ERISA Basics/Prohibited Transactions

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MAY 2021

Origins of the Employee Retirement Income Security Act of 1974 (ERISA)

- The 1950s and 1960s saw significant increase in private sector employer sponsored retirement plans
- The number of instances in which employers or unions attempted to use the assets of these plans for purposes other than paying benefits to retired workers and their surviving dependents also increased
- Studebaker automobile company terminated its underfunded pension plan in 1963, leaving several thousand workers and retirees without the pensions that they had been promised
  - Congress began considering legislation to ensure the security of pension benefits in the private sector
- ERISA was signed into law by President Gerald Ford on Labor Day, September 2, 1974

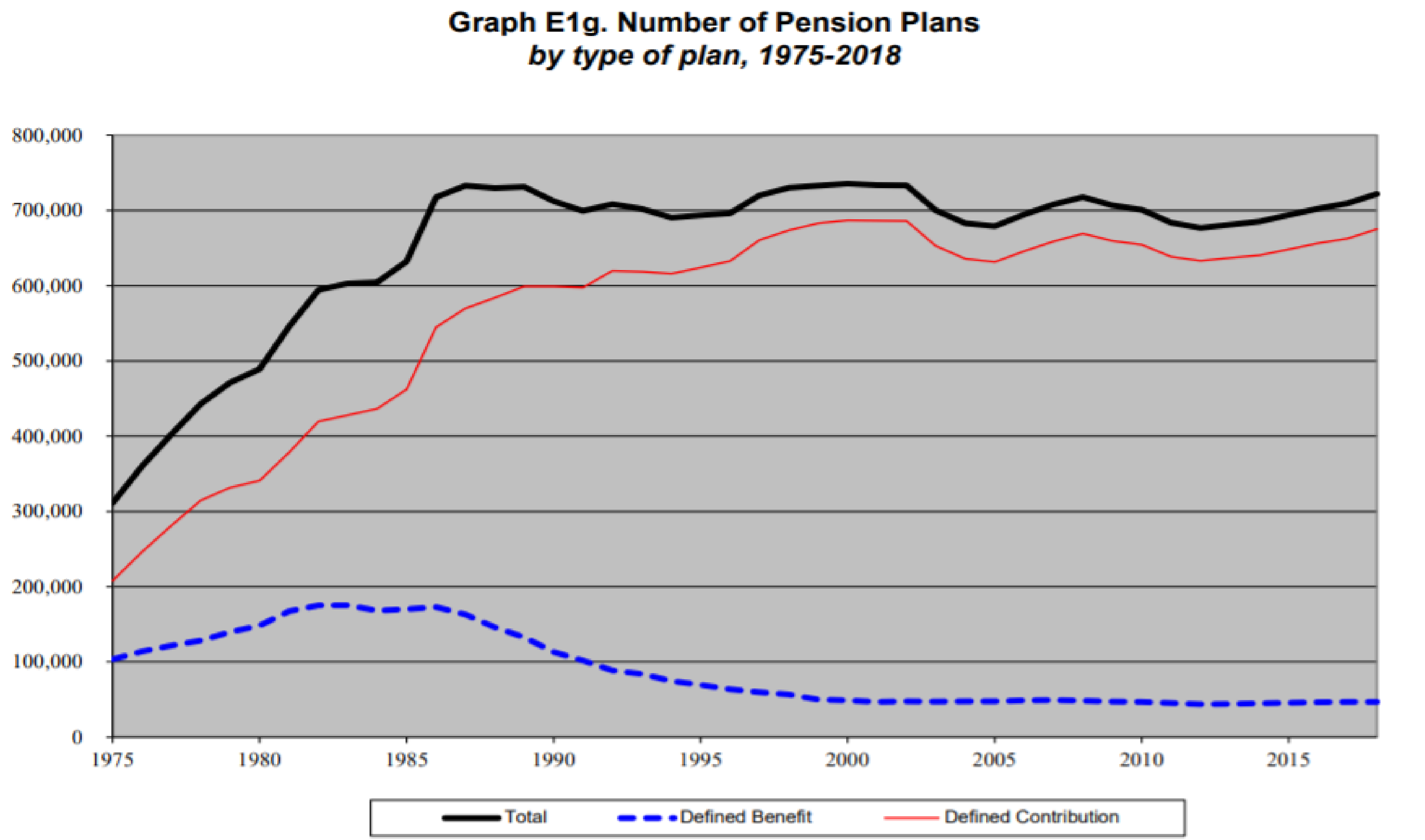
Goals of ERISA

- Provide a comprehensive federal scheme for the regulation of employee pension and welfare benefit plans offered by ***private-sector*** employers
- Regulate the responsibilities of plan fiduciaries and issues regarding plan administration
- Prohibit companies from using pension funds for purposes other than paying pensions and retiree health benefits
- Limit the age and length-of-service requirements that firms can require participants to meet to receive a pension
- Protect the rights of plan participants and beneficiaries in employee benefit plans.
  - protections include requirements relating to reporting and disclosure, participation, vesting, and benefit accrual, as well as plan funding

Types of Retirement Plans Covered by ERISA

- Defined Contribution Plans
  - provide an individual account for each participant that accrues benefits based solely on the amount contributed to the account and any income, expenses, and investment gains or losses to the account
  - contributions are specified but not the benefits
  - employee bears the investment risk
- Defined Benefit Plans
  - specify either the benefit that will be paid to a participant or the method of determining the benefit
  - plan sponsor's contributions to the plan vary from year to year, depending on the plan's funding requirements
  - plan assets must be sufficient to pay the benefits that participants have earned
  - employer bears the investment risk for the assets held by the plan

Change in the DB/DC Landscape



NOTES: The methods used to develop the statistics in this report have changed over time. These changes are outlined in Appendices A through I. Excludes "one-participant plans."

Pension plan statistics are weighted to estimate the impact of delinquent filers. This may result in non-integer plan counts and associated statistics in the underlying data. For more information on the weighted estimates, refer to the "Weights" section in the User Guide of the Form 5500 Private Pension Research File.

SOURCE: Form 5500 filings with the U.S. Department of Labor.

The Titles of ERISA

- Title I: Protection of Employee Benefit Rights
- Title II: Internal Revenue Code Provisions
- Title III: Jurisdiction, Administration, and Enforcement
- Title IV: Pension Benefit Guaranty Corporation and Plan Termination

Title I: Protection of Employee Benefit Rights

- Reporting and Disclosure
  - Summary Plan Description (SPD)
  - Annual Form 5500
  - Summary Annual Report
  - Quarterly benefit statement to participants in DC plans
  - Benefit statement at least once every three to participants in DB plans
  - Summary of Material Modifications
- Participation Requirements
  - Can exclude anyone who is not age 21 or who has not completed a year of service
  - Cannot exclude anyone who has attained a certain age (i.e., 65)

Title I: Protection of Employee Benefit Rights

- Anti-cutback Rule (aka, protected benefits)
  - Accrued benefits (some exceptions)
  - Normal retirement
  - Early retirement
- Minimum Vesting requirements for DC plans
  - 3-year cliff
  - 6-year graded
  - 100% if safe harbor plan

Title I: Protection of Employee Benefit Rights

- Benefit Protection for Spouse
  - Defined benefit plans and money purchase plans must provide preretirement and postretirement survivor annuities to married employees unless a written election to waive the survivor annuity is signed by both the employee and his or her spouse
  - In the event of divorce, ERISA requires plan administrators to honor qualified domestic relations orders (QDROs) issued by state courts that divide the pension or account balance between the two parties.

Title I: Protection of Employee Benefit Rights

- Fiduciary Responsibility
  - ERISA Section 3(21)(A) provides that a person is a "fiduciary" to the extent that the person:
    - exercises any discretionary authority or control with respect to the management of the plan or exercises any authority with respect to the management or disposition of plan assets
    - renders investment advice for a fee or other compensation with respect to any plan asset or has any authority or responsibility to do so, OR
    - has any discretionary responsibility in the administration of the plan
- Fiduciary Standard of Conduct
  - a duty of loyalty, a duty of prudence, a duty to diversify investments, and a duty to follow plan documents to the extent that they comply with ERISA

Title I: Protection of Employee Benefit Rights

- Investment Fiduciary 5-Part Test
  - (1) renders advice to a plan as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property; (2) on a regular basis; (3) pursuant to a mutual understanding; (4) that such advice will be a primary basis for investment decisions; AND that (5) the advice will be individualized to the plan.

Title I: Protection of Employee Benefit Rights

- ERISA Section 404c Fiduciary Protection for Participant Directed Accounts
  - Allows fiduciaries to be relieved of liability for participants' investment decisions
    - Offer a broad range of investments, including at least three options, each of which is diversified and has materially different risk and return characteristics
    - Ability to transfer among investment options at least once in any three-month period
    - Deliver information to participants about the plan, its investment options, and its operations before participants make investment decisions
    - In the case of an ESOP:
      - Employer securities must be publicly traded on a generally recognized exchange with sufficient frequency and volume to enable prompt trades.
      - Participants must be provided with the same information as other shareholders.
      - Voting, tender, and other rights must be passed through to participants.
      - Confidentiality of the purchase, holding, or sale of employer securities, as well as the exercise of voting, tender, or other shareholder rights, must be maintained.
      - An independent fiduciary must be appointed in situations where there is the potential for undue employer influence on participants, such as a tender offer.

Title II: Internal Revenue Code Provisions

- Limits on Plan Contributions and Benefits

401k Plan Limits for Year	2021	2020	2019	2018	2017	2016	2015
401k Elective Deferrals	$19,500	$19,500	$19,000	$18,500	$18,000	$18,000	$18,000
Annual Defined Contribution Limit	$58,000	$57,000	$56,000	$55,000	$54,000	$53,000	$53,000
Annual Compensation Limit	$290,000	$285,000	$280,000	$275,000	$270,000	$265,000	$265,000
Catch-Up Contribution Limit	$6,500	$6,500	$6,000	$6,000	$6,000	$6,000	$6,000
Highly Compensated Employees	$130,000	$130,000	$125,000	$120,000	$120,000	$120,000	$120,000
Non-401k Related Limits							
403b/457 Elective Deferrals	$19,500	$19,500	$19,000	$18,500	$18,000	$18,000	$18,000
SIMPLE Employee Deferrals	$13,500	$13,500	$13,000	$12,500	$12,500	$12,500	$12,500
SIMPLE Catch-Up Deferral	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000
SEP Minimum Compensation	$650	$600	$600	$600	$600	$600	$600
SEP Annual Compensation Limit	$290,000	$285,000	$280,000	$275,000	$270,000	$265,000	$265,000
Social Security Wage Base	$142,800	$137,700	$132,900	$128,400	$127,200	$118,500	$118,500

Title II: Internal Revenue Code Provisions

- Coverage and Nondiscrimination
  - Tax-qualified retirement plans may not discriminate in favor of *highly-compensated employees* (HCEs) with regard to coverage, amount of benefits, or availability of benefits
- Nondiscrimination Test
  - The plan must benefit at least 70% of non-highly compensated employees. This is called the percentage test; OR
  - The plan must benefit a percentage of nonhighly compensated employees which is at least 70% of the percentage of highly compensated employees benefitting under the plan. This is called the ratio test; OR
  - The plan must benefit a classification of employees that does not discriminate in favor of highly-compensated employees (nondiscriminatory classification test) and the average benefit percentage of the nonhighly compensated employees must be at least 70% of the average benefit percentage of the highly-compensated employees (average benefit percentage test).

Title III: Jurisdiction, Administration, and Enforcement

- ERISA is administered and enforced by three bodies: the Labor Department's Employee Benefits Security Administration (EBSA), the Treasury Department's Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC)
  - EBSA focus on enforcing ERISA
  - IRS focus on plan compliance
  - PBGC applies only to defined benefit plan

- Coordination between EBSA and IRS on most matters

Prohibited Transactions

- Prohibited transactions generally include:
- a transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person;
- any act of a fiduciary by which plan income or assets are used for his or her own interest;
- the receipt of consideration by a fiduciary for his or her own account from any party dealing with the plan in a transaction that involves plan income or assets;
- the sale, exchange, or lease of property between a plan and a disqualified person;
- lending money or extending credit between a plan and a disqualified person; and
- furnishing goods, services, or facilities between a plan and a disqualified person.

Prohibited Transactions

- Two types of Prohibited Transactions
  - “Parties in Interest” transactions
  - “Self-dealing” transactions
- Parties in Interest (“disqualified person”)
  - any individual or any entity having anything to do with the plan, including fiduciaries; employees of the employer maintaining the plan; owners of the employer maintaining the plan; service providers to the plan, including recordkeepers; and generally, anyone related to any of these people or entities.

Prohibited Transactions

- Self-Dealing:
  - Dealing with the assets of the plan in his/her own interest or for change to his/her own account
  - Acting in his/her individual account, or in any other capacity, acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries
  - Receiving any consideration for his/her own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan

Examples of Prohibited Transactions

- **Sale or exchange or leasing of any property**
  - *Example* - The owner decides to purchase a limited partnership interest of an investment owned by the plan. The transaction would be prohibited even if it is properly appraised or beneficial to the plan.
  - This includes direct or indirect transactions, even if the transaction is conducted under fair market value.
- **Lending money or extending credit**
  - *Example:* The plan lend money to the owner or the plan makes indirect loans to a third party to lend to the owner.
- **Use of Plan Assets by Disqualified Person**
  - *Example:* Failure to transmit participant contributions on a timely basis.
  - This is considered an indirect loan to the employer. The employer has effectively borrowed the assets from the plan which makes this a prohibited transaction.

Prohibited Transactions

- **Liability under ERISA:**
- ERISA requires a full, prompt correction of prohibited transactions. Generally, this means that the plan must be made whole, and the party involved must disgorge any profits resulting from the transaction.
- **Liability under the Code:**
- The Code imposes a 15% excise tax on "disqualified persons" in connection with qualified plan prohibited transactions. A *disqualified person* under the Code is similar to a *party in interest* under ERISA, although not identical. The amount subject to the tax is the amount involved in the transaction, and the tax can increase rapidly if the transaction is not promptly and appropriately addressed. An individual liable for this tax would use an IRS Form 5330 to report the liability and pay the tax.

Helpful Links

- Choosing the Right Retirement Plan: https://www.irs.gov/pub/irs-pdf/p3998.pdf
- 2021 Compliance Calendar: https://www.mercer.com/our-thinking/law-and-policy-group/retirement-plan-compliance-calendars-now-available.html
- Investment Fiduciary Guidance: https://www.federalregister.gov/documents/2020/12/18/2020-27825/prohibited-transaction-exemption-2020-02-improving-investment-advice-for-workers-and-retirees

Questions?

THANK YOU!

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