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Corporate restructuring in light of economic volatility often gives rise to questions of whether, and how, to terminate an employer's 401(k) or profit-sharing plan. These can arise, for example, in negotiating merger or purchase agreements, or in connection with a more general rethinking of corporate structure and benefit programs. In addition to business-related considerations such as cost, transaction leverage, and employee relations, there are a number of potential legal and logistical issues. This article provides a general overview of legal and logistical points to consider and practical tips for the termination process.

Considerations in Deciding Whether to Terminate

Plan Permanency Rule

The definition of "plan" under the Internal Revenue Code of 1986, as amended, and treasury regulations implies some level of permanence. 26 U.S.C. § 401(a); 26 C.F.R. § 1.401-1(b)(2). Even if the plan language permits termination, abandonment of a plan within a few years of establishment for reasons other than business necessity is considered evidence that it was never a bona fide program for the exclusive benefit of employees. If the IRS concludes that a bona fide plan was never established, it is retroactively disqualified, resulting in significant negative consequences for both employees and the employer. Rev. Rul. 69-25.

In evaluating permanency, the IRS looks at facts and circumstances, including benefits to highly compensated employees, the employer's likely ability to make ongoing contributions, and whether any profit-sharing contributions were recurring and substantial. Rev. Rul. 69-24; Rev. Rul. 69-25.

If terminating within a few years of a plan's establishment, the employer should document the legitimate business justifications for termination. If the employer seeks a final determination letter, it must specify the reason for termination, and, if "adverse business conditions" is selected, provide additional detail. IRS Form 5310; Instructions to IRS Form 5310.

Successor Plan Rule

If the employer has another individual account plan or may establish one, the employer should consider the successor plan rule. Generally, elective deferrals cannot be distributed upon termination if the employer maintains another 401(k), profit sharing, stock bonus or money purchase plan. I.R.C. §§ 401(k)(10)(A) and 414(i). An exception exists if fewer than 2% of eligible employees in the terminated plan are eligible under the other plan during the 12 months before and after termination. 26 C.F.R. § 1.401(k)-1(d)(4)(i).

Termination Timing and Responsibilities Post-Termination

While the termination date is generally specified in resolutions, much of the work takes place after formal termination—as the administrator and service providers ensure the delivery of required notices and filings, distribution of plan assets, and maintenance of required documentation.

In terminations connected to a corporate restructuring, the employer should consider who will inherit administrative and sponsor responsibilities—generally the successor entity unless expressly transferred to another entity. In order to avoid potential fiduciary breaches, including effectively orphaning the plan, if the plan sponsor will cease to exist before termination is completed (e.g., if it will be dissolved), the plan sponsor should consider appointing a board member or officer, or a group thereof, to retain responsibility for completing the termination. 29 C.F.R. § 2578.1.

Safe Harbor Rules

While there are exceptions in light of Covid-19, mid-year termination of a safe harbor plan is generally permitted only if it is in connection with certain business transactions or the employer incurs a substantial business hardship. I.R.C. §§ 410(b)(C) and 412(c)(2); 26 C.F.R. §§ 1.401(k)-3(g) and 1.401(m)-3(f)(4); I.R.S. Notice 2020-52. If not, the employer cannot take advantage of the ACP/ADP safe harbor for the year of termination.

Multiple Employer Plans

If an employer participates in a multiple employer plan rather than sponsoring a single employer plan, the employer should review the plan documents and contact the sponsor to understand the withdrawal or termination process. Distribution of plan assets likely requires spinning off and terminating a single employer plan.

Partial Termination

While beyond the scope of this article, employers should bear in mind the partial plan termination rules if they decide not to fully terminate a plan. If a corporate restructuring or other event causes a significant group of participants to become excluded from the plan, it may trigger a partial termination. I.R.C. § 411(d)(3)(A); 26 C.F.R. § 1.411(d)-2.

Formal Termination of the Plan

Once the decision is made, the employer should ensure the plan document contains all necessary language. The plan should have language permitting and governing termination. If not, or if the employer wishes to revise it, the plan may be amended. Generally, the plan document specifies the entity with termination authority (e.g., the employer or a committee) and may outline the termination process. Additionally, employers should consult with any other governance procedures that may inform the process.

Since termination ends a plan's remedial amendment period, the employer should review the plan language to ensure it is updated and meets the tax qualification requirements. Rev. Proc. 2016-37. Required amendments and any additional discretionary changes should be adopted before termination becomes effective.

Required amendments include those needed to reflect legal changes, set forth in the applicable Cumulative List or Required Amendments List, and optional provisions that were implemented in advance of the deadline for adopting a formal amendment (e.g., coronavirus-related distributions under the Coronavirus Aid, Relief, and Economic Security Act). If the plan does not include these updates before termination, it will not meet the tax qualification requirements under the Code.

Once the plan document is in order, the employer can adopt resolutions establishing a termination date. Often, to minimize successor plan issues, the resolutions will specify a termination date just before a transaction closes. The resolutions should cease all contributions and, unless the plan already does so automatically, provide that affected participants vest fully as of the termination date. I.R.C. § 411(d)(3); 26 C.F.R. § 1.411(d)-2(a)(1). The resolution may delegate various post-termination responsibilities, including execution of the requisite plan amendment and authority to take actions implementing the termination (e.g., recordkeeper instructions, determination letter application forms, and selection of an IRA provider). In addition, once termination resolutions have been adopted the plan should also be amended to reflect any changes (e.g., vesting and cessation of contributions).

Sorting Out Termination Logistics

Early in the process the employer should review logistics, and develop a clear timeline and communication strategy.

Communication with Service Providers

Service providers to be notified include recordkeepers, investment advisors, trustees, custodians, consultants, auditors, and counsel. The employer should review providers' contracts for any termination procedures and notice requirements. Moreover, early, clear, and ongoing communication between the service providers and the employer's internal project managers can help to identify any potential issues, avoid delays, and facilitate a smooth termination process. If there are any special issues, understanding the service providers' capabilities and processes is key.

As a preliminary matter, the parties should understand:

- Who is responsible for what data, for example, employee census and contact information, plan asset and benefit information?
- What is the timeline (communications, determination letter filing, distribution dates)?
- Who has responsibility for developing, mailing and tracking various participant notices?

Missing Participants and Beneficiaries

"Missing" participants and beneficiaries are those for whom the employer no longer has current contact information. The DOL and IRS require plan fiduciaries to make significant efforts to locate these individuals. DOL Field Assistance Bulletin 2014-01 (Aug. 14, 2014); IRS, Minimum Distributions for Missing Participants and Beneficiaries of Retirement Plans (May 6, 2020). Both the location efforts and decisions related to distribution if individuals cannot be found are fiduciary in nature.

To comply with ERISA's fiduciary obligations, the DOL requires the following steps:

- Using certified mail
- Reviewing related plan records
- Contacting designated beneficiaries
- Using free internet searches

When using related records, plan fiduciaries should factor in privacy considerations, and may ask the other plan to contact the individual on the terminating plan's behalf. Depending on the size of the account balances, additional steps may be required to fulfill an administrator's fiduciary responsibilities, such as using fee-based internet searches, credit reporting agencies, and commercial locator services. The IRS guidance on missing participants is not specific to plan terminations, but generally provides for a search of alternative contact information in related records, use of a commercial locator service, credit reporting agency or proprietary internet search tool, and use of certified mail.

If individuals cannot be located using the above steps, the DOL's preferred course of action is for remaining accounts to be rolled over to an IRA. If no IRA provider can be identified, the DOL instructs that the plan administrator may consider establishing an interest-bearing, federally insured bank account in the name of the missing individual, or transferring the account to a state unclaimed property fund (weighing interest accrual and fees against the state database's potential for facilitating recovery).

Another option is to use the Pension Benefit Guaranty Corporation's missing participant program which was recently opened to defined contribution plans on a voluntary basis. Within 9 months of performing a diligent search, a terminated plan may either transfer all missing individuals' account balances to the PBGC, or provide it with information regarding how missing individuals' accounts have been distributed (to be passed along if the individuals are later found). There is a $35 fee for the transfer of each account over $250, and no fee for providing information to the PBGC. 29 C.F.R. § 4050.203.

Plan Loans. Under some plans, termination itself is an event of default or acceleration for outstanding plan loans. Failure to repay within the specified period then results in a deemed distribution. 26 C.F.R. § 1.72(p)-1, Q/A-4 and Q/A-11. If not, repayments can continue until final distribution. In either case, at the time of actual distribution outstanding plan loans are offset from the remaining account balance. 26 C.F.R. §§ 1.402(c)-2, Q/A-9(b) and 1.72(p)-1, Q/A-13. The loan amounts will be taxed as income, and, if applicable, will be subject to the 10% early distribution penalty. 26 C.F.R. § 1.72(p)-1, Q/A-11(b).

There are a few ways to mitigate the negative tax consequences of a deemed distribution or offset:

Immediate Repayment. Participants can repay loan balances upon default or acceleration.

Rollover of Offset Amount. An offset is treated as an actual distribution, so participants can "roll over" the amount via a contribution to an eligible retirement plan, including an IRA, before the participant's due date for filing a tax return, including extensions, for the year of the offset. I.R.C. § 402(c)(3)(C).

Rollover of Outstanding Loan. Plans may provide for in-kind distributions of outstanding promissory notes so participants can roll over both their account balances and outstanding loans to a receptive plan (not to an IRA). 26 C.F.R. § 1.401(a)(31)-1, Q/A-16. In some cases, the employer can work with applicable service providers to accommodate group or individual rollovers to a related plan—for example where a plan is terminated pre-transaction and the acquiring company sponsors a plan that can accommodate rollovers, or where a not-for-profit entity with a 403(b) plan absorbs the employees of a shuttered for-profit subsidiary that terminated a 401(k) plan.

Use of Forfeitures or Unallocated Amounts

To distribute all assets, any unallocated amounts or forfeiture accounts must be addressed. The employer should review the plan language on using forfeitures and amend if necessary (provided accrued benefits are not cut back). Early consideration can avoid last-minute scrambles to identify plan expenses to pay with these amounts or to allocate to participants.

Many expenses associated with terminating a plan may be paid using plan assets, including forfeiture accounts (if permitted). Termination is a settlor decision, but implementation steps, such as developing and sending participant communications and bringing the document into compliance with current law, are generally fiduciary actions, meaning they can be paid for with plan assets. DOL Advisory Opinion 97-03A (Jan. 23, 1997).

Participant Communication Strategy

Following formal termination, plan participants must be notified that they may take a distribution, including rolling their account balance over to an IRA or another eligible retirement plan. They will also need to be informed of what happens if they do not take action. The employer may want to highlight certain points, such as how plan loans will be handled and details about in-kind distributions, if any.

Employers should develop an overall plan for participant communications, identifying what communications will be sent, when they will be sent, and who is responsible for developing and sending. Employers will want to build in time to identify missing participants and beneficiaries, flagging any returned mail. In developing the timeline, employers must bear in mind the 1-year period for distributing plan assets, addressed below.

Summary of Material Modifications

The plan administrator must provide an SMM within 210 days of the close of the plan year in which the termination is adopted. 29 C.F.R. § 2520.104b-3. This may be combined with other participant communications. Practically, due to the timing of distributions, the SMM will likely be sent much earlier than its deadline.

Notice to Interested Parties

If the employer is filing for a determination letter, the employer must provide a notice to interested parties within the 10 to 24 day period before filing. 26 C.F.R. § 1.7476-2(c)(1); Rev. Proc. 2020-4. Notices must be provided using a method reasonably calculated to ensure notice to each party. "Interested parties" are present employees with accrued benefits, former employees with vested benefits, and beneficiaries currently receiving plan benefits.

Section 402(f) Notice

For distributions that are rollover-eligible (i.e., most distributions of account balances of $1,000 or more), notice must be provided to participants and beneficiaries describing distribution options, including rollovers, and information about taxation ("Section 402(f) notice"). 26 C.F.R. § 1.402(f)-1. These are required within a reasonable period (at least 30 and no more than 180 days) before distributions are made. Recipients may waive the 30-day requirement after receipt of the notice. IRS Notice 2009-68. To comply with the safe harbor for automatic rollovers to an IRA (if no election is made), the notice should describe the automatic rollover provisions. 29 C.F.R. § 2550.404a-2.

While the plan administrator is ultimately responsible for this notice, the recordkeeper often will take responsibility for sending the Section 402(f) notice, usually with some standard cover letter. Sometimes the service provider will be willing to customize the cover letter or include additional mailings, particularly if there is an ongoing relationship with the employer. Other times employers may have little ability to customize this mailing, and may want to supplement with communications of their own.

Supplemental Communications

Communicating early and often with participants about the termination process can aid understanding, encourage employees to make active elections, and help root out missing participants. Supplemental communications can offer reminders and answer frequently sked questions.

Moreover, if the employer is unable to customize the Section 402(f) notice to its satisfaction, a supplemental communication offers an opportunity to contextualize and explain the plan termination. Certain aspects of the termination may require additional explanation and election options; for example, where employers are facilitating rollovers to a related plan or where in-kind distributions are permitted.

Filing for a Determination Letter

While not required, a plan may apply to the IRS for a determination that the plan document meets the qualification requirement at the time of termination. I.R.S. Pub. No. 794 (Rev. 11-2016). This process can identify plan document compliance issues and allow for correction in advance of the final distribution of plan assets. If the IRS were to audit a terminated plan and discover potential issues, correction can be far more difficult and costlier than if identified during the final determination letter process.

In evaluating whether to seek a determination letter, the employer may consider the risk of potential compliance issues and the cost and difficulty of post-termination corrections, compared to the time and expense associated with a determination letter filing. In most circumstances, a final determination will be useful in providing clarity and comfort for individually designed plans that do not have a recent determination letter.

On the other hand, an employer using a volume submitter plan may determine that the risk is insufficient to justify the time and expense of a determination letter application, given that the volume submitter document has a compliance statement from the IRS. It is important to remember that the determination letter process only addresses the plan document and will not review the plan's operation. If there are operational failures, these should be corrected prior to termination through the IRS's Employee Plans Compliance Resolution System. Rev. Proc. 2019-19.

The employer may submit a determination letter any time within a year of termination or distribution of substantially all plan assets. Rev. Proc. 2016-37. However, to allow sufficient time for IRS to review prior to the final distribution of plan assets, the employer should apply promptly after the plan is formally terminated. Prior to submission, the employer must provide notices to interested parties. 26 C.F.R. § 1.7476-1(b)(5). The employer will use IRS Form 5310 (as opposed to the Form 5300 used for ongoing plans) which requires certain additional information, including:

- Documentation of formal termination
- The reason for termination, including a detailed explanation if terminated due to adverse business conditions
- Historical information for the last 5 years, including information about contributions, forfeitures rollovers, and participants who terminated without full vesting
- Information as of the plan's termination date or latest valuation, including an asset and liability statement and documentation regarding outstanding plan loans.

Distributing Benefits to Participants

Upon termination, plan assets must be distributed "as soon as administratively feasible". Rev. Rul. 89-87. This generally requires distribution within one year of the date on which the plan terminated. If distributions are not made within the required time frame, the plan will be treated as an ongoing plan.

Employers should plan accordingly, allowing time for the processing of a determination letter application, if any, and correction of any issues, and for location of missing participants or beneficiaries. If the employer timely filed for a final determination letter, distributions generally may be delayed until the determination letter is received (but may not be delayed due to an IRS audit). I.R.M. 7.12.1.8 (Sept. 26, 2018).

Prior to making final distributions, the employer should perform the applicable non-discrimination testing for the final plan year, taking into account any applicable adjustments if termination creates a short plan year. If highly compensated employees had excess employee contributions or aggregated contributions, the excess amounts must be distributed no more than 12 months after plan termination. 26 C.F.R. §§ 1.401(k)-2(b)(2)(v); 1.401(m)-2(b)(2)(v); and 1.402(c)-2, Q/A-4(c).

If the participant's account has already been distributed, the applicable portion is deemed to be a corrective distribution and is not eligible for rollover. In preparation for final distributions, the employer should update account balances to reflect any changes since the last valuation and liquidate plan assets, to the extent not distributed in kind.

Since elective deferrals must be distributed as a lump sum, unless the employer has an alternative defined contribution plan, employers frequently choose to amend the plan and distribute all account balances in the form of a lump sum (for these purposes, "lump sum" includes the distribution of an annuity contract). I.R.C. § 401(k)(1); 26 C.F.R. § 1.401(k)-1(d)(4)(ii).

In some cases, participants may be receiving installment or annuity payments already. Outstanding installments can be paid in a single lump sum (which may be eligible for a rollover). 26 C.F.R. § 1.402(c)-2, Q/A-6. If a participant is receiving annuity payments through an individual annuity contract, plan termination normally will not impact payments.

If a participant or beneficiary has been sent the required notification and has made no election, the DOL provides a safe harbor for automatic rollovers to an IRA (including, for non-spouse beneficiaries, to an inherited IRA established for the beneficiary). 29 C.F.R. § 2550.404a-3. The safe harbor requires the fiduciary to satisfy certain IRA provider and investment option selection requirements.

Closing Out the Plan Termination

A final Form 5500 must be submitted no later than 7 months following the date of the distribution of all plan assets, unless filing under an authorized extension (note that an extension for a short plan year may require filing of an IRS Form 5558). Instructions for DOL Form 5500; IRS Form 5558. This will not necessarily be the year in which the plan was formally terminated.

A Form 1099-R must be issued to participants by January 31 of the calendar year following the year of the distribution. 2020 General Instructions for Certain Information Returns. A copy of the Form 1099-R must be filed with the IRS by the following March 31 for electronic filers (February 28 for paper filers).

Conclusion

Terminating a 401(k) or profit-sharing plan can be more complicated and time consuming than initially expected, and will not be the appropriate solution in all situations. Early consideration of logistical and legal issues, and the creation of a clear termination strategy, including a timeline and allocation of responsibilities, can help to ensure legal compliance and a smooth termination process.