

# Pension ANALYST



Important Information

Plan Administration and Operation

January 2002\*

## New Year Brings New Rules for Small Plans

**WHO'S AFFECTED** These rules apply to sponsors of "small" qualified defined benefit and defined contribution plans. In general, a small plan is a plan with fewer than 100 participants.

**BACKGROUND AND SUMMARY** In general, sponsors of qualified plans that are subject to the ERISA reporting and disclosure rules (i.e., plans that are neither governmental plans nor nonexempt church plans) must hire an independent qualified public accountant to audit the plan's financial statements. The auditor's report must be attached to the plan's annual Form 5500 return/report. Small plans have traditionally been exempt from this audit requirement.

However, for plan years beginning after April 17, 2001, new Department of Labor (DOL) regulations add special rules that small plans must now meet to continue to be exempt from the annual audit requirement. These rules require anyone who handles "non-qualifying plan assets" to be bonded and require the plan sponsor to include additional information on the plan's summary annual report (SAR).

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) also contained a provision targeted at small plans. This provision requires the IRS to waive the user fee for requesting a determination letter in the case of new small plans. This user fee waiver applies to determination letter requests made after December 31, 2001, and is intended to encourage the establishment of qualified plans by smaller employers. IRS Notice 2002-1 sets forth the requirements that a plan must meet to be exempt from the user fee.

**ACTION AND NEXT STEPS** Sponsors of small plans should review these new rules carefully. If a plan is subject to the audit requirement for the first plan year beginning after April 17, 2001, the plan sponsor will need to decide whether to meet the new rules for exemption or to engage an independent qualified public accountant to perform an audit. If a plan sponsor is preparing to request a determination letter for a small plan, he should determine whether a user fee is required and be certain to submit the appropriate paperwork with the determination application.

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The new year brings with it some new rules that affect only "small" qualified defined benefit and defined contribution plans. One of these rules is intended to safeguard the assets held by these plans. The other rule is an attempt to encourage the establishment of qualified plans by smaller employers.

### **New Rules for Avoiding an Annual Audit**

Generally, the sponsor of a qualified defined benefit or defined contribution plan must hire an independent qualified public accountant to audit the financial statements of the plan. The auditor's report must be attached to the annual Form 5500. Until recently, "small plans" have been exempt from this audit requirement.

However, in the late 1990's, it became clear that the amount of assets held in small plans had risen dramatically, and that these plans had become an increasingly important retirement savings vehicle for a large number of employees. At the same time, situations involving disappearing assets made it clear that these plans were particularly vulnerable to fraud and abuse. In an effort to improve the security of these plan assets, the Department of Labor (DOL) issued final regulations, effective for plan years beginning after April 17, 2001, adding new rules that small plans must meet to avoid an annual audit. The small plan audit exemption is no longer automatic.

For purposes of these audit rules, a "small plan" is a plan with fewer than 100 participants at the beginning of the plan year. However, if a plan has no more than 120 participants at the beginning of the plan year, the plan administrator can choose to classify it as a small plan if it was classified as a small plan in the previous year.

For plan years beginning after April 17, 2001, *both* of the following conditions must be met to avoid the annual audit:

- Anyone who handles plan assets that are not "qualifying plan assets" must be bonded in an amount at least equal to the non-qualifying assets, and
- Additional information must be included on the summary annual report (SAR).

If either of these requirements is not met, the plan must engage an independent accountant to audit the plan and then attach the accountant’s report to the Form 5500. Each of these conditions is described in more detail below.

**Bonding Requirement**

In general, all fiduciaries and individuals that handle plan funds must be bonded. Fiduciary bonds must be at least 10% of the assets handled (with a minimum bond of \$1,000), but do not need to be more than \$500,000.

For small plans to avoid an annual audit, fiduciaries and individuals that handle plan funds may need to be bonded for a greater amount.

If at least 95% of the assets of the plan at the beginning of the plan year are “qualifying plan assets,” then no additional bonds are required. However, if more than 5% of plan assets at the beginning of the plan year are *not* “qualifying plan assets,” then any person who handles the nonqualifying assets must be bonded in an amount at least equal to the assets that are non-qualifying.

“Qualifying plan assets” include:

- Qualifying employer securities.
- Plan loans that meet the prohibited transaction exemptions.
- Any assets held by a bank or similar institution, an insurance company qualified to do business under the laws of a state, an organization registered as a broker-dealer under the Securities and Exchange Act of 1934, or any other organization authorized to act as a Trustee for individual retirement accounts.

**Bonding Not Required.** Let's take the Alpha 401(k) Plan as an example. This plan is selftrustered (i.e., officers of the plan sponsor act as trustees) has the following assets:

Bank/Ins. Co./Mutual Fund Assets	\$520,000 (Qualifying)
Qualifying Employer Securities	\$ 40,000 (Qualifying)
Participant Loans	\$ 20,000 (Qualifying)
<u>Real Estate Limited Partnership</u>	<u>\$ 20,000 (Non-Qualifying)</u>
Total Plan Assets	\$600,000

Total Qualifying Plan Assets:	\$580,000 (96.67% of total)
Total Non-Qualifying Plan Assets:	\$ 20,000 (3.33% of total)

Since 96.67% of the total assets are “qualifying plan assets,” the plan meets the requirement that at least 95% of the assets be “qualifying plan assets.”

**Bonding Required.** In contrast, let's look at the assets of the Beta Plan (again, assume a self-trusted plan). These assets are broken down as follows:

Qualifying Plan Assets	\$558,000 (93% of total)
<u>Non-Qualifying Plan Assets</u>	<u>\$ 42,000 (7% of total)</u>
Total Plan Assets	\$600,000

Since the total "qualifying plan assets" are less than 95% of the total plan assets, any person who handles the non-qualifying assets will need a fidelity bond of at least \$42,000 (i.e., the amount of the non-qualifying assets) to meet the first condition necessary to avoid an annual audit.

However, ERISA already requires a fidelity bond of at least 10% of the amount handled. Beta Plan should already have a \$60,000 fidelity bond. Since this bond exceeds the amount of bond needed to avoid the annual audit, Beta Plan does not need to get an additional bond.

### **Additional SAR Information**

To avoid the annual audit, a small plan's summary annual report (SAR) must include the following information *in addition* to the information that is currently required.

- The name of each institution holding qualifying plan assets and the amount of such assets held by each institution as of the end of the plan year.
- The name of the surety company issuing the fidelity bond, if the plan has more than 5% of its assets in non-qualifying assets.
- A notice indicating that participants and beneficiaries can ask to examine or receive copies, without charge, of:
  - Evidence of any bond for non-qualifying assets; and
  - Copies of statements received from each institution holding qualifying assets that describe the assets held by the institution as of the end of the plan year.
- A notice stating that participants and beneficiaries should contact the Regional Office of the U.S. Department of Labor's Employee Benefits Security Administration if they are unable to examine or obtain copies of the statements received from each institution holding qualifying assets or evidence of the bond, if applicable.

If you use Prudential Retirement's Form 5500 preparation service, the SAR we provide for plan years beginning after April 17, 2001, will include this additional information, when required.

### **Exemption from Determination Letter User Fee**

In an attempt to encourage the establishment of qualified plans by smaller employers, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) contained a provision that requires the IRS to waive the user fee for requesting a determination letter in the case of new small plans. This user fee waiver applies to determination letter requests made after December 31, 2001. IRS Notice 2002-1 sets forth the requirements that a plan must meet to be exempt from the user fee.

## **Small Employer Requirement**

To be eligible for the user fee exemption, the employer sponsoring the plan must have:

- No more than 100 employees who each received \$5,000 or more compensation from the employer for the calendar year immediately preceding the calendar year in which the determination letter request is made; and
- At least one employee who was a non-highly compensated employee (NHCE) for the plan year immediately preceding the plan year in which the letter is requested and who participated in the plan during that preceding plan year.

In making this determination, the employer must count all employees of all employers that belong to its controlled group or affiliated service group, as well as all "leased employees." Compensation for an employee who is not a self-employed individual is W-2 wages plus 401(k) and 403(b) elective deferrals and section 457 deferred compensation. For a self-employed individual, compensation is his net earnings from self-employment before deduction of his elective deferral contributions.

## **New Plan Requirement**

The determination letter user fee is not waived for all plans sponsored by small employers, as defined above. The fee is only waived for new plans. To qualify as a "new plan," the determination letter must be requested before the later of:

- The last day of the plan's fifth plan year; or
- The last day of any remedial amendment period that begins within the plan's first five years of existence.

The second part of this requirement makes the user fee waiver available to many plans that have been established since December 9, 1989, because the GUST\* remedial amendment period began within the first five years of the plan effective date and the amendment deadline has still not occurred. However, if a plan has been created as a result of a spin-off, its age is measured from the effective date of the plan from which it spun-off. Similarly, if a plan is the result of a merger of two or more plans, that plan's age is measured from the earliest effective date of any of the original plans.

## **Requesting Determination Letters after December 31, 2001**

New small plans that meet the requirements described above may request determination letters (including GUST determination letters) after December 31, 2001, without paying a user fee. However, the determination letter filing must still include a signed Form 8717.

If a determination letter application was filed before January 1, 2002, but is withdrawn after December 31, 2001, the IRS will not refund the user fee. Similarly the user fee paid with an application that was filed before January 1, 2002, but is modified after December 31, 2001, generally will not be affected.

## **Plan Sponsor Next Steps**

If you sponsor a small plan that will not meet the new requirements for avoiding an annual audit, you will need to engage an independent qualified public accountant to perform an audit for the first plan year beginning after April 17, 2001.

If you are preparing to request a determination letter for a small plan, you should review the rules for the user fee exemption. If the exemption applies, make sure you submit Form 8717 with your application to claim the waiver of the user fee.

If you have questions about how either of these new rules affects your plan, please contact your Prudential Retirement representative.

\* "GUST" refers to: The Uruguay Round Agreements Act, the Uniformed Service Employment and Reemployment Rights Act of 1994, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Internal Revenue Service Restructuring and Reform Act of 1998, and the Community Renewal Tax Relief Act of 2000.

### **Pension Analyst by Prudential Retirement**

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