Plan Sponsor
Digest
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Your Challenge, Our Solutions™

Fidelity bonding versus fiduciary liability insurance

Fidelity bonding or fiduciary liability insurance? It's not an either/or question. Each has its own function in protecting the plan and its fiduciaries against claims for certain plan losses.

Are retirement plans required to have a fidelity bond and fiduciary liability insurance? Pension law (ERISA) generally requires every person who handles funds or other property of a plan ("plan officials") to be bonded. For example, officers and employees of the plan or plan sponsor who handle the receipt, safekeeping, and disbursement of plan funds are subject to bonding. Fiduciary liability insurance is optional.

What is the purpose of a fidelity bond? The purpose of a fidelity bond is to protect your retirement plan from risk of loss due to acts of fraud or dishonesty by individuals handing the plan's assets. These acts include such things as theft, embezzlement, and forgery.

How much coverage must the bond provide? Each plan official must be bonded in an amount equal to at least 10% of the amount of funds he or she handled in the previous year, with a minimum bond requirement of $1,000. Generally, the maximum bond amount that can be required for any plan official is $500,000 per plan. So, for example, if your plan had $1 million in assets, each plan official would have to be bonded for $100,000. The maximum required bond amount is $1 million for officials of plans that hold employer securities.

If the amount of funds handled increases after the bond is purchased, must the bond be updated during the plan year? No. The bond amount must be fixed or estimated at the beginning of the plan's reporting year based on the highest amount of funds handled by the person in the preceding plan year. At the beginning of each plan year, the plan administrator or another appropriate fiduciary should review the adequacy of your plan's fiduciary bond.

Why would we need fiduciary liability insurance, too? As discussed, your plan's fidelity bond insures against losses due to fraud or dishonesty on the part of persons handling plan funds. Fiduciary liability insurance protects against claims for losses sustained because of a breach of fiduciary duty or because of administrative errors.

What additional protection does fiduciary liability insurance provide? Wrongful acts that may be covered by fiduciary liability insurance include negligent investment practices, failure to diversify investments, conflicts of interest, failure to provide participants and beneficiaries with required information, errors in computing eligibility, failure to timely deposit money in participant accounts, and other negligence in administering a plan.

What should we consider when we're looking at fiduciary liability insurance? Some factors you'll want to weigh include the amount of coverage available versus your needs, what the coverage includes, exclusions, premiums and deductibles, and whether any defense costs included in the policy count against the overall policy limit.

Can we use plan assets to purchase a fidelity bond and fiduciary liability insurance? Yes, with a qualification for fiduciary liability insurance. Because the purpose of the pension law's bonding requirements is to protect employee benefit plans and bonding doesn't benefit plan officials or relieve them of their obligations to the plan, you can use plan assets to purchase your plan's bond. With fiduciary liability insurance, the policy must allow the insurer to recover any paid losses from the fiduciary whose breach caused the loss. For more comprehensive coverage, you, as the employer, may want to purchase the insurance as part of your executive compensation package.

The importance of plan compliance

To preserve its tax-exempt status, a qualified retirement plan must comply with legal and regulatory requirements, both in form (the plan documentation) and in operation (how the plan is operated in accordance with the plan document). Plan sponsors must work with their service providers to ensure that plans are properly maintained and to limit plan defects.

Plan disqualification

When the IRS discovers that a plan is not in compliance with qualified plan requirements, disqualification (originally the IRS's only course of action) is a possible outcome. When a retirement plan is disqualified, the plan's trust loses its tax-exempt status and becomes nonexempt. As a result, employees, the employer, and the plan's trust are all negatively impacted. A retirement plan's trust is a separate legal entity that is tax exempt. If a plan is disqualified, the trust loses its tax-exempt status and must pay income taxes on trust earnings.

Participants lose out

When a plan is disqualified, it means participants must include as taxable income any vested contributions the employer makes to the plan on their behalf in any calendar year for which the plan is deemed disqualified.

IRS Example: Pat is a participant in the XYZ Profit Sharing Plan. The plan has immediate vesting of all employer contributions.

- In calendar year one, the employer makes a $3,000 contribution to the trust under the plan for Pat's benefit.
- In calendar year two, the employer contributes $4,000 to the trust for Pat's benefit.
- In calendar year two, the IRS disqualifies the plan retroactively to the beginning of calendar year one. Pat would have to include $3,000 in her income in calendar year one and $4,000 in her income in calendar year two to reflect the employer contributions paid to the trust for her benefit in each of those calendar years.

Note: If the plan has a five-year graded vesting schedule and Pat is only 20% vested in her employer contributions in calendar year one, then she would include $600 (20% x $3,000) in her income for the year.

Sponsors lose out, too

Disqualification also impacts the plan sponsor. The sponsor's tax deduction for amounts it contributed to the trust may be delayed or restricted as a result of a plan disqualification based on the deduction rules that apply when the plan is deemed nonqualified. Generally, sponsors of qualified plans cannot deduct contributions as of the point at which the plan is considered to be disqualified.

Fallout for rollovers

Plan disqualification has an impact on rollovers, too. Plan distributions that were rolled over to other eligible retirement plans or individual retirement accounts (IRAs) are no longer considered eligible rollover distributions. As a result, all eligible rollover distributions that were rolled into an IRA or other qualified plan after the point the plan was considered to be disqualified would not be eligible for rollover and would be subject to taxation at that point.

Correction programs

Because the consequences for innocent, nonhighly compensated plan participants can be extremely negative, the IRS established a program to assist plan sponsors in correcting the most common operational and plan document errors and retaining the plan's tax-exempt status. The IRS Employee Plans Compliance Resolution System (EPCRS) encompasses three programs for correcting operational and plan document errors: the Self-Correction Program (SCP), the Voluntary Compliance Program (VCP), and the Closing Agreement Program (CAP). Through EPCRS, a plan sponsor can correct plan errors, pay a preset fee to regain its compliant status, and avoid the negative consequences of disqualification.

More details on the tax consequences of plan disqualification may be found in an IRS publication: Employee Plans News, Issue 2012-1, March 20, 2012 (www.irs.gov/pub/irs-tege/epn_2012_1.pdf).

Make compliance a focus

Maintaining compliance is key to avoiding disqualification. A strong partnership between employer and service provider can help ensure that all the necessary steps are taken to make certain the plan is in compliance with the vast number of regulatory requirements that need to be satisfied. One of the best ways to assure proper compliance is to keep your service providers informed of any major changes in business circumstances that could impact the operation of your plan.

Small plan audit waiver

Situation: We sponsor a small retirement plan with fewer than 70 participants. We know that qualified small plans are allowed to elect to waive the annual audit requirement, but we're not familiar with all the rules surrounding when an audit is required.

Question: How do we determine if our small retirement plan's books and records have to be audited for Form 5500 purposes?

Answer: The U.S. Department of Labor (DOL) generally requires qualified retirement plans to be audited annually by an independent certified public accountant. The DOL considers a plan with fewer than 100 participants at the beginning of the plan year to be a small plan that is eligible to waive the audit requirement when specific conditions are met.

Discussion: Small retirement plans are eligible for the audit waiver if at least 95% of their assets are "qualifying plan assets." Qualifying plan assets include:

- Qualifying employer securities
- Loans to plan participants
- Assets held by a bank or similar financial institution, insurance company, registered broker-dealer, or any organization authorized to act as trustee for individual retirement accounts
- Shares issued by a registered investment company
- Investment and annuity contracts issued by a qualified insurance company
- Assets in individual accounts over which the participant or beneficiary exercises control and receives an annual statement from a regulated financial institution describing the assets held or issued by the institution and their amount

If less than 95% are qualifying plan assets, any person handling nonqualifying plan assets must be bonded.

The plan's summary annual report (SAR) must contain additional information, such as the name of each regulated financial institution holding or issuing qualifying plan assets and their amount as reported at the end of the plan year (except for certain qualifying assets). Additionally, the plan's SAR must provide the name(s) of the surety company issuing the required bonding, if applicable.

The SAR also must include a notice indicating that participants and beneficiaries may, upon request and without charge, examine or receive copies of evidence of the required bond and any statements from the regulated financial institutions describing the plan assets.

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