Focus on 457 SM

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Revenue Ruling 2004-57: Will It Lead To The "Balkanization" of §457(b) Deferred Compensation Plans?

Revenue Ruling 2004-57 permits a labor union to establish and administer a separate IRC §457(b) plan for its members, provided the governmental employer for whom the union members work adopts the union plan.

When this Ruling was first published, many public plan sponsors had a "so what" response, since there has never been any legal or regulatory issue preventing public employers from establishing "multiple" §457(b) plans (which some plan sponsors already have done). However, the implications of Revenue Ruling 2004-57 are more far reaching than a simple "multiple plan" administrative platform.

Revenue Ruling 2004-57 clarifies that a §457(b) plan offered and administered by a union will not fail to be treated as a "governmental" plan just because it is offered by a tax-exempt union. The ruling outlines a number of conditions, however, that must be met to achieve governmental plan status, including some that are quite onerous on the governmental employer who adopts such a plan. Most importantly, the *governmental employer adopting the union plan is considered to be the entity establishing and maintaining the plans and is still the plan fiduciary.*

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Governmental Employer is the Plan Fiduciary

Though a union may have designed its own plan, including the selection of investment options and recordkeeper, the governmental employer must still adopt the plan. The governmental employer is the entity establishing and maintaining the plan in the same manner as it established and maintains the current plan for all employees. This means the governmental employer is the fiduciary, even though the union (or their designee) determines the selection of investment options, pricing, recordkeeper, and other plan services. *By agreeing to adopt the union plan, the governmental employer is approving the selections made by the union.*

Aside from the fiduciary liability issue, there are also some practical problems with this framework. First of all, if the plan sponsor has established investment guidelines for its current plan, and then adopts a plan sponsored by a union, the governmental employer must ensure that the investment guidelines for the union plan conform to, and don't conflict with, the current plan's investment guidelines. As the plan fiduciary, the governmental employer must apply the same standards in evaluating the union plan as they would in evaluating any pre-packaged or "bundled" program offered by a vendor. A union plan that does not meet those requirements should not be adopted.

There is also another inherent conflict if the union collectively bargains to have its plan offered by the employer. For example, if one or more elements of the union plan do not meet the fiduciary standards previously established, the employer may have to violate the terms of the collective bargaining agreement in order to fulfill its fiduciary obligation overall. Employers agreeing to offer a union-sponsored plan in a collective bargaining agreement without the imposition of fiduciary standards will almost certainly face a conflict at some point in the future.

As the administrator of the program, the union would have the option to change the plan from time to time, including investment options and service vendors. As the plan fiduciary, the employer must either approve such changes or cease participating in the union plan. As mentioned earlier, this could result in a violation of the collective bargaining agreement.

Impact on Other Participants

Many large public employers already offer a plan that is competitively priced. If, by adopting the union-sponsored plan, a sizable percentage of assets leave the current program, there could be serious consequences to the original plan. The fees on the original plan could increase significantly as the assets of the plan are reduced by assets transferring to the union plan. As the plan fiduciary, the employer is responsible for ensuring that the plan(s) serve the best interest of plan participants and their beneficiaries. By accommodating the request of one union to establish their own plan, remaining union and non-union employees who stay in the original plan may experience higher fees and/or reduced services due to the diminished assets in the original plan.

How Many Plans Will Be Offered?

Plan sponsors are faced with a significant issue when deciding how many plans to offer. The vast majority of public employers offer a single plan for all employees, since the larger plans generally have the lowest administrative fees, lowest management fees, and greater array of services. Large plans have "clout" with all types of service providers, which is why the larger plans are often so much more attractive than those offered by smaller governmental employers, even those that are "pooled" with other small employers.

As the plan fiduciary, the employer must determine where to draw the line between appeasing union groups and safeguarding the best interests of plan participants from an economic point of view. The break-up of an employer's larger plan into many smaller pieces in order to appease various groups may result in the "balkanization" of the larger plan. If this happens, participants could see their fees increase and services drastically diminish.

Administrative Implications Are Complex

Under the revenue ruling, the employer is responsible for coordinating the contribution limits and other requirements of §457(b) among all plans it offers since all of the plans are treated as one plan under the IRC. This means the employer must advise plan "A" of deferrals made on behalf of a participant in plan "B" and coordinate the total contribution limits among all plans. In addition to the contribution limits, all plans offered by the employer must provide for procedures to correct excess deferrals from one plan vs. another. This coordination not only applies to payroll deferrals, but to catch-up deferrals and benefit payments. Among other items, the normal retirement age and other provisions affecting catch-up will need to be the same between all plans so they can be coordinated effectively. Distributions, Qualified Domestic Relations Orders (QDRO's), hardships, and loans must be coordinated between all the plans offered by the employer, with overall IRS limits applied to the total.

Aside from administrative complications, there are investment issues to consider. If the creation of two or more plans causes assets in certain investment options to decrease, such options may be subject to higher fee break points than was previously the case. Many stable value fund options not only provide for reduced fees as assets grow, but they also impose transfer restrictions to "competing" funds. If one or more investment providers deem that the two or more plans offered by the employer have “competing” options, transfer fees that did not previously exist could now be imposed.

The employer may be faced with the higher costs of overseeing multiple plans with multiple payroll feeds and hundreds of investment options in the various underlying plans. The participant’s ability to transfer among plans may also be an issue. While union members could be allowed to participate in either the union plan or the employer’s plan, non-union members cannot be allowed to participate in the union plan. The plan documents and the participant communications would have to clearly establish which employees are eligible to participate in each plan and whether in-service transfers are allowed for participants eligible for more than one plan.

An Open Door To Conflict of Interest – Unions Beware

The editors of *Focus on 457* would like to make it clear that a discussion of these issues is not to imply that unions should not sponsor plans or be active in the oversight and governance of plans in which their members participate. To the contrary, union and employee association members have been, and continue to be, very important stakeholders in these plans and in fact serve as Board or Committee members for many public plans. There is no question that union members play an important role in these plans. The issue is whether *vendors* will inappropriately use Revenue Ruling 2004-57 as a temptation to pay for access to plans they would not otherwise win in competitive bidding under independent scrutiny. This is no different than past situations where some vendors have used other conduits (i.e; payments or employment offers to public officials or Board/Committee members) to gain access to public plans in lieu of competitive bidding. Unfortunately, Revenue Ruling 2004-57 may create another conduit for potential misuse.

Unions will need to beware of vendors who will ask that the union endorse their company or program in exchange for “endorsement fees” or other forms of compensation. This is particularly the case for vendors whose participation in public plans has been limited because their firm or investment products did not fare well in the public bid process used by the vast majority of governmental plan sponsors to select recordkeepers and investment providers. These vendors may attempt to gain access to plans through an endorsement that permits them to avoid the scrutiny of a public bid. Most unions will not succumb to such influence, but the temptation will be there from certain vendors. As the plan fiduciary, the employer will need to carefully evaluate whether any vendors can be added without the scrutiny of a public bid simply because they are “endorsed” by a sponsoring entity (union or otherwise).

Governmental employers and employee unions and associations must carefully weigh the benefits and drawbacks of offering multiple-plans in light of the fiduciary responsibility of the employer, and the impact on all participants and beneficiaries.

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