in a defined contribution plan to be allocated annually to plan participants.

What to Do

A New Way to Pay

The goal really is to pay reasonable fees for your services and to eliminate any excess revenue the vendor may receive. And the way to do that is to switch to a cost model rather than a revenue model. If an agreement could be negotiated between the plan sponsor, or adviser on their behalf, and the recordkeeper to define the cost, then the excess revenue then could be applied to the Plan Expense Account.

In the past, there was no mandate for providers to disclose to sponsors the revenues earned on a plan's investment funds. However, since the implementation of the Department of Labor's 408(b)(2) disclosure requirements, most service providers to retirement plans – including pension, profit sharing, 401(k), and 403(b) plans subject to ERISA – are now required to make written disclosure of their services, and total compensation. This, in turn, will make it easier for a plan to know exactly how much their recordkeepers are receiving and if it is feasible to establish a Plan Expense Account. Anyone who is a plan fiduciary needs to be aware of the fees their plan pays. Once you are aware, you may be able to negotiate such an Account.

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