APRIL
MAY
2019

Employee Benefits Update

Proposed IRS regs liberalize rules for hardship withdrawals

Fiduciary liability
First Circuit shifts burden of defending a fiduciary breach claim

Have you outgrown the need for matching 401(k) contributions?

Take a close look at your plan expense categories

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Proposed IRS regs liberalize rules for hardship withdrawals

How hard should a hardship be to justify a hardship withdrawal from a 401(k) plan? There are more rules than you might think. However, proposed IRS regulations could, according to the agency itself, enable eligible plan participants "to access their money more quickly with a minimum of red tape." Below is a short summary of several key provisions of the detailed proposed regulations.

The status quo

To provide context for the proposed (and highly likely) changes, here's where things currently stand. These are — and continue to be under the proposed regulations — the most accommodating rules you can require participants to follow; you also can be more restrictive.

IRS rules require that hardship distributions be because of an "immediate and heavy need," "limited to the amount necessary to satisfy that financial need," and the participant can't "reasonably obtain the [required] funds from another source." Plan sponsors are required to review "all relevant facts and circumstances" before agreeing to permit a hardship withdrawal.

The rules, however, provide several safe harbors under which plan sponsors don't need to make a judgment call. These involve:

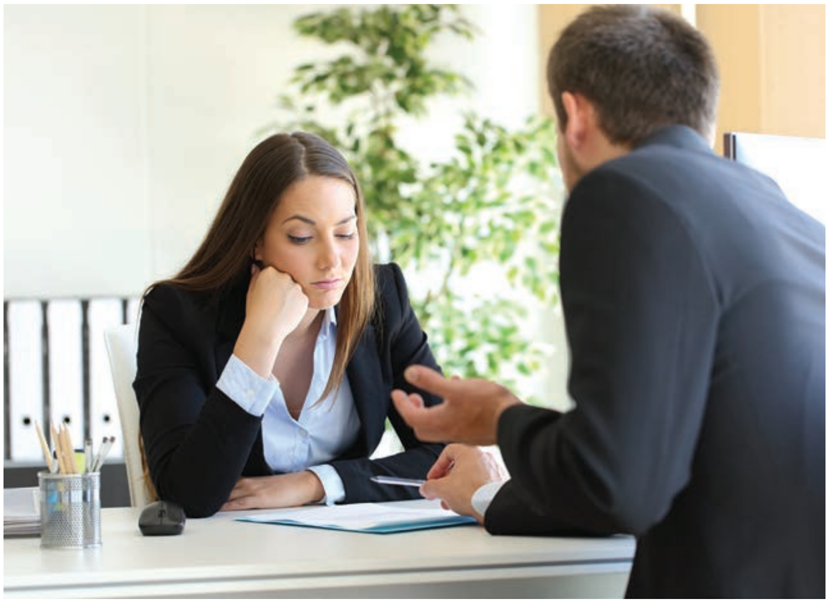
- Medical expenses for the participant or the participant's family members,
- Costs directly related to the purchase of a principal residence (excluding mortgage payments),
- Tuition, related educational fees, and room and board expenses for the next 12 months of postsecondary education for the participant or the participant's family members,
- Payments to prevent eviction from a primary residence,
- Certain kinds of repairs to a damaged primary residence, and
- Funeral expenses for the participant or a family member.

The 2018 Bipartisan Budget Act's proposed regulations include these same safe harbors and added several new categories, including expenses stemming from a federally declared disaster, such as a major hurricane, and medical, educational and funeral expenses for a beneficiary that isn't a dependent.

3 key changes

The proposed regulations make three key changes to hardship withdrawal eligibility, each of which is seen as liberalizing their availability:

1. Relief from other sources. Before taking a hardship withdrawal, participants will no longer be required to show they have borrowed all that they can using available plan loans.



How should you respond to the changes?

Employers could make one of several moves in response to the proposed IRS regulations on hardship withdrawals. (See main article.) Other than dropping the six-month postwithdrawal contribution resumption restriction, plan sponsors could:

- Ignore the rest of the changes made by the proposed regulations,
- Make their plans' hardship withdrawal requirements more stringent, or
- Stop allowing hardship distributions altogether.

Plan sponsors might eliminate hardship withdrawals when they believe participants who use that option are doing themselves more financial harm than good. Statistics show that leakage from plans is a significant issue as participants deplete their retirement savings. Liberalizing hardship rules may further exacerbate leakage in the future.

Hardship withdrawals are typically taken by relatively young participants who tend to wait longer to resume contributing to their accounts. According to the Employee Benefit Research Institute, the lowest income quartile of participants who take a hardship distribution and wait two years before resuming deferrals take a 25% hit on their ultimate retirement savings accumulations when they stop working.

Still, it's unusual for a retirement plan not to allow hardship withdrawals. Sponsors who worry about the long-term impact of such distributions can take other steps to minimize them, including limiting the size of distributions and allowable reasons. For example, a plan sponsor might decide that the financial burden of a home purchase or college tuition payment doesn't qualify as a hardship distribution under its plan.

Create a communication program tailored to participants who take (or are considering taking) hardship withdrawals. Then, default those who do into promptly resuming their deferrals, if they suspend them following a hardship withdrawal.

2. Source of distributions from plan contributions and earnings. Participants can draw hardship distributions from qualified nonelective contributions, qualified matching contributions, employer safe harbor contributions and earnings on those contributions, and earnings on regular 401(k) plan contributions.

3. No waiting period to resume contributions. Effective January 1, 2020, plan sponsors will no longer be able to require a participant who has taken a hardship withdrawal to wait six months before resuming plan contributions. Unlike the first two, this change isn't optional, assuming you have a hardship withdrawal provision in the first place.

These changes are intended to become effective retroactively to January 1, 2019, but could be subject to some fine-tuning in the regulations' final version.

Sponsor duties

Beginning in 2020, plan sponsors would also be able to take advantage of a liberalized standard for policing participant compliance with eligibility requirements for hardship withdrawals. Specifically, participants would need only "represent, in writing, by an electronic medium … that he or she has insufficient cash or other liquid assets to satisfy his or her hardship need" unless the plan sponsor or plan administrator "has actual knowledge to the contrary."

What is "actual knowledge to the contrary"? For example, suppose a plan sponsor happens to learn or hear something that suggests that a participant isn't as financially challenged as he or she has told you, or the participant recently received a bonus award. Would that represent "knowledge" on the plan sponsor's part, or only evidence for speculation about the participant's financial position? It's unclear at this time and just one concern if plan sponsors decide to retain hardship withdrawals in light of the proposed regulations.

Food for thought

The proposed regulations might prompt you to rethink your current policy on hardship withdrawals. Remember, plans aren't obligated to allow hardship withdrawals, and they can be a headache to administer. Look for the final version of the regulations later this year.

Fiduciary liability

First Circuit shifts burden of defending a fiduciary breach claim

A recent ruling could set the stage for a definitive U.S. Supreme Court opinion regarding retirement plan fiduciaries' liability on the subject of monitoring plan expenses. The U.S. Court of Appeals for the First Circuit's ruling in *Brotherston v. Putnam Investments* shifts a key aspect of the burden of proof of a fiduciary breach from the plaintiff employees to the plan sponsor defendant.

Imprudent actions

In 2015, a class action suit by Putnam employees charged their employer with a fiduciary breach by limiting their 401(k) plan investment choices to actively managed Putnam funds with higher fees than comparable index funds. The trial court (before the case was appealed) found that Putnam "did not independently investigate Putnam funds before including them as investment options under the plan, did not independently monitor them once in the plan, and did not remove a single fund from the plan lineup for underperformance." (Other allegations, not described here, were also made.)

An imprudent act by plan fiduciaries might not have created a dispute without proof that plan participants had suffered a loss because of the imprudent act. The question of harm was a key piece of this case. An expert witness for plan participants quantified a loss by comparing the impact of the higher fee structure of the funds chosen by the Putnam investment team with those of alternative index funds offered by another prominent fund manager (Vanguard).

The question is: Which party bears the burden of proof to show that the fiduciaries' imprudent procedures resulted in a loss by plan participants?

The trial court accepted Putnam's argument that the fact that it lacked a prudent process for monitoring plan investments didn't necessarily render the entire investment lineup imprudent. ERISA offers some support for the view that the absence of "procedural prudence" doesn't have to lead to sweeping liability for decisions that even a prudent fiduciary might have made. The lower court also agreed with Putnam's view that the analyst's report failed to prove that participants had sustained a loss. However, according to the appellate court, it wasn't clear why the district court made such a conclusion.

Burden of proof

The most broadly applicable issue in the case is which party bears the burden of proof to show that the fiduciaries' imprudent procedures resulted in a loss by plan participants: Is it the plaintiffs' burden to show a breach of fiduciary duty? Or must the plan sponsor prove it shouldn't be held responsible for any loss?

In a lengthy review of related court decisions and principles of trust law, the appeals court overturned the trial court with this conclusion: "Once an ERISA plaintiff has shown a breach of fiduciary duty and loss to the plan, the burden shifts to the *fiduciary* to prove that such loss was not caused by its breach."

The appeals court sought to dispel any conclusion that it was turning the tables on fiduciaries. "Nothing in our opinion places on ERISA fiduciaries any burdens or risks not now faced routinely by financial fiduciaries," such as investment advisors, it stated.

According to the court, any "plan such as the plan in this case can easily insulate itself by selecting well-established, low-fee and diversified market index funds." In addition, the court stated that, if a fiduciary believes it can find funds that beat the market, it "will be immune to liability unless a district court finds it

imprudent in its method of selecting funds, and finds that a loss occurred as a result."

The case was sent back to the trial court to reconsider its ruling in light of the principles established by the appeals court.

Looking ahead

The ruling evens the split between eight of the 10 federal appeals courts that have ruled on this issue. The other circuit courts that have already ruled as the First Circuit just did are the Fourth, Fifth and Eighth. Those on the other side of the issue are the Sixth, Ninth, Tenth and Eleventh. Such a scenario often leads to a U.S. Supreme Court ruling to resolve the inconsistent appellate court opinions. But even if your company isn't based in one of the 19 states whose appeals courts are now aligned with this latest ruling, the issue is one that all plan sponsors should follow closely. □

Compliance Alert

Upcoming compliance deadlines:

4/1 Initial required minimum distribution for participants who attained age 70½ in 2018 (applies to qualified plans where the participant is at least a 5% owner and to IRA accounts)

4/15 Deadline for corrective distribution of 2018 excess deferral failures

4/15 Deadline for filing of 2018 individual tax returns and making contributions eligible for deductibility

5/15 Deadline for filing 2018 Form 990, "Return of Organization Exempt From Income Tax"

Have you outgrown the need for matching 401(k) contributions?

From time to time, it can be helpful to question the way you've been administrating your retirement plan. For example, many plan sponsors provide matching contributions on participant 401(k) plan deferrals believing it's essential to motivate employees to set aside enough for retirement, and to maximize overall plan contributions for ERISA discrimination testing purposes.

Yet some sponsors don't realize there's an alternative: making substantial nonelective contributions instead of matching contributions. It's not a strategy that will work for all employers, but there is nothing to lose — and perhaps much to gain — by at least considering it.

2 questions to ask

Some plans routinely make periodic small nonelective contributions merely to supplement matching contributions, but won't suspend those matching contributions. To start exploring the idea, ask these two questions about the traditional matching contribution approach:

1. By essentially subsidizing (with matching contributions) only employees who can afford to contribute to their retirement today, are you discriminating against employees who have more pressing immediate financial needs, such as paying unexpected large medical bills?

2. Are matching contributions really necessary to communicate to employees the importance of saving for retirement?

Beyond the fairness question, the main reason you might replace matching contributions with nonelective contributions is to gain some flexibility in allocating the dollars you want to distribute. Within limits, you could steer a higher proportion of those dollars toward key employees.

Alternative strategies

If this sounds good, here are some alternative strategies to look into:

A safe harbor plan. An option is to make solely safe harbor nonelective contributions for all eligible participants. Under the safe harbor formula, each participant receives at least a 3% contribution and your plan automatically passes muster with ERISA nondiscrimination requirements.

Social Security "integration." This option takes advantage of "permitted disparity" rules. Essentially it allows you to adjust for the fact that employees with earnings significantly above the Social Security taxable wage base ($132,900 in 2019) will wind up with a disproportionately lower (relative to their earnings) Social Security retirement benefit than workers whose compensation during most or all of their working careers has been below the wage base. The potential adjustment is making higher (subject to certain limits) proportionate contributions to retirement plan accounts for employee earnings above the Social Security wage base. Nondiscrimination and top-heavy testing apply to this allocation formula.

Comparability allocation. Another opportunity to direct disproportionate amounts of nonelective contributions involves something called a "comparability allocation" or a "cross-testing" formula. This entails divvying up employees into "allocation groups" and varying the amount of dollars as a percentage of compensation allocated to each group. While possible, there are still complex discrimination hurdles to clear, and with complexity comes higher administrative costs.

Regardless of which option you may choose, the sky isn't the limit on the amount of dollars that can be steered to employees with nondiscretionary contributions; aggregate per-participant limits applicable to garden variety 401(k) plans with matching contributions apply to all defined contribution plans. This year the limit on "annual additions" including elective deferrals, matching contributions, nonelective contributions and allocations of forfeitures from former participants is $56,000 ($62,000 when you add in catch-up contributions for participants at least 50 years old).

Consider the options

Perhaps you're not a good candidate for a dramatic plan design change now. Circumstances and philosophies can change — and, if they do, the ideas presented here may provide ways to change with them. Consult your employee benefits specialist to find out whether nonelective contributions may be right for your plan. ◻

Take a close look at your plan expense categories

Keeping a sharp eye on your 401(k) plan's expenses — a fundamental duty of fiduciaries — can require the use of a magnifying glass, at least metaphorically speaking. Take the case of what's paid out of retirement plan investment funds, as opposed to paid directly by the plan or the company as the plan sponsor. Individual pieces can be measured in basis points (hundredths of one percent), but they add up. This means that even small distinctions can substantially affect participant investment returns over time.

Common contributors to gross expense ratio

A fund's gross expense ratio encompasses charges paid by plan participants. It represents the total percentage of the fund's assets that are used to run the fund. It can be complicated when revenue sharing — payments by the asset manager to recordkeepers, custodians and brokers — is involved.

The following are some common plan expenses that count toward a plan's gross expense ratio:

Asset management fee. This is the cost of paying people who actually are responsible for making decisions about the fund portfolio's investments. These fees will be significantly lower for passively managed funds, such as index funds vs. actively managed funds.

"Shareholder servicing" and "Sub T/A" fees. Service providers charge these fees to cover recordkeeping, administrative and custodial services.

12(b)-1 fees. These are payments to brokers who sell funds to the plan and service those accounts.

ERISA budget accounts. Some recordkeepers credit any payments they receive from asset managers to a plan's "ERISA budget account." Fees the plan pays directly for those services are adjusted accordingly so that the plan doesn't overpay.

Some funds may enter into fee waiver or expense reimbursement agreements to minimize costs to participants. And remember, ERISA requires disclosure of certain information to plan participants.

A critical task

It's important to know exactly what you're paying and to whom so you can benchmark those fees to determine reasonableness and negotiate fees. Ask whether the funds have lower cost share classes that may reduce potential costs to participants. This is a highly simplified introduction to plan expense review — one of the most important aspects to understanding and properly managing a 401(k) plan. Contact your benefits advisor for more information about the many complexities surrounding this critical task of plan fiduciaries. ◻

The solution for skyrocketing audit fees

Finding ways to cut costs while maintaining quality seems to be at the top of every executives to do list. As the person responsible for your organization's employee benefit plan audit, we can help you not only reduce your audit costs but also provide a higher level of service.

Pension auditors must sift through enormous amounts of financial data in accordance with the requirements of numerous laws, regulations and professional standards. If they don't know what they're doing, they can easily get lost in the numbers, run up large fees and fail to provide an accurate assessment of a plan's financial status.

Pension audit specialists

Insero & Co. specializes in pension plan audits. Our professionals have extensive experience in this area and to ensure that our audits meet the highest standards of quality, our firm is a member of the American Institute of Certified Public Accountants (AICPA) Employee Benefit Plan Audit Quality Center and is registered with the Public Company Accounting Oversight Board (PCAOB).

Insero & Co. is the independent registered public accounting firm for many companies that file a form 11-K with the Securities and Exchange Commission. We currently perform audits for more than 150 plans ranging in size from 100 to 60,000 participants, and from $1 million to more than $10 billion in assets.

Big firm capabilities, small firm attentiveness

As our many satisfied clients will testify, we offer the comprehensive benefit services of a large national firm, but at less cost and with a higher level of service. With more than 125 accountants, professional consultants and support staff, our firm is large enough to bring robust resources to bear on almost every client need, yet small enough to provide the personal attention and relationship-based service that is important to our clients.

The culture of Insero & Co. is hands-on and proactive, shaped by the old-fashioned notion of doing what is in the best interest of the client. In addition to pension and corporate audits, we provide a full range of tax, accounting and consulting services, including internal audit/Sarbanes-Oxley services, outsourced accounting and wealth management.

Go with the experts

We would welcome the opportunity to discuss your audit or other needs and put our expertise to work for you. Please contact Vince Leo at 585-697-9683 or Mike Giess at 585-697-9639 and let us know how we can be of service.

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