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Should They Stay or Should They Go: Dealing with Terminated Participants

Sooner or later, every retirement plan will have to deal with participants who have terminated employment but still have balances in the plan. In most circumstances, the plan document provides guidance on how to proceed; however, there are a number of factors that can make the determination a little more complex than what it seems at first blush.

Why do we Care?

Before exploring the options for handling former participant balances, it is helpful to understand several aspects of plan maintenance that may steer employers in one direction or another.

Count the Cost

Many plan service providers set their fees in whole or in part based on plan size. This may include total assets, the number of participants, average account balance or some combination of these factors. Understanding how fee schedules are structured is one factor in determining the most appropriate policy for dealing with former plan participants. For example, if fees decrease as plan assets increase, it might make sense to design the plan to minimize outflows to terminated participants. On the other hand, if fees increase as average account balances decrease and many former participants have below-average balances, taking steps to expedite distributions may be the more appropriate course of action.

Stand and be Counted

The number of participants is used to determine another critical threshold for retirement plans—the plan audit threshold. Generally, plans with more than 100 participants on the first day of any plan year are required to engage an independent qualified public accountant to audit the plan's financial statements and attach the audit report to Form 5500. Former participants with remaining balances are counted for purposes of the 100-participant threshold.

Since it is not uncommon for the cost of a plan audit to reach five figures, plan sponsors often seek to delay being subject to the requirement as long as possible. One way to do this is, to the extent possible, to design the plan so that former participants can/must have their balances distributed to them as soon as possible following termination of employment.

Tell the Participants

Anyone who works with retirement plans on a semi-regular basis is quite aware of the seemingly

endless number of disclosures that must be provided to participants each year, including the Summary Plan Description, Summary Annual Report and many others. A number of these disclosures include information describing the rights of anyone with a balance in the plan, so they must be provided to former employees as well.

While the IRS and Department of Labor (DOL) both allow certain documents to be provided via electronic means such as e-mail, the requirements for doing so can be daunting with respect to former employees who no longer access a company e-mail account as part of their jobs. Plan options that allow for immediate distributions can minimize the burden of providing many of these disclosures to former employees.

Tell the IRS

Participant disclosures are not the only concern. Plans that include former employees with remaining balances are required to file a form with the IRS each year. Prior to 2009, this information was required to be attached to Form 5500; however, after a temporary suspension of this reporting requirement, it is now satisfied by filing Form 8955-SSA directly with the IRS each year.

The form lists the name, social security number and vested account balance for terminated employees. The IRS shares this information with the Social Security Administration so that it can notify recipients of social security benefits that they may be entitled to additional benefits from a former employer's retirement plan. As a result, plans must not only report participants when they terminate, they must also monitor prior years' forms and "unreport" terminees once they receive distributions.

What are the Options?

Plan sponsors have a fair degree of flexibility in designing their plans to deal with former participants with balances; however, once the design is determined, sponsors must consistently follow the provisions they put in place.

Small Balances

IRS and DOL rules allow plans to force distributions to former participants with vested account balances of less than $5,000 after providing them with at least 30 days advance notice of their right to request a cash distribution or a rollover to an IRA or a new employer's plan.

Due to concern that automatically cashing out former employees could cause them to prematurely spend amounts they had set aside for retirement, the rules require employers to establish rollover IRAs on behalf of former participants with balances between $1,000 and $5,000 who do not respond to the advance notice. Those with less than $1,000 can be cashed out with the appropriate taxes withheld. These rules leave sponsors with several plan design options.

1. Force out all vested balances below $5,000 with those from $1,000 to $5,000 going to IRAs and those below $1,000 being paid in cash;
2. Force out all vested balances below $5,000 with all of them going to IRAs;
3. Force out all balances below $1,000 with all of them being paid in cash; or
4. Eliminate forced distributions altogether.

When the rules for automatic IRA rollovers were first effective in 2005, very few providers were set up to accept them, causing many employers to elect option 3 or 4, above. However, the marketplace has adapted, and many providers are now able to accommodate automatic rollovers. Therefore, plan sponsors are able to elect options 1 or 2, above, without taking on substantial administrative burden.

The timing of forced distributions is a critical element to consider. Not only do plan documents specify the threshold, e.g. $5,000, but they also specify the timeframe in which distributions are processed. For example, many plans provide that participants are eligible to take distributions as

soon as possible following termination of employment.

Combining this provision with the forced distribution provision may require that former employees with balances below the threshold be provided the applicable notices very soon after termination with the forced distributions being processed 30 to 60 days later. Since some recordkeepers are only set up to process these "sweeps" quarterly, semi-annually or annually, sponsors should coordinate their plan provisions to avoid inadvertently delaying forced distributions in violation of plan terms.

Larger Balances

Terminated employees with vested balances exceeding $5,000 generally cannot be forced out of a plan; however, plan sponsors can provide them with the applicable notices and forms to communicate distribution options. There is one important exception to this general rule. Any portion of a participant's account that was rolled into the plan from an IRA or an unrelated employer's plan can be disregarded for purposes of the $5,000 forced distribution limit. Consider this example.

Joe Participant has terminated employment and has a total vested account balance of $14,000 as follows:

Elective Deferrals	$3,000
Employer Match	1,500
Rollover	9,500
Total	$14,000

If the $9,500 rollover balance is disregarded, Joe's vested balance is only $4,500; therefore, if the plan document is written to require forced distribution to former employees with balances below $5,000, Joe's entire account balance can be processed under those rules.

Fees

IRS and DOL guidance allows plans to charge certain fees to participant accounts. This includes not only ongoing plan management expenses but also distribution fees. However, the plan document must include language authorizing the charges and the method of allocating the expenses must be disclosed to participants, usually in the Summary Plan Description. For example, the plan may provide that general management expenses are allocated proportionately based on account balance while distribution fees are charged directly to the accounts of the participants requesting the distributions.

Residual Distributions

From time-to-time, a former employee takes a full distribution of his or her account before all contributions or investment gains are allocated. This may occur, for instance, in a safe harbor 401(k) plan for which the employer allocates a 3% nonelective contribution at the end of the plan year. Since these contributions cannot be subject to a last day of employment rule, any participant eligible at any point during the year is entitled to the contribution even if he or she terminated employment earlier in the year.

So, what happens to the residual account balance generated by the contribution? The answer depends somewhat on timing. As described above, terminated participants must be provided with a distribution notice at least 30 days in advance of a distribution. The notice is considered "stale" after 180 days. Therefore, if the residual contribution is credited to the participant's account fewer than 180 days after the date the notice was provided, the plan can issue a distribution of the residual using the same method as the initial payment, e.g. cash distribution, rollover to IRA, etc.

If it has been more than 180 days, the account is subject to the distribution rules in the same manner as if there had been no previous distribution paid. In many such situations, the residual balance will be below the forced distribution threshold and can be processed as such.

What about Plan Terminations?

When an employer elects to terminate its plan, all participants are entitled to take distributions regardless of their employment status. Generally

speaking, the distributions are processed according to the rules outlined above. But, what happens when participants with more than $5,000 do not make a distribution election? What happens if notices to former employees are returned due to invalid addresses?

Fortunately, the DOL has provided guidance on how to handle these situations. If plan sponsors follow a four-step program but are still unable to obtain an election from participants, the accounts in question can be rolled over using the automatic rollover rules regardless of balance. The four steps are as follows:

- Use certified mail for the initial distribution notice;
- Check other plan records as well as those for other company benefit programs;
- Check with a designated plan beneficiary; and
- Use one of the governmental letter-forwarding services.

A fifth step that may be employed is to hire a locator service specializing in finding missing account holders. The expenses for all of these steps can be allocated to the accounts of the missing participants.

Conclusion

There are many options available to employers to address the account balances of former employees, and there is no "one size fits all" solution. As with most plan-related decisions, the appropriate solution depends on an employer's specific facts and circumstances as well as the capabilities of the various service providers involved.

Although there is flexibility in how the plan is designed to accommodate these situations, the actual plan operation must adhere to the provisions written in the plan documents. Sponsors should work with knowledgeable providers who can coordinate the efforts of all parties involved to develop a practical and workable solution.

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