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Defined Contribution Retirement Plan Oversight - Considerations for Terminated Participants

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Introduction

When considering plan pricing efficiencies, large numbers of terminated participants may hurt a plan's demographic profile. Terminated participants with smaller balances may reduce the overall average account balance, which may in turn impact the total fees charged by record keepers and other vendors. Once an employee leaves a company, it is possible that he or she will have an address change or a new email address, potentially making it difficult for a plan sponsor to contact that employee. Difficulties contacting terminated employees and the potential negative impact on plan pricing both create compelling reasons for plan sponsors to look for solutions to remove terminated participants.

Issues resulting from terminated participants

There are a variety of considerations and notices that a plan sponsor should confirm are being sent to the last known address on file for a terminated participant. Under ERISA, a terminated participant in a retirement plan must receive all the required notices, including fee disclosures and annual reports. Similarly, if a plan transitions to a new record keeper or implements a fund change, a terminated participant must receive those notifications as well. These requirements can complicate the work of a plan sponsor and their interaction with the record keeper.

> ***"Large numbers of terminated participants may hurt a plan's demographic profile."***

Furthermore, having a significant number of terminated participants can also trigger a plan audit. Per ERISA requirements, a plan with a participant count over 100 is required to be audited. The participant count includes all eligible employees, active participants, and terminated participants with a balance. Audits can be time consuming for plan sponsors and may also be quite costly.

Finally, low-balance terminated employees could potentially adversely affect plan pricing and overall plan health measures. Most recordkeepers price plans looking at the unit cost of administration on a per participant basis (per capita). In asset-based pricing models, terminated participants with low balances may not generate enough revenue to cover their unit cost. This may cause the record keeper to increase the asset-based fee for all participants. Furthermore, in a per capita pricing model, the low-balance terminated participants are still responsible for paying the administrative costs, potentially inhibiting growth within their own portfolios.

Solutions

Plan sponsors do have several options to help address challenges presented by terminated participants. Most retirement plan record keepers have either a proprietary IRA product to roll small balances into, or they contract with a third party for similar services. If a plan sponsor elects to utilize this feature, terminated participants could have their balances removed from the plan based on the following guidelines:

- Automatic Cash-Out
  - Under ERISA, a plan sponsor could identify terminated participants with a balance under $1,000 and have their account cashed out and a check mailed to their last known mailing address. Typically, the recordkeeper will withhold a percentage of the balance for tax purposes and send the participant a 1099-R form at the end of the year to reflect this action. It is the responsibility of the participant to make sure the income generated from the cash-out is accurately reflected in their tax filing. If the last known address is no longer accurate, that money may be placed in a forfeiture account; however, the plan may be responsible for paying it out if contacted by that participant at a future date.

- Automatic Rollover
  - Under ERISA, terminated Participants with a balance under $5,000 could have their account balance rolled into an IRA at a vendor selected by the plan sponsor. But remember that not all Rollover IRA providers are created equal. Plan sponsors should endeavor to understand the fees, investment options, technology offerings, and benefits when selecting an IRA provider. Additionally, the rollover IRA service provider may be able to search for the participant while holding the assets, therefore removing that responsibility from the plan sponsor.

Utilizing one of these features may help plan sponsors reduce their administrative burden by decreasing the total number of accounts administered by the plan. The force-outs may help shift plan demographic data to a more favorable profile, centered on active participants and/or those with balances over $5,000. Plan sponsors should review their plan document to ensure that it allows for either a small balance cash-out or an automatic rollover program before acting.

Lastly, several third-party vendors have built solutions to help plan sponsors with terminated participants. Utilizing a vendor outside of the record keeper to administer a small balance cash-out or rollover may be a more appealing solution. Third-party vendors may have a more robust approach to locating and communicating with terminated participants. According to Millennium Trust, "plan sponsors who utilize automatic rollover IRAs will have been deemed to have met their fiduciary responsibility."[1]

[1] *Millenium Trust Company. "Automatic Rollover IRAs: The Key to the Uncashed Checks Dilemma" 2018*

Selection of a rollover IRA provider is a fiduciary decision, and plan sponsors should be sure to follow a prudent process in making this decision. The DOL has also established a safe harbor for selecting an automatic rollover provider. For the safe harbor to apply, the provider must meet the following requirements:[2]

1. The automatic rollover plan is only for accounts under $5,000.
2. The rollover must be to an IRA provider authorized by the IRS.
3. The IRA provider must invest rolled funds in an investment vehicle that provides safety, liquidity, and a reasonable return. Also, fees charged by the provider must be reasonable.
4. Participants must receive notifications such as a Summary Plan Description or a Summary of Material Modifications that describes the retirement plan's automatic rollover provisions.
5. Neither the selection of an automatic rollover provider nor the investment of funds with the automatic rollover provider would result in a prohibited transaction, unless the prohibited transaction is specifically exempted pursuant to section 408(a) of The Employee Retirement Income Security Act.

Conclusion

The process to force out terminated employees with balances under $5,000 does require thoughtful engagement by the plan sponsor; however, there could be significant benefits for plan sponsors and their employees, as well as for terminated participants. Regardless, managing terminated participants is an important retirement plan oversight topic that should be reviewed periodically and documented. Your plan record keeper and plan advisor should be able to provide significant assistance with the process to make the exercise as efficient and effective as possible.

[2]Cornell Law School, Legal Information Institute. "Safe Harbor For Automatic Rollovers to Individual Retirement Plans" September 28, 2004.

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