

Terminating a Qualified 401(k) or 401(a) Plan

Properly terminating a qualified 401(k) plan, profit sharing plan or money purchase plan is not as simple as ceasing funding and distributing the plan assets. There are certain regulatory requirements and administrative functions that the plan fiduciary must follow to complete the process.

Formal election to terminate the plan - Once the employer decides to terminate the plan the employer should adopt a board resolution describing the intent to terminate the plan the effective date of the termination, followed by the adoption of a plan termination amendment. The plan termination date is important as it is the date when all contributions to the plan will cease and benefits and plan liabilities must be determined.

Notify all service providers - The employer should notify all service providers (e.g., record keepers, third-party administrators, investment providers, attorneys, trustees, accountants, etc.) of its intention to terminate the plan and the date of termination. Service providers often assist employers in the termination process.

Notify participants and locate missing participants - All plan participants and beneficiaries must be notified of the termination of the plan to make them aware that all assets must be disbursed, and to advise them of the options for disbursement of their account balances under the plan. If a participant's notification letter is returned as undeliverable, the employer should make a diligent effort to locate the individual to verify whether he or she is missing or simply is nonresponsive. The Department of Labor issued [Field Assistance Bulletin 2014-01](#) that provides guidance for employers on the options for handling accounts of missing and nonresponsive participants. Additionally, the Pension Benefit Guaranty Corporation (PBGC) in December 2017 issued final regulations that provide that the PBGC is available to take responsibility for holding the account balance of missing participants and beneficiaries in terminating retirement plans, including defined contribution plans, and paying them out when participants or beneficiaries are located. Participation in the PBGC missing persons program is voluntary for 401(a) and 401(k) defined contribution plans.

Update the plan documents - Before an employer can properly terminate a plan, the plan documents must be up-to-date with all current laws and regulatory changes. An employer may have to amend the plan before terminating it in order to bring the documents into compliance with any recent law or regulatory changes.

Plan vesting - The account balance of current employees and former employees who have not forfeited the non-vested portion of their account balance, as of the plan termination date, must be made 100% vested. This is a requirement and the employer may not choose an alternate vesting schedule for a plan termination.

Allocation of all assets – No assets of a defined contribution plan may revert to the plan sponsor, therefore, when terminating the plan any unallocated assets, as itemized below, must either be allocated to plan participants or used to pay reasonable plan administration expenses.

- Forfeiture account - The disposition of forfeiture accounts must occur according to the plan document provisions and elections. Depending on the election in the plan document forfeitures may be used to pay reasonable plan administration expenses, be reallocated to eligible participants or used to offset employer contributions.
- Suspense accounts generated from past corrective actions under the plan (e.g., unallocated contributions of excess annual additions under IRC Section 415) are used to reduce funding of a contribution to the plan.
- An ERISA Expense Account, if applicable, should only be used to pay for what the Department of Labor (DOL) considers "necessary" fees. Excess revenue in the plan, which may be held to pay for plan expenses is considered plan assets, and should only be used to pay for administrative expenses and should not be used for settlor expenses.
 - *Administrative expenses* are considered by the DOL to benefit 401(k) plan participants exclusively and in general cover plan administration and investment management fees.
 - *Settlor expenses* are considered to benefit the 401(k) plan sponsor in more than an incidental way. Common settlor expenses include consulting fees for professional guidance during the plan formation, design or termination process.
 - Any amount remaining after all expenses are paid must be allocated to plan participants.

A plan sponsor should consult an independent legal counsel about the use of these plan assets during the decision making process.

Final testing and monitoring limits - Nondiscrimination testing must be performed to insure the plan is in compliance during its final plan year, including ADP/ACP testing, top heavy testing and general nondiscrimination testing. All limits must be monitored and corrected if exceeded including the 402(g) annual deferral limit, the 415 annual additions limit and the annual compensation limit. Any corrections needed due to test failure or exceeding required limits must be corrected before assets are distributed to participants and beneficiaries.

Distribute plan assets - The employer must pay out assets according to the participant's direction. All distributions, whether distributed directly to the plan participant or rolled over to another retirement plan or IRA, must be reported on Form 1099-R. Upon an election to terminate a plan, all plan assets must be distributed as soon as administratively feasible. A plan that distributes assets within 12 months following the plan termination date is presumed to have distributed its assets as soon as administratively feasible. When a terminating plan's assets are not paid out by this time, the plan is treated as a frozen plan instead of a terminated plan and the document must continue to be updated for regulatory changes until all assets are paid out.

Final Form 5500 - The employer must file a final Form 5500 for the final plan year. Depending on the time necessary to complete all distributions, the final plan year may not be the same plan year that contains the plan's termination date. The final Form 5500 must be filed by the last day of the seventh month following the close of the final plan year. The end date for the final plan year is the actual liquidation date of all of the plan's assets. In this instance, the employer may be required to continue to file a Form 5500 for the plan until the plan assets are fully distributed. **Employers are not required to file Form 5500 for owner-only retirement plans (plans that cover only an owner or owner and spouse) if the plan assets are \$250,000 or less at the end of the year. However, even if the assets are less than this amount, Form 5500-EZ is required to be filed for the final year when the final distribution occurs.**

Other Plan Termination Considerations

Mid-Year Termination Date – A mid-year plan termination date results in a short plan year for the final year of the plan. A short plan year can affect nondiscrimination test results such as actual deferral percentage (ADP) or actual contribution percentage (ACP) testing and requires pro-ration of certain limits such as the 415 annual additions limit and the 401(a)(17) annual compensation limit, compensation definitions. Plan sponsors should discuss these issues with their plan attorney.

401(k) Successor Plan Rule – When a 401(k) plan terminates, if a successor plan exists, the elective deferrals (including Roth contributions) under the terminating plan cannot be distributed. A successor plan is any defined contribution plan (other than an ESOP) that exists at any time during the period that begins on the termination date of the 401(k) plan and ends 12 months after the distribution of all plan assets of the terminating plan and is sponsored by the same employer that sponsors the terminating the 401(k) plan. An exception applies however, if less than 2% of the eligible employees under the terminating plan are eligible under another plan during the 24-month period beginning 12 months before the termination date of the 401(k) plan, then the other plan is not a successor plan. A successor plan can be another 401(k) plan, profit sharing plan or money purchase plan. However, a successor plan does not include SIMPLE IRAs, SEPs, 403(b) or 457 plans.

Safe harbor Plan Termination – If a safe harbor plan terminates mid-year the safe harbor status of the plan cannot be maintained. Instead, the plan is treated under the rules that permit a reduction or suspension of safe harbor contributions during the plan year including (but not limited to): 1) making the safe harbor contribution through the plan termination date and 2) amending the plan to require ADP/ACP testing for the short plan year using the current year testing method.

File for a determination letter - Although the IRS does not require it, an employer may request an IRS determination of the plan's qualified status to give assurance that the plan was qualified at the time of termination, thereby avoiding potential issues if later audited by the IRS. IRS Form 5310, *Application for Determination for Terminating Plan*, is used for this purpose. Such request could potentially extend the amount of time it takes to complete the plan termination.

Additional Resources

For additional guidance and information regarding retirement plan terminations, see link to the IRS Retirement Plans FAQs regarding Plan Terminations at [frequently asked questions](#).

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