

RETIREMENT PLAN COMPLIANCE WITH THE NEW AUTOMATIC ROLLOVER RULES: WHAT ARE THE ALTERNATIVES?

Involuntary Cashout of Plan Benefits of \$5,000 or Less

The mandatory cashout provisions of tax-qualified retirement plans permit plan administrators to involuntarily distribute plan benefits of \$5,000 or less to terminated participants. Absent an election by the participant requesting a direct rollover, the cashout provisions would allow the plan to simply issue the participant a check for the account balance less 20% automatic tax withholding. If the participant does not roll over the sum received plus the additional amount that was withheld for income taxes into an individual retirement account (IRA) within 60 days of receipt, income and penalty taxes attributable to an early distribution arise.

New Automatic Rollover Rules under EGTRRA

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) modified the "mandatory cashout distribution rule" to provide that effective on or after March 28, 2005 involuntary distributions of more than \$1,000 made from qualified plans, tax deferred annuity or 403(b) plans, governmental and church plans must be rolled over by the plan administrator into a designated IRA, absent a participant election requesting that the distribution be paid either to the participant, or to another in a direct rollover.

Compliance Alternatives

Plan sponsors must decide whether to:

- COMPLY, and as such continue to involuntarily cashout plan participants with plan benefits of \$5,000 or less, thereby requiring the plan to comply with the IRA requirements affecting automatic rollover requirements; or

- NOT COMPLY, by reducing the threshold amount that would trigger an involuntary cashout of plan benefits to no more than \$1,000, thereby allowing the plan to avoid complying with the automatic rollover requirements.

What Actions Are Required of the Plan Sponsor?

Plan sponsors must take the first 3 steps discussed below regardless of whether their decision is to comply or not comply with the new automatic rollover requirements:

- *Amend Plan.* A model amendment for plan sponsors to use to comply with the automatic rollover rules is included in IRS Notice 2005-5. Rather than complying, the plan may be amended either to eliminate the involuntary cashout provision altogether or limit involuntary cashouts to participants with a plan benefit of no more than \$1,000. If the decision is made to lower the limit, it should be noted that in determining if a participant's benefit exceeds \$1,000, amounts attributable to rollover contributions from other plans are taken into account. There are no model amendments for plans choosing not to comply with the new automatic rollover rules.

In any event, the plan amendment must be adopted before any post-March 28, 2005 mandatory cashouts are made. For calendar year plans, the amendment deadline is December 31, 2005. For fiscal year plans, the amendment deadline may be much earlier, i.e., the last day of the first plan year ending on or after March 28, 2005. Government and non-electing church plans are granted additional time to comply with the new rules and to amend their plans.

- *Update Participant Notice.* If the plan decides to comply, the participant must be notified that absent an affirmative distribution election, the cashout benefits will be rolled over to an IRA set up by the plan. This notice may be included in a revised special 402(f) tax notice or in a separate new notice that is issued with distribution materials. For plans that choose not to comply with the new automatic rollover rules, the distribution notices should be revised to show participant consent is now required for lump-sum payments between \$1,000 and \$5,000. Sponsors of defined benefit plans choosing not to comply may want to create a separate notice for this group of participants that does not

include the complicated benefit comparisons that must be provided to participants who are eligible for annuities.

- *Update SPD or SMM.* An updated Summary Plan Description (SPD) or Summary of Material Modifications (SMM) that describes the automatic rollover provisions must be provided to plan participants. If the plan chooses not to comply, the SPD should be reviewed to determine whether any updates are necessary. An updated SPD or SMM may be necessary, for example, to reflect that participants may now defer payment of benefits that are between \$1,000 and \$5,000.
- *Contract with IRA Providers.* This step is taken by plans that choose to comply with the new rules. In this case, plan administrators must select and make arrangements with financial institutions to accept automatic rollovers. Financial institutions and service providers already holding plan assets would be the likely targets for employers to contact to establish IRAs under the new automatic rollover rules.

Choosing Not to Comply: Potentially Higher Plan Administration Expense

Plan sponsors should keep in mind that reducing the limit on involuntary distributions from \$5,000 to \$1,000 may increase the cost of maintaining plans if enough participants decide to leave their benefits in the plan, and may create additional responsibilities for plan fiduciaries (e.g., locating participants and accounting for small benefits). Sponsors of defined benefit plans will also be required to pay PBGC premiums on behalf of participants who defer payment.

Distributions Not Subject to the New Automatic Rollover Rules

- Distributions to surviving spouses and alternate payees pursuant to a QDRO
- Deemed distributions following a participant's plan loan default.

ERISA Fiduciary Issues: The DOL Safe Harbor Regulations

Department of Labor (DOL) regulations provide a "safe harbor" for satisfying the fiduciary responsibilities associated with selecting an institution to receive

the automatic rollover and making an initial investment election for the rollover funds. These safe harbor regulations apply to all automatic rollovers.

Under the safe harbor regulations, the plan fiduciary is required: (1) to enter into a contract with the IRA provider on behalf of the participant; (2) to invest the IRA in a product that is designed to preserve principal and provide a reasonable rate of return; (3) to prevent fees and expenses to be charged for the IRA that are greater than those the provider charges for comparable IRAs; and (4) to provide participants with an updated SPD or a SMM that describes the automatic rollover requirements, the investment product, IRA provider, and fees and expenses associated with the IRA (and whether any will be borne by the plan or the plan sponsor).

A REMINDER: EMPLOYERS SHOULD POST THE USERRA NOTICE IMMEDIATELY

On March 10, 2005 the DOL issued a model USERRA Notice to assist employers in complying with the Uniformed Services Employment and Reemployment Act (USERRA) regulations affecting the rights of military personnel. Employers are reminded that the notice should be posted immediately. The model USERRA notice was issued on March 10, 2005, the same date that the notice requirement under the Veterans Benefits Improvement Act of 2004 is effective.

You may obtain additional information on a plan sponsor's employee benefits and executive compensation compliance obligations by checking the Employee Benefits & Executive Compensation Compliance Calendar.

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