Issue

What rules apply to how expenses are allocated among plan participants in a defined contribution pension plan?

Background

A number of questions have been raised in the course of investigations and otherwise concerning the propriety of certain expense allocation practices in defined contribution plans. This memorandum is intended to respond to the various requests for guidance from the National and Regional Offices on these issues.[1]

The two principal issues raised with respect to the allocation of plan expenses in defined contribution plans involve the extent to which plan expenses are required to be allocated on a pro rata, rather than per capita, basis and the extent to which plan expenses may properly be charged to an individual participant, rather than plan participants as a whole. For purposes of discussing these issues, we assume first that the expenses at issue are proper plan expenses[2] and second that, with respect to the plan as a whole, the amount of the expenses at issue are reasonable with respect to the services to which they relate.

Analysis

ERISA contains no provisions specifically addressing how plan expenses may be allocated among participants and beneficiaries. The Act and implementing regulations, however, do address certain instances in which a plan may impose charges on particular participants and beneficiaries. For example, section 104(b)(4) provides that the plan administrator may impose a reasonable charge to cover the cost of furnishing copies of plan documents and instruments upon request of a participant or beneficiary.(3) Also, section 602 permits group health plans, subject to certain conditions, to require the payment of 102% of the applicable premium for any period of continuation coverage elected by an eligible participant or beneficiary. Further, the Departments regulations under sections 404(c) and 408(b)(1) provide that reasonable expenses associated with a participant's exercise of an option under the plan to direct investments or to take a participant loan may be separately charged to the account of the individual participant.[4] By contrast, regulations may limit the ability of a plan to charge a particular participant or beneficiary by requiring that information be furnished free of charge upon request of a participant or beneficiary.[5]

Section 404(a)(1) generally provides, in relevant part, that fiduciaries shall discharge their duties with respect to a plan "solely in the interest of the participants and beneficiaries", prudently (404(a)(1)(B)), and "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of [Title I] . . . " (404(a)(1)(D)). Plan fiduciaries, therefore, would be required to implement allocation of expense provisions set forth in the plan, unless such provisions otherwise violate Title I.

Accordingly, plan sponsors and fiduciaries have considerable discretion in determining, as a matter of plan design or a matter of plan administration, how plan expenses will be allocated among participants and beneficiaries.

Allocating Expenses Among All Participants - Pro rata v. Per capita

In analyzing formulas for allocating expenses among all plan participants, the starting point is a review of the instruments governing the plan. Inasmuch as ERISA does not specifically address the allocation of expenses in defined contribution plans, a plan sponsor, as noted above, has considerable discretion in determining the method of expense allocation. Where the method of allocating expenses is determined by the plan sponsor (i.e., set forth in the plan documents), fiduciaries, consistent with section 404(a)(1)(D), will be required to follow the prescribed method of allocation. The fiduciary's obligation in this regard does not change merely because the allocation method favors a class (or classes) of participants. When set forth in plan documents, the method of allocating expenses, in effect, becomes part of defining the benefit entitlements under the plan.[6]

When the plan documents are silent or ambiguous on this issue, fiduciaries must select the method or methods for allocating plan expenses. A plan fiduciary must be prudent in the selection of the method of allocation. Prudence in such instances would, at a minimum, require a process by which the fiduciary weighs the competing interests of various classes of the plan's participants and the effects of various allocation methods on those interests. In addition to a deliberative process, a fiduciary's decision must satisfy the "solely in the interest of participants" standard. In this regard, a method of allocating expenses would not fail to be "solely in the interest of participants" merely because the selected method disfavors one class of participants, provided that a rational basis exists for the selected method.[7] On the other hand, if a method of allocation has no reasonable relationship to the services furnished or available to an individual account, a case might be made that the fiduciary breached his fiduciary duties to act prudently and "solely in the interest of participants" in selecting the allocation method. Further, in the case where the fiduciary is also a plan participant, the selection of the method of allocation may raise issues under the prohibited transaction provisions of section 406 of ERISA where the benefit to the fiduciary is more than merely incidental.(8) For example, if in anticipation of the plan fiduciary's own divorce, the fiduciary who is also a plan participant decides to change the allocation of expenses related to a determination of whether a domestic relations order constitutes a "qualified" order from the account incurring the expense to the plan as a whole, such change in allocation by the fiduciary could constitute an act of self-dealing under section 406 of ERISA.

While a pro rata method of allocating expenses among individual accounts (i.e., allocations made on the basis of assets in the individual account) would appear in most cases to be an equitable method of allocation of expenses among participants, it is not the only permissible method. A per capita method of allocating expenses among individual accounts (i.e., expenses charged equally to each account, without regard to assets in the individual account) may also provide a reasonable method of allocating certain fixed administrative expenses of the plan, such as recordkeeping, legal, auditing, annual reporting, claims processing and similar administrative expenses. On the other hand, where fees or charges to the plan are determined on the basis of account balances, such as investment management fees, a per capita method of allocating such expenses among all participants would appear arbitrary. With regard to services which provide investment advice to individual participants, a fiduciary may be able to justify the allocation of such expenses on either a pro rata or per capita basis and without regard to actual utilization of the services by particular individual accounts. Investment advice services might also be charged on a utilization basis, as discussed below, whereby the expense will be allocated to an individual account solely on the basis of a participant's utilization of the service.

Allocating Expenses to an Individual v. General Plan Expense

In contrast to the preceding discussion, which focused on methods of allocating plan expenses among all participants, the following discussion focuses on the extent to which an expense may be allocated (or charged) solely to a particular participant's individual account, rather than allocated among the accounts of all participants (e.g., on a pro rata or per capita basis). The Department provided some guidance on this issue in Advisory Opinion No. 94-32A. In analyzing the extent to which a plan may charge a participant (or alternate payee) for a determination as to whether a domestic relations order constitutes a "qualified" order, the Department concluded in AO 94-32A that imposing the costs of a QDRO determination solely on the participant (or alternate payee) seeking the QDRO, rather than the plan as a whole, would violate ERISA.

Since the issuance of AO 94-32A, the Department has had an opportunity to review the Act and the opinion in the context of a broader array of plan expense allocation issues raised in the course of investigations. On the basis of this review, the Department has determined that neither the analyses or conclusions set forth in that opinion are legally compelled by the language of the statute. Except for the few instances in which ERISA specifically addresses the imposition of expenses on individual participants, the statute places few constraints on how expenses are allocated among plan participants. In this regard, the same principles applicable to determining the method of allocating expenses among all participants, as discussed above, apply to determining the permissibility of allocating specific expenses to the account of an individual participant, rather than the plan as a whole (i.e., among all participants).[9]

Examples of Specific Plan Expenses

Hardship Withdrawals. Some plans may provide for the allocation of administrative expenses attendant to hardship withdrawal distributions to the participant who seeks the withdrawal. ERISA does not specifically preclude the allocation of reasonable expenses attendant to hardship withdrawals to the account of the participant or beneficiary seeking the withdrawal.

Calculation of Benefits Payable under Di erent Plan Distribution Options. Some defined contribution plans may charge participants for a calculation of the benefits payable under the different distribution options available under the plan (e.g., joint and survivor annuity, lump sum, single life annuity, etc.). ERISA does not specifically preclude the allocation of reasonable expenses attendant to the calculation of benefits payable under different distribution options available under the plan to the account of the participant or beneficiary seeking the information.

Benefit Distributions. Some plans provide for the imposition of benefit distribution charges on the participant to whom the distribution is being made. These charges may be assessed for benefit distributions paid on a periodic basis (e.g., monthly check writing expenses). ERISA does not specifically preclude the allocation of reasonable expenses attendant to the distribution of benefits to the account of the participant or beneficiary seeking the distribution.

Accounts of Separated Vested Participants. Some plans, with respect to which the plan sponsor generally pays the administrative expenses of the plan, provide for the assessment of administrative expenses against participants who have separated from employment. In general, it is permissible to charge the reasonable expenses of administering a plan to the individual accounts of the plans participants and beneficiaries. Nothing in Title I of ERISA limits the ability of a plan sponsor to pay only certain plan expenses or only expenses on behalf of certain plan participants. In the latter case, such payments by a plan sponsor on behalf of certain plan participants are equivalent to the plan sponsor providing an increased benefit to those employees on whose behalf the expenses are paid. Therefore, plans may charge vested separated participant accounts the account's share (e.g., pro rata or per capita) of reasonable plan expenses, without regard to whether the accounts of active participants are charged such expenses and without regard to whether the vested separated participant was afforded the option of withdrawing the funds from his or her account or the option to roll the funds over to another plan or individual retirement account.

Qualified Domestic Relations Orders (QDROs) and Qualified Medical Child Support Order (QMCSOs) Determinations. ERISA does not, in our view, preclude the allocation of reasonable expenses attendant to QDRO or QMCSO determinations to the account of the participant or beneficiary seeking the determination.[(10)]

It should be noted that, pursuant to 29 CFR § 2520.102-3(l), plans are required to include in the Summary Plan Description a summary of any provisions that may result in the imposition of a fee or charge on a participant or beneficiary, or the individual account thereof, the payment of which is a condition to the receipt of benefits under the plan. In addition, 2520.102-3(l) provides that Summary Plan Descriptions must include a statement identifying the circumstances that may result in the ". . . offset, [or] reduction . . . of any benefits that a participant or beneficiary might otherwise reasonably expect the plan to provide on the basis of the description of benefits . . . "These requirements are intended to ensure that participants and beneficiaries are apprised of fees and charges that may affect their benefit entitlements.

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