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State Initiatives to Expand the Availability and Effectiveness of Private Sector Retirement Plans

How Federal Laws Apply to Plan Design Options

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DECEMBER 2014-01

INTRODUCTION

Americans are facing a retirement crisis. What used to be a three-legged stool for retirement – Social Security, company retirement benefits and personal savings – has become unstable for too many because most companies do not provide pension plans for their employees[1] and employees have not saved much for their own retirement.[2] The U.S. personal saving rate has declined dramatically over the past several decades and is currently very low by historical standards.[3] According to the Employee Benefit Research Institute, more than 67 million Americans do not have access to a retirement savings plan through their employers.[4] Today, the confidence of many Americans to have a secure retirement is at an all-time low.[5] A recent poll showed that Americans fear outliving their retirement savings more than their own death.[6]

Policymakers should be concerned about the budget and tax consequences if more Americans enter retirement with limited financial resources. As income falls, there is less consumer spending and the available tax base is reduced. More Americans facing poverty in their retirement has consequences. For those who have little or nothing more than Social Security benefits – averaging about $1,300 per month[7] – the costs of food, housing, health care, transportation and other necessities that remain unmet would likely fall to federal, state, and local governments. This shortfall will strain government programs such as Medicare, Medicaid, and food stamps.

States are responding to the current demographic, economic and workforce trends by exploring ways to establish and operate user-friendly, low-cost retirement programs that employers could easily adopt. From California to Connecticut, states are studying ways to promote

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[1] King, Peter. "The Vanishing Pension: If Your Company Still Offers a Guaranteed Retirement Plan You're Fortunate These Days. But How Safe Is It?" *Newsday*, August 6, 2005 at http://www.pensionresearchcouncil.org/news/?id=22.

[2] According to the EBRI's 2014 Retirement Confidence Survey, 80 percent of workers between 25-34 years of age and 48 percent of workers 45 years of age and older have saved less than $25,000 for retirement. Helman, Ruth; Adams, Nevin; Copeland, Craig; and VanDerhei, Jack. "The 2014 Retirement Confidence Survey: Confidence Rebounds---for Those with Retirement Plans." Employee Benefit Research Institute, Issue Brief No. 397. March 2014 at http://www.ebri.org/pdf/surveys/rcs/2014/EBRI_IB_397_Mar14.RCS.pdf.

[3] See Brookings Institution, Chart, U.S. Personal Saving Rate, 1970-2012, March 14, 2013 at http://www.hamiltonproject.org/multimedia/charts/u.s._personal_saving_rate_1970-2012/

[4] Copeland, Craig. "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2013." Employee Benefit Research Institute, Issue Brief No. 405. October 2013 at http://www.ebri.org/pdf/briefspdf/EBRI_IB_405_Oct14.RetPart.pdf.

[5] Ibid.

[6] Taylor, Chris. "Is Outliving Your Savings a Fate Worse Than Death?" Reuters. November 12, 2014 at http://www.reuters.com/article/2014/11/12/us-retirement-savings-deathwish-idUSKCN0IW1VH20141112..

[7] Social Security Administration. Monthly Statistical Snapshot, September 2014. October 2014 at http://www.ssa.gov/policy/docs/quickfacts/stat_snapshot/2014-09.html.

retirement security for private sector workers.[8] Employer-provided retirement plans are often more effective for encouraging retirement savings.

However, because this is a new area for states, most are not familiar with how federal laws would apply. State pension plans have always been exempt from the federal Employee Retirement Income Security Act (ERISA) enacted to protect private sector employee benefit plans, including retirement plans. As states now contemplate ways to help expand the availability and effectiveness of private sector retirement savings options, they must understand how ERISA and other federal laws would apply to any new program for the private sector.

States are familiar with public pension plans. They primarily manage defined benefit plans, in which states are their own fiduciaries, have responsibility for the returns on investments, and promise retirees a certain benefit. The pension plan's funds are often pooled and professionally managed. Because of their fiduciary responsibilities, state pension plans are keenly aware of the risks of their portfolio in down markets and the importance of recruiting and retaining high-quality employees and advisors to manage those investments. Because states are already familiar with fiduciary duty and sound investment policy, federal requirements under ERISA and other laws should not be unfamiliar.

An additional challenge is understanding how federal laws may preempt state laws for different types of private sector retirement plans. The objective of this policy brief is to summarize ERISA's requirements, describe the three major categories of state-sponsored retirement plan options, and explain how ERISA and other federal laws apply. The paper concludes with a summary of key issues as well as some advantages and disadvantages for state policymakers to consider in deciding whether, and how, to expand the availability of retirement plans for private sector employers and employees.

ERISA and Retirement Plans

What Is ERISA?

ERISA was passed in 1974 to protect the participants and beneficiaries in *private sector* employee benefit plans, including retirement plans (defined benefit and defined contribution).[9] ERISA exempts federal, state or local governmental plans;[10] however, a plan created and/or operated by a government for private sector employees would not be considered a

[8] For more information about state-specific initiatives, please go to http://cri.georgetown.edu.
[9] 29 U.S.C. Sec. 1001 *et seq.*
[10] ERISA Sec 3(32), 4(b)(1).

governmental plan. A state could not escape ERISA regulation simply by bringing private sector workers into its own retirement system.

ERISA can affect a state's retirement initiative in one of two ways.[11] First, a retirement program that is considered an ERISA "pension plan" must comply with ERISA, including its framework for establishing and running the plan; fiduciary duties of prudence and acting in the best interest of participants and beneficiaries; participant disclosure and government reporting requirements; dispute resolution; and prohibited transactions rules. Second, regardless of whether the plan is an ERISA plan, ERISA preempts any state law that relates to an "employee benefit plan."

ERISA Requirements

To some, "ERISA" coverage conjures up visions of onerous fiduciary obligations and unlimited liability. Indeed, one court has famously said the ERISA fiduciary duties are the highest known to law.[12] ERISA does have a lot of rules, but it also provides workable standards for running a retirement program; a sound set of participant protections; and a well-established system for resolving disputes over benefit claims.

What follows is a brief summary of the ERISA rules on establishing and maintaining a plan; fiduciary duties; federal government reporting and participant disclosure; and when, where, and how a participant or fiduciary can sue for unpaid benefits or harm to the plan.

1) Establishing and Running a Plan
An ERISA retirement plan is established by an employer or union (the "plan sponsor") and operated under the terms of a written plan document.[13] Besides setting how benefits are determined and when they vest and are paid, an ERISA plan must designate one or more individuals, committee, or entity as the "named fiduciary" - the point person responsible for the other fiduciaries. The document also describes who may amend the plan, and it may provide for the delegation of authority by the fiduciaries to others. All plan assets (employee and employer contributions and investment earnings) must be held in a trust or in an insurance company annuity.[14] Plan assets are sacred and

[11] This paper follows the common usage that the term "ERISA" only refers to the fiduciary, participant safeguards, reporting and disclosure, and enforcement rules found in Title I of ERISA. Technically, the Internal Revenue Code (Tax Code) rules that govern the favorable income tax treatment afforded to qualified retirement plans also are found in ERISA, in Title II. With a few exceptions, the Department of Labor (DOL) regulates Title I and the Internal Revenue Service (IRS) regulates Title II.
[12] *Donovan v. Bierwirth*, 680 F.2d 263, 272 fn.8 (2d Cir. 1982).
[13] ERISA Sec. 402.
[14] ERISA Sec. 403.

bulletproof - they may only be used to pay benefits or to cover legitimate plan expenses. Each plan must maintain a fidelity bond.[15]

2) <u>ERISA Fiduciaries and Their Duties</u>.

Besides the plan sponsor, named fiduciary, and trustee, anyone with control over plan assets is a fiduciary. This includes a money manager or anyone with responsibility to appoint or fire a money manager.[16] A person who is performing ministerial duties is not a fiduciary.[17] Examples include most record keepers, lawyers, and other advisors. A person can wear two hats, serving in both a fiduciary and non-fiduciary role. For example, when a plan sponsor or employer decides to adopt, amend, or withdraw from a plan, this is a "settlor" decision outside of the fiduciary rules.

Fiduciaries are expected to be experts and to act prudently for the exclusive benefit of participants.[18] However, ERISA recognizes that not every fiduciary will be an expert, so a fiduciary may instead hire experts to advise them or delegate certain duties to an expert. Hiring or delegating to an expert is itself a fiduciary act. Neither perfection nor clairvoyance is expected of ERISA fiduciaries, just prudent and well thought-out, reasonable decision making. In the words of a famous judicial opinion, "prudence not prescience" is required.[19]

The plan sponsor and named fiduciary sit at the top and are ultimately accountable for what goes wrong. In a state-sponsored program that is considered an ERISA plan, the sponsor and named fiduciary could be a state-created entity, such as a special purpose trust company and/or special board. Under the ERISA concept of prudence, if these fiduciaries are diligent in hiring and monitoring consultants, money managers, trustees, and the like, then they will not have violated their ERISA fiduciary duties even if one of their delegates acts imprudently.

Employers adopting a state-sponsored retirement plan will, in effect, have made the ERISA fiduciary decision in selecting the plan's board, investment advisors, and other fiduciaries. The employers' exposure to ERISA fiduciary liability should be minimal as long as the state plan is overseen by a knowledgeable board and advised by a team of experts, and the plan's funds are in the hands of top-shelf investment managers, trustees/custodians and the like. As mentioned in the preceding paragraph, the state board itself would be an ERISA fiduciary; however, the board can fulfill its ERISA duties

[15] ERISA Sec. 412(a).
[16] ERISA Sec. 3(21)(A).
[17] DOL Reg. Sec. 2509.75-5.
[18] ERISA Sec. 404.
[19] *DeBruyne v. Equitable Life Assurance Soc'y of the United States*, 920 F.2d 457, 465 (7th Cir. 1990).

by establishing and following proper governance procedures and putting in place a team of professionals to operate the plan and invest its assets.

Special Investment Consideration. A large portion of fiduciary efforts concerns the investment of plan assets, especially for 401(k) and other defined contribution plans. ERISA allows fiduciaries to sidestep much of their fiduciary responsibilities by allowing participants to invest their own plan accounts.[20] For this to happen, participants must be given a choice of at least three diversified investments funds - say an S&P 500 fund, an international fund, or a fixed-income fund - the opportunity to switch investments at least quarterly and, of course, proper disclosure to participants. With daily valuation and a dozen or more funds, it is relatively easy for most plans to meet this so-called 404(c) exception. For participants who do not make any investment election, most likely those who were auto-enrolled in the plan, the participant may be "defaulted" into a diversified lifecycle, assets allocation, or similar all-in-one fund.[21] Importantly, although the participant can be made legally responsible for his or her own investment choices, the plan fiduciaries remain responsible for selecting and monitoring the investments offered on the fund lineup.

3) Reporting and Disclosure Requirements

Each plan must file an annual report (Form 5500, 5500-SF or 5500EZ) with the Internal Revenue Service (IRS) each year that includes a financial statement and other investment information; an actuarial report (for defined benefit pensions plans); and a representation that the plan did nothing illegal. Plans with fewer than 100 participants may file simplified annual reports and are not required to have an outside audit. For a state-sponsored retirement plan, the annual audit and annual report filing should be a manageable project.

The ERISA disclosure obligations include giving participants a readable "plain English" summary plan description (SPD), a notice of plan amendments (SMM), and information on plan fees, investments and payroll withholding (for 401(k) only).[22] Participants also must be given a benefit statement (quarterly for 401(k) and other defined contribution plans, and annually for defined benefit plans). The good news is that most record keepers have fully automated the process, and it should not present an undue burden for state-sponsored plans. Many plans now add simple one or two-page readable information sheets to the ERISA disclosure so participants have accessible information.

[20] ERISA Sec. 404(c); DOL Reg. Sec. 2550.404c-1.
[21] ERISA Sec. 404(c)(5); DOL Reg. Sec. 2550.404c-5.
[22] ERISA Sec. 105.

4) <u>Benefit Disputes and Litigation</u>

ERISA offers a well-developed system for resolving participant disputes. Before suing, a participant must make a benefit claim, have the claim denied by the plan, appeal the denial, and have the appeal also denied.[23] Only then may the participant sue and only in federal court.[24] The appeal/denial process must be in writing, and the participant must be given notice of his or her rights and an explanation of the denial and what other information might be needed to prove the claim. The participant has a right to all relevant plan documents that relate to the claim. The plan may specify a reasonable statute of limitations for making a claim and bringing a lawsuit, otherwise the analogous state statute governs. A court may award legal fees to either party, but absent outrageous conduct by the participant or his or her counsel, the employer or plan is unlikely to be awarded fees. However, a court may award fees to a losing participant, if he or she had "some degree of success on the merits."[25] A plan may provide that all disputes be litigated in a particular jurisdiction, for example, a New York-based plan could limit litigation to the courts of New York and Westchester Counties.

If the plan suffers a loss, for example, due to fraud or negligent action by a money manager, the fiduciaries may sue on the plan's behalf. Again, the suit must be in federal court. Courts generally have not required participants to exhaust administrative remedies before suing for breach of fiduciary duty.

5) <u>Prohibited Transactions</u>

ERISA (and the Tax Code) penalize certain "prohibited transactions" between a plan and a related party.[26] These transactions include the direct or indirect sale, exchange, or leasing of any property or lending of money or supplying goods and services between the plan and a party in interest. Fiduciaries are obligated to make sure the plan avoids these transactions. Fiduciaries also must avoid self-dealing or taking actions that are adverse to the plan. (There are numerous statutory and U.S. Department of Labor (DOL)-issued exemptions to these prohibited transactions.) Illegal transactions must be reversed, the plan made whole, and a penalty paid by the related parties.[27]

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[23] *See Amato v. Bernard*, 618 F.2d 559, 566-67, 569 (9th Cir. 1980)(noting that although ERISA does not require the exhaustion of administrative remedies, the legislative history and the text of ERISA make it clear that Congress intended for such a requirement to apply).

[24] Technically, a participant may contest a claim denial in state court. However, the federal Rules of Civil Procedure give the plan the right (which is almost always exercised) to remove the case to federal court.

[25] *Hardt v. Reliance Standard Life Ins. Co.*, 560 U.S. 242, 245 (2010)(quoting *Ruckelshaus v. Sierra Club*, 463 U.S. 680, 694 (1983)).

[26] ERISA Secs. 406-408. Similar rules are imposed by the Tax Code.

[27] ERISA Secs. 406, 408.

If a state-sponsored retirement plan is covered by ERISA, the state will have reporting and disclosure requirements and fiduciary responsibilities imposed on the plan's board and its delegates. But ERISA also offers a well-established body of law for operating the plan. Indeed, even if a state plan is designed to be exempt from ERISA, the board should still have accountability and transparency and provide its participants with summary and benefit statements, have an annual independent audit, and have a system for resolving benefit claims. If there are disputes about benefits, there will still be state law claims against the people responsible for the plan and their delegates.

ERISA and Preemption

If a plan is covered by ERISA, state laws relating to the plan are generally preempted. ERISA expressly preempts "any and all state laws [that] relate to any employee benefit plan" other than laws that regulate insurance, banking or securities,[28] and a state cannot treat a plan as an insurance company or bank for purposes of those state laws. Preemption is intended "to enable employers to establish a uniform administrative scheme."[29] ERISA can preempt a state law even if it only indirectly affects employee benefit plans and even if it is consistent with ERISA's goals.[30] However, not all laws that touch on benefit plans are preempted. Indeed, the Supreme Court has recently shown greater reluctance to find that a state law is preempted by ERISA unless, for example, the law mandates the benefits to be offered or the manner in which plans are administered.[31]

Conflicting Legal Interpretations. Within this framework, a dispute is emerging within the lower courts over how close a state can get to mandating that employers take retirement benefit-related actions and survive a preemption challenge. Legal scholars identify two important cases.

<u>Against Preemption:</u> *Golden Gate Restaurant Association v. City and County of San Francisco.* In *Golden Gate Restaurant Association v. City and County of San Francisco*, the Ninth Circuit found that the San Francisco Health Care Security Ordinance, which included a mandate that employers spend a specified amount each year for their employees' healthcare, either through payment of insurance premiums, reimbursement of medical expenses or paying into a medical program administered by San Francisco, was not preempted by ERISA.[32] The court determined that the ordinance did not regulate benefits or charges for benefits because it "did not require employers to establish their own ERISA plans or to make changes to any existing ERISA plans"

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[28] ERISA Sec. 4(b).
[29] *Egelhoff v. Egelhoff*, 532 U.S. 141, 148 (2001) (quoting *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 9 (1987)).
[30] *Id*.
[31] See *Cal. Div. of Labor Standards Enforcement v. Dillingham Constr., N.A.*, 519 U.S. 316, 324-25 (1997); *State Conference of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 649 (1995).
[32] 546 F.3d 639, 642-43 (9th Cir. 2008).

and it was "not concerned with the nature of the health care benefits an employer provides to its employees." Further, the court determined that the ordinance provided discretion to ERISA administrators to determine plan eligibility and entitlement to particular benefits and that the city payment option gave employers a realistic alternative to paying benefits under an ERISA plan and also gave employers something in return for their payment to San Francisco.

For Preemption: *Retail Industry Leaders Association v. Fielder*. On the preemption side, the Fourth Circuit ruled in *Retail Industry Leaders Association v. Fielder*, that Maryland's Fair Share Health Care Fund Act, requiring for-profit employers with more than 10,000 employees in Maryland (only Wal-Mart was large enough) to spend at least 8 percent of their total payroll cost on employee health insurance or pay the state the difference, was preempted by ERISA.[33] The court found that the act was preempted because it had an impermissible "connection with" employee benefit plans and it "directly regulated employers structuring of their employee health benefit plans" because employers would have to alter their employee plans to meet the minimum.

The Maryland case involved a single employer and required that employer to do something. In the San Francisco case, the court found that simply asking the employer to provide funds to the state to provide health care was not enough of a burden to make ERISA apply to them. The question is whether the San Francisco case would be seen as precedent, especially outside of the Ninth Circuit's jurisdiction, for states proposing that employers either maintain their own retirement plan or offer a state-sponsored retirement plan.

State-Sponsored Retirement Plans for Private Sector Employees

There is a range of options available for states interested in expanding the availability and effectiveness of retirement plans for their private sector employers and employees. These design options fall into three major categories:

1. Individual Retirement Accounts (IRAs)
2. 401(k)/Defined Contribution Plans
3. Defined Benefit Plans

Each of these programs can be designed to define the role of employers, employees, plan administration and asset management, but every choice raises questions related to how federal law applies. There is much confusion over how federal law would affect the design and operation of a state-sponsored retirement plan:

- Is the plan covered by ERISA?;
- Will ERISA preempt any portion of a state enabling law?; and

[33] 475 F.3d 180, 184-85 (4th Cir. 2007).

- What are the basic federal income tax and securities laws with which any program (ERISA-regulated or not) must comply?

These are among the key issues for states to consider in determining what type of retirement savings plan could help expand the availability and effectiveness of options for the private sector. Although much of the policy discussion to date has been focused on state options designed to be exempt from ERISA coverage, there also are plan design options covered by ERISA. Policymakers can and should determine what option is most suitable to achieve their desired policy goals.

State-Sponsored Payroll Deduction Individual Retirement Accounts (IRAs)

The plan design option that ordinarily would not be subject to ERISA would be IRAs (Individual Retirement Accounts and Annuities).[34] Any employee or self-employed person can set up an IRA by signing on with a bank, insurance company, or custodian and depositing money. IRAs are typically set up, controlled, and funded by an individual, not his or her employer. The individual account holder typically makes the decision about how to invest funds. The individual controls the account and may invest in just about anything, including mutual funds, stocks, bonds and annuities, but not art, jewelry and other “collectables.”

For most individuals the contributions are tax-deductible. Tax penalties apply to “early” withdrawals. Besides regular IRAs, most earners can contribute to a Roth IRA - contributions are not deductible, but withdrawals can be 100% tax-free. Special limits on tax deductions and eligibility to make Roth contributions apply to high-income individuals.

The DOL has ruled that an employer IRA payroll deduction program is not an ERISA plan if:

- It is employee-pay-all (the employer doesn’t make any contributions);
- Employee participation is completely voluntary;
- Employer involvement is limited to making the program known to employees, without endorsement, processing payroll withholding elections, and answering questions; and
- The employer is not paid for offering the program.[35]

IRAs can be a simple, low-cost alternative for retirement savings. Employers can offer IRAs to their employees, process employee contribution elections, and transmit the contributions to the IRA vendor without triggering ERISA regulation if the level of employer involvement is kept to a minimum. However, if an employer sponsors, maintains, or contributes to an IRA for its

[34] See ERISA Sec. 4(a) (requiring that a plan be established or maintained by an employer or union (or both) to be covered by ERISA).
[35] DOL Reg. Sec. 2510.3-2(d).

employees, the IRA becomes an ERISA plan. Today, the ready availability of payroll companies and technology allows businesses to more easily support and employers to more easily collect payroll deductions, making IRAs an increasingly attractive option.

Auto –IRA Model: ERISA Preemption Is Possible

Many states are considering requiring an auto-enroll feature in a state-sponsored IRA plan design. There is considerable research that suggests that individuals are much more likely to save if they are automatically enrolled in their employer's retirement savings plan and would have to make a decision to opt out of the savings.[36] Such auto-enrollment features have been spectacularly successful in encouraging private sector employees - who tend not to act - into saving for retirement.[37] However, auto-enrollment could trespass on the DOL's rule that employee participation must be voluntary. If the employer is using auto-enrollment in the program, it is possible to argue that this would be interpreted as the employee's participation no longer being voluntary under the DOL's ERISA exemption.

On the other hand, if the state is sponsoring an IRA plan with an auto-enroll feature, then it should remain exempt from ERISA as long as it is clear that it is the state and not the employer requiring the contribution to the IRA unless the employee opts out. It is the state, not the employer, imposing the auto-enrollment feature. Therefore, since the employer is not mandating the contributions and in fact has no choice in program design, the employer's involvement remains within the safe harbor.[38] The employer's responsibilities are only related to the processing and transmitting of the contributions to the state-sponsored IRA plan. In addition, if the employee is given advance notice and ample opportunity to opt out of contributing and, yet, takes no action, he or she has effectively elected to contribute. Since the employee was not *required* to contribute and could opt out at any time, participation should be considered voluntary.

A state would need to design an IRA program that meets the DOL exception. This could be met if the state would set the IRA terms, select the vendor[s] and permissible investments, and prepare and distribute the marketing/employee communication materials. The employer role would need to be limited to making the state IRA available to its workers, distributing materials

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[36]Butrica, Barbara A. and Karamcheva, Nadia S. "Automatic Enrollment, Employee Compensations, and Retirement Security." Center for Retirement Research, Boston College, CRR WP 2012-25, November 2012 at http://crr.bc.edu/wp-content/uploads/2012/11/wp_2012-25-508.pdf.

[37] Ibid.

[38] *See Current Challenges and Best Practices for ERISA Compliance for 403(b) Plan Sponsors*, ERISA Advisory Council Report, (Nov. 9, 2011); *but see* DOL Field Assistance Bulletin 2006-02, Q&A 1, indicating that automatic contributions to a health spending account could be voluntary.

and election forms, answering basic questions, and withholding and transmitting employee contributions.

California's Secure Choice Program: ERISA Preemption Questions Remain

On September 28, 2012, California enacted its Secure Choice Retirement Savings Trust Act ("SCRST Act"). It is one of the first states to pass a law and begin working to develop a retirement savings option for its private sector employers. The law creates a nine-member board to administer the California Secure Choice Retirement Savings Trust program and an employer requirement to maintain a "payroll deposit retirement savings arrangement" for their employees. [39] The California approach appears to contemplate a state-sponsored IRA program that would require that employees automatically contribute a set percentage of their pay unless they opt out[40]. From the employees' perspective, the decision whether to contribute is voluntary since the employee can opt out at any time and the default (i.e., doing nothing) is to save for one's own retirement. The employer's involvement in this type of state-sponsored IRA should be minimal since it would neither "sponsor" nor have any control over the arrangement. Employers would simply remit directly to the Trust any funds deducted from employees' payroll.[41]

The California Secure Choice Program is in the design phase, and important unanswered questions remain about how it will be affected by ERISA and other federal laws. [42] For example, if it only requires the employer to withhold from payroll and transmit the withholdings to an IRA, there is a strong argument that it could survive a preemption challenge, but that remains to be seen.

State-Sponsored 401(k)/Defined Contribution Plans

A 401(k) is a specialized employer retirement plan to which employees may make tax-deductible contributions from their wages. Contributions are typically invested by the employees from a menu of investments selected by the employer. Employers also may match a portion of each employee's contributions. The employee contribution limits are much higher for a 401(k) than an IRA. If the plan permits, participants may make Roth 401(k) contributions.

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[39] Exceptions to this mandate apply to employers with fewer than five employees, those covered by the Railway Labor Act, or if the employer already sponsors a retirement plan or has an IRA payroll deduction plan in place or similar plan in place. CSCRST Act Secs. 10032(g) and 10032(d).

[40] Employees who do not opt out will contribute 3 percent of their annual salary or wages to the program, but employees can change that amount or opt out.

[41] The law specifies that funds can be invested by the Treasurer of California, the board of the California state pension plan, or by some combination of CalPERS and private managers. CSCRST Act100004(c) and (a).

[42] Certain wording in the California statute suggests that the legislature intended the program to be a hybrid 401(k) and/or pension plan. However, these plans could not be offered in a non-ERISA format. An individual annuity product might be an available non-ERISA alternative under the California statute.

The plan also may allow employees to borrow from their account. As with IRAs, penalties apply on “early” withdrawals.

The Question of Multiple Employer Plans (MEPs): One Plan or Many?

An important legal uncertainty facing any state-sponsored program open to establishing an ERISA-covered 401(k)/defined contribution or defined benefit model (see next section) is whether the plan will be regulated as a single plan maintained by a group of unrelated employers (called a MEP or multiple employer plan) or a collection of separate employer plans.

Today, small businesses tend to avoid offering retirement benefits because they are too expensive and too time-consuming to manage, and they expose the company to liability if something goes wrong. On the other hand, the economies of scale generated by numerous businesses joining in a single plan should make a state-sponsored program less expensive and its selected cadre of fiduciaries and service-providers would do most of the administrative heavy lifting, making the plan more attractive to employers.

There are several regulatory and cost advantages to being treated as a MEP. As a MEP, one IRS Form 5500 Annual Report is filed; one ERISA fidelity bond purchased; and a single annual audit by an independent accountant conducted, for the entire plan. In a non-MEP, as a collection of separate plans, each employer would need its own Annual Report, bond and audit, depending on whether the particular employer had reached the 100-participant threshold.

Participating employers in a state-sponsored program that is a MEP also should have minimal ERISA fiduciary responsibility (basically whether to join, remain in, or leave the plan) and thus, minimal liability exposure. In a non-MEP collection of single plans, each employer may be viewed as having greater fiduciary responsibility for plan functions and thus, greater potential liability.

Significantly, as discussed in the next section, multiple employer plans also enjoy exemption from the federal securities laws that could otherwise treat the program as a “security” or “regulated investment company.”

In either a MEP or collection of single plans approach, each employer would be tested separately for compliance with the Tax Code coverage and nondiscrimination tests. One risk for a MEP (or an upside to a collection of single plans) is that if one participating employer violates one of the tax qualification rules, the mistake can affect the entire plan. However, it should be possible to significantly mitigate this risk in plan design by using the IRS correction procedures to limit the expense of correction to the offending employer.

The IRS and DOL appear to have different views on what it takes to be a MEP. The IRS has ruled that the combined plan of many unrelated employers is a single plan as long as the program's assets are combined in one pool, without any employer-by-employer segregation.[43] For a 401(k) or other defined contribution plan where participants have individual accounts, pooling all assets should not put any participant's account at additional risk from fraud, mismanagement, or other incompetent or nefarious behavior by other employers or participants.

The DOL, however, seems to have an extra requirement: According to the Department, unrelated employers can maintain a single plan only if they "are tied together" by "a genuine economic or representational interests."[44] Whether a group of employers is sufficiently tied in an "affinity group" is not mentioned in ERISA as a MEP requirement. However, even under the affinity group standard, a state-sponsored retirement plan should create a sufficient tie-in to pass muster with the DOL. The DOL's Advisory Opinion[45] on this question predates the development of state-sponsored retirement plans, so the question is not settled, but the DOL would be expected to wish to encourage state-sponsored ERISA programs as a policy matter.

Massachusetts' ERISA 401(k) Plan for Nonprofits[46]

On March 22, 2012, Massachusetts enacted a 401(k)-type plan for certain nonprofits known as the Massachusetts Connecting Organizations to Retirement (CORE) Plan.[47] This bill authorizes the state treasurer to set up a state-sponsored tax-deferred plan for nonprofits with no more than 20 employees.[48] Participation by nonprofits is voluntary. To minimize investment and administrative costs, the statute expects that the plan will be a multiple employer plan and that participant accounts will be invested in the same options as are available under the existing deferred compensation plan for state employees. Participating employers will automatically deduct (with an opt out) pre-tax earnings from participants' paychecks into individual employee accounts. Withdrawals from these accounts will be taxed at retirement.

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[43] IRC Sec. 413; Treas. Reg. Secs. 1.413-2 and 414(l).
[44] DOL Advisory Opinion 2012-04A, May 25, 2012.
[45] Ibid.
[46] Unless otherwise noted, all information was retrieved from a presentation by David Lynch, Executive Director, Deferred Compensation, Office of the State Treasurer, State of Massachusetts, "Massachusetts CORE Plan," during the Georgetown Center for Retirement Initiative's webinar, "Private Sector Retirement Security Initiatives in the States," October 16, 2014, at http://cri.georgetown.edu/events/.
[47] Carlisle, Jon. "Grossman and Jakious Announce Major Step Forward in Creation of Non-Profit Retirement Plan." Governor Steven Grossman Press Release. June 9, 2014, at http://www.mass.gov/treasury/about/media-pubs/treas-press-rel/2014/nonprofitirspr.pdf.
[48] H3754 bill language at https://malegislature.gov/Bills/187/House/H3754.

Massachusetts' plan is covered by ERISA with small employers subject to reporting and disclosure requirements and the other ERISA and Tax Code rules. The state will provide participating employers with information regarding their obligations.

CORE Plan design includes portability, auto-enrollment, retirement income planning resources, and restricted early withdrawal options. Individuals will have their own account that is portable from one nonprofit employer to another nonprofit employer. While many people cash out their 401(k) when leaving an employer, the CORE plan hopes to discourage this "leakage" so individuals leave their account and allow it to grow. Employees of participating nonprofits generally will be automatically enrolled in the program at a default contribution rate of six percent of income. The contribution rate would be programmed to increase up to ten percent of income with no additional effort from the employer or employee. Benefit statements will include a projection of the participant's retirement income. Another retirement planning resource provided is a Web-based tool, the Retirement Income Control Panel, which will provide account access as well as plans tools such as savings projections based on an assumed rate of return. Lastly, pre-retirement withdrawals due to hardships will be allowed with the specific guidelines yet to be set.

State-Sponsored Defined Benefit Plans

The traditional defined benefit pension plan is the most effective vehicle for helping workers prepare for retirement. Benefits are typically paid as a lifetime annuity (or joint and survivor annuity), reducing the possibility of someone depleting his or her nest egg too quickly, perhaps even before retiring. The plan sponsor or its delegate is responsible for investing the plan's funds, keeping this critical activity out of the hands of employees, some of whom may be woefully unprepared for the task. Benefits are funded by employer and, sometimes, employee contributions. (Employee contributions are after-tax; so-called Section 414(h)(2)" pick-ups," in which governmental employees can make pre-tax contributions to a defined benefit plan, are not allowed in private sector plans.)

Defined benefit plans are the quintessential retirement plan for employees because the sponsor/employer is responsible for funding and investments and there is less possibility of leakage (an employee's withdrawing the benefit before retirement). Pensions, however, can present difficulties for employers because poor investment markets or decreases in interest rates can increase employer costs and negatively affect the employer's balance sheet. Defined benefit plans are also more complicated and expensive to operate, requiring the assistance of an actuary on top of the usual team of advisors and payment of Pension Benefit Guaranty

Corporation premiums.[49] However, negative perceptions aside, it is possible to design a defined benefit plan with a benefit formula and conservative funding methods that minimize the possibility of any contribution or balance sheet "surprises" and still provide meaningful retirement income to participants. Also, as outlined in the next section, hybrid pension designs may further protect sponsors and employers.

Cash Balance Plans

A cash balance plan offers retirees some of the advantages of a traditional defined benefit plan while minimizing the employer's risk of getting hit with an unexpectedly large contribution when investment markets or interest rates turn the wrong way. Each participant has a hypothetical bookkeeping account in the plan to which the employer makes an annual "addition" (typically equal to a percentage of salary). The account also "grows" each year based on stated formula (typically a fixed-income benchmark). At retirement, the account is converted into an annual pension using IRS-required interest and mortality assumptions. The employer still bears the funding and investment responsibility for the plan, but the bookkeeping account system makes it much easier to predict (and budget for) the amount of contributions. Besides the lifetime pension, most cash balance plans allow retirees to take their entire account in a single lump sum. Indeed, for a number of participants the bookkeeping account "frames" the plan benefit as a lump sum and not a pension, and many choose the cash.

Despite seemingly obvious advantages, few have proposed that a state-sponsored retirement plan be a traditional or hybrid defined benefit model. Why? Most likely it is the same uncertainties that have chased many private sector employers away from pension plans and into 401(k) plans. However, it may be possible to craft a state-sponsored MEP-type defined benefit plan using conservative assumptions where the possibility of surprise underfunding is remote.[50]

Other Legal Considerations in Plan Design: Federal Securities and Tax Laws

Federal Securities Laws

Any state-sponsored retirement program will commingle and invest program moneys - in various mutual funds, separate accounts, group trusts and/or in tandem with the state's own pension system. The program should be designed so that these investments are not required

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[49] The Pension Benefit Guaranty Corporation or PBGC is a quasi-government corporation created by ERISA to insure a portion of private sector pension benefits.

[50] The National Conference on Public Employee Retirement Systems (NCPERS) has developed a proposal for a defined benefit pension plan to be funded by employer and employee contributions. NCPERS believes it has designed a pension plan referred to as "Secure Choice," that would not raise the usual concerns among employers and taxpayers about potential liabilities and costs. www.ncpers.org. For full disclosure, NCPERS is a client of K&L Gates, and I have worked on NCPERS' Secure Choice model.

to be registered as an investment company or security under the federal securities laws. [51] Ordinarily, this should be relatively simple, since the 40 Act generally excludes qualified retirement plans from regulation. The Securities and Exchange Commission (SEC) has taken the position that only a single plan - one in which all assets are commingled and available to pay benefits under the IRS rules (i.e., a MEP) - would be exempt. Unfortunately, several statements by the SEC have suggested that it may view the existence of an affinity group as an additional requirement.[52]

While a full discussion of federal securities laws is beyond the scope of this paper, in certain instances, especially where the plan invests alongside the state pension system, an additional "fail-safe" step may be needed to achieve exemption from federal securities laws. Specifically, a state could use its own banking powers to establish a non-depository trust company to serve as trustee of the plan. The trust would be exempt from the 40 Act and would not need to be registered as a security under the 33 Act.[53] Significantly, the securities law exemptions only apply to qualified plans; they do not provide relief for IRA arrangements or for commingled investment funds holding IRA assets.

<u>Tax Code: IRAs and Qualified Retirement Plans</u>

***IRAs*.** For a worker not covered by a company retirement plan, the contribution to an IRA is tax-deductible up to the Tax Code limits - for 2015, $5,500 for someone under age 50 and $6,500 for those who will be at least 50 by year-end.[54] (Dollar limits are indexed annually for inflation.) Rules similar to the prohibited transaction requirements discussed under ERISA also apply to an IRA. So, for example, an individual could not invest his or her IRA to fund in his or her own business. Investment income accumulates tax-deferred. Federal tax is due only on distribution (plus an excise tax for certain "early" pre-59-1/2 withdrawals). An individual may also establish a Roth IRA in which contributions are made after-tax but distributions, including investment earnings, are completely tax-free.

***Qualified Retirement Plans*.** 401(k) and other defined contribution plans are more complex than IRAs, but offer far greater savings potential and flexibility. [55] Employee 401(k)

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[51] The Investment Company Act of 1940 ("40 Act") regulates most mutual funds. Group trusts are pooled investment vehicles that limit investors to qualified plans, IRAs, and certain other tax-favored plans. Rev. Rul. 81-100, 1981-1 C.B. 326. Group trusts may register under the 40 Act.

[52] See Samaritan Health Systems, SEC No-Action Letter (Dec. 14, 1993); Communications Workers of America, SEC No-Action Letter (Jan. 27, 1980).

[53] Sec. 3(a)(2) of the 33 Act; Sec. 3(c)(11) of the 40 Act.

[54] Individuals who earn above certain amounts and who participate in an employer retirement plan, may only make post-tax contributions to an IRA. IRC Sec. 408(o)(4). Since the state programs are targeting employees without any form of retirement benefit, this limit is unlikely to affect many participants.

[55] A much relaxed version of the Tax Code qualification rules applies to retirement plans for government employees.

contributions are tax-deferred up to the Tax Code's limits --for 2015, $18,000 for those under 50 and $24,000 for those who will be at least 50 by year-end. (Dollar limits are indexed annually for inflation.) Alternatively, an employee can contribute up to these same limits as post-tax Roth 401(k) contributions. Employers also are allowed to contribute using "matching" or discretionary contributions. (An employer also may contribute to an employee's IRA, but that would trigger ERISA regulation.) For a defined benefit plan, the employer must make quarterly contributions calculated by an actuary using IRS-permitted assumptions and intended to fully fund all benefits over time. Employer contributions to a defined contribution plan are deductible in the year made.[56] Employees are always 100 percent vested in their own contributions and, depending on the plan's terms, employer contributions can vest anywhere from immediately to over three to six (seven for a defined benefit) years.[57]

To achieve these tax advantages, a defined contribution or a defined benefit plan must be "qualified" by meeting numerous Tax Code requirements. First, the plan must be "established and maintained by an employer."[58] This rule could be an issue for state-sponsored plans because the state (or an entity set up by the state) may be interpreted as establishing and running the plan, not the employers. However, the requirement should be satisfied simply by having the employers adopt the state program and agree to provide benefits to their employees under the plan's terms. While the IRS has never ruled on the issue, it appears that it has never challenged a group plan's qualification under the established and maintained requirement.[59]

Aside from who may establish a plan, the qualifications requirements boil down to a series of rules, mathematical formulas, and limits that are intended to keep the plan from favoring favor highly compensated employees (HCEs) too heavily.[60]

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[56] IRC Sec. 404(a).

[57] IRC Sec. 411.

[58] Treas. Reg. Sec. 1.401-1(a)(2).

[59] Further, IRS instructions for completing Form 5500 annual reports and Form 5300 requests for a determination on qualification, suggest that the IRS would support this view.

[60] An HCE is any employee who is (or was in the prior year) 5% owner or was paid $115,000 in 2014 (indexed). Qualification rules include 1) the plan must cover a reasonable percentage of employees who are not HCEs (NHCEs), for example, a plan benefiting 70% of NHCEs would pass "coverage"; 2) the plan's benefit structure or other important features may not discriminate in favor of HCEs; 3) 401(k) and any matching contributions must pass special mathematical tests (ADP and ACP, respectively) that compare the ratio of contributions by HCEs to NHCEs - failure usually results in a return of "excess" contributions to HCEs; 4) the plan may not count an employee's compensation above $265,000 (indexed) in calculating his or her benefits; 5) the annual contribution added to an employee's account may not exceed $53,000 or 100% of compensation; 6) payments must begin by age 70 1/2 or, for non-5% owners, retirement; and 7) a plan must follow its written terms.

Violation of any of the Tax Code requirements could, in theory, cause a plan to be "disqualified." Disqualification causes a plan to retroactively lose all favorable tax benefits: participants are immediately taxed on vested benefits, even if not paid out; the plan must pay income tax on its investment earnings; the employer can lose its tax deduction; plus participants and the employer may have interest and tax penalties imposed for not reporting the retroactive income when it was contributed to the plan.

However, because of the draconian consequences, the IRS is loath to disqualify a plan. Instead, it has created a series of procedures where an employer can correct a qualification defect.[61] Depending on the relative size and nature of the error, and how it was caught (by the employer and self-corrected or by the IRS on audit), almost all errors may be fixed by undoing the mistake, making all participants whole, and perhaps, by the employer paying an IRS user fee or penalty.

Key Issues to Consider in Structuring a State-Sponsored Plan

The key issues that a state legislature must confront and alternatives which should be considered in setting the general specifications for a state-sponsored retirement program include the following:

Program/Feature	IRA	401(k)/DC	DB (Pension)
ERISA Regulation	Non-ERISA	ERISA	ERISA
Administrative Simplicity	Yes	Somewhat (single plans vs. MEP affects burden on employers)	Complex
Contributions Allowed	Employee pre-tax/Roth	Employee pre-tax/Roth; and Employer	Employee after tax; and Employer
Investments	Employee chooses from plan "menu", including a state-pooled and professionally managed option and/or private sector (third-party) options	Employee chooses from plan "menu", including a state-pooled and professionally managed option and/or private sector (third-party) options	Sponsor and its delegates control

[61] Rev. Proc. 2013-12.

Can Employers be required to adopt	Maybe. Depends on ERISA interpretation by federal courts if challenged	Unlikely	No
Auto-enrollment with Employee Opt Out	Maybe. Depends on ERISA interpretation by federal courts if challenged	Yes	Not applicable
Pros	• Simple • Low-cost • Easier to establish	• Some complexity but flexible design • Employees may contribute \$18,000 (\$24,000≥ *age 50);* • Allows employer contributions	• Complex but provides lifetime pension income • Less leakage
Cons	• Relatively low contribution levels of \$5,500 (\$6,500≥ age 50) • No employer contribution • Investment risk on participant • Participant leakage	• Some participant leakage[62] depending on plan design • Investment risk on participant	Funding/investment risk on employers

Of course, the chart leaves off the many, many nuances that must be analyzed before a program can be designed and enabling legislation crafted. Yet, if the basic parameters can be set - simplicity vs. stronger retirement vehicle, ERISA or no-ERISA regulation-- the actual task of designing the program will be significantly streamlined.

[62] Leakage is a term to refer to plan fund withdrawals made by participants from IRAs or 401(k)/defined contribution plans. Data from HelloWallet, for example, suggests that 75 percent of 401(k) plan participants breached their savings because of basic money management problems, and 26 percent of 401(k) participants used their 401(k) savings for non-retirement needs. http://www.hellowallet.com/wp-content/files_mf/hellowallet_retirementbreach2.pdf.

Conclusion

Too many Americans are finding it increasingly difficult to save for their retirement. The implications for government programs could be significant in the future as the population continues to age and live longer than ever before. More state governments are recognizing the need to get ahead of this trend and look for innovative ways to expand the availability and effectiveness of retirement plans for private sector employers and employees.

States are leading the way in developing standardized, easy-to-use retirement plans to help private sector employees save for retirement. State experimentation should be encouraged because every state has unique demographic, economic, and retirement needs. The federal government should look for ways it can be supportive of state efforts to expand and tailor their own retirement security initiatives. No plan design option is without some uncertainty regarding how federal employee benefit, tax and/or securities laws apply. In any approach, some employer involvement, from simple payroll withholding to making matching or other contributions, will be needed.

For states interested in an IRA approach, the effectiveness of an auto-IRA model would be greatly enhanced if there were legal certainty that auto-enrollment would not trigger ERISA coverage. Although simpler, lower cost and easier to establish, IRAs are limited by low contribution levels, no possibility of employer contributions and, perhaps, one might argue, too much control (although this possibly could be reduced with program design) by participants. To permit larger employee contributions, employer contributions, and generally greater flexibility, a 401(k) defined contribution approach would be needed. Although a defined contribution plan would be covered by ERISA, as we have seen with Massachusetts' plan, this may not necessarily be viewed as an obstacle. An ERISA plan can be structured to minimize the possibility of ERISA liability to the state and the program governing board, be user-friendly to adopting employers, and offer employees the added protections that ERISA provides. Finally, a defined benefit plan would involve greater responsibility on the board and employers but would offer employees a more predictable retirement program. By creating an IRA, 401(k) defined contribution or even a defined benefit plan, a state would be taking an important and much-needed step in helping Americans save for a more secure retirement.

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