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Form 11-K Audits: Best Practices for Examining Retirement Plan Financials

Complying With AICPA, PCAOB and SEC Rules From Engagement Letter Through Filing

WEDNESDAY, APRIL 18, 2012

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Today's faculty features:

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The Growing Complexities Of Administrating An Employee Benefit Plan

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Over the last decade, the rules and regulations governing employee benefit plans have increased and grown more complex. During this same time, enforcement of the rules has become more stringent. The time required for a plan administrator to stay informed of all the rules and properly implement them is significant. However, the time and money to correct an error in the plan's operation, once it has occurred, can be even more significant.

The best way to avoid errors is to be informed of the relevant government regulations. It is also critical to be familiar with plan documents relevant to the specific plan being administered, since every plan is unique.

Following are four issues we see quite often during our audits of employee benefit plans:

1. Administrative Failures And Errors

Administrative failures and errors can occur when plan administrators don't follow Department of Labor (DOL) rules.

The most common error of this type involves plans failing to remit monies withheld from employees' paychecks in a timely manner. The rules are different depending on the number of participants in a plan. Small plans, those with less than 100 participants, by regulation have seven days from the date the money is withheld from an employee's paycheck to remit the money to the plan.

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For large plans, those with 100 or more participants, the plan sponsor must deposit monies withheld on the earliest date the employer can reasonably segregate these amounts from its general assets, *but* in no event later than the 15th business day of the month following the month in which the employer withheld the contributions from the employee's paycheck.

This rule continues to cause confusion for plan sponsors even after years of increased enforcement. The issue: plan sponsors continue to be focused on the part of the rule *after* the "but." However, the DOL enforcement of the rule is almost exclusively based on the part of the rule *before* the "but." That is, the plan sponsor must deposit monies withheld from employees' paychecks "on the earliest date the employer can reasonably segregate these amounts from its general assets…" For larger companies this is generally even fewer days than the seven days sponsors of small plans have.

The DOL may note during an audit that a company had been remitting money between three to six days after the money was withheld, so it may appear that the sponsor is doing a good job. However, the DOL can determine that the company has shown that they can "reasonably segregate" the funds in three days and all deposits that took more than three days could be considered late.

When this type of error occurs, if identified quickly, the cost to fix the error will be substantially less than the time to correct it. The sponsor will have to replace the lost earnings for the days the money was not in the plan and have to pay an excise tax of 15 percent on the amount of the lost earnings.

The second most common type of administrative failure occurs when administrators fail to follow their own plan document, commonly called an operational defect. This generally applies to what is defined as "compensation" under the plan.

Many plans will exclude certain types of income from the definition of "compensation" under a plan document. This includes overtime, vacation, bonuses, stock-based compensation and taxable fringe benefits. Others plans will include all wages that appear in Box 1 of Form W-2 in the definition of compensation.

If the plan document provides that all compensation, including bonuses, is to be deferred upon, and deferrals are not calculated on the bonuses, a very costly error has been made.

When a plan fails to follow an employee's election to withhold, the employer has to make a corrective contribution equal to 50 percent of what the employee would have withheld, plus 100 percent of what the employer would have matched, plus any lost earnings. The employer cannot go back to the employee to recoup the amounts that should have been withheld. Since this error often occurs with bonuses, the amounts involved can be substantial, especially if it is first discovered after numerous years.

2. Failure To File

Benefit plans are required to file Form 5500 annually. Plan administrators or sponsors that have failed to file for one or multiple years are concerned that if they begin to file the delinquent forms they will bring unwanted attention to themselves from the Internal Revenue Service (IRS) or the Department of Labor (DOL). They may choose an approach of waiting until IRS catches them and then dealing with it.

This is never a good idea. One of the correction programs established by the IRS is the Delinquent Filer Voluntary Compliance

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Program (DFVCP) for plans and plan sponsors who have not been filing annually. The DFVCP is only available to plans subject to Title I of ERISA.

Plans filing under the DFVCP agree to pay the following penalties under the program: Per the DOL website, large plans, those with 100 or more participants, pay "$10 per day for each day the annual report is filed after the date on which the annual report was due (without regard to any extensions), not to exceed $2,000. In the case of a DFVCP submission relating to more than one delinquent filing for the same plan, the maximum penalty amount is $2,000 for each annual report, not to exceed $4,000 per plan."

Small plans, those with fewer than 100 participants, pay "$10 per day for each day the annual report is filed after the date on which the annual report was due (without regard to any extensions), not to exceed $750. In the case of a DFVCP submission relating to more than one delinquent annual report filing for the same plan, the maximum penalty amount is $750 for each annual report, not to exceed $1,500 per plan."

By coming forward voluntarily, plan sponsors will effectively limit their exposure to penalties. Plan sponsors that have already received a DOL Notice of Intent to Assess a Penalty are automatically disqualified from the program. The DOL penalties can far exceed those listed above, so it is better to come forward voluntarily.

3. Plan Document Management

The IRS will often review plan documents to ensure that plans are up to date with all the current rules and regulations governing a plan and that plan documents are signed. Plan sponsors that fail to keep their plan document signed and up to date may be fined. The past decade has had two large groups of amendments and several other small ones. In 2001, plans had to adopt amendments for the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). More recently plans had to adopt amendments for the Pension Protection Act of 2006.

These amendments were substantial, and most plan administrators were aware of the need to make the amendments. However, on almost an annual basis, lawmakers are requiring plan administrators to make other amendments. In 2010, for example, administrators needed to amend their plans for the HEART Act, which protects benefits for armed services members who die or become disabled during service.

Many administrators think they are safe because they use prototype plans that are maintained and updated by insurance or trust companies. However, while many of these prototype plan documents may be updated automatically, there may be paperwork that an administrator must sign for their individual plan to give effect to these amendments. Administrators may neglect this paperwork, and therefore their plan may not have been actually amended.

4. Investment Oversight Responsibilities

This applies to both sponsor-directed and participant-directed investments.

Sponsor-directed: All defined-benefit and many defined-contribution plans have sponsor-directed investments. This means the sponsor of the plan directly chooses what the plan is investing in. Should the sponsor make a poor investment decision, it could directly affect the benefits available for participants. Sponsors may believe they are doing a good job selecting investments, but that may not be the case. They should take the necessary steps to show they are using good judgment. This includes, but is not limited to, creating an investment committee to review investments periodically and also seeking the guidance from outside investment advisors.

Participant directed: These plans which offer different investment options to participants, and participants in turn decide what to invest in, may seem less risky. Most will offer several different mutual funds or similar investments that cover different types of investment strategies, such as large cap, small cap, fixed income, international, target date and stable value, just to name a few. The plan sponsor may believe that by making the different options available they have done their job. When a plan was first established, the sponsor may have investigated different funds to make sure only the best were made available to their participants.

The question is, how often have those choices been reviewed? Funds that were performing well five years ago may not be performing well today. Within each category there will be numerous funds from which to select, and they all will have varying returns. To complicate matters further, each fund will have different fees. In the past the fees have been mostly hidden – buried within the investment returns and disclosed as an average percentage somewhere in the small print in a prospectus.

Starting in 2012, each participant's share of fees, based on the funds they are investing in, will be presented in total on the face of his or her statements. This will undoubtedly cause participants to become more fee conscious than they already are. Investments that once looked like good choices to offer to participants may not look as attractive anymore. If the investment choices available to participants aren't being reviewed and updated periodically, well-intentioned plan sponsors may find themselves in trouble.

In certain situations, courts have ruled that plan sponsors are responsible for a shortfall in benefits because of both bad investment decisions (for sponsor-directed plans) and for bad investment options to choose from (for participant-directed plans).

So what is a plan sponsor to do? Between all the rules, the constantly changing regulations and litigious nature of our society, plan sponsors are forced to spend more time on the governance of these plans.

The answer is not to neglect good governance and not to go it alone. Even small companies should establish committees to review their plans at least annually if not quarterly. These committees should seek guidance from professionals familiar with the industry, including investment advisors and ERISA attorneys. Often the insurance or trust company that is administering the plan will offer investment advice or assist in making the necessary amendments to the plan document. These services may or may not be at the top of the list of concerns when a sponsor selects a custodian to work with. The sponsor may be more concerned with fees or the type of services provided to participants.

When hiring an insurance or trust company, sponsors should be sure to ask the following:

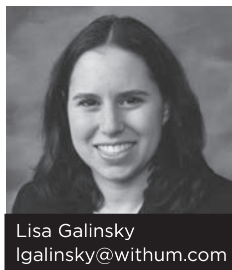
- What is the process for selecting investments in the plan?
- How often will investment selections be reviewed and updated?
- Who is responsible for amending the plan to stay in compliance with all laws and regulations on an ongoing basis, and what is the plan sponsor's responsibility in that process?

Lastly, those plans that require an annual audit to accompany their form 5500 filing should seek out a qualified audit firm. In addition to performing a proper audit, an experienced auditor can often ask the right questions and identify issues while they are still small and easy to manage.

Both the DOL and the IRS have several "self correction" and "voluntary correction" programs. While it would be inaccurate to say that they never levy fines or penalties, both agencies are focused on protecting the participants and their benefits. Plan sponsors who have made errors and have voluntarily come forward to correct them were pleasantly surprised that both agencies will work with plan sponsors to remediate the problems instead of looking to punish a sponsor for unintentional wrongdoing.

UNDERSTANDING HARDSHIP DISTRIBUTIONS

By Lisa Galinsky, CPA, CVA, Senior Manager & Donna Nevolo, CPA, Manager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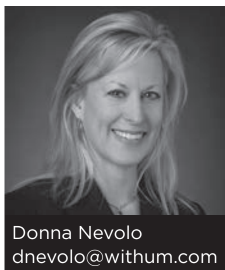
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Retirement plans are established by employers to provide a means for employees to save for their retirement. The IRS approves plans that meet certain guidelines, and these qualified plans provide tax incentives for employers and their participating employees. To achieve their designated purpose for retirement savings, retirement plans are designed to limit the circumstances for withdrawals.

Generally, distributions can occur when a participant terminates employment, becomes disabled, dies, or reaches the age of 59 1/2. Additionally, retirement plans can, but are not required to provide for hardship distributions for active employees who are under the age of 59 1/2. The plan document is required to identify the specific types of distributions allowed by the plan.

Hardship distributions are allowed in 401(k) and 403(b) plans only when specific criteria are met. The IRS specifies that the distribution is required to satisfy a financial need that is characterized as "immediate and heavy". The following expenses are deemed to be immediate and heavy by the IRS:

- ✓ Medical expenses
- ✓ Purchase of a principal residence (excluding mortgage payments)
- ✓ Repair damage to a principal residence
- ✓ Payments to stop eviction from a principal residence
- ✓ Funeral and burial expenses
- ✓ Tuition and related educational fees

For a plan to allow for hardship distributions, the plan document must specifically describe the type of hardship distributions that are allowed by the plan, but may exclude other items deemed immediate and heavy by the IRS. The plan document must also identify the specific funds available for hardship distributions. Such distributions can be limited to the employee's total elective contributions and Roth contributions, or can also be available from vested employer matching and profit-sharing contributions, if specified in the plan document.

Distributions are not deemed to be immediate and heavy if the plan participant has other resources available to pay for the expense. Therefore, before a participant is eligible to receive a hardship distribution, the participant must first obtain all available distributions and loans allowed under the plan and any other plans maintained by the employer. The amount and availability of the participant's personal resources and those of the spouse and minor children should also be considered in the determination, as well as anticipated insurance reimbursements, etc. If the loans and other available distributions and personal resources do not satisfy the employee's hardship, then a hardship distribution for the uncovered portion can be considered.

In addition to the penalties and income taxes imposed, there are other consequences to the participant when taking a hardship distribution. The participant is prohibited from making contributions into the plan for a period of six months after the distribution. Hardship distributions cannot be repaid to the plan, and, as such, the distribution permanently reduces the participant's account balance.

The amount of the hardship distribution may not exceed the amount needed to cover the cost of the hardship plus taxes and penalties resulting from the distribution. A written request form and supporting documentation must be provided to the plan sponsor and/or to the plan administrator, whomever has the authority and responsibility to approve such transactions. Examples of supporting documentation can include, but are not limited to copies of bills or notices received by the participant and/or documentation of an impending or foreseeable hardship. Determinations of hardship are generally made on the basis of relevant facts and circumstances. The plan sponsor or plan administrator can rely on written representation as to the availability of the participant's personal resources to satisfy the hardship, unless they have knowledge to the contrary.

Once approved, a hardship distribution can be processed, and the withdrawal, net of taxes withheld, can be provided to the participant. Unless the distribution comes from Roth contributions, hardship distributions are taxed as ordinary income on the participant's personal federal income tax returns, and if the participant is under the age of 59 1/2 at the time of distribution, the participant will also be subject to a 10% penalty on their federal income tax return. Additionally, hardship distributions may be subject to state income taxes.

In addition to the penalties and income taxes imposed, there are other consequences to the participant when taking a hardship distribution. The participant is prohibited from making contributions into the plan for a period of six months after the distribution. Hardship distributions cannot be repaid to the plan, and, as such, the distribution permanently reduces the participant's account balance.

Retirement plans can allow for hardship distributions if specified in the plan document. The distribution can be deemed to satisfy the criteria of an immediate and heavy financial need if supporting documentation has been provided by the participant and all other means to satisfy the need have been considered and exhausted, including participant loans, other plan distributions and personal resources. When these requirements have been satisfied, approval for such a distribution can be granted to the participant in an amount not to exceed the amount of the immediate and heavy financial need, including the related penalties and taxes. Upon approval, the participant would be prohibited from making deferral contributions into the plan for a period of six months following the distribution. While hardship distributions can be a desirable plan option for participants, the tax implications and permanent reduction in retirement savings are negative consequences which highlight the position that retirement savings should only be used as a last resort when satisfying an immediate and heavy financial need.

NEED MORE INFORMATION?
If you need more information regarding this or any other topic affecting your retirement plan, visit our Withum ERISA Knowledge Corner online, follow us on Twitter at WSB_ERISA or contact us at ERISAhelp@withum.com to arrange a free consultation today.

The information contained herein is not necessarily all inclusive, does not constitute legal or any other advice, and should not be relied upon without first consulting with appropriate qualified professionals for your plan's individual facts and circumstances.

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