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Frequently Overlooked Non-Compliance: Small Balances Cash-Outs

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Generally, qualified pension plans cannot distribute benefits without the participants' consent prior to participants reaching normal retirement age. One exception is a plan provision present in most retirement plans (both defined contribution and defined benefit) frequently referred to as "small balances cash-outs." According to this provision, plans may make an automatic cash-out distribution to terminated participants without their consent if the value of their vested account balances (or vested accrued benefits for defined benefit plans) is $5,000 or less.

Plan sponsors are required to give such participants a notice 30 to 60 days prior to the cash-out payment. The notification should give participants the option to roll over their accounts to a new employer's plan or into an Individual Retirement Account (IRA) instead of receiving cash and incurring a tax liability. No notification is required for automatic cash-out payments to participants with vested balances of less than $200.

With the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Congress made changes to these rules by implementing a requirement that certain small balances cash-outs have to be automatically rolled over to an IRA and not paid directly to the participants, unless the participants specifically elect otherwise. The automatic rollover requirement affects participants with vested account balances (accrued benefits) larger than $1,000 but not more than $5,000.

If participants do not make an affirmative election, the plan can make a lump-sum payment directly to participants with vested account balances (accrued benefits) of $1,000 or less; for participants with vested account balances between $1,000 and $5,000, the cash-out distribution is done by an automatic rollover to an IRA established on behalf of the participant.

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Determination of account balances subject to the automatic cash-out provision

IRS allows plans using the $5,000 cash-out limit to disregard rollovers into the plan when calculating participants' vested account balance and determining if terminated employees can be forced out of the plan. The importance of this rule is that it makes it possible for participants with significant rollovers into the plan, but accumulations under the plan as a result of contributions and earnings of less than $5,000, to have their entire account balance subject to automatic cash-out and rollover.

Summary of plan administrator responsibilities (safe harbor requirements)

- Vested account balances (accrued benefits) subject to the automatic

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cash-out provision should not exceed the plan's cash-out threshold (maximum cash-out limit is $5,000) and otherwise meet the provisions of Code section 411(a)(11).

- Plan administrators must designate an authorized IRA provider (banks, credit unions, licensed insurance companies, registered investment companies, etc.) to receive the automatic rollovers of cash-outs valued between $1,000 and $5,000.
- The plan should have a written agreement with the IRA provider addressing the investment options and the expenses associated with the account.
- The amounts rolled into the IRA must be invested in investment options designed to preserve principal and provide a reasonable rate of return. The investments do not need to be guaranteed and can include money market funds and interest-bearing savings accounts, certificates of deposit, fully benefit-responsive stable value products, etc.
- The fees charged to the IRA should not exceed the fees charged by the IRA provider for comparable IRAs (IRAs established not as a result of automatic rollovers).
- The plan documents and the summary plan description (SPD) should reflect the plan's automatic rollover and mandatory cash-out provisions. The documents must describe the types of investments that will be available under the IRA and how fees will be charged and allocated under the IRA.
- The rollover, the selection of the IRA provider, or the investment products in which the amounts are invested must not represent a prohibited transaction. For example, this may be the case if the plan sponsor receives something of value when selecting the IRA provider or investment product. The Department of Labor (DOL) has issued certain prohibited transaction exemptions.

“Monitoring participants' accounts and taking proactive steps will improve the plan's performance, reduce the administrative burden, and reduce the possibility of future problems.”

Complying with the automatic rollover provisions creates concerns about plan sponsors' fiduciary responsibilities under ERISA. According to the DOL, plan administrators can satisfy their fiduciary responsibility if they have met the above-listed safe harbor requirements.

Significance of small balances cash-outs

Non-compliance with the plan provisions regarding automatic cash-outs is considered a breach of fiduciary responsibility. But another very important aspect is that complying with these provisions can be quite beneficial for the plan. Provided that the plan agreement with the IRA provider has met the ERISA safe harbor rules, the fiduciary responsibility of the plan sponsor with regard to the terminated participants whose balances were rolled over into IRAs ends when the funds are transferred to the IRA provider. As of that point, the participants are deemed to be exercising control over the assets of the IRA and cease to be plan participants.

The significance of this is that many of the plan fees are based on participant counts and the required plan notices (fee disclosures, summary annual reports, etc.) must be provided to all plan participants with account balances (including former employees). As a result, forcing out of the plan the participants with small balances can generate substantial savings for the plan.

It also has one very important side benefit, which includes preventing future situations where the plan sponsor may need to expend a lot of time and resources tracking down missing participants. Since participants with small account balances are the ones most likely to forget about their accounts after employment termination, cash-out distributions to those former employees before they become missing can prevent those situations. Monitoring participants' accounts and taking proactive steps will improve the plan's performance, reduce the administrative burden, and reduce the possibility of future problems.