401(k) Plans Need The Involuntary Cash-Out Rule

By Ary Rosenbaum, Esq.

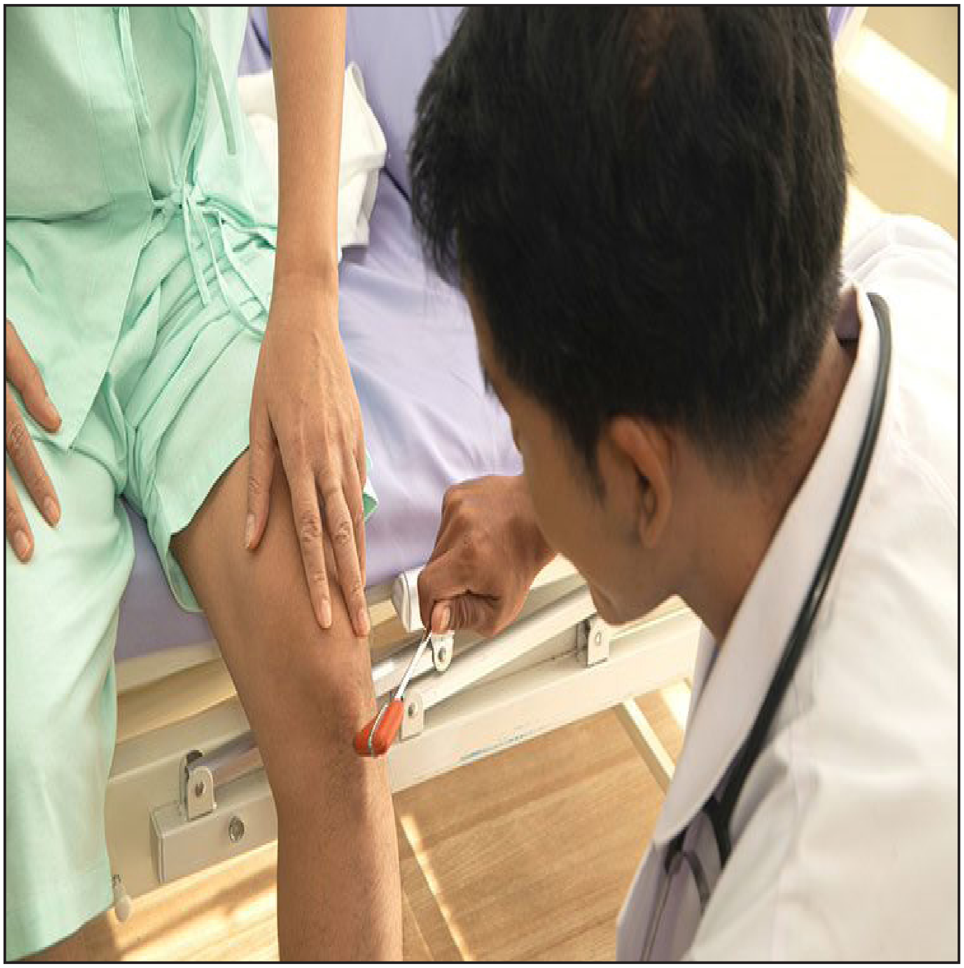
They always say that it's hard to say goodbye, I never had that issue as a former employee. I was never sentimental to former employers, but other former employees may think differently. As a 401(k) plan sponsor, you certainly want former employees to say goodbye and take their 401(k) account balance with them. One way you can eliminate the balances of former employees is the use of the involuntary cash-out provision, which is something that your plan has and should exercise.

Former employees are participants

Regardless of their position as a former employee, they are participants in your 401(k) plan. When it comes to ERISA and participant rights, there is absolutely no differentiation between current and former employees. Former employees have the same rights and responsibilities as participants as current employees. While former employees don't have the right to any contributions or the right to defer, they have the same rights in terms of ERISA-protected rights for plan participants. One of the most important tasks you have as a 401(k) plan sponsor and plan fiduciary is providing ERISA-required notices. It is certainly more difficult to handle the distribution of notices to former employees than it is for current employees. Former employees can move from one part of the country to another, they can fall off the face of the earth. Even with online distributions of notices now allowed, losing track of former employees through bounced emails can be troubling if you don't follow up since that's a sign that you need to mail a notice to an address that may no longer be valid. When dealing with plans that are terminated or full of former employees, bounced mail and emails are a fact of life. As a plan fiduciary, you have a requirement that notices be delivered to all plan participants, former employees can throw a wrench into your job as a plan sponsor. More notices to former employees creates more headaches, and more work, which leads to more costs. In addition, these participants still would exercise control of their own investments. The rules that govern participant-directed investments (ERISA §404(c)) aren't understood by most 401(k) plan sponsors who assume wrong that just offering it, absolves them from any liability for participant investment losses. Participant direction of their investments still requires plan sponsors to do something on their end as plan fiduciaries through a prudent process. The process includes meeting the plan's financial advisors and reviewing and replacing investment options. A huge chunk of limiting liability for participant-directed investments is where there is a potential problem with former employees. Limiting liability for participant direction of investment is dependent on providing enough information to participants to make informed investment decisions. Whether it's investment education or investment advice, the fact is that most former employees are going to fall through the cracks. I can't imagine any 401(k) plan sponsor diligently reaching out to former employees with investment education. I would imagine that most former employees have the same investments in the plan when they leave employment. I just believe that most former employees don't bother checking their account balances or rebalancing their investments. This is a potential liability headache that any 401(k) plan sponsor like you wouldn't want. Keeping former employees in your plan could be a potential liability headache if the stock market goes through a bear market and former employees want to blame someone and you provided zero investment information to them.

The cost of it

Many 401(k) plan sponsors feel that having assets from former employees is a good thing because plans with a large asset size get better pricing when it comes to daily 401(k) administration. The problem is that those assets belonging to former participants tend not to be the deciding factor when it comes to pricing the plan for 401(k) administrative services. Quite honestly, I feel that small account balances belonging to former employees are a headache for most plan providers. Also, keeping too many former employees in your plan may risk you having your 401(k) plan subject to a plan audit. Whether it's 100 participants or 120 participants (the 80-120 rule), your headcount for purposes of a required plan audit includes former employees with account balances. If you never qualified for an audit, but the former employee headcount subjects the plan to it, that is probably an extra $15,000 in added plan administrative expenses. In addition to the cost of the audit, you're also subjecting yourself to meeting the auditor's multiple requests for information so that they can complete the audit. Of course, the problem with former employees could be lessened with the involuntary cash-out rule.



The Involuntary Cash-Out Rule

One tool for dealing with former employees is this thing called the involuntary cash-out rule. If a former employee's account balance is below the cash-out limit (usually $1,000 or $5,000), you don't need their consent to make a distribution to them after the termination of employment. Plans with the cash-out rule must notify participants or beneficiaries if their benefit will be cashed out, giving them the option of how they will receive the money. Lump sum amounts below $1,000 can be paid out to the individual in cash but amounts above $1,000 must be rolled over to a designated Individual Retirement Account of the plan sponsor's choice if the individual does not otherwise specify how they want to take the money. There are a handful of companies that offer this IRA solution such as PenChecks, that can make it easy for you to dispose of these small account balances, and they will handle the issues of contacting and locating these former participants about their IRA balance. The current limit you can put in your plan is $5,000, it can increase to $7,000 in 2024, thanks to SECURE 2.0. While the increase is optional, any plan sponsor not increasing this limit is making a mistake because it means they can distribute more accounts to former participants because of a higher limit. I believe that every plan should have an involuntary cash-out limit, and if you have it, you have to use it because it becomes mandatory, as part of your plan document.

The missing participants

You lose track of former employees and that's a problem when it comes to their account balances, whether they are above or below the involuntary cash-out limit. The beauty of having an involuntary cash-out provision is that balances you distribute to an IRA provider, such as PenChecks is that they take care of the problem of locating former participants who can't be found. If former participants are above the limit, they still will be your headache. Almost all 401(k) plan sponsors don't bother with missing participants until they terminate their plan. The Department of Labor (DOL) has focused its concern on missing participants and these dormant account balances. If the DOL is concerned, so should you. As part of your annual request to former employees to take their money, identify which letters bounce back or which emails back bounce. You can easily track down former employees with personal search engines on the Internet. Whether it's a per-person or monthly charge, you can easily find people you've lost track of. As with anything you do as a 401(k) plan sponsor, you need to document what you do.

The nature of former employees

Former employees are likelier to sue likelier to complain about you to the DOL than current employees. That is a fact of life and I say this as a former employee. Getting these former employees out of your 401(k) plan through the cash-out rule would be great for you and good for them as it's a tie that no longer has to bind.

The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com
Follow us on Twitter @rosenbaumlaw