12 Retirement Plan Concepts Financial Advisors Must Know

By Editor Test *Wed, Sep 14, 2011*

In this article, an ERISA attorney sets out to help retirement plan advisors understand basic retirement plan concepts that can help them develop and maintain their retirement plan book of business.

When it comes to the retirement plan industry, advisors have enough on their plate. Developing an investment policy statement, developing an investment option lineup, or conducting participant education isn't easy. Advisors don't need to become retirement plan experts, but they should be aware of some very basic concepts on how the industry works in order to stand out among their competition as well as augmenting their client's overall retirement plan experience.

It is my belief that better educated retirement plan advisors will help create better retirement plans. Hopefully, this article will further help retirement plan advisors understand basic retirement plan concepts that can help them develop and maintain their retirement plan book of business.

Qualified vs. non-qualified plans. Qualified plans allow the employer (who will abide by the requirements of ERISA and the Internal Revenue Code) a tax deduction for contributions it makes to the plan and employees typically do not pay taxes on plan assets until these assets are distributed. With non-qualified plans, select employees can receive larger contributions, but the employer cannot receive a deduction for contributions until a participant receives a distribution and the participant's contributions are subject to a risk of forfeiture and the employer's creditors in bankruptcy. Despite their limitations, non-qualified plans are highly attractive for some plan sponsors.

Fiduciary. Using discretion in administering and managing a retirement plan or controlling the plan's assets makes that person a plan fiduciary to the extent of that discretion or control. So, fiduciary status is based on the functions performed for the plan, not just a person's title. A plan's fiduciaries will ordinarily include the trustee, investment advisors, all individuals exercising discretion in the administration of the plan, all members of a plan's administrative committee (if it has such a committee), and those who select committee officials. Attorneys, accountants, and actuaries generally are not fiduciaries when acting solely in their professional capacities. The key to determining whether an individual or an entity is a fiduciary is whether he or she exercises discretion or control over the plan. As the current definition of a fiduciary stands now, registered investment advisors are fiduciaries, stockbrokers are not. The Department of Labor has proposed a new definition that will include brokers as fiduciaries. If you are a broker, you will have to determine how you will respond if you have to become a plan fiduciary.

Brokers must determine if they can exist with the fiduciary tag, or leave the retirement plan industry, or partner up with registered investment advisors and perform non-fiduciary functions.

Fiduciary responsibilities. Fiduciaries have important responsibilities and are subject to standards of conduct because they act on behalf of participants in a retirement plan and their beneficiaries. These responsibilities include: acting solely in the interest of plan participants; carrying out their duties

prudently; following the plan documents; diversifying plan investments; and paying only reasonable plan expenses. Fiduciaries that do not follow these responsibilities will have breached their fiduciary duty and may be personally liable to restore any losses to the plan, or to restore any profits made through improper use of the plan's assets resulting from their actions.

Bundled vs. unbundled 401(k) providers. There are two main delivery models of 401(k) services. The first approach is called the bundled provider, where one single vendor provides all investment, recordkeeping, administration, and education services. The unbundled approach is where the plan sponsor actually becomes the bundler, by picking different independent services providers for each of the necessary 401(k) services. Most small plans use the bundled provider approach, but plans that become larger in size ($2 million or more) should determine whether the unbundled approach is more cost effective.

Defined benefit plans. A defined benefit plan promises a specified monthly benefit at retirement, which is based on a participant's salary, length of employment, and age, based on an actuarial formula. While fallen out of favor for larger employers because of governmental regulation and the proliferation of 401(k) plans, they are still highly attractive for sole proprietors and small businesses.

Cash balance plans. A cash balance is a defined benefit plan (They are not hybrid plans as some may claim) that defines the benefit in terms that are more characteristic of a defined contribution plan. In other words, the cash balance plan defines the promised benefit in terms of a stated account balance (which is actually hypothetical). Working with a 401(k) plan, cash balance plans are more flexible in plan design than traditional defined benefit plans and may be a great fit for professional services firms as well as any company willing to pay 5% to 7% for their staff, which will lead to larger contributions for highly compensated employees.

Defined contribution plans. Unlike a defined benefit plan, it does not promise a specified retirement benefit. It offers a defined contribution allocation formula which allocates contributions to a participant's account, where the participant will bear the gains and losses from the investments in their account (whether they direct their investment or not. Profit sharing plans are a defined contribution plan. Note that a 401(k) plan is a profit sharing plan with a cash or deferred arrangement. In addition, no profits are needed to make a profit-sharing contribution.

Section 408(b)(2) regulations. The Department of Labor regulation that is supposed to be implemented in April 2012, requiring plan providers to reveal to the plan sponsor direct and indirect compensation that they receive from a plan. All financial advisors should consider revising their service agreements to comply with the new fee disclosure regulations.

Safe harbor 401(k). A feature under 401(k) plans where fully vested contributions are made to employees, whether they be matching or profit-sharing (3% across the board to participants, whether they defer or not). By making this contribution and providing an annual notice, a plan sponsor is considered to have automatically passed the salary deferral (ADP), matching (ACP), and top-heavy discrimination tests. Any plan currently failing or barely passing any of these tests should consult with their third-party administrator (TPA) to determine whether a safe harbor design is a good fit.

New comparability/cross-tests plan design. A form of a profit-sharing allocation that divides the employees of the plan sponsor into groups where the goal is to give a larger percentage contribution to highly compensated employees. At a minimum (barring any strange demographics), highly compensated employees can receive at least three times the percentage contributions that non-highly compensated employees can get (which is called a minimum gateway). One of the benefits of the safe harbor 3% profit-sharing contribution is that it can always be used to satisfy the minimum gateway.

ERISA §404(c). The provision in ERISA that limits a plan sponsor's liability in a participant-directed investment retirement plan. Many plan sponsors and advisors thought that offering plan participants some mutual funds to invest in and Morningstar profiles exempts plan sponsors from liability. Section 404(c) protection requires a process. Plan sponsors need an investment policy statement (IPS) that details why plan investments were picked. They must review and replace investment options with their financial advisors at least annually based on the terms of the IPS and meaningful education must be given to participants. All decision-making in this §404(c) process should be documented.

The myth of free administration. There is no such thing as a free lunch of free 401(k) administration. Whether plan sponsors are using an insurance company platform or are large enough to deal directly with mutual fund companies, they are paying for administration whether they believe it or not. Whether the administration fees are considered "free" or low, the provider makes up the low cost through wrap fees (hidden fees added to mutual funds by insurance providers) or 12b-1/revenue sharing fees (that mutual fund companies wouldn't have to share in a bundled environment).