401k Audit Issues With Plan Transfers: Identifying Change of Provider Issues in Annual Plan Audits

Auditor's Role in Ensuring Compliance With DOL Rules and Fiduciary Standards

WEDNESDAY, JUNE 15, 2016, 1:00-2:50 pm Eastern

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401k Audit Issues With Plan Transfers

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Issues with 401(k) Plan Transfers and Change of Providers for Plan Sponsors and Administrators

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June 15, 2016

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Overview – Common Plan Transfer Scenarios

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- Common Plan Transfer Scenarios
  - Plan merger (with respect to merging-in plan)
  - Plan spin-off
    - Can spin off plan assets to new plan or to existing plan
  - Vendor changes
    - New recordkeeper
    - New trustee

Outline

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- Overview of Legal Requirements Pertaining to Plan Transfers
  - Documentation – plan amendments, trust documents, agreements
  - Communication – legally-required notices, fiduciary requirements, blackout period
  - Reporting – IRS and DOL
- Specific Compliance Issues that Arise with Plan Transfers
  - Timing of asset transfer
  - Plan loans
  - Recordkeeping issues
  - Protected benefits (e.g., in-service distribution rights)
  - Payroll and source code transfers
  - Long blackout periods
- Legal Requirements for Plan Audits

Legal Requirements – Documentation

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- Formal written approval to transfer plan assets or merge plans
  - All transfers of plan assets require approval
  - Approving entity (e.g., Board of Directors, Benefits Committee) often depends upon plan governance and vendor requirements
- Plan amendments
  - Required for plan mergers and plan spin-offs
    - Amendment will provide for the merger and reflect any special rules
    - Surviving plan will reflect the principal provisions of the other plan relating to the calculation of benefits
  - May not be required for vendor changes; depends on the circumstances
    - Recordkeeper change may require new document for prototype plan

Legal Requirements – Communication

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- Advance notice to plan trustees, recordkeepers, investment managers and unions typically required
  - If trustee or recordkeeper to be removed or replaced, potential advance notice requirements in contract
  - Specific investments (e.g., GIC's) may have penalties or restrictions on liquidating investments for transfer
    - Determine how much advance notice must be given to liquidate and transfer funds
  - If plan has union employees, CBA may require notice and/or consent
- Notice to participants
  - Advance notice of fund transfers, rights and options to direct investments (404(c) Notice)
  - SOX blackout notice
  - Fee disclosures and QDIA notice
  - Summary of Material Modifications (SMM)
  - Determination of whether the above notices apply to a particular plan transfer scenario must be made on a case-by-case basis

Legal Requirements – Communication 404(c) Notice to Participants

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- Under ERISA Section 404(c), fiduciaries of individual account plans are not responsible for participant investment decisions so long as the participants have the right to exercise control over their investment decisions
- There are two options to preserve 404(c) protection when transferring accounts:
  - Fund mapping
    - Need expertise for fund mapping
  - Transfer to the plan's qualified default investment alternative (QDIA)
  - Hybrid approach
- Once decision is made, must notify participants in writing of any fund transfers and participants' rights to direct investments
  - 404(c) notice must be provided at least 30 days (but not more than 60 days) before date of change

Legal Requirements – Communication 404(c) Notice to Participants

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- Fund mapping must meet requirements for a “qualified change in investment options” within the meaning of ERISA Section 404(c)(4)(B):
  - Accounts must be reallocated among one or more new investment options offered in lieu of investment options offered immediately before the effective date of the change
  - New investment options must have characteristics relating to risk and rate of return that are reasonably similar to the existing investment options immediately before the change
  - Written notice must be sent to the participant or beneficiary **at least thirty days** but no more than sixty days before the effective date of the change explaining how the account will be invested in the absence of affirmative investment instructions from the participant or beneficiary, and must include information comparing the new and existing investment options
  - The participant or beneficiary must not have provided affirmative investment instructions contrary to the change before the effective date of the change
  - The investments of the participant or beneficiary in effect immediately before the effective date of the change must have been the product of the exercise of control by the participant or beneficiary

Legal Requirements – Communication QDIA Notice to Participants

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- Transfer to a QDIA – Fiduciaries will be afforded ERISA Section 404(c) relief for QDIAs, provided that the fiduciary prudently selects the QDIA fund and meets all of the following conditions:
  - Each participant is given an opportunity to direct the assets in his or her account, but does not do so
  - Participants and affected beneficiaries are furnished an advance notice (both before initial investment in a QDIA and an annual QDIA notice) that describes the circumstances under which plan contributions will be invested on their behalf in a QDIA
  - Participants are automatically provided investment information relating to the QDIA, such as a fund prospectus
  - Defaulted participants are permitted to transfer out of the QDIA with the same frequency afforded other participants, but at least once each quarter
  - The plan offers a broad range of investment alternatives that satisfy ERISA Section 404(c)
- Advance notice pertaining to a QDIA must be provided at least 30 days in advance of the date of plan eligibility or 30 days in advance of the first investment in a QDIA, and annual notice thereafter (at least 30 days before beginning of plan year)

Legal Requirements – Communication SOX Blackout Notice

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- ERISA requires the administrator of a defined contribution plan to provide participants with at least 30 days' advance written notice of a blackout period
  - "Blackout period" means a period of **three or more consecutive business days** during which the normal ability of participants and beneficiaries to direct or diversify assets credited to their accounts, to obtain plan loans, or to obtain distributions from the plan is temporarily suspended or restricted
  - Certain situations are not treated as blackout periods, including:
    - Suspensions or restrictions that result from the application of federal or state securities laws
    - Suspensions or restrictions that apply to particular individuals based on qualified domestic relations orders (QDROs)
    - Regularly scheduled suspensions or restrictions that are incorporated into the plan and are disclosed to participants and beneficiaries through the summary plan description, summaries of material modifications, or other documents that describe the plan's investment alternatives

Legal Requirements – Communication
SOX Blackout Notice

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- Exceptions to the minimum 30-day notice requirement available only in limited circumstances, such as determination that providing 30 days' advance notice would violate ERISA's fiduciary standards or inability to provide 30 days' advance notice is due to unforeseeable events or circumstances beyond the plan administrator's control
  - In these cases, the plan administrator must provide the blackout notice to participants and beneficiaries as soon as reasonably possible
- The notice may be provided in electronic form if it is reasonably accessible to the recipients in accordance with DOL's electronic disclosure rules
- A plan administrator who fails to provide a blackout notice to participants and beneficiaries in accordance with ERISA may be fined up to $110 a day from the date of the plan administrator's failure or refusal to provide the notice
- Pension Protection Act of 2006 amended ERISA § 404(c) to provide fiduciaries relief from liability during blackout periods if they authorized and implemented the blackout period consistent with the requirements of ERISA
- Additional rules apply if plan holds company stock

Legal Requirements – Communication Fee Disclosure Notice

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- DOL regulations require initial and annual disclosures of information related to investment fees
  - Two major categories of information: "plan-related information" and "investment-related information"
  - Goal is to provide participants with the necessary information to make informed investment decisions
- Plan administrator must provide a participant with both plan-related and investment-related information on or before the date the participant can first direct his investments under the plan
- Thereafter, the plan administrator must provide participants with the required disclosures at least annually
- Any changes to plan-related information must be communicated to participants at least 30 days (but no more than 90 days) before the effective date of the change. If the plan administrator is not aware of the change 30 days before the effective date of the change, the notice must be provided as soon as reasonably practicable
- Most plan administrators rely on their 401(k) vendor to prepare the participant disclosures for them, but providing the disclosures is plan sponsor's ultimate responsibility

Legal Requirements – Communication SMM (Summary of Material Modification)

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- Plan transfer or merger may need to be described in a summary of material modifications (SMM) that updates the plan's summary plan description (SPD)
  - Not an advance notice requirement – SMM must be provided within 210 days after the end of the plan year in which the merger takes place
  - Advance participant communications often suffice to meet the SMM requirement – communications should include a statement or legend indicating that they are intended to be SMM also

Legal Requirements - Reporting

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- IRS Form 5310-A may need to be filed to put IRS on notice of the plan merger, at least 30 days in advance of the merger
  - Usually <u>not</u> required for 401(k) merger – exception for defined contribution plan transfers or mergers when:
    - Sum of account balances in each plan prior to merger equals FMV of entire plan assets;
    - Assets of each plan are combined to form one plan; and
    - Immediately after merger each participant has an account balance equal to the sum of the account balances the participant had in the plan immediately prior to the transfer/merger
- If plan merged, complete and file a final Form 5500 for the last year of the merged plan (plan year ended on the merger date)
  - Merger/spinoff of plan assets will also be reflected on Schedule H of surviving plan
- Simple vendor change may not require any IRS or DOL reporting

Compliance Issues – Asset Transfer

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- Timing of asset transfer
  - Is asset transfer a few days following plan merger date allowed?
  - Frequent desire to hold transfer until after most recent payroll clears
    - Often a tension between preferred merger date/transfer date (e.g., last day of the plan year) and best date for payroll purposes
    - If assets not transferred reasonably soon after merger/transfer date, need to file additional Form 5500 for new plan year (if after last day of plan year)?

Compliance Issues – Participant Loans

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- How will participant loan program transfer over when one plan merges into another?
  - Participant loan program is <u>not</u> a legally protected benefit, but any outstanding loans must be addressed as part of asset transfer
  - Participant continues to have obligation to repay loan
    - Loan repayments set up on a different payroll deduction basis may need to have repayment schedule adjusted to reflect new payroll frequency
    - If terminated participant making continued repayments via check or ACH, must address continuing repayment options
  - Confirm that proper payroll feeds are set up after plan transfer

Compliance Issues – Protected Benefits

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- Internal Revenue Code Section 411(d)(6) and ERISA section 402(g) protect certain optional forms of benefit and early distribution rights
  - Forms of payment – lump sum, annuity options, installments
    - If 401(k) plan offers lump sum, installment option not protected benefit
    - BUT, annuity option for money purchase accounts (which may be merged into 401(k) plan) must be preserved
  - Timing of payments (both in-service and following termination from employment)
  - Mode of payment – cash, employer securities
    - If 401(k) plan offers in-kind distribution option, not a protected benefit
- Prospective elimination of protected benefit is permitted, but right to benefit accrued under transferring plan must be protected
- Plan may add involuntary cash-out distribution of no more than $5,000

Compliance Issues that Arise with Plan Transfers – Protected Benefits

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- Defined contribution (401(k)) plans may <u>not</u> eliminate and must preserve rights to in-service withdrawals, including:
  - age 59-1/2 withdrawal
  - employer contribution withdrawals
  - after-tax withdrawals
  - rollover withdrawals
  - disability withdrawals
    - Plan sponsor may, however, make reasonable changes to definition of disability (unless union group)
- Loan program and hardship withdrawal option are <u>not</u> protected benefits
  - Plan sponsor must continue any outstanding loans
  - If plan has union participants, review CBA before making any design changes

Compliance Issues - Recordkeeping

- Recordkeeping issues related to tax basis – plan records must be transferred to properly report the taxability of distributions
  - Roth 401(k) – plan must track basis in Roth 401(k) contributions and earnings
    - Roth 401(k) contributions are tax-free if a qualified Roth distribution occurring after the end of five-taxable year period that begins with first tax year in which participant first made Roth contributions, and made after the participant reaches age 59-1/2, is disabled or dies
  - If plan permits employee after-tax contributions, plan must maintain separate accounting for contributions and earnings because earnings are taxable when distributed
  - Rollover contributions – benefits merged or transferred may include after-tax contributions

Compliance Issues – Payroll and Source Codes

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- Payroll codes must be harmonized with transferring plan. Following plan merger usually one single definition of eligible compensation for 401(k) deferrals, employer contributions, etc.
  - If there are multiple payroll feeds they must be harmonized so that proper compensation definition is followed and maintained
- Recordkeeper often must create new sources with separate distribution codes to preserve protected benefits
  - Separate sources adds complexity and costs to 401(k) administration
  - Addition of new sources may required changes to hierarchy for in-service withdrawals, loans and partial distributions

Compliance Issues – Miscellaneous

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- Vesting – if vesting schedule is different, maintain separate accounts or fully vest those not 100% vested?
- QDRO rights – alternate payee rights must be carried over and maintained following plan transfer
- Small Accounts of Deferred Vesteds ($1,000 or less; $5,000 or less) – transfer over or sweep out?
- Beneficiaries – is transfer of beneficiary designations possible?
- Unused forfeitures
- Record retention

Legal Requirements – Plan Audits

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- ERISA-covered defined contribution plans such as a 401(k) plans with 100 or more participants as of the first day of the plan year must file Form 5500 as a large plan
  - Large Plans (100 or more participants) – must have an audit completed by an independent qualified public accountant
  - Small Plans (fewer than 100 participants) – generally exempt from audit requirement
- Plan transfer/merger can cause additional new audit requirement (e.g., two small plan merger to form large plan) or eliminate future audit requirements (e.g., plan merged into larger plan will file last Form 5500 for year of transfer)

Legal Requirements – DOL Focus on Audit Quality

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- In 2015, the Employee Benefits Security Administration (EBSA) of the DOL released "Assessing the Quality of Employee Benefit Plan Audits," a comprehensive report reviewing the quality of audit work performed by independent qualified public accountants with respect to financial statement audits of employee benefit plans
  - Nearly four out of 10 (39%) employee benefit plan audits completed by independent qualified public accountants for the 2011 filing year contained "major deficiencies with respect to one or more relevant GAAS requirements" which "would lead to rejection of a Form 5500 filing"
  - Common audit deficiencies include:
    - Insufficient review of plan documents and administration
    - Failure to obtain evidence of required communications to participants
    - Inadequate review of employee eligibility, participant accruals and non-discrimination testing
    - Failure to obtain evidence of adequate internal controls.

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Key Points

Key Points

- Follow the money
- Plan level testing and Participant level testing
- These are not just financial statement audits
  - "Is the Participant being treated in accordance with the Plan document and ERISA guidelines"

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Transfer of Plan Assets and Plan Mergers

- A plan sponsor may decide to change the custodian of plan assets for a variety of reasons.
  - Cost
  - Relationship
  - Service
  - Investment options

- Plan mergers are typically the result of the acquisition of one company by another or a plan sponsor combining plans
  - Merger reduces administrative burden of Plan sponsor.
  - Usually involves a transfer of plan assets to a trust account similar to a Plan changing custodians.

- In both scenarios, it is essential to ensure that the transfer was successfully completed at the plan level and account balances were properly reallocated to participants.

Transfer of Plan Assets and Plan Mergers

- Plan should continue to use its ongoing basis of accounting.
- Liquidation basis of accounting is NOT appropriate in both scenarios.
  - Per TIS Section 6931, Financial Statement Reporting and Disclosure—Employee Benefit Plans, liquidation basis of accounting is not appropriate *"because the plan obligations are not being settled with the participant".*

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Transfer of Plan Assets and Plan Mergers

- Potential audit risks
  - Amounts not completely transferred
    - If not completed at year end, this may be a deposit in transit
  - Amounts not properly reallocated to participants
  - Participant data transferred is not accurate/complete
  - Change in audit scope (limited vs. full scope)
    - i.e. Investments and/or loans go are no longer certified
  - Small balance force outs
  - New custodian does not have a SOC-1 report.

Transfer of Plan Assets and Plan Mergers

- Additional audit steps:
  - If limited scope, obtain a limited scope certification from both custodians.
  - If full scope, confirm balances.
  - Obtain the new plan document.
  - Agree the investment and loan balances transferred out of the predecessor custodian's trust statement to the amount transferred in on the successor custodian trust statement.
    - Potential reconciling items: Forfeiture account, participant loans, reimbursement of market value adjustment of a FBRIC from predecessor custodian.
  - For a sample of participants, agree that the participant's account was properly transferred and reallocated at the successor custodian.
  - Consider any blackout period when testing the timeliness of remittance of employee contributions.

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Transfer of Plan Assets and Plan Mergers

- Additional Disclosures:
  - Audit report
    - If limited scope, include certifications from both custodians in your basis for a disclaimer of opinion.
  - Financial Statements and Footnotes
    - Be sure to pluralize trustee/custodian
    - Disclose as a subsequent event if transfer occurred subsequent to year end.
    - Based on timing of merger, consider if additional statements are necessary for presentation of final short year pursuant to 29 CFR 2520.104-50.

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Plan Termination

- Retirement plans can be terminated
  - Voluntary (i.e. cost cutting, business restructuring)
  - Mandatory (i.e. dissolution of plan sponsor)
- Plan should use liquidation basis of accounting when liquidation is “imminent”.
  - In accordance with FASB ASC 205-30-25, liquidation is imminent when a plan for liquidation has been approved by the persons with authority to make such a plan effective, and the likelihood is remote that execution of the plan will be blocked by other parties.

Plan Termination

- Potential audit risks
  - Plan sponsor does not take appropriate steps to terminate the Plan.
    - Amendments
    - Notice to participants
    - Ceasing contributions
  - Benefits are not completely paid out.
  - Benefits are not paid in accordance with Plan document.
  - Participants are not fully vested.

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Plan Termination

- Additional audit steps:
  - Determine the effective date, specific terms, and conditions for the termination through review of supporting documentation:
    - Plan documents, termination amendment
    - Minutes of trustee and board meetings,
    - Correspondence with regulators, participants, and service providers).
  - Obtain notice of Plan termination sent to Plan participants.
  - Increase testing on benefit payments
    - Participant's who's participation in the plan has been terminated due to the termination should become 100% vested in their account balance.
    - Plan sponsor must make reasonable effort to locate missing participants/beneficiaries (DOL Field Assistance Bulletin 2014-01)
    - Confirm benefits paid with participants.
    - All plan assets should be distributed within one year of termination date.

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Plan Termination

- Additional audit steps:
  - Increase testing on benefit payments
    - If any plan assets revert back to the plan sponsor, verify that the reversions comply with the plan's provisions and IRS
  - Valuation
    - Consider additional testing the liquidation value of illiquid plan assets.
  - Materiality
    - Consider beginning net assets or benefit payments

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Plan Termination

- Additional Disclosures:
  - Audit report
    - Emphasis of a Matter – basis of accounting
      - Note change to liquidation basis due to Plan termination
  - Financial Statements and Footnotes
    - Use appropriate statements (ongoing v. liquidation basis)
    - Describe Plan termination in “General” and “Plan Termination” footnotes.
    - If decision to terminate was made after the financial statement date, disclose as a subsequent event.
    - Update “Investment Valuation” accounting policy.
    - Accrue estimated costs and income that the Plan can expect to incur during liquidation.

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