Automatic Rollovers – March 28th Deadline is Here

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) added a new rule – section 401(a)(31)(B) of the Internal Revenue Code of 1986, as amended (the "Code") – that requires plans with mandatory distributions over $1,000 to provide that, if a participant fails to elect to receive the distribution directly or have it paid to a designated plan or IRA in a direct rollover, the distribution must be made in a direct rollover to an individual retirement plan ("IRA"). The requirement becomes effective for distributions on or after March 28, 2005. The implementation of this provision raises a number of plan qualification and fiduciary issues described below. Although helpful IRS and DOL guidance has been issued to address many of the concerns, there still remain some unanswered questions and key decision points for plan sponsors to make.

This article briefly describes the applicable rules (with a summary of IRS and DOL guidance), including decision points and action steps necessary to comply with (or avoid) Code section 401(a)(31)(B). It also points out a few key open issues that may impact your plans. Although the IRS has granted some transition relief for amending plan documents and transferring cashouts to a designated IRA, plan sponsors still must be in operational compliance as of March 28, 2005 (or the extended deadline for governmental and church plans). Therefore, we advise all plan sponsors to review the attached checklist to ensure compliance.

A. <u>IRS Guidance</u>

In Notice 2005-5, the IRS clarifies a number of key tax issues regarding the automatic rollover requirement now found in Code section 401(a)(31)(B). IRB 2005-3 (Dec. 28, 2004). This IRS guidance came at a much needed time, as plan sponsors decide whether to comply with these rules or avoid the rules altogether, and as IRA providers develop suitable products. The guidance is summarized below.

<u>Affected Plans</u> – The automatic rollover rules apply to nearly all types of tax-favored retirement plans – 401(a) plans, 401(k) plans, 403(a) plans, 403(b) plans, and governmental (but not tax-exempt) 457(b) plans – if they have a mandatory cashout provision. Importantly, plans maintained by governmental employers and churches (including non-electing church plans) are also covered even though the Code's cashout rules do not otherwise apply to them. Because such plans are not subject to ERISA compliance with the DOL safe harbor regulations outlined below does not protect these plans from state and local fiduciary exposure.

<u>Applicable Distributions</u> – The automatic rollover rules only apply to mandatory distributions to a participant of more than $1,000 (with no dollar cap as may occur under a governmental plan not subject to the $5,000 limit) that are eligible rollover distributions. A mandatory distribution is a distribution that is made without the participant's consent and that is made to a participant before the participant attains the later of age 62 or normal retirement age. The automatic rollover rules apply to the entire amount of a mandatory distribution, including any rollover contribution – even if it wasn't taken into account to determine the cashout limit. However, distributions to beneficiaries or alternate payees are not covered, nor is a plan loan offset or minimum required distribution.

Effective Date – The automatic rollover rules generally apply to mandatory distributions made on or after March 28, 2005. However, governmental plans have until the close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after January 1, 2006 to comply. Moreover, a non-electing church plan where the church convention has amendment authority has until 60 days after the close of the earliest church convention that occurs on or after January 1, 2006 to comply.

Transition Relief – Employers have until December 31, 2005 to transfer automatic rollover amounts (associated with post-March 27, 2005 cashouts) to a traditional IRA. This relief is available for employers who cannot timely process mandatory distributions due to lack of sufficient administrative procedures for automatic rollovers, including establishing IRAs to accept the automatic rollovers.

Plan Amendment – Plans with mandatory distributions over $1,000 must adopt a good faith plan amendment by the end of the first plan year ending on or after March 28, 2005 (or, for governmental and certain church plans, by the end of the grace period described above). Therefore, non-governmental employers with a calendar-year plan year must amend their plans by December 31, 2005. However, a non-governmental employer with a April 1 – March 31 plan year must amend the plan by March 31, 2005. The Notice includes the following sample, good faith amendment:

> "In the event of a mandatory distribution greater than $1,000 in accordance with the provisions of section _____, if the participant does not elect to have such distribution paid directly to an eligible retirement plan specified by the participant in a direct rollover or to receive the distribution directly in accordance with section(s) _____, then the plan administrator will pay the distribution in a direct rollover to an individual retirement plan designated by the plan administrator."

Adoption of this amendment will not result in a volume submitter plan or master or prototype plan becoming an individually designed plan.

Plan sponsors who wish to avoid the automatic IRA rules altogether also have until the end of the plan year that includes March 28, 2005 to reduce their mandatory cashout provision to $1,000 (or lower). IRS website, Employee Plans News bulletin. However, the amendment is slightly more complex than simply replacing "$5,000" with "$1,000," effective for distributions on and after March 28, 2005. For example, the following additional issues should be considered when drafting the amendment:

- Distribution Between $1,000 and $5,000: Plan sponsors can limit the distribution options available for payments that exceed $1,000 but do not exceed $5,000. For example, a plan sponsor may provide that only a single lump sum option is available for participants who elect a distribution of their account/accrued benefit between $1,001-$5,000, and no spousal consent is required. For many employers, it makes sense not to extend annuity options to such a small benefit.

- Prior Rollover Contributions: The IRS confirmed that the automatic rollover provisions count rollover contributions towards the $1,000 limit, regardless of whether such contributions are counted for purposes of the plan's cashout limit. Therefore, to avoid the automatic rollover rules where the plan ignores rollovers in determining mandatory distributions, sponsors should amend their plans to (1) lower the cashout ceiling to $1,000 (or less), and (2) either count rollover contributions for the cashout limit or require participant consent for any distribution that includes rollover accounts where the total distribution will exceed $1,000.

- Payments to Spouses and Alternate Payees: The automatic rollover rules only apply to participants, they do not apply to cashouts to spouses, other beneficiaries, or alternate payees. Typically, a plan's cashout provision will cover all types of cashouts from the plan; therefore careful drafting may be required to retain the $5,000 cashout limit for everyone other than the participant. Of course, having multiple cashout limits adds complexity to the plan that may not be welcomed; therefore, an alternative is to lower the cashout for everyone.

Presumably, these related amendments will also be afforded the same year-end timeline. Also for plans with an outstanding funding waiver or the employer is in bankruptcy, these amendments should not trigger any issues under Code section 412(f) or 401(a)(33) because they do not increase benefits and are required as a condition of plan qualification.

IRA Establishment – The Notice permits mandatory distributions to be rolled over to a deemed IRA under Code section 408(q) or a group IRA establish by an employer or employee association under Code section 408(c), as well as regular traditional IRAs. The plan administrator can execute the necessary documents to establish an IRA on the participant's behalf with a financial institution selected by the plan administrator. (This action does not violate the Patriot Act.) Moreover, the trustee or issuer will not be treated as failing to satisfy the IRS disclosure requirements merely because the package is returned by the U.S. Postal Service as undeliverable after it was mailed to the participant, using the plan administrator's most recent mailing address in the records of the employer and plan administrator.

IRS Disclosures – A plan administrator must notify the participant in writing (including the use of electronic media), either separately or as part of the 402(f) notice, that absent an affirmative election by the participant, the distribution will be paid to an IRA. The notice must identify the trustee or issuer of the IRA. A plan administrator will not be treated as failing to satisfy this notice requirement (or sec. 402(f)) merely because the notice is returned as undeliverable by the US Postal Service after having been mailed to the participant using the participant's most recent mailing address in the records of the employer and plan administrator. We anticipate an updated model 402(f) notice in the near future.

Although the timing of a plan amendment may be delayed, plan sponsors should make decisions quickly because revised distribution packages and election forms (including a revised 402(f) notice) should be in place by the March 28 deadline. See attached checklist.

B. DOL Guidance

In March 2004, the Department of Labor ("DOL") proposed a safe harbor rule that would protect fiduciaries of the plans with mandatory cashout requirements from fiduciary liability under the Employee Retirement Income Security Act of 1974 ("ERISA") that may result from complying with the Code's mandatory automatic IRA provision. 69 Fed. Reg. 9900 (March 2, 2004). As a companion to the proposed rule, DOL issued a proposed class exemption for financial institutions that sponsor their own plans to allow them (or their affiliates) (i) to be IRA providers for mandatory distributions from their in-house plans, (ii) to select an investment product in which they (or their affiliates) have an interest, and (iii) to receive fees in connection with these services. 69 Fed. Reg. 9846 (March 2, 2004).

On September 28, 2004, DOL issued the much anticipated final regulation and adopted the class exemption, with some key modifications. 69 Fed. Reg. 58018, 69 Fed. Reg. 57964. The safe harbor rule will apply to any rollover of a mandatory distribution up to $5,000 made on or after March 28, 2005. DOL indicated that fiduciaries may rely in good faith on the regulation even prior to the effective date. The class exemption, however, cannot be relied upon prior to the effective date of March 28, 2005.

1. Final Rule

Under the DOL final regulation, a fiduciary is deemed to have satisfied his or her fiduciary duties under section 404(a) of ERISA – with respect to both the designation of an IRA provider and the initial investment choice for the automatic IRA – if the arrangement meets the following requirements:

Amount. The cashout amount (excluding prior rollover contributions) is more than $1,000 but does not exceed $5,000. DOL also extended the applicability of the safe harbor rule to mandatory distributions of $1,000 or less (not subject to the Code rules). 29 C.F.R. § 404a-2(d); See Rev. Rul. 2000-36, 2000-2 C.B. 140. The question whether an outstanding participant loan should be counted in determining the $5,000 threshold was referred to Treasury and IRS for consideration. As indicated above, a loan offset is not subject to the automatic rollover rules but, presumably, the loan balance is counted for determining if the cashout and automatic rollover limit has been reached.

Type of Account. The mandatory cashout must be directed to an IRA account/annuity under Code section 408(a) or 408(b).

Type of Investment. Investment must be limited to those products designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity and taking into account the extent to which charges can be assessed against the account (e.g., money market funds, interest-bearing savings accounts, certificates of deposits, and "stable value products"). The investment products must be offered by a regulated financial institution, such as a bank the deposits of which are insured by the Federal Deposit Insurance Corporation.

Permissible Fees and Expenses. The fees and expenses relating to the IRA may include set-up charges, maintenance fees, investment expenses, termination costs and surrender charges. In response to numerous negative comments, DOL dropped the proposed limitation that the fees and expenses charged to the IRA (other than set-up costs) could not exceed the income earned by that account. The only fee and expense limitation retained by the final rule is that fees and expenses must be comparable to the fees and expenses charged for comparable IRAs established for rollover distributions other than these mandatory cashouts.

Disclosure. Before the mandatory cashout, participants must be furnished with a summary plan description ("SPD") or a summary of material modifications ("SMM") that includes an explanation of the mandatory cashout process, including an explanation that the mandatory cashout will be invested in an investment product designed to preserve principal and provide a reasonable rate of return and liquidity, a statement explaining the allocation of fees and expenses, and the name, address and phone number of a plan contact who may provide further information on the cashout. Therefore, it appears that in order to rely on the safe harbor, plan sponsors should distribute a revised SPD or an SMM to all participants by March 28, 2005, without regard to the general timing rules for such disclosures.

Written Agreement With IRA Provider. The final rule adds an explicit requirement for a written agreement between the plan and the IRA provider on which the plan fiduciary may rely under the safe harbor regulation. The agreement must contain representations with respect to specific requirements of the safe harbor rule, including the type of investments for rolled-over funds and the attendant fees and expenses. DOL believes that such information is already being included in the documents currently utilized by the IRA providers, and that no special documents would have to be prepared for purposes of safe harbor, however, practice has indicated otherwise – many IRA providers have developed a special agreement to meet this requirement. (Also, prototype IRA documents will likely need to be revised to reflect the safe harbor limitations or at a minimum have the agreement override any contrary provisions.) Notably, the plan fiduciary is not required to monitor the provider's compliance with the agreement's representations beyond the point in time when the funds are rolled over into the account in accordance with the agreement. DOL confirmed that following the rollover, the participant will be treated as exercising control over the assets in the IRA account for purposes of ERISA section 404(c).

No Prohibited Transaction. The fiduciary's selection of an IRA and of an initial investment product must not result in a non-exempt prohibited transaction. 69 Fed. Reg. 58018 (Sept. 28, 2004).

2. Applicability of the Automatic Rollover Rule to Distributions of Missing Participants in Terminated Plans

In guidance issued by DOL two days after publishing the final DOL regulation, DOL stated that fiduciaries of terminated defined contribution (DC) plans could rely on the DOL safe harbor regulation in rolling over accounts of participants who are determined to be missing or otherwise fail to elect a method of distribution in connection with the plan termination. Field Assistance Bulletin No. 2004-02 (Sept. 30, 2004). Significantly, the safe harbor rule would protect such fiduciaries regardless of the amount involved in the mandatory rollover distribution for missing participants. However, in a footnote, the DOL explains that its guidance is limited to terminating defined contribution plans that do not provide for an annuity form of distribution and where the plan sponsor is not a member of a controlled group that contains another defined contribution plan for which the funds could be transferred. This limitation is necessary to comply with the Code because, except for that one exception, participant consent is required for distributions in excess of $5,000 prior to normal retirement age, which would prohibit an automatic rollover to a designated IRA of such amounts, even in the case of plan termination. Treas. Reg. § 1.411(a)-11(e)(1).

Plan sponsors of certain terminating DC plans who want to use the automatic rollover rules for missing participants should first amend their plan documents to reflect this intent and have this language covered by a favorable IRS determination letter prior to transferring such amounts.

3. <u>In-House Class Exemption</u>

With one exception, DOL adopted the proposed class exemption without substantial modification. 69 Fed. Reg. 57964 (Sept. 28, 2004). As with the safe harbor rule, DOL extended the applicability of the exemption to the mandatory cashouts of $1,000 or less. Unlike with the final safe harbor rule, the final class exemption does *not* eliminate the cap on the permissible amount of fees (other than set-up charges) to the income earned by the account. Accordingly, financial institutions that intend to rely on this exemption for cashing out participants from their in-house plans and placing them in the proprietary IRAs would need to ensure they comply with the income fee cap.

Finally, according to DOL, the class exemption would not be available to financial institutions that have not previously provided comparable IRA accounts because they would not meet the condition that the fees and expenses charged for the mandatory rollover accounts must be comparable to the fees and expenses charged for comparable IRAs established for reasons other the receipt of mandatory cashouts.

With respect to missing participants in in-house plans, unlike the safe harbor rule, the class exemption's protection would be limited to distributions of up to $5,000 (plus prior rollovers if the plan so provides).

C. Open Issues

Despite the helpful IRS and DOL guidance, there remain a number of issues that are still not fully addressed. For example:

- Post Age-62/Normal Retirement Age Distributions: If a plan's cashout and automatic rollover rules apply regardless of the age of the participant (which is not uncommon), technically, the safe harbor rule does not protect the post-age 62/normal retirement age cashouts. This is the case because the DOL regulations use the term mandatory distributions described in section 401(a)(31)(B) of the Code, which does not include distributions made after the later of age 62 or normal retirement age. See Notice 2005-5, Q&A-2.

- Timing of Automatic Rollovers: Although the IRS has indicated that plan sponsors have until December 31, 2005 to roll over 2005 cashouts, there is no general timeline for making direct rollovers to the default IRA because the 60-day period for indirect rollovers does not technically apply to direct rollovers. See Code § 402(c)(3). Presumably, the plan terms will control when the transfer must be made -- i.e., cashout as soon as administratively practicable following severance from employment.

- Automatic Rollover Valuation Date: What is the appropriate date to measure whether the automatic rollover rules are triggered and what happens if when the distribution is processed, the account/accrued benefit is slightly less than the $5,000 cashout limit, but when the check is cut to the participant in place of the IRA, the payment is slightly over the cashout limit? And vice versa.

- Puerto Rico Plans: Puerto Rico plans are subject to the Puerto Rico Internal Revenue Code, which does not include an automatic rollover provision. However, a number of Puerto Rico plans are dual qualified (i.e., meet the qualifications to be tax-favored plans in both the U.S. and Puerto Rico), which would mean that these plans would also need to comply with the automatic rollover rule (or otherwise avoid it). In addition, the rule is based on an individual retirement plan under the U.S. Code, which is different from a Puerto Rico IRA. Therefore, it is unclear whether a Puerto Rico IRA could be used and whether the DOL safe harbor would be satisfied by the use of such an IRA.

- Deemed IRAs: Although the IRS guidance expressly permits the use of deemed traditional IRAs for the automatic rollover rules, it is unclear whether the DOL safe harbor protection will continue to apply. The DOL regulations limit the IRA product to one that satisfies all the requirements of section 408(a), but deemed IRAs generally do not met the no commingling requirement. Moreover, even if the safe harbor applies, the final deemed IRA regulations indicate that there continues to be a fiduciary duty to monitor the deemed IRA assets, which conflicts with the safe harbor provisions. (Of course, these issues should not concern non-ERISA plans.)

Checklist For Automatic Rollover Compliance
Non-Governmental Plans

March 28, 2005 Deadline. By March 28, 2005 plan sponsors must:

__. Determine whether to retain $5,000 cashout or reduce it to $1,000 or less. Must be in operational compliance with this decision on and after March 28, 2005.

and

If elect to retain the $5,000 limit

Ideally, plan sponsors should take the following steps by March 28, 2005*:

___. SPD/SMM*: Distribute SPD or SMM to participants that describes the automatic rollover provisions.

___. § 402(f) Notice*: Revise 402(f) Notice to include the following sentence (or can be a separate written communication): Absent an affirmative election by the participant to elect a lump sum or rollover the distribution to an IRA or another eligible employer plan, a mandatory distribution that exceeds $1,000 will be paid to an individual retirement plan maintained by [insert IRA provider] and that the distribution may be transferred to another IRA.

___. Cashout Form*: Revise cashout form to reflect the default option of an automatic rollover for amounts over $1,000 (counting prior rollover contributions). It may be advisable to also explain (although not required) that in the event of the participant's death, the IRA beneficiary rules apply (not the beneficiary designated under the plan) to amounts automatically rolled over to the IRA.

___. Fiduciary Agreement*: Enter into a written agreement with an IRA provider that agrees to accept the mandatory distributions and certifies compliance with Code section 401(a)(31)(B) and the safe harbor rules under DOL Reg. § 2550.404a-2 (and, to the extent applicable, the in-house class exemption). Moreover, the agreement should provide that the terms of the IRA are overridden by the terms of the agreement to the extent necessary to comply with such Code and DOL provisions.

___. System Changes: Internal systems (or third party administrator's systems) should be updated to flag distributions subject to the automatic rollover provisions to prevent the system default provisions from issuing a check to the participant (less mandatory 20% withholding) without an affirmative election of a lump sum payment.

In addition, the automatic cashout provision should not apply to any portion of the cashout that represents minimum required distributions or a plan loan offset.

If elect to reduce cashout limit to $1,000 (or less)

___. Related Cashout Issues. Plan sponsors must also determine the following additional issues by March 28, 2005: (1) count rollover contributions in the cashout limit?, (2) limit $1,000 - $5,000 distributions to lump sums?, and (3) lower cashout limit for beneficiaries and alternate payees?

___. Cashout Form: Revise cashout form to reflect the new $1,000 (or less) cashout limit for distributions on and after March 28, 2005. Any cashouts still in process on 3/28/05 should comply with the new rules – therefore, amounts greater than $1,000 should not be involuntarily cashed out and a letter to the participant explaining this may be prudent.

___. Distribution Packages: All references to the $5,000 cashout provision should be changed to the new cashout limit. And if the plan sponsor elects to limit distributions between $1,000 - $5,000 to lump sums only, a new distribution form may be needed.

___. System Changes: Internal systems (or third party administrator's systems) should be updated to flag distributions subject to the new lower cashout limit, and if applicable, flag distributions from $1-5k for lump sum only option.

December 31, 2005 Deadline.

__. Plan Amendment. By December 31, 2005 (or if earlier, by the end of the plan year that includes March 28, 2005), plan sponsors (or another party with amendment authority) must amend the plan document to reflect the automatic rollover provisions or the lower cashout (and related changes described above).

___. Transfer Plan Assets to Designated IRA (if retained $5,000 cashout).

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* However, if procedures are not in place to transfer assets to an IRA provider by March 28, 2005, it is arguable that cashouts of more than $1,000 (and these related disclosures) may be delayed until later in the year, provided that disclosures are given prior to the time assets are transferred to the IRA, which is not later than December 31, 2005.

If a cashout form for a greater than $1,000 distribution was sent prior to March 28, 2005, but the cashout was still in process as of such date, a default lump sum payment (with no election) should not be made. Instead, a new distribution package should be mailed that describes the automatic rollover provision and wait another 30 days to roll over the amount to the IRA.