Why Retirement Plan Sponsors should let Former Employees take their Money and "Roll"

By Ary Rosenbaum, Esq.

I often joke that the worst thing that could happen to my own law practice is when I have to hire my first employee. While it's inevitable that I will have to make my first hire, my trepidation is not just focused on the money, it's the fact that I was an employee once too. Whether you are an owner or an employee, you must realize that most employees aren't the happiest of campers because almost all are never satisfied with their salary (like good capitalists, they always want more) and a good chunk think they can do a better job than their bosses. Some like me start their own business or change employment, while most just complain and sulk. While managing employees is tough, it's even tougher to handle former employees. While many employee-employer relationships end amicably, many do not. Too many employers make mistakes in the handling of their employees and get sued on discrimination and/or contractual grounds. That is why employers as plan sponsors need to minimize their liability in how they handle their retirement plan(s), especially when dealing with former employees. Retirement plan sponsors need to make sure former participants take their retirement plan money with them because maintaining the assets of aggrieved former employees is a recipe for disaster.

This article is intended to advise retirement plan sponsors on how they can use the distribution and rollover rules of retirement plans to their advantage and to minimize their liability risk as retirement plan sponsors.

Let Their Money Go

The Internal Revenue Code restricts the distribution of retirement plan assets to plan participants. Typically retirement plans restrict distributions until the participant dies, becomes disabled, or otherwise has a severance from employment (retirement or termination), or plan termination. So while retirement plans can have an option that allows the distribution of retirement plan assets to employees who terminate prior to retirement, a retirement plan still has the power to restrict participants from receiving a distribution of their assets until death, disability, or retirement, even if they terminated employment with the plan sponsor decades earlier.

Why would you willingly hold the retirement plan assets for former employees who terminated employment so many years ago? Nothing good could come from that. Saying goodbye is hard to do, but to avoid liability, say goodbye to your former employees and let them have the opportunity to take their money out when they terminate employment. If something goes wrong with the plan, even something as simple as the stock market going south, you are more likely to be sued by a former employee than a current one because they no longer are dependent on you for their livelihood and/or they hold a grudge against you.

While people in the retirement plan business will point out that daily valued 401(k) plan fees are predicated on asset size and removing former employees from the plan reduces plan assets (thereby increasing costs as a percentage of assets), the fact is that former employees that still have money in the plan tend to have smaller account balances and the liability that goes with these "in-active" participants outweigh their benefit of maintaining plan asset size.

Former Employees are a Compliance Headache

Under ERISA (the Employee Retirement Income Security Act of 1974 for those scoring at home), participants are given a right to information from the plan sponsor regarding their retirement assets. Those rights are also applicable to former employees who are still considered plan participants if they have their retirement assets in the plan. Under ERISA, participants have certain rights to information that have to be respected and complied with. They must get a summary of annual reports; they must get a statement of their account, a copy of the summary plan description (SPD), and any summary of material modifications to the SPD as a result of any plan amendments. So while distributing these materials to active employees is easier through e-mail and by in-person or inter office delivery, these tasks are often neglected for former employees because they are out of sight, out of mind. The problem with forgetting about former employees is even more dangerous with participant directed 401(k) plans.

A participant directed retirement plan need to meet the requirements of Section

404(c) of ERISA, plan sponsors can only escape liability if plan participants have enough information to make investment decisions. That information is usually through participant education, which is conducted on the job site or online. How many former employees don't get that opportunity? A large majority don't. In addition, former employees are less likely to get relevant information on the changes to the fund lineup as well as any decisions to jettison investment options and map them over to new options on the plan's lineup. When dealing with a financial advisor making the investment decisions, a third party administrator handling the day to day administration of the plan, and a plan sponsor with information about former employees, many times the ball is dropped and former participants don't get the relevant information.

In addition, having multiple plan participants may cause unnecessary audit expenses. Except for the 80-120 rule (where I don't want to bore or lose you), retirement plans are required to have an independent auditor prepare an audit of the plan's assets and have it attached to its annual Form 5500 return. So plans with many participants who are former employees may trigger that 100 (120 in many cases, sorry for boring you) participants count that makes the plan required to get an audit. Audits aren't inexpensive, depending on the plan and the auditor, a good audit can cost between $8,000 and $35,000. That's a lot of money to pay because the plan has many former employees as participants.

Former Employees' Money isn't easy to get rid of

We don't live in an ideal world, if we did we would all be using Macintosh computers. In addition, we also can't simply hand a check to a former employee their retirement plan assets on date of termination and wish them luck. Retirement plans require a participant's consent to receive a distribution of their retirement assets after termination of employment, except for one exception.

Most retirement plans include a provision that allows the plan to distribute a former employee's vested balance without their consent if the balance is less than $5,000. This is referred to as the involuntary cash-out rule.

While this was a great rule, the IRS did some major tinkering to it in 2005. These rules now require plan sponsors to roll over the assets belonging to a former employee of any involuntary cash-out

amounts between $1,000 and $5,000. This means that the plan sponsor can no longer distribute amounts within this range to by check to the participant. Instead, the plan sponsor must establish a Traditional IRA to which the amount must be rolled over. Since setting up these IRAs can be burdensome and may involve fiduciary liability, plan sponsors had a choice not to abide by this rule by simply amending their plan by reducing the involuntary cash-out limit to $1,000.

Whether to use the $1,000 or $5,000 depends on you, the plan sponsor. If you have a large amount of employee turnover and have the prospect of many employees that fall with the $1,000 to $5,000 range (plus you have a financial advisor to rely on), using the IRA approach for the involuntary cash-out rule makes sense. However, if you limited time for the recordkeeping of these IRAs, have minimal turnover and/or most former employees have account balances more than $5,000, having that lower threshold may make a lot of sense.

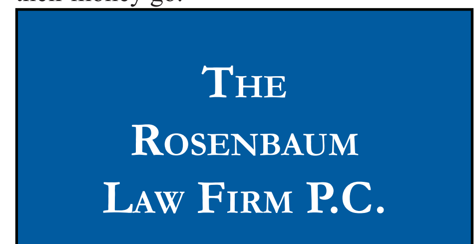
What to do

While it would be wise to get rid of the account balances of former employees from your retirement plan, the consent and involuntary cash-out make that a tough task. What to do? I think it's wise to work with a financial advisor and a third party administrator who understands the problems with having multiple former employees with small account balances.

Upon termination, you have to advise these former employees that they have the opportunity to receive a distribution of their vested account balance by rollover or by payment of check to them.

As plan sponsor, you should educate the former employees about the benefits of receiving a distribution of their account balance after termination of employment. They should understand the benefits of taking the assets with then, namely more choice of investments, choice of financial advisors, and consolidating all retirement plan assets under one roof instead of having it spread among various former employees. The former employees should be told that by no longer being employed by you will make them less likely to monitor their plan investments, which does a financial disservice to them. Any good employer conducts meetings with former employees before or after termination of employment regarding severance pay, vacation pay, and health insurance. So adding a component on why it's wise to roll-over their vested account balance is a no brainer.

Things that come to those who wait were left there by those who got there first. However, plan assets left by former employees who wait cause a potential liability headache to you, the plan sponsor. When it comes to former employees, let their money go.



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