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RETIREMENT ♦ PLAN ♦ EXPERTS

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Don't Let Missing Participants And Small Balances Become A Big Problem

At some point, almost every company that sponsors a retirement plan will experience the "fun" of tracking down a missing participant in order to pay a benefit. Although difficult to avoid completely, there are steps employers can implement as part of normal operations that can greatly minimize the headache. One of the most effective steps is to distribute benefits to former employees as soon as possible after termination of employment, before they have an opportunity to become missing.

Forcing Distribution of Small Balances

The IRS has rules in place that dictate when terminated participants can/must take distributions of their account balances from defined contribution plans. Embedded within those rules are certain options that can facilitate the efficient payout of smaller balances to many former employees.

Generally, participants who have vested account balances in the plan of at least \$5,000 are permitted to keep their money in the plan as long as they wish, subject to required minimum distributions on attainment of age 70½. Participants with balances below that threshold can be forced to take their money out of the plan as long as they are given appropriate notice 30 to 60 days prior to the payment. The notification gives participants the option to rollover their accounts into an IRA of their choice or to a new employer's plan rather than receiving the payment in cash and incurring a tax liability.

If the participant does not make such an election by the end of the notice period, the employer automatically distributes cash and withholds the appropriate taxes for balances below \$1,000. For balances between \$1,000 and

\$5,000, the force-out is via an automatic rollover to an IRA established on behalf of the participant.

When the mandatory distribution rules first took effect in 2005, there were not many automatic IRA rollover options available in the marketplace. As a result, many employers elected to reduce the cash-out threshold to \$1,000. Amounts below that level could be forced out via check with taxes withheld but larger amounts could remain in the plan. Fast forward to the present and there are numerous options for automatic IRA rollovers for participants who do not respond to the notice. However, many plans still provide for the lower cash-out limit. A plan amendment can increase the limit to the maximum of \$5,000 thereby allowing for the almost immediate payout to a greater number of former employees.

If a terminated participant has a vested balance of less than \$200, his or her account can be forced out via a cash payment without having to go through the notification process.

What if the Participant's Account Balance includes Rollovers?

Consider a participant who joins his or her company's 401(k) plan and accumulates an account balance of only \$1,500 before terminating employment. However, the participant rolled \$7,000 into the plan from a previous employer's plan. That makes a total vested balance of \$8,500 which is well above the maximum allowable cash-out limit.

In recognition of this potential conundrum, the IRS created an option that allows plans using the \$5,000 cash-out limit to disregard unrelated rollovers into the plan when determining whether or not a former employee can be forced out. Plans with lower cash-out limits are not allowed to take advantage of this rollover exclusion.

Check the Plan Document

Keep in mind that usually when the law provides options on how to handle a certain situation, each plan document

must specify which option will be used for that particular plan. As a result, it is always important to check the terms of the plan to make sure it contains the proper language authorizing the preferred option. If not, it is often very straightforward to amend the plan to elect a different option.

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What about Larger Balances?

Participants with (non-rollover) vested balances exceeding \$5,000 cannot be forced out of the plan; however, there are steps employers can take to encourage former participants to take distributions of their larger balances. Sometimes simply including plan distribution forms along with other termination paperwork on an employee's last day of

work is enough of a reminder to them to request payment. In addition, it is permissible to charge regular plan fees to the accounts of former employees even if the company pays the same expenses for active employees.

What if the Plan is Terminated?

Suppose that an employer decides to terminate its plan. The plan cannot be completely wrapped up until all assets are distributed. Although the cash-out rules described above provide a solution for smaller balances, they do not typically apply to larger balances.

Fortunately, the Department of Labor has provided a solution for plans that are completely terminating. In short, sponsors of terminating plans can automatically rollover vested balances exceeding \$5,000 as long as they first take the following four steps to locate missing participants:

Certified Mail: Use certified mail to send out the required distribution paperwork, special tax notice, etc.

Related Plan Records: Check other plan records as well as records for other company benefits such as health insurance plans.

Designated Plan Beneficiary: Check with the participant's designated beneficiary to see if he or she

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can provide contact information that may help locate the missing individual.

Letter Forwarding: Use the Social Security Administration (SSA) letter-forwarding service to notify the former participant of the impending plan termination and provide the distribution paperwork. Both the IRS and SSA had letter-forwarding services; however, the IRS discontinued its service during 2012. The SSA service remains active but there is one key difference. The IRS program was free for requests involving fewer than 50 letters, whereas the SSA charges \$35 per letter forwarded.

Plan sponsors should also consider using a commercial locator service or a credit reporting agency. Fortunately, the reasonable fees for all of these steps can be charged to the accounts of the missing participants being located.

What about Residual Balances?

From time to time, a former participant may receive a full distribution only to have a residual amount hit his or her account. This may be due to a the participant being eligible for an employer contribution that is not deposited until after the close of the year. A safe harbor nonelective contribution is one example. Sometimes, the residual amount is due to investment earnings that are not posted to the account until after the distribution is taken. Regardless of the source, any trailing amounts must be handled.

As long as the paperwork for the original distribution was signed or the small balance forced out within 180 days, the residual can be processed using the same instructions. For example, if the participant's original paperwork requested a rollover to an IRA at a certain financial institution and that paperwork was signed within 180 days, the

residual distribution can be rolled to that same IRA at the same financial institution without the need for additional paperwork.

If more than 180 days has passed, the residual account balance is handled as if no previous distribution has occurred. In other words, residuals below the cash-out threshold are processed the same as any other small balance requiring notification before forcing out the amount in question. If the residual exceeds the cash-out limit, the participant has the option to keep the money in the plan.

What Happens when a Participant Does Not Cash a Distribution Check?

An uncashed check is one that has not been returned (and was, therefore, presumably received by the participant) but also has not been negotiated. Dealing with these checks can be especially challenging and there is no direct guidance on how to handle such situations.

Even if not cashed, the check proceeds are considered taxable income to the participant and should be reported as such on Form 1099-R for the year the distribution was issued. However, the dollars representing those proceeds remain in the plan until the check is physically cashed. As a result, plan fiduciaries remain responsible to prudently manage those assets.

Many plans include provisions that allow such amounts to be forfeited. If the participant comes forward in the future, the plan must make him or her whole by reinstating the forfeited amount and paying the distribution.

A few years ago, it became popular practice to simply pay the entire amount of the distribution to the IRS as income tax withholding. Although very clean and efficient from the plan sponsor's perspective, the IRS issued guidance indicating such practice was not acceptable. Therefore, sponsors should no longer pursue 100% withholding as an option.

What Happens when the Distribution Fee Exceeds the Account Balance?

It is not uncommon for an employee to be eligible for a plan or to decide to make deferrals for a very short period prior to terminating employment, sometimes only a single pay period. In those situations, the participant's vested

account balance is usually a minimal amount; so minimal, in fact, that the fee charged to process the distribution is greater than the balance. The plan can adopt procedures that automatically charge the fee against such accounts even though no actual distribution is paid.

For example, assume a plan's recordkeeper charges a fee of \$85 to process each distribution. The plan's administrative policy could provide that the fee will automatically be charged to the accounts of all terminated participant with vested balances below \$85. The amounts charged are paid to the recordkeeper as a fee and the accounts are eliminated.

Plan sponsors that choose to use this type of procedure should work with their advisors and consultants to make sure the decision is properly documented and communicated to employees.

Summary

As the saying goes, an ounce of prevention is worth a pound of cure. In the case of small balances and missing participants, there are many steps a plan sponsor can take to keep these potentially bothersome situations from becoming big headaches.

Since many fees are based on participant counts and many plan notices (participant fee disclosures, summary annual reports, etc.) must be provided to former employees with balances, eliminating those balances can save the plan/plan sponsor money. By being proactive in this area, sponsors can keep their plans lean and running at peak efficiency.

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