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WHAT'S WRONG WITH THIS 403(b) PLAN?

Second in a three-part series, this article highlights some of the operational errors that can be discovered during a 403(b) plan audit.

Universal availability is a concept unique to 403(b) plans. It provides that all employees must be permitted to make elective deferrals if any other employee is allowed to make them. This concept is important because it helps to identify the number of plan participants for purposes of determining whether an audit is required.

Based on this definition, it appears that it would be simple to determine if the plan needs an audit—just take an employee head count. It's not that simple, however, because certain employees may be excluded from the count. The most common exclusion error relates to the application of the "20-hour rule."

Worthy Academy misapplied this rule by looking only at the employee's expected weekly schedule, though it should be based on the employer's reasonable expectation that the employee will work less than 1,000 hours during the year. As a consequence, Worthy Academy improperly excluded employees from participation in the plan.

This is a compliance failure that could put the plan's tax-qualified status at risk. An equal risk would exist if Worthy had enrolled employees who didn't qualify as eligible under the plan.

INVESTMENTS AND PROHIBITED TRANSACTIONS

One of the differences between 401(k) plans and 403(b) plans is the nature of the plan's investments. In a non-church 403(b) plan, participants may chose to invest in annuity contracts or mutual fund custodial accounts. Group contracts are considered plan assets; however, individually issued contracts are not plan assets.

When investment contracts aren't correctly identified, they may not be included in plan assets and participants holding the contracts may not be considered plan participants. Improperly excluded investment contracts may cause the sponsor to believe that an audit isn't required when, in fact, it is. DOL Field Assistance Bulletin ("FAB") 2010-1 may help plan sponsors to accurately identify the nature of the investments in the plan and ensure that the funds are properly included or excluded from plan assets.

Another operational error that frequently occurs is failure to remit employee contributions to the plan "as soon as the funds may reasonably be segregated from general assets of the employer." This results in a prohibited transaction and requires the employer to restore lost earnings on the late remitted contributions. A seven-business-day remittance safe harbor is available for a small plan with fewer than 100 participants that isn't subject to audit.

Compensation used by plan sponsors when calculating employee salary deferrals and determining annual deferral limits may not match the way compensation is defined in

the plan document. In the case of Worthy Academy, the plan defined compensation as W-2 Box 1, while Worthy Academy's payroll has been excluding overtime and bonuses when calculating plan contributions. As a result, the contributions aren't accurate and Worthy will have to restore contribution shortfalls plus lost earnings.

Errors may also arise in administering 403(b) plan loan programs. Loan repayments may not be collected as required, which could result in a taxable distribution to the participant, an excess loan amount may be issued, or the vendors may ignore the loan policy rules. If the loan was funded by a non-plan asset, the loan itself isn't considered a plan asset and will be out of the scope of the plan audit.

ACCURATE DATA

In 403(b) plans, participants may transfer "tax-free" assets from one contract to another and it's important for the parties to be aware of the plan's contract exchange rules. Because there are often multiple investment vendors in 403(b) plans, it's important for plan sponsors to ensure that accurate demographic data—such as hiring date, birth date, and termination dates—are maintained and provided to all vendors. When plan sponsors don't accurately maintain this information, the vesting earned by participants can't be accurately calculated and the distributions paid to the participants may not be correct. In addition, the investment vendor may issue Form 1099 in the name of the annuity company rather than in the name of the plan.

ERISA Section 412 requires 403(b) plans to be covered by a fidelity bond in order to protect the plan from loss or dishonesty perpetrated by the plan administrators. Some plans have purchased fiduciary insurance, which covers plan fiduciaries, instead of a fidelity bond, which covers the plan. DOL investigators often cite plans for failing to obtain a bond, for deficiencies in the amount, and/or for naming the plan sponsor rather than the plan as the insured party.

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