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Benefits News

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Small Plans Do Need an Audit Unless…

Deborah Fabricant

The conventional wisdom that ERISA does not require an annual audit for the Form 5500 of a "small plan" (see discussion below – generally, a plan with less than 100 participants) is a misconception. In fact, under ERISA, all retirement plans require an audit by an independent qualified public accountant ("IQPA") (see ERISA § 104(a)(2)(A)), unless the plan meets very specific audit exemption requirements. As explained below, ERISA's small plan exemption requirements do not depend solely on the number of participants in a plan. Instead, they depend on the number of participants in the plan and the nature of the small plan's assets.

What are the DOL audit exemption rules?

Under DOL regulations (DOL Reg. § 2520.104-46) the audit requirement for a small plan is waived in a given plan year only if that small plan meets one of the following conditions:

1. At least 95% of the plan's assets are invested in "qualifying plan assets;" (defined below); or

2. If the 95% "qualifying plan assets" test is not satisfied, and 5% or more of the assets are invested in non-qualifying plan assets, the plan is covered by a qualifying fidelity bond that is equal to at least 100% of the value of all the non-qualifying plan assets **and** complies with the normal ERISA bonding rules under ERISA § 412 (see DOL Reg. § 2520.104-46(c) and § 2520.104-46(b)(1) and (d)).

The DOL defines the following as qualifying plan assets (see DOL Reg. § 2520.104-46 (b)(1) ii):

1. qualifying employer securities as defined by ERISA,

2. participant loans that meet the prohibited transaction exemption requirements under ERISA § 408(b)(1),

3. assets held by a regulated financial institution,

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4. shares issued by an investment company registered under the Investment Company Act of 1940 (i.e., registered mutual fund),

5. investments and annuity contracts issued by an insurance company qualified to do business under the laws of any state, and

6. assets in the individual account of a participant/beneficiary over which the participant/beneficiary has the opportunity to exercise control and with respect to which the participant or beneficiary is furnished, at least annually, a statement directly from a regulated financial institution describing the assets held (or issued by) such institution.

Any plan asset that does not fall into one of these categories is a non-qualifying asset. For example, direct ownership interests in partnerships, LLCs, real estate, mortgages, loans, gold coins, fine art, and other collectibles are non-qualifying plan assets.[1]

How do the DOL exemption rules work?

To determine if a "small" plan requires an audit, the first step is to determine whether a plan really is a small plan.[2] A pension plan with fewer than 100 participants at the beginning of the plan year, as measured on the last day of the preceding plan year, is generally considered a small plan (see DOL Reg. § 2520.104-46).

If a plan does have fewer than 100 participants, the next step is to determine if, as of the last day of the preceding plan year, at least 95% of the plan's assets were "qualifying plan assets." If they were, the plan qualifies for a small plan waiver exemption so long as 1) the conditions of the waiver are disclosed in the plan's Summary Annual Report ("SAR") and 2) the plan meets certain enhanced participant disclosure requirements.[3]

If a plan does not meet the "qualifying plan assets" threshold, each person who handles non-qualifying plan assets must be covered by a fidelity bond that is at least equal to 100% of the non-qualifying plan assets and must also meet the regular ERISA § 412 requirements – i.e. that any person that handles plan assets is covered by a fidelity bond in an amount no less than 10% of the amount of plan assets (that the person handles) with a minimum of $1,000 and a maximum of $500,000. Here is an example of how these requirements may work:

Plan X's plan year 1:

Plan X has 90 participants and holds a partnership interest in a privately held real estate limited partnership (the "LP interest"). In plan year 1, the LP interest constitutes 4% of all Plan assets. Although the LP interest is a non-qualifying plan asset, the 5% threshold is not exceeded so no audit is required and the regular

[1] Of course, it isn't as cut and dried as it sounds. For example, gold coins held in an account with a regulated financial institution in the plan's name might qualify while gold coins held in a safety deposit box likely would not qualify.

[2] A one-participant plan, covering only the owner of the sponsor, the owner and his or her spouse, or partners in the sponsoring partnership and their spouses, is not subject to ERISA, and therefore does not require an audit or a fidelity bond (see DOL Reg. § 2510.3-3(c)). But note that a one-participant plan immediately becomes subject to ERISA if anyone else other than the business owner and their spouse becomes eligible to participate in the plan, and the plan would then have to meet the DOL audit requirements.

[3] The DOL waiver regulations spell out these specific enhanced SAR reporting requirement and disclosure requirements (see DOL Reg. § 2520.104-46(b)(1)(i)(B) and (C)).

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fidelity bond requirements apply (meaning a bond would be required in an amount equal to 10% of the amount of plan assets with a minimum of $1,000 and a maximum of $500,000.)

Plan X's plan year 2:

In plan year 2, Plan X still has 90 participants, and the LP interest is valued at the same value as in year 1. In plan year 2, however, the value of the Plan's qualifying assets has declined substantially and now the LP interest constitutes 6% of the total of Plan X's plan assets for year 2. Plan X therefore must either obtain a plan audit (and a regular fidelity bond) or if it does not wish to obtain a plan audit, it must fulfill the enhanced fidelity bond requirements (meaning a bond would be required in the amount of the full value of the non-qualifying assets and if that amount is still less than 10% of the amount of total plan assets, an additional amount bringing the total bond amount to 10% of total plan assets.)

What are the consequences if the plan fails to meet the audit waiver requirements?

Interestingly, there is no express "penalty" in ERISA for a small plan holding more than 5% non-qualifying assets and for which the plan administrator has failed to obtain a sufficient fidelity bond, and/or obtain a plan audit for failing to meet these specific requirements. However, there are multiple potential ramifications. For example, the non-compliant plan may be deemed to have filed an incomplete Form 5500, resulting in rejection of the Form 5500 and ultimately, if a compliant amended Form 5500 is not filed, the plan administrator may be assessed penalties under ERISA. In addition, the plan administrator and other fiduciaries, by failing to fulfill a variety of fiduciary and/or other statutory obligations may be subjecting themselves to investigatory scrutiny/enforcement activity by the DOL as well as exposing themselves to potential participant claims.

Needless to say, the potential ramifications of non-compliance can be costly and although the audit waiver requirements are not simple, they can be readily managed to ensure compliance by taking pro-active steps to review plan assets and plan fidelity bonds annually.

Pre-Approved Defined Contribution Plans Alert: IRS Issues New Revenue Procedure

Douglas Van Galder

With the recent issuance of Revenue Procedure 2017-41, the IRS continues to pointedly alter the landscape for qualified retirement plan documents. Effective January 1, 2017, the IRS eliminated their determination letter program for individually designed plans ("IDPs"), except for a plan's initial approval or upon termination. Industry practitioners commented at the time that the IRS was encouraging qualified retirement plan sponsors to utilize pre-approved (i.e. volume submitter ("VS") or master and prototype ("M&P")) plans over IDPs, if possible. The IRS's encouragement became explicit as one of the stated purposes of the revenue procedure is "to expand the Provider market and encourage employers that currently maintain individually designed plans to convert to the pre-approved format." The elimination of the prior five-year restatement cycle for IDPs and issuance of this new revenue procedure impacting the next six-year remedial amendment cycle for providers of pre-approved defined contribution plans was also a way for the Employee Plans Division of the IRS to address their significant budgetary and staffing issues.

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New Pre-Approved Defined Contribution Plan Opinion Letter Program

The next—which will be the third—six-year cycle for pre-approved defined contribution plans begins October 2, 2017 and ends on October 1, 2018. Plan documents updated to comply with the IRS's Cumulative List of Changes in Plan Qualification Requirements for Pre-Approved Defined Contribution Plans and the applicable Lists of Required Modifications submitted during this upcoming time by industry providers will likely receive their favorable opinion letters in late 2020. Plan sponsors will then be afforded the usual two-year remedial amendment period to restate their defined contribution plans in their entirety.

Highlights of New Revenue Procedure

- Combines the previous procedures for VS and M&P Programs into a new, single Opinion Letter Program.
- The new program will have two types of pre-approved plans: Standardized and non-standardized. Standardized plans are essentially the same as they were under the predecessor M&P program while non-standardized plans adopt the flexibility of plans under the predecessor VS program.
- Standardized or non-standardized plans may be designed as a basic plan document with an adoption agreement, or as a single plan document.
- Adopting employers may make minor modifications to non-standardized plans but may not modify standardized plans.
- The IRS will continue to accept determination letter applications (using Form 5307) for pre-approved plans that make more than minor modifications.
- Money purchase, 401(k), and profit sharing plans may now be combined into one adoption agreement with a basic plan document, or a single plan document.
- Non-standardized employee stock ownership plans may include a 401(k) feature.
- Non-electing church plans may now file for opinion letters.
- Non-standardized plans may now use non-safe harbor standards for hardship distributions.
- Trusts or custodial accounts may not be submitted as part of the opinion letter application because the IRS will no longer rule on their exempt status and trust/custodial provisions must be in a document separate from the plan provisions.

Please feel free to contact our Firm if you would like to discuss any of the foregoing information in greater detail.

5300 Series Filing Fees Effective January 3, 2017

This month's *Building Block* provides basic information about the fees charged by the IRS for Determination Letters.

Click here to view the chart of 5300 Series Filing Fees

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Firm News & Events:

Boutwell Fay is a proud sponsor of the 2017 Annual Meeting of the National Association of Minority and Women Owned Law Firms ("NAMWOLF")

The annual meeting takes place on September 17-20 in New York City. Attendance is free for In-House Counsel. More information about NAMWOLF and the Annual Meeting and Law Firm Expo is available at www.namwolf.org

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Save the Date

Sherrie Boutwell will be presenting on *Fiduciary Duties for 403(b) Plans* in 3 different cities this fall: Portland Oregon (Nov. 6), Newport Beach, California (Nov. 8) and San Diego, California (Nov. 9). Stay tuned for more details in our upcoming newsletter.

Alison Fay Presented to the Western Pension & Benefits Council

Alison Fay spoke at the Western Pension & Benefits Council Orange County Chapter Technical Lunch forum on August 22, 2017 on the subject of state-based retirement initiatives.

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