Allocating Plan Expenses

Considerations for choosing an allocation method

In the past few years, we have seen increased interest in allocating recordkeeping costs to participant accounts. This might occur when, for example, the plan's investments pay no revenue sharing, or when revenue sharing is allocated back to the accounts of the participants whose investments generated it. The Employee Retirement Income Security Act (ERISA) clearly permits plan expenses to be allocated to participants. However, the devil is in the details. Here, the "devil" is the how of allocating the charges to participants.

Fortunately, there is Department of Labor (DOL) guidance. Unfortunately, some plan sponsors may be unaware of it. Selecting an expense allocation method is a fiduciary act, which means that fiduciaries must make a prudent decision. The first step is to recognize the issue. The second is, by a prudent process, to evaluate the various considerations and then make a choice.

A major consideration is whether all of the participants should be charged with the plan costs. For example, should participants who are invested in the company stock fund pay their share of plan expenses? What about participants invested in brokerage accounts? A good starting point is that all participants should be charged for plan services.

Also, DOL guidance explains that the expense allocation method may be more favorable to certain participants than to others, provided there is a rational basis for using the method. That is, there must be a reasonable relationship between the amounts allocated and the value of the services. This raises the question: What is the rational basis for not charging participants in brokerage accounts and company stock funds when they receive substantially the same services as other participants—e.g., the benefit of the tax deferral, daily valuation and participant information?

Next, determine the method for allocating expenses to participant accounts. The most common strategy is to do so proportionately with account balances—called the "pro rata" method. Based on the aforementioned DOL guidance, this is generally acceptable. The guidance says: "… 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 …"

An alternative is the "per capita" method, where each participant's account is charged the same dollar amount. On that topic, the DOL guidance says: "A per capita method of allocating expense among individual accounts (i.e., expenses charged equally to each account, without regard to assets in the individual account) *may also provide* [emphasis added] 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."

The DOL says the pro rata method is equitable in most cases, while the per capita method "may" be reasonable. In other words, in some cases, per capita allocation may not be reasonable. Unfortunately, the DOL guidance isn't much help in determining when it *is*. Still, one approach would be to consider the major features of the plan and decide whether the participants benefit proportionately to their account balances, or equally, from each of those features. For example, one could argue that the plan's tax qualification—and the work needed to maintain the qualification—benefits participants in proportion to their account balances. After all, participants with higher balances benefit to a greater degree from the tax-advantaged status of the plan. On the other hand, plan features like the website and communications materials could be viewed as benefiting all participants equally.

Our point is to illustrate the kind of analysis that a plan committee should perform. Reasonable people could differ on the relative benefits of different plan services to different participants. Thus, after a thorough analysis, a committee could prudently conclude that some expenses could reasonably be allocated per capita, while others should be allocated pro rata.

Finally, the DOL said in its guidance that certain expenses should probably, by their very nature, be allocated on a pro rata basis. The specific example was investment-related expenses, which the DOL strongly "suggests" should be allocated pro rata. That could apply, for instance, to an investment adviser's fees, which benefit the accounts of the participants invested in the plan's lineup of investment choices.

Fred Reish is a partner at Drinker Biddle & Reath LLP's Employee Benefits & Executive Compensation Practice Group, chair of the Financial Services ERISA Team and chair of the Retirement Income Team. Follow Fred on Twitter @FredReish, and visit his blog at fredreish.com. **Bruce Ashton**, a partner at the company, and **Joshua Walkbeser**, an associate, contributed to this article.

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