Flashpoint: What's Been Happening?

We hope everyone is enjoying their new year, and that there is relatively mild weather where you live. We had our annual snowstorm scare here in Atlanta two weeks ago, with warnings from the press about everything from getting off the roads early to making sure you have baby food in your cabinets. It snowed a touch in the middle of the night, most of which had melted by the time the city awakened. What am I going to do with all that baby food I bought, when our youngest is 23? (Just kidding, just kidding …)

The Latest on the Fiduciary Regulation

We know that everyone and their uncle have posted or mailed or emailed their opinions on what will happen with the Fiduciary Regulation under the Trump administration. As I write this, no one really knows what is going to happen next. If you are like most of our affected clients and many financial institutions, you are going forward with compliance because of the looming April 10 deadline.

We have, however, had some very important recent developments that make compliance with the new rule easier. Two sets of FAQs were issued by the Department of Labor (DOL) on January 13, 2017, for reference by practitioners, and the second of those had information that is very important for both third party administrators (TPAs) and financial advisors. (FYI: the DOL also issued a set of FAQs particularly for plan sponsors and IRA investors.)

First, for the TPAs: Neither the original regulations nor the first set of FAQs addressed what we considered to be the most important question for you: is the recommendation of a financial institution to act as recordkeeper and fund holder a fiduciary recommendation under the new rules? If the answer is "yes," and if you direct your clients towards the recordkeeper(s) that you prefer and receive revenue sharing as a result, that recommendation would be fiduciary in nature. Fortunately, the second set of FAQs revealed that the answer to this question is a definitive "no," so long as you are not giving advice about the actual investments. This should permit most nonproducing TPAs to work with recordkeepers in pretty much the same way as they have historically. We can all breathe a collective sigh of relief.

Remember, however, that your recommendation of an investment advisor or manager is a fiduciary recommendation if you are paid for it, even if you provide a list of people with whom you commonly work. (Also remember that "payment" for your advice could take the form of a thank-you lunch from the advisor or even possibly a cross-referral.) There is little guidance so far about the ramifications of this type of recommendation, but the regulation and the preamble were clear that, as a fiduciary, you are held to ERISA's co-fiduciary liability rules. Under those rules, if you know about a breach of fiduciary duty by someone else and do nothing to ameliorate the situation, you can be equally liable for the breach. So, if you recommended an investment advisor on Day 1 and found out on Day 4 that the Plan Sponsor or Plan Administrator had breached their duties, you could be fully liable if you don't act to repair the breach … such as notifying someone further up the responsibility ladder (like the company owner, assuming he or she is not the bad actor), the participants, or the DOL. We have some ideas about how to handle these situations, but are hoping to get some more guidance before the deadline.

The second issue that was clarified by the second set of FAQs affects financial advisors and managers who are fiduciaries. ERISA prohibits a fiduciary from financially benefitting from certain advice; in other words, the income of a fiduciary advisor must not be affected by whether the Plan fiduciary takes the advisor's advice. Therefore, the compensation structure for many, if not most, fiduciary advisors is going to have to be a level fee—that is, a set dollar amount or a percentage of plan assets—that is unaffected by the actual investments selected.

If the advisor receives any kind of additional compensation, such as commissions or revenue sharing, the advisor must offset this against what the plan pays, so that the total income to the advisor stays the same. This "offset" structure was approved in the mid-1990s in an opinion letter that is commonly referred to as the "Frost Letter." (DOL Opn. Ltr. 97-15A)

The first set of FAQs included language in a discussion about how the Best Interest Contract Exemption applied that made many believe that the Frost Letter had been overruled and that the receipt of any transaction-based compensation or revenue sharing is now a prohibited transaction, requiring the use of the Best Interest Contract Exemption (BICE) with its many administrative burdens.

The second set of FAQs clarified that this interpretation of what was said in the first FAQs is incorrect. The Frost Letter is alive and well and continues to prevent fiduciary advisors from engaging in a prohibited transaction. If there is no prohibited transaction, there is no need for an exemption, including BICE. This means that the business model of advisors using the offset model for compensation will likely be able to continue unchanged. Remember, however, that there are still new rules that have significant effect if you are giving advice to participants about distributions and rollovers, requiring advisors to comply at least with the limited version of BICE that has come be to known as "BICE Lite."

There is a bill in Congress that proposes to delay the regulation for two years. There are still some court cases pending that challenge the legality of the regulation. The Trump DOL could refuse to enforce the new regulation (which would make life easier for plans on audit, but would not affect the participants' rights to sue those who are fiduciaries under the new regulation in regard to an alleged ERISA breach of duty). As noted above, everything about what happens next is true speculation. We're keeping our eye on this as things develop.

A Present From the IRS

In our work for the ASPPA Government Affairs Committee, we have joined with ASPPA to lobby the IRS for many years about the relatively new interpretation of the rules that prohibited use of forfeitures to reduce qualified nonelective contributions (QNECs), qualified matching contributions (QMACs), or 401(k) safe harbor contributions. For plans that have regular profit sharing or matching contributions that are subject to a vesting schedule, amounts left behind when an unvested or partially vested participant leaves (called "forfeitures") could not be used to pay for the cost of QNECs, QMACs, or safe harbor contributions in later years. (All three of these contribution types either eliminate the need for certain nondiscrimination testing in a 401(k) plan or help the plan to pass the test.) The ostensible reason for this rule was regulations requiring that QNECs or QMACs be nonforfeitable at the time contributed. Because forfeitures are what is left over when the participant is paid his or her partially vested interest, these amounts were obviously not nonforfeitable when contributed.

Practitioners, including us, argued that this interpretation of the rule was too narrow. Surely the real meaning of the rule was that funds that were QNECs or QMACs had to be nonforfeitable when they were allocated to the participants' accounts, not at the time they were originally contributed. The IRS finally agreed, issuing a proposed Treasury regulation (Section 1.401(k)-6) that uses the "nonforfeitable when allocated" rule, thereby permitting the use of forfeitures for this purpose. Because safe harbor contributions under safe harbor 401(k) plans are considered to be QNECs or QMACs, it is also permissible to use forfeitures to fund these contributions.

This new regulation follows the 2016 Notice issued by the IRS that loosened the rules regarding when and how safe harbor 401(k) plans may be amended during the plan year. The answer to that question went from "almost never" to "almost always" under that Notice. All in all, nice gifts from the IRS.

Before you go forward to use forfeitures to reduce employer contributions, note that the new guidance can create a document problem that must be handled as part of the change. All prototype and volume submitter defined contribution documents were required to be amended by April 30, 2016, and most (if not all) were required to remove any provision that permitted use of forfeitures to fund QNECs, QMACs, or safe harbor contributions. As a result, to take advantage of the new guidance, your plan must be amended. That amendment must be signed by the end of the plan year during which it is to be effective.

When you prepare this amendment, be careful: if the plan previously allocated forfeitures to participants' accounts, it is possible that you cannot change this provision until 2018. The rule for this is that the change in forfeiture use must be adopted before any participant completes the requirements to receive an allocation of the forfeiture to his or her account. If that date has passed, the participant's right to that allocation has matured and cannot be taken away. That would require that the amendment be effective prospectively, as of the first of the following year.

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If you have any questions about the fiduciary rules or the 401(k) forfeiture change, please call us.

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This intimate regional conference offers you the chance to get close and personal with our panel of speakers composed of Alison Cohen, Ilene Ferenczy, Robert Richter, David Schultz, and Derrin Watson. Mingle with them and other attendees at Ilene's home BBQ. Bring your most intriguing questions and issues to them during the program and at the "Ask the Oracles" session.

Here are some of the topics they are working on: eligibility & rehire; mergers and acquisitions challenges; 403(b) documents and should you get in the market; prototype updates; Form 5500 updates; missing participants; cash balance; DOL regulations update; ethics, and more.

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