4Q17 Retirement Plan Quarterly Legislative Update

Are Health Savings Accounts Impacting 401(k) and Other Qualified Plan Salary Deferrals?

As the health care industry continues to evolve and employee's choices to help them manage their own health care costs have added additional complexity, the increase in employee's use of health savings accounts (HSAs) does not appear to be adversely impacting 401(k) contributions. HSAs, which are available to participants enrolling in high-deductible health plans, allow their participants the ability to save and grow their accounts tax free for current and future qualified medical expenses. According to a recent study by Fidelity, from November 2016 through November 2017, more than one in four participants on the Fidelity platform increased their retirement plan contributions, and the current average contribution rate of 8.5% is the highest in almost ten years. Over that same one year timeframe, the number of new HSA accounts at Fidelity grew 35%. Fidelity's research also shows that HSA participants across all income levels defer more in the 401(k) plans then the average defined contribution plan participant at the same income levels. It remains to be seen however, what the long term effect of the HSAs may be on qualified plan contributions, if any, given the ability to defer salary into both plans.

There are potential drawbacks of HSA plans, including a 20% penalty if used for non-qualified expenses prior to age 65, limited investment choices, and higher fund expenses. However, the ability to offset the out of pocket costs of the high-deductible plan, should a medical emergency arise, and the ability to set aside more money, tax-free in addition to qualified plan contributions will lead to tax efficient strategies that employees at all levels can use to help them meet their financial goals. Highly compensated employees, and those that can afford to do so have been taking advantage of the opportunity to defer pre-tax to their HSAs for future expenses, while paying their out of pocket medical expenses with after-tax dollars. However, in a January 2018 NAPA.net article, Trevis Parson, Chief Actuary at Willis Towers Watson stated, "if the situation allows it, employees should contribute to their HSAs to realize the tax advantage of funding more immediate qualified medical expenses, which would otherwise have to be paid with after-tax income". Of the 555 firms recently surveyed by Willis Towers Watson, 73% offered a high-deductible plan tied to an HSA.

It is likely that as the awareness of the benefits of health savings accounts increases the number of firms offering these plans, and employee communication campaigns continue to help increase retirement plan participation, total assets in both HSAs and qualified retirement plans will continue to grow. In addition to Fidelity, other traditional retirement plan recordkeepers have already added the HSA plan servicing capabilities to their platform in an effort to offer a more streamlined package to employers looking to tie an HSA plan to their high-deductible health plan. This is a predictable result, given the similarities to qualified plan administration. If this trend continues, it will only mean continued growth in the number of HSA plans and participants in the future.

The H.R. 1 Tax Cuts and Jobs Act's Impact for Business Owners

Although there was speculation that the new tax law would include reductions in salary deferral limits for qualified plans, those concerns were put to rest with the new Tax Reform Act H.R. 1 being signed into law December 22, 2017. Below is the chart illustrating the IRS cost of living increases for qualified plan contributions for tax year 2018.

With the exception of the retirement plan limit increases noted above, not much is changing regarding plan rules and limits for employers and employees in traditional defined contribution and defined benefit plans. Beginning January 1, 2018, the Act permanently reduces the tax rate imposed on C corporations from 35% to 21%. It also repeals the corporate alternative minimum tax. The other business structures that may be significantly impacted by the new law are those considered to be "pass through" entities. These businesses include certain S Corps, LLCs, Partnerships and Sole Proprietors. Some of these businesses will receive up to a 20% pass through deduction under the new regulations. This deduction however, phases out between the business owner's joint income of $315,000 and $415,000.

2018 COLA Increases

	2018	2017
401(k), 403(b), Profit-Sharing Plans, etc.		
Annual Compensation	275,000	270,000
Elective Deferrals	18,500	18,000
Catch-up Contributions	6,000	6,000
Defined Contribution Limits	55,000	54,000
ESOP Limits	1,105,000 220,000	1,080,000 215,000
Other		
HCE Threshold	120,000	120,000
Defined Benefit Limits	220,000	215,000
Key Employee	175,000	175,000
457 Elective Deferrals	18,500	18,000
Control Employee (board member or officer)	110,000	105,000
Control Employee (compensation-based)	220,000	215,000
Taxable Wage Base	128,400	127,200

Court Cases Targeting Stable Value Funds

The objectives, and typical investment make-up of stable value funds are similar across most providers. Approximately 83% of all existing 401(k) plans offer a stable value fund according to a 2017 survey by MetLife. The summary of the Stable Value Investment Association's definition of a Stable Value fund is: a low risk, high quality, diversified fixed income fund, protected from interest rate volatility by contracts from banks and insurance companies, designed to preserve capital while providing steady, positive returns, and considered to be conservative compared to other 401(k) investments. There have been several lawsuits filed on behalf of participants claiming their plan's stable value fund has taken on too much risk, others have claimed their plan sponsors have selected a fund that has not taken enough risk. Additionally, suits have been filed against plan sponsors for not offering a stable value fund at all. With total assets in stable value funds continuing to rise, it is not surprising that any variance from the average stable value fund's total return, expense, yield or volatility by a plan's selection will likely draw the attention of the legal firms who enjoy tracking these numbers.

As with the monitoring of other retirement plan investments, the plan fiduciaries need to be aware of their stable value fund's expenses, and in a low interest rate environment, even more so, as higher than average expense ratios will reduce the fund's yield and compounded return by a proportionately greater percent in a low rate environment. Equally important is for the plan fiduciaries to look at the underlying investments of the fund. As noted above, although the fund's objectives are similar, the differences in how each fund selects investments to achieve those objectives is worth understanding, in order to match the plan's goals and workforce demographics with the risk level of the stable value fund that is ultimately selected.

Of the lawsuits up to this date regarding stable value funds that have been decided, the only plaintiffs that have been successful were those where the court ruled that the plan sponsors chose stable value funds that either had excessive fees or took on excessive risk. No cases have been settled in favor of those who claimed the funds took too little risk.

In the case of Tibble v. Edison International, the Ninth Circuit Court in California ruled in favor of the plan sponsor, regarding their decision not to include a stable value fund in the plan's line-up, and to offer only a Money Market fund as their capital preservation investment choice. The ruling in the defendant's favor was made not solely based on the risk and return of the Money Market investment, but on the prudent process by which the plan sponsors selected the fund, and the documentation that the sponsors provided to the court outlining their decision making process. The claim regarding the decision to not include a stable value fund was dismissed because of the evidence showing that the sponsors had considered the pros and cons of the stable value choice. The documentation of these discussions was a key factor in the court's decision.