SEYFARTH SHAW

MANAGEMENT ALERT

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IRS Okays Charging Expenses to Terminated Participants Only

Last May, we reported that the U.S. Department of Labor had ruled that plans may use different methods of allocating administrative expenses to the accounts of plan participants without violating ERISA, as long as the method used is reasonable. The Labor Department specifically noted that charging different expenses to different groups of participants, such as terminated participants, may be permissible.

While welcoming the Department's flexible approach, we also warned that charging expenses to terminated employees but not to current employees in a 401(k) or other defined contribution plan could violate the Internal Revenue Code. Specifically, the Code provides that a terminated employee whose account balance exceeds $5,000 has the right to leave his or her account in the plan until normal retirement age, and the plan cannot impose a "significant detriment" on former employees who choose to exercise this right. This raised the question of whether charging former employees but not current employees for the administrative cost of maintaining their accounts was a "significant detriment" that, in effect, punished the former employee for exercising the right to the leave his or her account in the plan until age 65.

Requirements for charging expenses

The IRS has now ruled that charging former employees but not current employees for administrative expenses is not illegal, as long as the expenses are reasonable and relate to the maintenance of the former employees' accounts. However, Revenue Ruling 2004-10, contains some important caveats:

- If former employees are charged with expenses related to their own accounts, the plan may not also shift expenses related to active employees to the former employees. Specifically, the IRS ruled that a plan may not allocate expenses related to active employees among all accounts, but only allocate expenses related to former employees to former employee accounts. However, it appears to be acceptable to have the employer bear the cost of administration for active employees but not former employees. Plan sponsors may wish to have their recordkeepers document the manner in which the fee charged to former employees is calculated in the event this issue is raised in a plan audit.

- The ruling applies literally only to pro rata allocations - e.g., where the plan charges each former employee's account an annual $50 administrative fee regardless of the account balance. However, there would seem to be no reason why a fee based on account balances would not also be acceptable, if it meets the other requirements.

- The amount of the fee must represent reasonable compensation for necessary services. The facts of the ruling do not disclose the amount of the fee, and there was no "safe harbor" amount included.

- Finally, the IRS warned that fees must not be charged to accounts in a manner that discriminates in favor of highly compensated employees. The ruling gives the example of a plan that changed its policy of charging QDRO determination fees to participant accounts in anticipation of the divorce of a highly compensated employee.

Other restrictions on terminated employees

The issuance of Revenue Ruling 2004-10 also provides a good opportunity for plan sponsors to review their other policies regarding former participants to make sure that they do not impose a forbidden "detriment" on those who choose to leave their accounts in the plan. In prior rulings, the IRS has ruled that a plan may not deny former employees the right to direct the investment of their own accounts if current employees are permitted to do so, but a plan may preclude former employees from taking out plan loans (although in some cases Labor Department guidelines require former employees to be eligible for loans). One issue that remains unresolved is whether a plan that permits hardship and other in-service withdrawals may preclude a former employee from withdrawing less than his or her full account balance.

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