Expense Recapture

One issue leads to another

There are two types of expense recapture accounts: one where the "recaptured" money is put in the plan and another where it is held by the provider. The Department of Labor (DOL) approves of the latter, while the former is well-accepted.

For those of you who are unfamiliar with expense recapture, it occurs where a plan's recordkeeper is receiving revenue sharing from a plan's mutual funds, commonly in the form of 12b-1 or sub-transfer agency fees. When the revenue sharing exceeds the amount the recordkeeper is entitled to—that is, exceeds a reasonable amount of compensation for the recordkeeper—plan fiduciaries have a duty to claim the excess for the benefit of the plan and the participants. That excess is commonly placed in an expense recapture account. These accounts have a number of names, including ERISA [Employee Retirement Income Security Act] budget and plan expense recapture accounts (PERAs).

In either scenario, whether the money is put in the plan or held by the recordkeeper, it can be used to pay expenses of operating the plan. However, it cannot be used to benefit the employer. In other words, it can be used only for the good of participants.

Where the money is held by the plan, any amounts left unused after paying that plan year's expenses must be allocated back to participants as of the last day of the plan year. As a result, the account is depleted annually—and there is nothing to report on the 5500 as a plan asset.

When the money is held on the books of a recordkeeper, it is typically not a plan asset. As a result, the balance can be carried forward from year to year. And, because it's not a plan asset, there's no need to report it on the 5500—right?

Not so fast. The DOL said the right to use the money was a plan asset. Therefore, it must be included in the financial reports on the Form 5500. And, for larger plans—i.e., those with 100 or more participants—the plan's accountants must consider the account in their audits. But what is the value of the contractual right to use the money? Unfortunately, the DOL offered no help on that point. One possible answer is the amount that remains at the end of the plan year and is carried over to the next.

One issue then leads to another. If the contractual right is a plan asset, and if all plan assets must be allocated to participants on the last day of the plan year, how does the contractual right get divided among participants? The DOL did not give an answer, and the Internal Revenue Service (IRS) hasn't addressed the question.

When the revenue sharing exceeds the amount the recordkeeper is entitled to, plan fiduciaries have a duty to claim the excess for the benefit of the plan and the participants.

Also, since the right to use the money is a plan asset, the fiduciaries—e.g., the plan committee—must prudently "manage" the asset. The fiduciaries need to make sure the amounts are being properly calculated and credited to the plan, used to pay permissible expenses and protected against loss or forfeiture. In the final analysis, the fiduciaries must make sure the money is used only to pay reasonable expenses and to provide benefits to participants. That's no easy job in these complex arrangements.

As an alternative, fiduciaries could consider using funds that do not pay revenue sharing. A fully transparent plan without revenue sharing would use low-cost investments and would allocate plan expenses—for instance, recordkeeping and advisory services—to participants' accounts. From a risk-management perspective, it doesn't get much better than that.

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