

"This Newsletter discusses the Department of Labor (DOL) and Internal Revenue Service (IRS) guidance that has been published to date on the 'automatic rollover' rules."

New Automatic Rollover Rules for Cash-Out Distributions

by
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Let's see. You've amended your company's qualified plans to increase the cash-out limit for small account balances from \$3,500 to \$5,000. In connection with this, you've also amended the plans' cash-out provisions to eliminate the so-called "lookback rule" - that crazy rule which said that, before you could currently cash a participant out, you had to look at whether the participant's account balance was previously (at the time of a prior distribution) more than the cash-out limit. And finally, you've amended the plans' cash-out provisions to say that rollover contributions will not be taken into account for purposes of determining whether you can cash a participant out.

Whew. With all of that work completed, you're done with all plan design work with respect to cash-out distributions for awhile, right?

Not quite. EGTRRA (the Economic Growth and Tax Relief Reconciliation Act of 2001) has reared its ugly head again. Specifically, there are new rules (commonly referred to as the "automatic rollover" rules) which require qualified plans that contain cash-out provisions to provide for the automatic rollover to an IRA of cash-out distribution amounts between \$1,000 and \$5,000, unless the recipient of the cash-out distribution affirmatively elects to either receive the distribution directly or have the distribution rolled over to another IRA of his or her choice.

This Newsletter discusses the Department of Labor (DOL) and Internal Revenue Service (IRS) guidance that has been published to date on the "automatic rollover" rules, as well as certain action items which qualified plan sponsors should undertake to ensure their plans comply with the new rules.

DOL and IRS Guidance

There have been four important pieces of governmental guidance issued in connection with the new "automatic rollover" rules. Each piece of guidance is briefly summarized below.

a. **DOL Safe Harbor Regulations.** First, EGTRRA specifically directed the DOL to issue regulations setting forth a safe harbor pursuant to which the fiduciaries of a qualified plan will be deemed to have satisfied their fiduciary responsibilities in connection with amounts that are rolled over under the automatic rollover rules. Proposed regulations were issued by the DOL in March of 2004. On September 28, 2004, the DOL issued the regulations in final form.

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Under the final regulations, the safe harbor applies to both (i) the designation of an institution to receive the automatic rollover, and (ii) the initial investment choice for the amounts that are rolled over. If the requirements of the safe harbor are met, then immediately following the automatic rollover the participant on whose behalf the rollover was made will be viewed as exercising control over the assets in the IRA. This means that plan fiduciaries, after the occurrence of the automatic rollover, are "off the hook" for any later investment decisions made under the IRA.

The requirements that must be met in order to qualify for the safe harbor are as follows:

- (i) **Distribution Amount.** The present value of the distribution (ignoring rollover contributions, if a plan says to do so) to be made cannot exceed \$5,000. In connection with this requirement, note that although EGTRRA applies the automatic rollover rules to the distribution of amounts of more than \$1,000 and less than or equal to \$5,000, the final regulations extend the safe harbor to the automatic rollover of amounts of \$1,000 or less. This means that a plan containing cash-out provisions may benefit from the safe harbor for the automatic rollover of all distributions in the amount of \$5,000 or less. The obvious advantage of this approach is that it allows a plan sponsor to administer all cash-out distributions of \$5,000 or less in the same manner. (Note, however, that the Tax Code provisions implementing the automatic rollover rules do not require distributions of \$1,000 or less to be subject to automatic rollover. As a result, if a plan sponsor wished, it could still provide for the involuntary cash-out of amounts of \$1,000 or less and provide the automatic rollover only to amounts in excess of \$1,000 and less than or equal to \$5,000.)
- (ii) **Rollover Must be Made to an IRA.** The automatic rollover must be made directly to an IRA with an IRA provider who meets all of the requirements of the Tax Code for being an IRA provider. The preamble to the final regulations specifically states that the safe harbor establishes no minimum or maximum number of IRA providers a plan sponsor can choose, so presumably a plan sponsor could choose different IRA providers for different plans (or different IRA providers for the same plan for employees at different locations).
- (iii) **Written Agreement with IRA Provider.** Plan fiduciaries must enter into a written agreement with the IRA provider. The written agreement must specifically address the participant's right to enforce the terms of the contractual agreement establishing the IRA. Importantly, fiduciaries are allowed to rely on the commitments of the IRA provider contained in the written agreement, and are not bound to monitor the provider's compliance with the terms of the written agreement beyond the point in time amounts are rolled over.
- (iv) **Investment Products.** The written agreement must provide, with respect to the investment of amounts that are rolled over, that: (a) the rolled over amounts will be invested in an investment product designed to preserve principal and provide a reasonable rate of return (whether or not such return is guaranteed) consistent with liquidity; (b) the investment product selected must seek to maintain, over the term of the investment, the dollar

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value that is equal to the amount invested in the product; and (c) the investment product must be offered by a state or federally regulated financial institution (such as an FDIC-insured bank or an investment company registered under the Investment Company Act of 1940). The preamble to the final regulations specifically indicates that the types of investments that would fall into the above categories would typically be such products as money market funds, interest-bearing savings accounts, certificates of deposit and stable value products.

- (v) **Fees and Expenses.** The written agreement must provide that all fees and expenses attendant to the IRA (such as establishment charges, maintenance fees, investment expenses, etc.) will not exceed the fees and expenses charged by the IRA provider for comparable IRAs established for reasons other than the receipt of an automatic rollover.
- (vi) **Participant Notices.** Prior to using the safe harbor for an automatic rollover, plan participants must be furnished a revised SPD or an SMM that describes the plan's automatic rollover provisions. The revised SPD or SMM must describe that cash-out distributions that are automatically rolled over will be invested in an investment product designed to preserve principal and provide a reasonable rate of return, and must indicate how the fees and expenses will be allocated. The revised SPD or SMM must also provide the name, address and phone number of a plan representative for participants to contact for further information regarding the plan's automatic rollover rules. Query whether the safe harbor can be relied upon with respect to a participant for whom a plan sponsor does not have a current address and has no means by which to provide the revised SPD or SMM to the participant.
- (vii) **No Prohibited Transaction.** With respect to automatically rolled over amounts, plan fiduciaries must not engage in any prohibited transaction in connection with the selection of an IRA provider or an investment product, unless the transaction is otherwise exempt under an applicable prohibited transaction exemption.

b. **DOL Prohibited Transaction Class Exemption.** Second, as a companion to the safe harbor regulations, the DOL also issued on September 28th a class exemption from the prohibited transaction rules. This class exemption was issued for the benefit of banks and other financial institutions that, as part of their business, generally already provide IRAs and investment products. According to the preamble to the final safe harbor regulations, the class exemption was issued so that such a bank or other financial institution is not required to direct automatic rollovers from its own plans to one of its business competitors.

Provided certain requirements are met, the class exemption permits an employer (which, again, will typically be a bank or other financial institution) to establish automatic rollover IRAs at an institution that is either itself or an affiliated entity. In addition, the employer is also permitted to select its own investment products, or the investment products of an affiliate, for purposes of the initial investment of the rolled over amounts. Finally, the class exemption allows the IRA provider to receive establishment and investment fees in connection with the amounts that are automatically rolled over.

c. **IRS Notice 2005-5.** Third, on December 28, 2004, the IRS issued Notice 2005-5. This Notice provides guidance, in the form of sixteen questions and

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answers, on a number of topics relating to the automatic rollover rules. Here are some of the highlights of the Notice:

- (i) **Applicability Date.** The automatic rollover requirements generally apply with respect to cash-out distributions made on or after March 28, 2005. However, as discussed below, there is some limited transitional relief for adopting plan amendments and for certain cash-out distributions that are made by December 31, 2005.
- (ii) **Grace Period.** If a qualified plan which contains cash-out provisions does not, after March 28, 2005, process a cash-out distribution for which a participant does not affirmatively elect either a direct rollover or direct payment, and that failure to process the distribution is due to the fact that the plan does not yet have proper procedures relating to automatic rollovers (including the establishment of IRAs to receive the automatic rollovers), the plan will not be treated as having failed to operate in accordance with its terms, provided the distribution is made on or before December 31, 2005.

Example. A qualified plan provides for distribution to commence as soon as feasible after termination of employment. The plan contains involuntary cash-out provisions. Employee X terminates employment on April 1, 2005, with a vested account balance of \$4,500, but fails to elect either a direct rollover or direct payment of her account balance. The plan does not make immediate distribution to Employee X because it has not yet finalized its procedures relating to automatic rollovers. Provided the distribution is completed by December 31, 2005, the plan will not be treated as having failed to operate in accordance with its terms.

- (iii) **Application to Certain Plans.** The Notice confirms that the automatic rollover rules, in addition to applying generally to qualified plans under Section 401(a) of the Tax Code, also apply to governmental plans, Section 403(b) plans and non-electing church plans (i.e., church plans with respect to which an election has not been made to have the Tax Code's participation, vesting and certain other rules apply).
- (iv) **Plan Administrator May Set Up IRA.** If a plan participant fails to elect either a direct rollover or direct payment, the plan administrator may execute the necessary documents to establish, on the participant's behalf, the IRA to which the participant's account will be directly rolled over. The plan administrator is permitted to use the participant's most recent mailing address for this purpose.
- (v) **Elimination of Cash-Out Provisions.** A plan which currently contains cash-out provisions may be amended to eliminate the cash-out provisions without violating the anti-cutback provisions of Section 411(d)(6) of the Tax Code. Although not specifically mentioned in the Notice, a plan sponsor could presumably also amend its cash-out provisions to reduce the cash-out limit from \$5,000 to \$1,000. In connection with this, note that a plan sponsor could decide either to make distributions of \$5,000 or less

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subject to a voluntary lump sum distribution or to eliminate the lump sum distribution option altogether. However, if the plan allows for the voluntary lump sum distribution of amounts in excess of \$5,000, that lump sum option may not be taken away without violating Section 411(d)(6).

- (vi) Rollover Amounts. Amounts attributable to rollover contributions made to a plan that exceed \$5,000 are subject to the automatic rollover rules. Of course, this would only be the case where, absent the rollover contributions, a participant's distribution is \$5,000 or less. The Notice makes clear that rollover contributions are subject to automatic rollover even though the rollover contributions are excluded for purposes of determining whether the value of a participant's benefit exceeds \$5,000 for purposes of the cash-out rules.

Example. A participant in a qualified plan has a \$15,000 account balance, \$11,000 of which is attributable to a rollover contribution by the participant of benefits from the qualified plan of a previous employer. Under the automatic rollover requirements, the entire \$15,000 (and not just the \$4,000 attributable to non-rollover contributions) would be subject to automatic rollover.

- (vii) Participant Notice. In order to comply with the automatic rollover rules, the plan administrator of a plan must notify a participant (either separately or as part of the Section 402(f) rollover notice) that, absent an affirmative election by the participant, the distribution will be automatically rolled over into an IRA. The notice given to the participant must identify the trustee or the issuer of the IRA. Presumably, this notice requirement could be satisfied through the proper distribution of an SMM or a revised SPD to the participant which contains the required information.

- (viii) Plan Amendment. For plans which contain cash-out provisions, a good faith plan amendment reflecting the requirements of the automatic rollover rules must be adopted by the end of the first plan year ending on or after March 28, 2005. For calendar year plans, this means that the good faith plan amendment must be adopted by December 31, 2005. For non-calendar year plans, the deadline may be sooner (for example, the deadline for a plan with an April 1 to March 31 plan year would be March 31, 2005). The Notice includes sample amendment language that may be used to adopt the good faith plan amendment.

d. IRS Employee Plans News Newsletter. Finally, on February 16, 2005, the IRS posted a one-page Employee Plans News newsletter on its website. This newsletter clarified three points, as follows:

- (i) Plan Amendments Reducing or Eliminating the Cash-Out Limit Need Not be Adopted By March 28, 2005. Amendments reducing or eliminating a plan's cash-out limit do not need to be adopted by March 28, 2005, but instead only need to be adopted by the same time as an amendment adding the required automatic rollover provisions would need to be adopted – that is, by the end of the first plan year ending on or after March 28, 2005. Because the purpose of such an amendment would not be to add the required rollover provisions, but instead to reduce or eliminate the plan's cash-out provisions, there was previously some question about

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whether such an amendment would need to be adopted by March 28th. Fortunately, the answer is no.

- (iii) Pre-Approved Plans May be Amended to Reduce or Eliminate the Cash-Out Limit. A prototype sponsor or volume submitter of a pre-approved plan may amend the plan to either reduce or eliminate the plan's cash-out limit without causing the plan to be considered to be an individually-designed plan.
- (iii) Elimination of Rule for Ignoring Rollover Contributions. If a plan will comply with the automatic rollover rules by reducing its cash-out limit to \$1,000, and the plan contains a provision stating that rollover contributions will be ignored for purposes of determining whether a participant may be cashed out, that provision for ignoring rollover contributions will need to be deleted from the plan in order to completely avoid the automatic rollover rules. That is true because amounts attributable to rollover contributions are included in determining whether a participant's accrued benefit is \$1,000 or less for purposes of the automatic rollover requirement, even though those rollover contributions are not taken into account for purposes of determining whether a participant may be cashed out. This is an important concept, and one not many have focused on until quite recently.

Example. A plan contains a \$5,000 cash-out provision. The plan also contains a provision ignoring rollover contributions for purposes of determining whether a participant may be cashed out under the \$5,000 cash-out provision. The plan sponsor for the plan amends the plan to reduce the cash-out limit to \$1,000, but does not delete the provision ignoring rollover contributions for purposes of determining whether a participant may be cashed out.

After the amendment, a participant terminates employment with a \$2,500 account balance, \$500 of which is attributable to employment with the current employer (i.e., the plan sponsor) and \$2,000 of which is attributable to a rollover contribution the participant made from the plan of a previous employer.

Under the plan's amended provisions, the participant can be cashed out because his account balance (ignoring the rollover contribution) is \$1,000 or less. However, because the rollover contribution cannot be ignored for purposes of the automatic rollover requirements, the cash-out distribution is subject to automatic rollover because the total distribution of \$2,500 is in excess of \$1,000. This is true notwithstanding that the plan was amended to reduce the cash-out limit to \$1,000.

Employer Action Items

If your company's qualified plans contain cash-out provisions, you may wish to initially consider whether to eliminate those cash-out provisions altogether (or, alternatively, to reduce the involuntary cash-out limit to \$1,000). Doing so would require a plan amendment to be adopted. As mentioned above, although there was previously some question about when such an amendment would need to be adopted, the IRS in its February 16th newsletter has indicated that plan sponsors have until the end of the first plan year ending on or after March 28, 2005, to

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adopt such an amendment. Thus, for calendar year plans, this deadline would be December 31, 2005. Note, however, that the plan will need to operationally comply with the new rule eliminating or reducing the cash-out limit for distributions that occur on or after March 28th, even if the amendment is adopted at a later date. Also, note that in order to completely avoid the automatic rollover rules, plans that are amended to reduce the cash-out limit to \$1,000 will also need to delete the rule (if one exists in the plan) ignoring rollover contributions for purposes of determining whether a participant may be cashed out.

Many companies dislike the administrative hassles and expenses (such as recordkeeping fees and, in defined benefit plans, PBGC premiums) associated with retaining small account balances. If your company is in that situation, but is still interested in reducing or eliminating the cash-out limit, one approach for handling administrative expenses associated with the small account balances would be to shift the cost of such expenses to participants to the greatest extent possible, in accordance with DOL Field Assistance Bulletin 2003-3. Proper plan provisions would need to be in place to do so, however, and so a plan amendment may be needed to do this.

Many companies will simply want to retain their plans' cash-out provisions as they are currently written. If that is your company's wish, several steps must be taken. First, you will need to work to identify an appropriate IRA provider and otherwise get into operational compliance with the automatic rollover rules. (With respect to finding an appropriate IRA provider, a good place to start would be to look to your plans' current investment vendors to see if they will be offering an IRA automatic rollover product.) In general, the operational work relating to automatic rollovers should be done by March 28th, although note the limited transitional relief discussed above for delayed cash-out distributions that are subsequently automatically rolled over by December 31, 2005.

Second, a good faith plan amendment adding the automatic rollover rules to your company's plans will need to be adopted by the end of the first plan year ending on or after March 28, 2005 (again, this date is December 31, 2005, for calendar year plans).

Third, a revised SPD or an SMM describing the automatic rollover rules will need to be prepared and distributed to participants prior to the time when any automatic rollovers are made.

Fourth, the plans' Section 402(f) rollover notices should be revised (or another separate notice prepared) to notify participants that, absent an affirmative election, a cash-out distribution will be paid directly to an IRA. Again, presumably this notice requirement could be satisfied through the distribution of a revised SPD or an SMM. However, it is probably still a good idea to go ahead and modify your plans' Section 402(f) notices as well. In this regard, IRS officials have recently indicated on an informal basis that they are unsure whether IRS personnel will be revising the model Section 402(f) notice that was previously distributed by the IRS.

Conclusion

The March 28, 2005, effective date for the new automatic rollover rules is fast-approaching. Although limited transitional relief may be available for delayed automatic rollover distributions and for adopting plan amendments, plan sponsors should take the time now to determine their course of action with respect to complying with the automatic rollover rules.