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Retirement Plans

Susan Bernstein of Schulte Roth & Zabel LLP discusses IRS guidance regarding how administrators of qualified employee benefit plans can comply with requirements involving payments to participants and beneficiaries who can't be found or aren't responsive.

IRS Provides Some Relief on Missing Participant Compliance Concern

BY SUSAN BERNSTEIN, ESQ.

Many sponsors of qualified plans have concerns about how to comply with certain Internal Revenue Service (IRS) requirements involving payments to participants and beneficiaries who cannot be found or are not responsive (Missing Participants). Missing Participants most often come to the attention of the plan administrator when communications are returned to the sender as undeliverable with no known forwarding address. The IRS recently issued guidance (Missing Participant Memo) to its Employee Plans examiners directing that qualified plans should not be found to have violated the tax code Section 401(a)(9) minimum required distribution requirements if certain steps have been taken.

Scope of the Missing Participant Problem

Missing Participants have presented significant challenges for plan sponsors who seek to maintain compliance with applicable law and governing plan documents. Despite best efforts by many plan administrators to educate and communicate to participants that they have a duty to keep their contact information up-to-date, the problems abound. The issues concern plans of all sizes, but are particularly challenging for larger plans and plans in industries with high turnover and immigrant workforces. Bad addresses arise due to many different reasons- the plan may have bad data, perhaps information was coded incorrectly such as dates of birth, social security numbers, zip codes, or the like, or the data may have simply become outdated (for example, the participant has moved with no forwarding information) and workers who may have provided the plan with erroneous information at the start such as false social security numbers.

Plan sponsors have to navigate various IRS distribution requirements to maintain the tax-qualified status of their plans. To comply, plan sponsors need to notify and pay participants upon the occurrence of certain events. Tax code Sections 411(a)(11) and 401(a)(31) provide that a plan cannot distribute a participant's benefit upon his or her termination from employment before normal retirement age if the vested benefit is greater than $5,000. But, depending on the plan design, some plans are designed such that they must distribute small balances that are under $5,000 (or in some cases under $1,000). And, in all cases, qualified plans are required to commence payment under tax code Section 401(a)(14) after the latest of termination from employment upon reaching the later of age 62 or normal retirement age as defined by the plan, subject to plan requirements (e.g., submitting a written application) or a participant's election to defer payment or Furthermore, tax code Section 401(a)(9) requires that qualified plans begin making required minimum distributions in the year following the year in which the participant attains age 70½ or retires.

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For example, Franklin was born on Dec. 11, 1941, having retired in 2010 and having age 70½ on June 11, 2012. His required beginning date was April 1, 2013. The plan sponsor attempts to comply with the minimum required distribution rules by providing notification to Franklin in 2012 of his distribution requirements in advance of the applicable deadline, but the envelope was returned as undeliverable. Accordingly, the plan sponsor was not able to make the distribution.

If a plan sponsor cannot find the participant when it seeks to make a mandatory cash out of a small benefit following termination of employment or a minimum distribution at age 70½, it cannot timely comply with the distribution rules. Further, the IRS requires plan sponsors to answer additional compliance questions on the Annual Return/Report of Employee Benefit Plans. Specifically, lines 41 of Schedules H and I of the Form 5500 asks, ''Has the plan failed to provide any benefit when due under the plan?'' This question was added in 2009 but the instructions to the Form did not include examples of what is a reportable failure. In 2015, the IRS clarified its instructions to explain that a reportable failure includes any unpaid minimum required distributions. Further, the IRS announced in 2016 that plan sponsors do not need to report unpaid minimum required distributions for Missing Participants if the plan has engaged in reasonable efforts or is in the process or engaging in such reasonable efforts.

If the plan is unable to comply with applicable distribution requirements, the plan runs the risk of jeopardizing its tax-qualified status because the plan is not being administered pursuant to its terms, which is considered to be an ''operational failure.'' The sanctions for disqualification are significant, including (i) immediate inclusion into income of all vested contributions; (ii) immediate inclusion into income of all earnings; (iii) loss of tax-deductions on all contributions, (iv) loss of the ability to roll over distributions on a tax deferred basis; and (v) loss of protection by the Pension Benefit Guaranty Corporation. Accordingly, plan sponsors want to use their best efforts to avoid operational failures by complying with applicable law.

Department of Labor Guidance

The U.S. Department of Labor (DOL) has not issued guidance to sponsors of ongoing qualified plans on what it considers to be reasonable steps to search for Missing Participants or how to handle payment of benefits to Missing Participants but makes it clear that locating Missing Participants is a fiduciary duty under the Employee Retirement Income Security Act of 1974, as amended (ERISA). The DOL has, however, expanded its enforcement efforts with a national scale review of the procedures used by large defined benefit plans to track down missing participants. As a result of the absence of guidance for ongoing plans, many plan sponsors rely on DOL Field Assistance Bulletins 2004-02 and 2014-01 as the relevant authority on how to address Missing Participants. According to these bulletins, a plan fiduciary of a terminated defined contribution plan has the responsibility to (1) locate missing participants; and (2) when efforts to communicate with a missing participant fail to secure a distribution election, distribute the account balance into a federally insured bank account in the name of the missing participant or consider in certain states, escheating the account balance to state unclaimed property fund. The DOL provides for a number of search methods to be employed by the plan fiduciary when trying to locate Missing Participants, including:

- Use certified mail—return receipt requested.
- Check records plan and employer records for more up-to-date information.
- Contact the participant's designated beneficiary (spouse, children, etc.) to find updated contact information for the missing participant.
- Use free electronic search tools (internet search engines, public record databases, obituaries, social media)
- Possible additional search steps include the use of Internet search tools, commercial locator services, credit reporting agencies, information brokers, investigation databases and analogous services that may involve charges.

Through its national scope audit, DOL auditors have stated that a plan fiduciary should take additional search steps, but has not elaborated on what steps are necessary. Some DOL auditors have stated that plans have inadequate procedures to find deferred vested participants who terminated prior to normal retirement age, especially those who are past their required beginning dates (e.g., age 70½). Certain DOL auditors have claimed that plan sponsors should use a different commercial locator service if one locator service fails to locate the participants, and still others have required that a plan must repeat search efforts indefinitely. The ERISA Advisory Council and other professional organizations including the American Benefits Council have requested that the DOL expand its guidance to address the void and corresponding uncertainty for ongoing plans, but to date, the DOL has not provided the requested guidance.

Pension Benefit Guaranty Corporation Guidance

The Pension Benefit Guaranty Corporation (PBGC) maintains a missing participant program for terminated single employer PBGC-insured defined benefit plans. As of 2013, the PBGC identified 38,000 people who had unclaimed pensions. Ongoing plans may not turn benefits over to the PBGC for Missing Participants. The PBGC issued a proposed rule in 2016 that would expand the program to voluntarily cover Section 401(k) and other defined contribution plans as well as other non-covered pension plans for plans that terminate after 2017. The goal of the program is to connect Missing Participants with their benefits in terminated plans. The PBGC program references the DOL guidance on diligent searches. Proposed PBGC regulations define distinct diligent search standards for defined benefit and defined contribution plans and add some clarity. The PBGC defines a commercial locator service as any business that finds lost persons for compensation using information from a database maintained by a consume reporting agency, and proposes to add that defined benefit plans use no-fee internet search engines.

The PBGC addressed the requirement to continue to pay premiums for Missing Participants in 2004. Even if

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a pension benefit is forfeited in accordance with IRS rules, such forfeiture does not cause the participant to be removed from the participant count for purposes of the flat-rate premium because the participant continues to have a claim for benefits. However, the PBGC Blue Book states that a ''plan administrator may drop the participant from the participant count for purposes of the flat-rate premium [and the variable rate premium] if the plan administrator reasonably believes that the participant is deceased and has no living beneficiary who may be entitled to benefits from the plan.''

Forfeiture and Reinstatement

Qualified Plans may, in accordance with Treasury Regulation Section 1.411(a)-4(b)(6), be designed to include plan language and procedures allowing for the forfeiture of benefits of Missing Participants, provided that reinstatement is made if the Missing Participant makes a claim in the future. In 2006, the DOL informally stated that the authority to interpret the meaning of ''forfeited benefit'' as used in Regulation Section 1.411(a)-4(b)(6) resides with IRS/Treasury. Nevertheless, the DOL has raised concerns that the forfeiture and reinstatement procedure can result in a prohibited transaction triggering a 15 percent excise tax under tax code 4975. Although the DOL has not endorsed the forfeiture and reinstatement procedure, the PBGC acknowledges the forfeiture and reinstatement procedure in its guidance. In fact, the PBGC provides that when there is a forfeiture of benefits, the benefit attributable to the participant shall be ''disregarded for purposes of determining the plan's current liability'' and for the variable-rate premium.

IRS Missing Participant Memo

Prior to the recent IRS Missing Participant Memo, the IRS had not provided guidance on reasonable search methods or what plan sponsors can do to maintain compliance in these circumstances with the tax qualified requirements. The IRS website in the ''Form 5500 Corner'' refers plan sponsors to the DOL bulletin: ''[A]lthough the Department of Labor's Field Assistance Bulletin 2014-01 is specifically applicable to terminated defined contribution plans, employers and plan administrators of ongoing plans may want to consider periodically using one or more of the search methods described in the FAB in connection with making reasonable efforts to locate [required minimum distribution] eligible missing participants.'' On June 7, 2017, the IRS Advisory Committee on Tax Exempt and Government Entities (ACT) issued a public report of recommendations to the Tax Exempt and Government Entities Division of the IRS, which included a recommendation that the IRS issue guidelines on what steps plan sponsors should take to find missing participants to satisfy qualified plan distribution rules. In response, the IRS looked at what type of guidance it could provide in this area.

On Oct. 19, 2017, the IRS issued a memorandum (the Missing Participant Memo), in which the IRS addresses the application of tax code Section 401(a)(9) to certain circumstances involving a plan's action related to a benefit of a participant or beneficiary whom the plan is unable to locate. The IRS selected search steps that are consistent with the DOL's guidance in FAB 2014-01. With respect to tax code Section 401(a)(9), the IRS makes clear that it will not challenge a qualified plan for a violation of the minimum distribution requirements if the plan has taken three steps:

1. Searched plan and related plan, sponsor, and publicly available records or directories for alternative contact information.
2. Used any of the search methods below:
   a. a commercial locator service;
   b. a credit reporting agency; or
   c. a proprietary internet search tool for locating individuals; and
3. Attempted contact via U.S. Postal Service certified mail to the last known mailing address and through appropriate means for any address or contact information (including email addresses and telephone numbers).

The new IRS guidance will be incorporated into Internal Revenue Manual Section 4.71.1 (Employee Plans Examination of Returns) by Oct. 19, 2019. The Missing Participant Memo applies to all IRS examinations open on or after Oct. 19, 2017.

Internal Controls

Plan Sponsors should implement procedures to (i) keep track of terminated employees to avoid them from becoming lost or missing and (ii) to search diligently for those who become Missing Participants. The internal controls should include the following:

- Educate participants on the important of updating their contact information by including reminders on statements, in summary plan descriptions, and in annual notices.
- Instruct call centers to confirm contact information on each call.
- Maintain multiple points of contact and especially at termination employers should request participants provide their cell phone numbers and personal email addresses, which tend to change less frequently than mailing addresses.
- Request cell phone numbers and email addresses of designated beneficiaries on beneficiary designation forms.
- Add ''address service requested'' on all envelopes so that the U.S. Postal Service will forward envelopes to any updated addresses made in the prior 12 months and return the envelope with a new address if the address changed more than 12 but less than 18 months.
- Run a death search periodically on terminated vested participants using either the Social Security Death Index or other online death search services which conduct obituary reviews.
- Forfeit benefits after exhausting the search process only if the plan document provides for forfeiture and reinstatement while continuing to monitor the DOL's position.
- Continue to pay PBGC flat-rate premiums for Missing Participants until the administrator reasonably believes the participant is deceased and has no living beneficiary who may be entitled to benefits from the plan.
- Continue to monitor regulatory guidance.

By staying on top of the census data, plan sponsors will reduce their need to manage Missing Participants. And, as soon as a participant or beneficiary becomes a Missing Participant, plan sponsors should initiate a plan to diligently search for them in accordance with the IRS Missing Participant Memo and DOL guidance. Plan sponsors should remember to document all of their efforts to locate Missing Participants. Although the IRS has not yet addressed any of the other qualification requirements that impact Missing Participants, at least for now the IRS has provided very clear guidance and relief so that plan sponsors of ongoing qualified plans have a means to satisfy the tax code Section 401(a)(9) minimum distribution requirements with respect to Missing Participants. The Missing Participant Memo will be well received by plan sponsors. Further DOL guidance and/or interagency guidance from the IRS, DOL and PBGC would be very welcome.

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