The Final Frontier: Adding a Retirement Tier

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401(k) plans have been with us for almost 40 years. Over that time, the focus for most plans has been on helping participants accumulate savings that will be consumed in retirement. With the decline in defined benefit plans, 401(k) plans are providing a large percentage of the supplemental retirement income for their participants. Now that many of those participants are at or near retirement age, plan sponsors are considering ways to help participants in the decumulation stage of saving, when retirement assets are spent.

A recent Issue Brief from the Employee Benefits Research Institute (EBRI) suggests that rollover Individual Retirement Accounts (IRAs) are not being used as effective investment alternatives for 401(k) plan assets. Once participants leave 401(k) plans and roll over their assets into IRAs, EBRI points out that their asset allocation is unlikely to match the asset allocation they had in their 401(k) plans, with a significant drop in the allocation of assets to equities or target date/ balanced funds.[1]

Accordingly, it can be helpful for retirees to have access to investment options in their 401(k) plan that allow them to use their plan accounts during retirement as an effective tool to supplement their other sources of retirement income. A Retirement Tier is one potential solution to help these participants manage their assets properly in the decumulation stage.

Retirement Tiers

A recent series of white papers (the "White Papers") sponsored by the Defined Contribution Institutional Investment Association (DCIIA) discusses the concept of including a Retirement Tier as a means of helping older participants. A Retirement Tier is described in the White Papers as "...a range of products, solutions, tools and services, all of which allow a defined contribution (DC)

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plan sponsor to broaden the plan's goal from one wholly focused on savings to one that also accommodates and supports participants who are near, entering, or in retirement."

In a nutshell, the White Papers focus on plan design ideas to assist those at or near retirement. As the White Papers point out, there are many ways to do this, and one size does not fit all. In other words, plan sponsors can mix and match the components of a Retirement Tier as best suits its goals and labor force.

The components could include:

- Offering former participants and retirees the option to fund their retirement through ad hoc partial withdrawals from the plan rather than rolling over a lump sum distribution into an IRA;
- Including more retirement income investment options, such as annuities offered inside or outside the plan;
- Adding investment options that are appropriate for participants making withdrawals;
- Providing targeted communications to participants who are near or in retirement on how to invest their savings while taking withdrawals; and
- Encouraging employees to consolidate their retirement savings by rolling into the plan any amounts accumulated in IRAs and plans of former employers.

The White Papers describe some of the benefits of offering a Retirement Tier. For example, by encouraging "roll-ins" and permitting partial withdrawals — as opposed to the current all-or-nothing lump sum distribution requirements found in most plans — a plan should see an increase in the total assets held by the plan. A larger plan asset base should provide the plan with greater leverage to negotiate lower recordkeeper and investment fees, which is to the benefit of all plan participants. Additional benefits of a Retirement Tier listed in the White Papers include:

- More satisfied and secure employees who are better prepared for the decumulation stage of retirement planning;
- Plan administration is more seamless when dealing with a former participant or retiree who is then rehired;
- Retirees are able to access familiar investment options that have been vetted by the plan fiduciaries;
- Better retirement outcomes for participants; and
- A happier and more productive workforce.

The White Papers make a good case for including a Retirement Tier design in a 401(k) plan. There are, however, some cost and legal issues that plan sponsors should consider. Specifically, if plan administration fees are being paid by the plan sponsor, those costs may go up with an increased participant headcount. And, although allowing partial withdrawals by retirees and former employees may lead to a larger plan asset pool, it may also, in the eyes of some, increase fiduciary

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risk simply due to the fact that there are more participants in the plan without an ongoing employment relationship with the plan sponsor. At the same time, retirees who have access to a Retirement Tier in the plan after retirement may be more satisfied with the options provided for their financial wellness in retirement, making them less inclined to sue.

Recordkeeping

Another concern with encouraging former employees to maintain account balances is keeping track of them. Once a participant terminates employment, the direct connection to the plan sponsor is lost. It then becomes important that former employees regularly inform the plan of any address changes so that they can receive their benefits in a timely manner. It should be noted that the Department of Labor (DOL) has an ongoing enforcement program in which plan fiduciaries have been accused of breaching their fiduciary duty for failing to follow up on uncashed checks and missing participants. This highlights the importance of selecting a recordkeeper that can assist in tracking former employees who remain in the plan. Plan fiduciaries must use due diligence and prudence in their selection of service providers. Plan sponsors considering adding a Retirement Tier should determine whether their existing recordkeeper has the capacity to track a large number of former employees, and, if not, they should consider finding a new recordkeeper who can.

Annuities

The Retirement Tier design can also include an annuity option as a means of reducing investment and longevity risk for retirees. If plan sponsors exercise this option, then plan fiduciaries will have to select an insurance carrier to provide the annuity payments. This is a fiduciary function which requires due diligence and prudence in the decision-making process. Many plan fiduciaries are wary of taking on this fiduciary responsibility out of concern that the insurance company could go bankrupt a number of years later causing their selection process to come under scrutiny. The DOL has a regulatory safe harbor to assist fiduciaries in limiting their potential liability, but many have felt that it is of little practical help. Congress is considering a more robust annuity safe harbor as part of the SECURE Act of 2019, but it remains to be seen whether this will make a difference or even be enacted. Plan participants who are allowed to take partial distributions as part of a Retirement Tier concept may also have the ability to access their own out-of-plan annuities, which would not have the same implications for the plan fiduciaries.

Discrimination Testing

Another important legal consideration is the application of non-discrimination tests under Internal Revenue Code section 401(a)(4). The Retirement Tier contemplates offering additional investment options that will be beneficial to those at or near retirement. Under Treasury regulations, the right to a particular investment option is a benefit, right, or feature that must be tested for non-discrimination. If a Retirement Tier investment option is offered to all participants, this test would be easily satisfied. There are several ways the non-discrimination testing can be satisfied with respect to both the Retirement Tier itself and an ad hoc distribution option.

If a plan sponsor wants to limit those investment options to participants at or near retirement age, then the plan would have to be tested for discrimination to see whether this group of employees

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includes a sufficient number of non-highly compensated employees. Obviously, this will depend on the plan's demographics and would likely be more problematic for smaller employers. Deciding which option would be best for a plan depends on a number of factors that need to be determined on a plan-by-plan basis.

Designing the Retirement Tier

One last point to consider is that plan design is a settlor function. The decision to add discretionary plan amendments for a Retirement Tier, such as the ad hoc distribution features, would not be subject to fiduciary review; therefore, any expenses associated with amending a plan to add a Retirement Tier could not be paid out of plan assets. This would include any pre-amendment consulting costs. Implementation of a Retirement Tier, however, would be a fiduciary function.

Conclusion

The Retirement Tier design is something plan sponsors may wish to consider. It has been reported that the baby boomer generation is reaching age 65 at the rate of 10,000 people per day, so there is a potential need. Participants who move their assets out of 401(k) plans and into IRAs may face higher investment costs and do not have access to the fiduciary fund selection provided by the plan. However, plan sponsors should consider the legal issues in any decision to move forward with adding a Retirement Tier.

If you are considering whether to add a Retirement Tier to your 401(k) plan and would like to discuss these or other factors specific to your plan, please contact a Trucker Huss attorney.

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[1] Craig Copeland, *Comparing Asset Allocation Before and After a Rollover From 401(k) Plans to Individual Retirement Accounts*, EBRI (Nov. 7, 2019).

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