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QRP Legal Issues

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Learning Objectives

At the completion of this course you will be able to

- recognize when plan assets may be used to cover plan expenses,
- better understand the legal distinctions between contractors and employees,
- identify the rules for plan audits, including new AICPA auditing standards, and
- describe the options that employers have when dealing with missing, nonresponsive, or terminated participants.

Icon Legend

Individual Exercise

Group Exercise

Group Discussion

Example

Job Aid

Additional Information

Paying Plan Expenses

A common question plan administrators ask is what fees can be paid out of plan assets rather than directly by the employer. This important question is part of the fiduciary's role to decide what to pay as plan expenses. The fiduciary must act in the best interest of the plan participants and beneficiaries and must act prudently in deciding whether a plan expense is appropriate and reasonable. The plan administrator must, therefore, determine if and when a particular expense ultimately benefits the plan participants.

Many would argue that paying any fees from participant accounts is not in the best interest of the participants because it reduces their future benefits. Others argue that if no fees are paid, it raises the costs associated with operating a plan and therefore may discourage employers from establishing a plan. And some fees, such as regulatory amendments, are in the best interest of the participants. Even though there is a reduction of future benefits, the amendment is required to maintain the plan's qualified status.

The Department of Labor (DOL) has weighed in to balance the best interest of the participants against the goal of encouraging employers to offer retirement plans. Therefore, *reasonable administrative* expenses incurred in maintaining the plan may be in the best interest of the participants.

Self-Dealing

An additional concern when looking at plan expenses is avoiding paying compensation or other consideration for transactions involving plan assets to a fiduciary (see ERISA Sec. 406(b)). A fiduciary is prevented from self-dealing or charging expenses to the plan for duties that the fiduciary did not actually perform. To do so would result in a prohibited transaction.

An exemption under ERISA Sec. 408(c) allows fiduciaries to be paid reasonable compensation for services rendered to the plan; however the fiduciary cannot receive further compensation for duties to the plan if the fiduciary is already being compensated by the employer for those services. DOL guidance further restricts a fiduciary from being compensated for any expenses other than those incurred directly by that fiduciary.

As a result, the fiduciary can recover only amounts incurred for services performed directly for the plan itself. For example, a trustee cannot charge a specific plan a fee for general expenses it incurred in maintaining another plan's assets.

Type of Expenses: Administrative vs. Settlor

The DOL has classified two types of fees to help determine when and if expenses can be paid from the plan: administrative and settlor.

Administrative fees are those expenses incurred in maintaining and conducting ongoing administrative activities involving the plan. These fees may be paid from plan assets. This includes fees for annual recordkeeping fees, annual reporting fees, distribution fees, or fees associated with IRS-mandated amendments to comply with new regulations or legislation.

Settlor fees are expenses incurred when an employer performs a settlor function. A settlor function is an action taken by the employer when the employer makes a business decision that involves plan establishment, plan design, or plan termination. These fees may not be paid out of plan assets because the fees are attributable to a decision that is in the employer's interest. A common example is an amendment fee to change a plan provision, even if the amendment benefits the participants, such as adding a loan feature or in-service distributions.

While some fees are rather simple to determine which category they fall in, other fees are difficult to distinguish. A fiduciary should always consider the facts and circumstances surrounding the expense in determining whether it is an administrative expense. Additionally, DOL Advisory Opinion 2001-01A[1] provides a number of hypothetical scenarios to assist plan administrators to determine which category a particular fee is in.

Additional Considerations

The plan fiduciary also has a duty to ensure the fees are reasonable. Even though recordkeeping fees generally are administrative expenses and can be paid from plan assets, if the fees are unreasonable, the fiduciary may have breached its fiduciary duty by paying these fees from plan assets.

The uniform and nondiscriminatory standard also comes into play. For example, if the plan allows a feature that typically is used only by highly compensated employees, such as a self-directed brokerage account, then those fees associated with that feature may not be charged to all participants.

Plan administrators may choose to charge a particular fee to only those participants that use that particular service. The plan administrator may also choose to treat employed and terminated participants differently. Field Assistance Bulletin (FAB) 2003-03 permits the plan to charge fees to terminated participants, where the plan may pay the expense for those still employed. The fees charged to terminated participants must be proportionate to their share of the fee, they cannot be charged the entire fee for all participants.

[1] "Guidance on Settlor v. Plan Expenses," U.S. Department of Labor, https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/advisory-opinions/guidance-on-settlor-v-plan-expenses. [Search "DOL Advisory Opinion 2001-01A Hypotheticals"; a search for "DOL Advisory Opinion 2001-01A" does not include the hypotheticals.]

Payment Methods

The DOL endorses only certain methods for paying expenses from plan assets. In FAB 2003-03, the DOL has indicated that there are several approved methods, but that some may be more appropriate than others—depending on the type of fee for which the plan is debited. The fiduciary should examine the fee and determine which is the most appropriate method based on the facts and circumstances. The plan administrator may choose to use a different method for each fee charged.

NOTE: *Plan administrators also should review fee disclosure requirements, which include making necessary disclosures to plan participants and beneficiaries when charging those fees directly to them.*

Pro Rata

One of the more popular methods for debiting fees from plan assets is to remove the fee based on the participant's account balance in relation to the entire plan balance, or in other words, on a pro rata basis. The pro rata method is the method the DOL recommends plans use if the fee incurred is based upon the account balances of the individual participants. Because the account balances of the highly compensated employees are often larger than the nonhighly compensated employees' (nonHCEs) account balances, the pro rata method is viewed as the least discriminatory method to use because the HCEs are charged with a larger portion of the fee.

If the pro rata method is used, the participant's entire account balance should be used to determine that participant's proportionate share of the fee, including any outside assets or self-directed brokerage accounts in which the participant may have an investment.

Per Capita

Fees may be taken from participant accounts on a per capita basis, or in a uniform (flat) amount pulled from each participant's account. The per capita method is most often used when the fee is a set amount that is charged to the plan, such as an annual recordkeeping fee. If there were ten participants in the plan and the annual recordkeeping fee was $3,000, each participant would be charged $300.

In FAB 2003-03, the DOL cautioned against using this method, however, if the fee charged is based on account balances within the plan. If the fee varies based on the amounts in the plan, like a financial advisor fee, the more appropriate method would be pro rata.

Utilization/Transaction Fees

Another method that may be used by plan administrators is to charge each individual participant a fee for using a feature of the plan. This method is most often used for distribution fees, loan origination fees, or qualified domestic relations order (QDRO) determination fees, where the fee is the result of one participant's request. Under this method, a participant who takes out a loan is charged a loan fee, and that fee will be deducted from the participant's account balance or loan proceeds.

ERISA Budget Accounts

Another method for paying plan expenses has many names, but "ERISA budget account" is the most common term used for the establishment of a separate account within the plan to pay fees. The ERISA budget account method collects amounts taken from investments for 12b-1 fees and sub-transfer agent fees generated from the investments, and places these amounts into a separate account within the plan. The account is then used to pay the plan's administrative expenses. A third party often facilitates the movement of 12b-1 and sub-transfer agent fees into the account. From that account, general fees, like advisor and recordkeeping fees, may be paid directly, resulting in both fee transparency and reduced impact on the participant accounts when fees are paid from the ERISA budget account.

The ERISA budget account method is becoming increasingly popular, but there is little guidance on how to administer such an account. The guidance that has been provided on this type of account indicates that the account may be used to pay reasonable administrative expenses of the plan. But no guidance has been issued on using it to pay an employer's settlor fees.

Use of Forfeiture Accounts

Forfeiture accounts may be used in multiple ways and the options should be identified in the plan document. If the plan document allows, forfeitures can be used for payment of the plan's administrative expenses. Because forfeitures are considered plan assets, the rules governing payment of expenses from forfeitures are the same as those for paying the expenses from other plan assets (Revenue Ruling 84-156). A plan administrator should check its plan document before applying forfeitures toward plan expenses.

Independent Contractors

The idea of using independent contractors, rather than hiring employees, has been embraced by many employers, including Microsoft, Uber, and FedEx, to name a few. The use of independent contractors can dramatically reduce administrative burdens and costs associated with hiring employees. However, companies must be diligent in ensuring that their independent contractors are not really employees. There are legal distinctions between being a contractor and an employee and the associated costs for misclassifying workers can be extremely high.

Determination of Worker Relationship

Historically, the DOL and the IRS investigated and audited companies where independent contractor misclassification was prevalent. Employers' misclassification is not surprising because there is no one definition of "independent contractor" under federal or state laws. The following discusses misclassification of employees in light of the IRS' determination method, an interpretation by the DOL (withdrawn in 2017), and a DOL opinion letter issued in April 2019.

IRS

To help in determining whether an employer/employee relationship exists, the IRS set forth in Revenue Ruling 87-41 what became known as the 20-factor test. In 1997, the IRS attempted to simplify and refine the test, consolidating the 20 factors into 11 and organizing them into 3 main groups: behavioral control, financial control, and the type of relationship of the parties. However, the IRS specifically provides that factors in addition to those listed in the 1997 guidance (i.e., the "Worker Classification Training Manual") and the 1987 Rev. Rul., may be relevant and considered when examining the totality of the circumstances. A summary of the consolidated factors, including industry examples, can be found in IRS Publication 15-A, *Employer's Supplemental Tax Guide* (Supplement to Pub. 15, *Employer's Tax Guide*) .

The following facts, as broken out into three categories by the IRS, provide evidence of the degree of control and independence in any employee-independent contractor determination.

Behavioral Control

Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of

- instructions the business gives the worker (e.g., when and where to work, what tools to use, where to purchase supplies) and
- training the business gives the worker.

Financial Control

Facts that show whether the business has a right to control the business aspects of the worker's job include the following.

- Extent to which the worker has unreimbursed business expenses
- Extent of the worker's investment (e.g., investment in facilities or tools used in performing services for someone else)
- Extent to which the worker makes his or her services available to the relevant market
- How the business pays the worker
- Extent to which the worker can realize a profit or loss

Type of Relationship

Facts that show the parties' type of relationship include the following.

- Written contracts describing the relationship the parties intended to create
- Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay
- Permanency of the relationship
- Extent to which services performed by the worker are a key aspect of the regular business of the company

If an employer wants assistance from the IRS, when making a determination of independent contractor status, they can use IRS Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, and the associated instructions.

DOL

Administrator's Interpretation No. 2015-1

On July 15, 2015, the DOL issued Administrator's Interpretation (AI) No. 2015-1, applying the Fair Labor Standards Act's (FLSA's) standard to "suffer or permit" as a basis to identify workers misclassified as independent contractors instead of employees. Whether a worker is considered an employee, as opposed to an independent contractor, is determined by a number of factors. One key factor is the degree to which a worker is economically dependent on—or economically independent of—an employer. The AI addresses each factor, providing citations to case law and examples. Each factor is analyzed in conjunction with the other factors and no one factor is more determinative than the others.

- Extent to which the work performed is an integral part of the employer's business
- Worker's opportunity for profit or loss depending on her managerial skill

- Extent of the relative investments of the employer and worker
- Whether the work performed requires special skills and initiative
- Permanency of the relationship
- Degree of control exercised or retained by the employer

On June 7, 2017, the Labor Secretary announced the withdrawal of AI No. 2015-1. The interpretation created an informal standard but was widely criticized by the employer community because the standard was set outside of formal rule making. The DOL noted that the removal of the interpretation "does not change the legal responsibilities of employers under the Fair Labor Standards Act…as reflected in the department's long-standing regulations and case law." The withdrawal of the guidance, however, appears to indicate a shift in enforcement focus of the DOL under the new Trump administration.

DOL Opinion Letter FLSA2019-6

On April 29, 2019, the DOL's Wage and Hour Division issued Opinion Letter FLSA2019-6, responding to a request for DOL guidance on the independent contractor status of service providers working for a "virtual marketplace" company under the FLSA. These service providers are commonly on-demand workers whose services are facilitated by Internet-based applications. Familiar examples of such workers include drivers for Uber and Lyft transportation services.

This opinion letter addresses the the applicant's particular fact pattern, but also identifies a number of factors derived from Supreme Court precedent that may determine whether a worker should be considered an independent contractor or an employee. The opinion letter also states that, "while the FLSA has a very broad scope of coverage, it is not so broad that all workers are caught within its reach – far from it." This confirms a shift from the prior position in AI No. 2015-1 that "most workers are employees under the FLSA's broad definitions." The factors listed in FLSA2019-6 are virtually identical to those in AI No. 2015-1. Among them are the following.

- Nature and degree of the potential employer's control
- Permanency of the worker's relationship with the potential employer
- Amount of the worker's investment in facilities, equipment, or helpers
- Amount of skill, initiative, judgment or foresight required for the worker's services
- Worker's opportunities for profit or loss
- Extent of integration of the worker's services into the potential employer's business

The opinion letter is based on a particular set of circumstances, but can be a guide for employers that rely heavily on independent contractors. Employers should also familiarize themselves with any applicable state laws that may be more restrictive.

Case Law

Lawsuits claiming improper classification of workers are trending and employers are spending significant time and expense defending such lawsuits. The following preeminent cases examine the determination of whether a worker is an employee under ERISA.

Nationwide Mutual Insurance Company v. Darden

In *Nationwide Mutual Insurance Company v. Darden*, 503 U.S. 318 (1992), Nationwide Mutual Insurance Company (Nationwide) maintained the Nationwide Agents' Security Compensation Plan (Plan) to which agent Robert Darden (Darden) was a party. The Plan was a two-part plan whereby Nationwide credited an agent's retirement account with an amount annually, based on the agent's yearly business performance. Additionally, after termination or retirement, Nationwide paid an amount equal to the total of the agent's policy renewal fees from the previous 12 months. To receive these benefits the agent had to agree to refrain from selling policies for a competitor within 25 miles for a year or they would forfeit any unpaid benefits under the plan.

Darden was terminated by Nationwide and began selling competitors' policies out of his same insurance office. Nationwide informed him that his benefits under the plan were forfeited. Darden responded that the benefits were vested under ERISA and therefore nonforfeitable. The District Court found in favor of Nationwide, stating that Darden was an independent contractor and therefore, not afforded the protection under ERISA because he was not an employee. Darden appealed the decision.

The Fourth Circuit Court of Appeals acknowledged that ERISA does not contain an expanded definition of "employee" and developed a three-prong test involving (a) the worker's expectations, (b) reliance on the expected payment, and (c) lack of bargaining power to negotiate the forfeiture clause out of the agreement. Based upon the test, the Court of Appeals concluded Darden was an employee for ERISA purposes. Applying this standard, the District Court found on remand that Darden was an "employee," and the Court of Appeals affirmed.

The U.S. Supreme Court reviewed the decision and held that where Congress failed to provide a meaningful definition of employee, the definition to be used was that of the master-servant relationship as it is understood in common law agency doctrine. The Supreme Court did not use the IRS' 20-factor test but acknowledged 12 of the 20 factors as summarized in *Community for Creative Non-Violence v. Reid*, 490 U.S. 740 (1989) for use in "determining whether a hired party is an employee under the general common law of agency." The Supreme Court did not address whether Darden satisfied the common-law test, but remanded the case for resolution.

Vizcaino v. Microsoft

Vizcaino vs. Microsoft, 97 F.3d 1187 (9th Cir. 1996), was a result of the IRS conducting a tax-related audit on Microsoft for tax years 1989 and 1990. When the IRS audited the company's payroll tax accounts, the IRS applied its 20-factor test and determined that a large portion of Microsoft's workforce was composed of actual employees, even though Microsoft called them "freelancers," considered them independent contractors for tax purposes, and required them to sign two agreements waiving their rights to benefits offered to employees. Microsoft conceded that the IRS was correct in determining the workers were de facto employees, not independent contractors. As a result, Microsoft issued Forms W-2 for the workers' earnings in those audited tax years and paid its share of Federal Insurance Contributions Act (FICA) taxes.

After settling with the IRS, Microsoft "converted" many of the freelancers to regular employees, paid them through payroll, and extended employee benefits to them. The remaining freelancers were either terminated or rehired by a temporary employment agency which supplied those workers back to Microsoft on an as needed basis. Upon learning of the IRS' determination, some of the terminated and reclassified workers sued Microsoft in an effort to get various permanent benefits, including access to the Microsoft Corporation Savings Plus 401(k) Plan and Microsoft Corporation Employee Stock Purchase Plan. The District Court held the freelancers had waived their benefit rights by virtue of the independent contractor agreements.

The Ninth Circuit Court reversed and held that the Microsoft workers were in fact employees and not independent contractors and, therefore, covered by the plan. The Court's decision was based upon Microsoft's agreement that the workers were employees during the course of the audit by the IRS, and those independent contractor agreements were not enforceable by either party because they were premised on a mutual mistake of fact. The Court stated that whether the employees were Microsoft's common law employees or agency employees turns on application of the "Darden factors" to their relationship with Microsoft.

Microsoft eventually agreed to pay $97 million to settle the class-action lawsuit.

Consequences of Misclassification

Businesses that misclassify workers fail to pay mandatory federal, state, and local taxes, as well as Social Security and Medicare contributions, workers' compensation insurance, work-related expenses, sick/vacation pay and risk costly liability for failure to provide employees with group health insurance as well as the ability to participate and receive contributions in retirement plans. If the misclassification was unintentional, businesses may face penalties for failing to file Form W-2, failure to follow federal employment tax laws, and unpaid tax liabilities. Additional fines and penalties may be imposed for fraud or intentional misconduct. Moreover, a business's retirement plan could experience an increase in benefits costs, demographic failures (e.g., coverage and nondiscrimination), and potential plan disqualification.

More details on penalties can be found in IRS Publication 15, *(Circular E), Employer's Tax Guide*.

Voluntary Classification Settlement Program

In September 2011, the IRS introduced the Voluntary Classification Settlement Program (VCSP) in Announcement 2011-44. The program was later modified by Announcement 2012-45. VCSP is designed to encourage employers to take advantage of the lenient penalty framework when employees are misclassified as independent contractors. Businesses pay less in back taxes and avoid interest and penalties if they reclassify their workers from independent contractors to employees on a forward-going basis.

VCSP is available for employers that consistently treated workers as non-employees, including filing all required IRS Form 1099-MISC for the reclassified workers for the previous three years.

The employer cannot currently be under an employment tax audit by the IRS and cannot be currently under audit concerning the classification of workers by the DOL or any state government agency. If the IRS or DOL previously audited an employer concerning the classification of the workers, the employer will be eligible only if the results of the prior audit were complied with and the employer is not currently contesting the classification in court.

Plan Audits

Background

"Title I: Protection of Employee Benefit Rights," Part 1 of ERISA, outlines the reporting and disclosure requirements for qualified retirement plans. ERISA's reporting and disclosure requirements were established primarily as a means to protect plan participants' interests and prevent plan abuses. To that end, employers with qualified retirement plans generally are required to file an annual return/plan report with the Employee Benefits Security Administration (EBSA). This annual report, IRS Form 5500, *Annual Return/Report of Employee Benefit Plan*, is designed to gather, among other things, detailed information about a plan's financial condition and operations.

Requirements

ERISA Section 104, which requires retirement plans to disclose financial information within Form 5500, also requires that an independent qualified public accountant (IQPA, or auditor) perform an annual audit of plan financial statements. Plans with 100 or more eligible participants (as of the first day of the plan year) generally are considered "large plans" and are subject to the audit requirement. Plans that filed as a "small plan" in prior years but now have 121 or more "eligible participants" (as of the first day of the plan year) are also subject to the audit requirement.

NOTE: *"Eligible participant" is defined as any employee who is able to participate (even if deferring zero), in addition to terminated employees with a balance.*

Types of Audits

A Form 5500 audit has two formats: a limited scope audit and a full scope audit. Employers should seek competent legal and tax counsel to determine the appropriate nature of the audit.

Limited Scope Audit

- The auditor limits the scope of examination in order not to audit the investment transactions and plan investment values.
- This type of audit is only available when the trustee or custodian holding the investments produces a certified statement as to the accuracy and completeness of the investment information.
- The auditor must still assess the non-investment plan activities, such as participant eligibility, employee and employer contributions, internal controls, and plan administrative expenses.

Full Scope Audit

- The auditor must audit the full scope of investment transactions and plan investment values.
- This type of audit is needed when the trustee or custodian cannot provide a certified statement as to the investment information within the plan.
- This type of audit is most often used when the plan holds nontraditional or "hard-to-value" assets (e.g., closely held companies, real estate).
- This audit requires more time and is more expensive to complete.

Hiring an Auditor

Select a Firm

Retirement plan audits can be very different from other types of audits that an accounting firm may typically conduct. Many ERISA rules and regulations are outside of the usual realms of personal/corporation taxation and the auditing of general business financial statements to which most auditor firms are accustomed. Not all auditors are truly experienced or skilled in retirement plan audits.

When selecting a firm to audit a retirement plan, consider the following.

- How long has the firm been doing retirement plan audits?
- How many retirement plan audits does the firm do each year?
- How experienced is the auditor in performing retirement plan audits?

Plan for Costs

While there are not set prices for retirement plan audits, among auditors, most audits will range from $5,000 to $15,000, depending on

- plan complexity, and
- full scope versus limited scope nature of audit.

Employers should discuss potential costs with the auditor they choose to engage and plan for the expense annually.

Timeline and Process

Form 5500 Filing

The Form 5500 filing due date for a retirement plan is the last day of the seventh month following the end of the plan year. For calendar year plans, the filing due date is July 31. The auditor's final report must be attached to the Form 5500 filing.

NOTE: *A two and one-half month extension to this deadline can be obtained by filing IRS Form 5558,* Application for Extension of Time To File Certain Employee Plan Returns, *by the above due date for the Form 5500. An automatic extension is granted when a*

- *plan year period and employer's tax year are the same; and*
- *the employer has been granted an extension of time to file its federal income tax return to a date later than the normal due date for filing Form 5500.*

This automatic extension cannot be extended beyond the total of 9½ months beyond the close of the plan year.

Audit Timeline

Most audit processes can take anywhere from one to three months to complete depending on the complexity of the retirement plan and the financial statements, and whether a full scope or limited scope audit is performed.

If this is the first year a plan needs to perform a Form 5500 audit, engaging a certified public accountant (CPA) early in the year may be helpful as the process can take longer.

Documents and Information

Employers must collect specific information, documents, and data for the auditor. In this step, the auditor learns about the retirement plan's processes and operation. Retirement plan information employers typically provide include the following.

- Executed plan documents and any amendments
- IRS determination or opinion letters
- Current summary plan description
- Board meeting minutes where the retirement plan was discussed
- Trust or recordkeeping agreements
- Copies of prior year Form 5500 filings
- Copies of fidelity bond insurance
- Copies of the plan's prior year audited financial statements
- Plan census data
- Reports of year-end compliance testing
- Distribution and loan reports, trust statements
- Statement on Standards for Attestation Engagements (SSAE) 16 Report

Verification

Plan Compliance

The auditor checks to see that the operation of the plan matches the rules found in the plan document. The auditor may ask the following questions.

- Have employees who meet the plan's eligibility requirements been allowed to participate in the plan?
- Has there been a timely deposit of all participant deferrals and plan loan repayments into the plan trust?
- Was the right compensation data used for plan purposes?
- Has the plan performed the necessary yearly compliance and nondiscrimination testing?

Financial Reporting

Large plan filers must submit a more detailed and complete financial schedule (Schedule H) with the Form 5500 filing than a small plan filer. The auditor must verify and confirm that the financial data reported is free of any material defects or inaccuracies. They must also verify and confirm that the retirement plan financial data aligns with the rest of the company's financial statements. They will review

- assets and liability balances for beginning and end of plan year;
- income statement of contributions and earnings; and
- distribution and fee dispersals.

Internal Controls

Internal controls are the policies and procedures that ensure that a plan is operating and controlled properly. These include both controls put in place by service providers, like the recordkeeper and trustee or custodian, and the controls in place to mitigate errors and inaccuracies within the retirement plan.

- SSAE 16 or System and Organization Controls (SOC) 1 reports, which are formal reports from service providers that outline the internal controls the service organization has put in place to prevent fraud and errors
- Data verification between employer and recordkeeper
- Plan administrator procedures and controls

Audit Report

At the end of the audit process, the auditor gives her final analysis on the compliance of the plan, along with her opinion on the plan's financial statements and if internal controls are effective and sufficient.

The auditor will issue one of the following opinions on behalf of the retirement plan and its operations.

Unqualified

The auditor concludes that the plan's operations and its financial statements are fairly and accurately represented and free of any significant defects (a "clean report"). An unqualified opinion does not necessarily mean that the business is in a good economic position, only that the retirement plan and its financials are transparent and free of any significant errors or issues.

Qualified

The auditor concludes that most matters within the plan and its financials are adequately represented, but due to the limited scope of the audit or due to one or more issues found, the auditor "qualifies" his opinion regarding the issue. The issue needs to be significant enough in nature to warrant mention, but should not be so pervasive within the retirement plan that it misrepresents the overall financial position of the plan.

Adverse

An issue(s) is both significant and pervasive within the plan. The auditor will issue disclaimers as to the accuracy of the financial statements and what issues need attention to bring the plan into compliance.

Disclaimer of Opinion

Due to the absence of necessary financial data or plan records, the auditor is unable to complete a full audit report and is, thereby, unable to determine or state an opinion on the plan's financial status.

At this point, the auditor can alert the employer to any plan failures that would require corrective measures, and review issues related to the accuracy of the plan's financial statements.

New AICPA Employee Benefit Plan Auditing Standard

DOL Assessment of Audit Quality

A DOL report issued in 2015 identified a number of quality issues with employee benefit plan audits subject to ERISA. The report follows a study examining the level and quality of audits for Form 5500 filings from 2011. The DOL reported audit deficiencies in 39 percent of all ERISA audits for 2011 (nearly 4 out of 10). The study also found a correlation between the number of plans a firm audited and the deficiencies later found in the audits that were reviewed by the DOL. Specifically, there was a significant drop in deficiencies when an auditor firm conducted more than 100 retirement plan audits a year, and the number of deficiencies dramatically increased for those auditor firms who performed fewer than 24 audits per year.

The report concluded that the quality of employee benefit plan audits had not improved since the DOL's previous studies. It made a number of recommendations, including making amendments to ERISA to allow the assessment of civil penalties against auditors in certain circumstances and working with the National Association of State Boards of Accounting (NASBA) and the American Institute of Certified Public Accountants (AICPA) to improve the investigation and sanctioning of CPAs who perform deficient audit work.

In response to the report, the AICPA's Auditing Standards Board (ASB) has worked closely with the DOL to revise the auditing standards in an effort to improve audit quality.

Changes to Plan Audit Standards

In July 2019, the AICPA's ASB issued as a final standard, "Statement on Auditing Standards (SAS) No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA (EBP SAS).*" The EBP SAS addresses the auditor's responsibility to form an opinion and report on the audit of the financial statements of employee benefit plans subject to ERISA.

Specifically, SAS No. 136

- creates new reporting requirements and performance requirements for audits of ERISA financial statements; and
- changes the form and content of the auditor's report for "limited-scope" audits (now referred to as "ERISA Section 103(a)(3)(C)" audits).

SAS No. 136 also includes requirements for

- communications with management or those charged with governance;
- considerations relating to ERISA Form 5500 filing;
- procedures for an ERISA Section 103(a)(3)(C) audit;
- engagement acceptance; and
- audit risk assessment and acceptance.

The EBP SAS is effective for audits of ERISA plan financial statements for periods ending on or after December 15, 2020; early implementation is not permitted.

Missing Participants

Employers often are faced with the task of locating missing participants and beneficiaries. The problem usually arises when

- lost participants attain age 70½ and must begin receiving RMDs,
- plans terminate, or
- a plan is designed to make mandatory distributions of separated participants' small balances.

Similar problems also occur when trying to provide notices or election forms to beneficiaries.

IRS Guidance

The IRS provides guidance for locating missing plan participants in the Employee Plans Compliance Resolution System (EPCRS), under Revenue Procedure 2019-19. Employers generally must take reasonable actions to find all current and former participants and beneficiaries to whom additional benefits are due, but who have not been located after a mailing to the last known address.

Such actions generally include mailing to the individual's last known address using certified mail, hiring a commercial locator service, or using a credit reporting agency or Internet search tools. An employer-sponsored retirement plan will not be considered to have breached its duty to protect a participant's assets if it has taken reasonable steps (considering the amount of the assets involved) to locate the individual.

The IRS and Social Security letter forwarding programs are no longer available as a means to search for participants and beneficiaries to whom benefits under the plan are due.

In October 2017, the IRS posted at its website an internal memorandum for retirement plan examination staff, concerning procedures retirement plans are expected to use when seeking missing participants or beneficiaries who are required to take required minimum distributions.

The memo informs IRS examiners that retirement plans should not be considered in violation, or challenged, if certain measures to locate missing individuals have been taken. This memo does not contain or constitute new or unexpected guidance, but essentially affirms what some in the industry have considered reasonable locating steps.

The IRS memo states that plans should not be considered in violation if they have done the following.

- Searched the records of the plan (including related or affiliated employers' plans), the plan sponsor, and publicly-available records or directories for alternative contact information
- Used the search capabilities of a commercial locator service, credit reporting agency, or proprietary internet search tool

- Attempted contact by U.S. Postal Service certified mail to the last known mailing address, and to any appropriate address or contact information (e.g., e-mail address or telephone number)

Examiners are informed in this memo that if these steps have not been taken, a plan may be challenged for violating its obligation to meet required distribution standards. Details on this memo were later shared in the IRS' December 2017 Employee Plans Newsletter.

DOL Guidance

In August 2014, the DOL released FAB 2014-01, replacing FAB 2004-02, which provides employers with reasonable procedures for locating missing participants of terminating defined contribution plans. It is the DOL's view that employers must take certain steps to locate missing participants before distributing plan balances.

Reasonable expenses attributable to locating missing participants can be allocated to the participant's account, as long as the allocation method is consistent with the employer-sponsored retirement plan's terms and the employer's duties under ERISA.

FAB 2014-01 limits its applicability to terminated defined contribution plans that do not have an annuity option or another defined contribution plan within the sponsoring employer's corporate group to which account balances may be transferred. Furthermore, while the locating mechanisms and search steps have relevance to ongoing plans and certainly provide a reasonable course of action for fiduciaries of ongoing plans to follow, they cannot be applied directly to ongoing plans.

Search Methods

Under FAB 2014-01, employers must use the following search methods. Guidance on distributing missing participants' account balances cannot be relied upon unless each of the following methods prove ineffective in locating a missing participant.

- Send certified mail
- Review related plan records (e.g., another plan of the employer)
- Contact the designated plan beneficiary
- Use free electronic search tools

In addition to these search methods, the DOL instructs fiduciaries to consider using Internet tools, commercial locator services, credit reporting agencies, information brokers, and investigation databases that may involve charges to locate missing participants. The DOL does not mandate that these types of search methods be used, however, fiduciaries must consider the size of the missing participant's account balance in relation to the cost of these services when deciding whether such services are appropriate.

Distribution Options

If an employer cannot locate a missing participant or beneficiary, it should check the plan documents to determine whether the plan allows for any of the following options.

Forfeiture

Some plans may forfeit a missing participant's or beneficiary's account balance and allocate it to other participants if the missing or unresponsive person cannot be located within a specified number of years after the balance becomes distributable. The forfeited amounts typically must be restored once the participant is located. This method generally is of no value if assets are being distributed because of plan termination.

IRA Rollovers

In 2004, the DOL released final regulations on automatic rollovers of certain mandatory distributions. These regulations provide a safe harbor that employers can follow when directly rolling over mandatory distributions of terminated participants' account balances (for balances between $1,000 and $5,000).

FAB 2014-01 indicates that rolling over a missing participant's account balance to an IRA is the preferred method of distribution for missing participants of terminated defined contribution plans because it is most likely to preserve assets for retirement purposes. The DOL advises employers to use the safe harbor regulations for automatic rollovers of mandatory distributions, regardless of the size of the missing participants' account balance.

The automatic rollover safe harbor relief offered in the DOL regulations depends on an employer also satisfying the following conditions detailed in IRS Notice 2005-5.

- The present value of the plan participant's vested balance must be greater than $1,000, but it cannot exceed $5,000. The safe harbor may be extended to balances under $1,000 if an employer chooses. Rollover assets and attributable earnings may be disregarded when determining the account value, depending on the plan document.
- The employer must automatically roll over assets to IRAs (IR accounts or annuities).
- There must be a written agreement between the employer and the selected IRA provider that contains certain required provisions.
    - The employer must invest the rollover in such a way as to protect principal and provide a reasonable rate of return. Types of investment products that would meet the safe harbor requirement include money market funds, interest-bearing saving accounts, certificates of deposit, and other stable value products.

- The investment product must be offered by a state- or federally-regulated financial institution, and must seek to maintain a stable dollar value equal to the amount invested in the IRA. The regulations define permitted institutions as banks or saving associations, credit unions, insurance companies, or registered investment companies.
- Fees and expenses related to the receiving IRA (and the underlying investments) cannot exceed the fees charged for IRAs that do not include plan cashouts.
- The terms of the IRA agreement must be enforceable by the participant on whose behalf the employer makes an automatic rollover.

- The employer must give participants of the distributing employer-sponsored retirement plan an updated SPD or a summary of material modifications (SMM) that discloses the employer-sponsored retirement plan's procedures governing automatic rollovers.
- The employer's selection of the IRA and the investments cannot result in a prohibited transaction under ERISA Sec. 406 unless such actions are covered by a statutory or administrative exemption issued under ERISA Sec. 408(a).

NOTE: *The safe harbor actions contained in the regulations are not intended to represent the exclusive means by which an employer might satisfy its duties under ERISA.*

Alternative Arrangements

If an employer cannot locate an IRA provider that is willing to accept a rollover contribution on behalf of a missing participant or beneficiary, the employer may consider either establishing an interest-bearing federally insured bank account in the name of the missing participant or beneficiary or transferring missing participant or beneficiary account balances to state unclaimed property funds.

In doing so, employers must understand that either of these types of distributions will subject the amounts to income taxation, withholding, and a possible early distribution penalty tax for the missing individual.

Federally Insured Bank Accounts

In selecting a bank and accepting an initial interest rate, an employer must give appropriate consideration to all available information relative to such selection and interest rate, including any associated bank fees.

Escheat to State Unclaimed Property Funds

Employers may transfer missing participants' or beneficiaries' account balances to state unclaimed property funds in the state of the individual's last known residence or work location.

The DOL states in FAB 2014-01 that principles described in Advisory Opinion 94-41A, which addressed an employer's duty to preserve plan assets in an ongoing plan, do not prevent an employer from voluntarily deciding to escheat missing participants' account balances under a state's unclaimed property statute to complete the plan termination process.

NOTE: *With regard to the application of state laws, including those governing escheat and signature requirements, the DOL notes that these issues are beyond the DOL's jurisdiction and does not offer further guidance on these issues.*

100 Percent Income Tax Withholding Not an Option

The DOL is aware that some employers have been distributing missing participants' account balances and imposing 100 percent income tax withholding to effectively transfer the balance to the IRS in the missing individual's name and Social Security number.

FAB 2014-01 indicates that the use of this option is not in the best interest of participants and beneficiaries and violates ERISA's fiduciary requirements. Employers cannot use 100 percent income tax withholding as an option to distribute missing participants' and beneficiaries' account balances.

PBGC

In late December 2017, the PBGC issued final regulations that modify existing guidance on missing participants and beneficiaries in terminating qualified retirement plans. These revised final regulations broaden guidance that formerly applied to single-employer defined benefit (DB) pension plans. The broadened guidance now applies to defined contribution plans, multiemployer (union) plans covered under PBGC's pension insurance program, and to certain other small professional services DB plans not previously covered.

The general purpose of this PBGC program is to assist participants and beneficiaries in securing retirement plan benefits to which they are entitled when a covered plan terminates. It also is of assistance to plan administrators attempting to dispose of assets that such missing individuals have not claimed.

The program is voluntary for terminating plans that are not insured by the PBGC.

Recent Activity

Legislation

Senators Elizabeth Warren (D-MA) and Steve Daines (R-MT) have introduced the Retirement Savings Lost and Found Act of 2018 (the Act). The Act would create the Office of Retirement Savings Lost and Found, which would rely on new tools and build existing reporting and disclosure rules to achieve two overall objectives: 1) assist participants and beneficiaries in finding and obtaining unclaimed retirement benefits in plans subject to ERISA's vesting rules, and 2) provide plan administrators with a new option for balances of missing or lost participants. The bill would generally become effective the second year after it is enacted.

Given the bipartisan sponsorship and support for this bill's concepts, it is possible that some or all of its provisions—on their own, or attached to other legislation—could find their way to enactment.

GAO Report

On March 5, 2018, the U.S. Government Accountability Office (GAO) released to the public findings and recommendations following a study to review steps federal agencies might take to assist participants in workplace retirement plans who face challenges managing their savings accumulated over the course of their careers. The GAO made a number of recommendations, including that the DOL issue guidance to help ongoing plan sponsors search for separated participants.

Stepped-Up Enforcement

After recovering more than a billion dollars for missing participants in defined benefit pension plans as part of an audit initiative, the DOL recently turned its attention to defined contribution plans. The increased scrutiny and enforcement activity by the DOL regarding missing defined contribution plan participants has led many in the industry to call for formal guidance addressing missing participants in ongoing defined contribution plans. Included should be guidance that would establish a safe harbor or framework that plan sponsors could use to meet their fiduciary obligations with respect to ongoing retirement plans, and distinguish "lost" participants from those that are merely "unresponsive."

The DOL has indicated that it is working to address these concerns. At an industry conference in February 2019, the Assistant Secretary of Labor for the Employee Benefits Security Administration (EBSA), indicated that the department is working on "sub-regulatory guidance" for plan sponsors and that the issue is "very much on our radar screen."

In the meantime, plan sponsors should establish, maintain, and enforce policies and procedures to identify and locate missing and unresponsive participants. They should follow plan documents and existing DOL and IRS guidance where applicable and be sure to document any steps taken as part of the process.

Appendix: Plan Expenses Case Study

Selina, Amy, and Gary created a company called Veep Lobbyists after a crushing political defeat. As the firm became more successful, they hired Dan, Jonah, and Mike. Veep Lobbyists (Veep) established a 401(k) plan named The Joint Sessions 401(k), to incentivize its employees. Gary was appointed plan administrator and hired Tom Kent Recordkeeping (TKR) as a service provider. TKR suggested that Veep Lobbyists conduct a plan study to see which features would be most appropriate for its 401(k) plan.

TKR established the plan for Veep and charged the employer a one-time fee. Veep decided to adopt a safe harbor plan with a discretionary new comparability profit sharing contribution. In addition, Veep offered self-directed brokerage accounts to its participants. Veep insisted that the plan receive a determination letter from the IRS, resulting in drafting and submission fees.

After the plan was established, Andrea—a TKR representative—traveled to Washington, D.C. and held an enrollment meeting for the Veep employees. TKR produced enrollment books, assisted in completing enrollment materials, and answered a variety of the employees' questions.

Veep grew quickly and added additional employees, all of whom were very aggressive with their contributions. Veep relied on its financial advisor to choose the appropriate platform of investments for the plan participants. Veep also purchased fiduciary liability insurance. The insurance was quite costly as it did not permit the insurer any recourse against any fiduciary that causes a potential breach.

TKR decided to offer a service to provide notice delivery for annual notices to participants and beneficiaries—including the cost of postage at a rate of $5 per person. Veep signed up for the notice delivery services. Veep also took advantage of TKR's extension of services plan, which provided for hardship, loan, and QDRO determinations. Veep relied on TKR to calculate the profit sharing contributions and true-up calculations. In addition, TKR prepared the plan's annual Form 5500, *Annual Return/Report of Employee Benefit Plan*.

Veep acquired Presidential Lobbyists in the following year and terminated the Presidential 401(k) plan. Based on the contract of sale, Veep was responsible for terminating the Presidential 401(k) plan—including performing final testing, document reviews, filing a final Form 5500, and performing a final audit.

Appendix: Plan Expenses Case Study continued

Which of the following fees can be debited from the plan?

Plan Study:	$750
Plan establishment:	$1,500
Preparation of Application for IRS Approval Letter:	$8,000
Enrollment Meeting:	$2,200
Advisor Fees:	$6,400
Self-Directed Brokerage Fees:	Variable
ERISA Fiduciary Insurance:	$10,000
Notice Delivery Fees:	$5/per participant plus postage
Hardship Determination:	$100/request
Loan Determination:	$75/request
QDRO Determination:	$850/review
Form 5500 preparation:	$725
Plan Termination:	$1,025

Appendix: Independent Contractor vs. Employee Exercise

Exercise 1

Sam Sparks performs auto repair services in the repair department of an auto sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company provides all facilities, repair parts, and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completing each job; and checks all estimates and repair orders.

Is Sam an independent contractor or an employee of the sales company?

Exercise 2

Steve Smith, a computer programmer, is laid off when Megabyte, Inc., downsizes. Megabyte agrees to pay Steve a flat amount to complete a one-time project to create a certain product. It isn't clear how long it will take to complete the project, and Steve isn't guaranteed any minimum payment for the hours spent on the program. Megabyte provides Steve with no instructions beyond the specifications for the product itself.

Steve and Megabyte have a written contract, which provides that Steve is considered to be an independent contractor, is required to pay federal and state taxes, and receives no benefits from Megabyte. Megabyte will file Form 1099-MISC, *Miscellaneous Income*, to report the amount paid to Steve. Steve works at home and isn't expected or allowed to attend the software development group meetings.

Is Steve an independent contractor or an employee of Megabyte, Inc.?

Appendix: Form 5500 Audit Checkpoints

- [ ] Determine if a Form 5500 audit is needed
- [ ] Determine nature of audit
- [ ] Hire an auditor
- [ ] Establish audit timeline and process framework
- [ ] Collect needed documents and information
- [ ] Test and verify plan compliance, financial reporting, and internal controls (auditor)
- [ ] Attach Form 5500 to audit report

Case Study Answers

Appendix: Plan Expenses Case Study continued

Plan Study:	~~$750~~
Plan establishment:	~~$1,500~~
Preparation of Application for IRS Approval Letter:	$8,000
Enrollment Meeting:	$2,200
Advisor Fees:	$6,400
Self-Directed Brokerage Fees:	Variable
ERISA Fiduciary Insurance:	$10,000
Notice Delivery Fees:	$5/per participant plus postage
Hardship Determination:	$100/request
Loan Determination:	$75/request
QDRO Determination:	$850/review
Form 5500 preparation:	$725
Plan Termination:	$1,025

= expense can be debited from the plan

= expense can possibly be debited from the plan; depends on other factors

= expense cannot be debited from the plan

Exercise Answers

Exercise 1

Sam Sparks performs auto repair services in the repair department of an auto sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company provides all facilities, repair parts, and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completing each job; and checks all estimates and repair orders.

Is Sam an independent contractor or an employee of the sales company?

Sam is considered an employee.

Exercise 2

Steve Smith, a computer programmer, is laid off when Megabyte, Inc., downsizes. Megabyte agrees to pay Steve a flat amount to complete a one-time project to create a certain product. It isn't clear how long it will take to complete the project, and Steve isn't guaranteed any minimum payment for the hours spent on the program. Megabyte provides Steve with no instructions beyond the specifications for the product itself.

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Is Steve an independent contractor or an employee of Megabyte, Inc.?

Steve is considered an independent contractor.