

Benefits

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MARCH 2005

Recently Issued Guidance On The Automatic Rollover Of Mandatory Qualified Retirement Plan Distributions

Action Required Prior To March 28, 2005

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The Department of Labor recently issued final "safe harbor" regulations relating to the automatic rollover of certain mandatory distributions from qualified retirement plans that contain a "cash out" feature. A "cash out" feature provides for an immediate distribution to a former employee of his or her vested accrued benefit under the plan when the benefit is below a certain threshold amount. The Internal Revenue Service also issued recent guidance in Notice 2005-5 and an IRS News Flash, dated February 16, 2005, that clarifies the automatic rollover rules. The following is a summary of the most salient features of these rules.

Background

Prior to the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), a qualified retirement plan was permitted to make an immediate "cash out" distribution to a participant who terminated employment with the company maintaining the plan without the participant's consent (or, if applicable, the spouse's consent) if the participant's vested accrued benefit did not exceed \$5,000.

However, EGTRRA amended the Internal Revenue Code of 1986 (the "Code"), by adding Code §401(a)(31)(B), requiring the plan administrator, absent distribution direction from the participant, to transfer the mandatory distribution to an individual retirement plan if the mandatory distribution amount is greater than \$1,000 but less than or equal to \$5,000. In addition, EGTRRA requires that the plan administrator notify the participant in writing (either separately or as part of a 402(f) notice) that the distribution may be transferred to another individual retirement plan without cost or penalty.

EGTRRA, however, provided that the automatic rollover provisions would not become effective until the Department of Labor issued final regulations which provide a safe harbor under which the designation of an institution to receive the mandatory distribution and the initial investment of funds (the "Automatic Rollover Transaction") would be deemed to satisfy ERISA's fiduciary responsibility requirements. The final regulations have now been issued and are effective for mandatory distributions made on or after March 28, 2005.

Summary of Department of Labor Regulations

The final safe harbor regulations set forth the following conditions that, if satisfied, will result in a plan fiduciary being deemed to have met ERISA's fiduciary responsibility requirements with respect to the Automatic Rollover Transaction:

Amount of Mandatory Distribution. The vested accrued benefit cannot exceed \$5,000 (excluding, if permitted by the plan's terms, rollover contributions and earnings thereon). Please note that even though the automatic rollover rules under Code §401(a)(31)(B) apply only to the vested accrued benefits that are greater than \$1,000 but less than or equal to \$5,000, the regulations extend the safe harbor to the automatic rollover of vested accrued benefits of any amount not in excess of \$5,000.

Rollover Distribution to an Individual Retirement Plan. The mandatory distribution must be rolled over to an individual retirement account or an individual retirement annuity.

Agreements with Individual Retirement Plan Providers. The plan fiduciary must enter into a written agreement with the individual retirement plan provider that specifically addresses the investment of rolled-over funds and the fees and expenses related to the individual retirement plan. If such an agreement is in place, once the amounts are rolled over, the plan fiduciary's ongoing responsibilities for the amounts rolled over ends.

Investment Products. Rolled-over amounts must be invested in an investment product designed to preserve principal and provide a reasonable rate of return. In addition, the investment product selected must seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product by the individual retirement plan. The investment products offered may range from bank deposits to mutual funds.

Fees and Expenses. Fees and expenses associated with the individual retirement plan must not exceed amounts charged by the individual retirement provider for comparable individual retirement plans that are not established for automatic rollovers.

Notice to Participants. Prior to an automatic rollover, participants must be furnished with a summary plan description or summary of material modifications that includes a description of the automatic rollover rules, the individual retirement plan provider, the investment product, the fees and expenses associated with the investment product, an explanation of how fees and expenses will be allocated, and the name and address of a contact person for further information.

Prohibited Transactions. The plan fiduciary may not engage in a prohibited transaction in connection with the selection of an individual retirement plan provider or investment product, unless such action is covered by a statutory or administrative exemption under Section 408(a) of ERISA. *Note: In an effort to provide relief from the prohibited transaction rules and, in connection with the issuance of the final safe harbor regulations, the Department of Labor issued a prohibited transaction class exemption with respect to the automatic rollover of certain mandatory "cash out" distributions.*

Summary of IRS Notice 2005-5

In addition to the Department of Labor's final safe harbor regulations, the IRS recently issued guidance on the automatic rollover rules. Notice 2005-5 clarifies certain areas affected by these rules, including:

- distributions that are subject to the rules (e.g., a plan offset loan is not subject to the rules),

- the application of the rules to governmental 457(b) plans, church plans and 403(b) arrangements,
- notification to participants regarding the rules,
- the establishment of an individual retirement plan with the provider, and
- the application of the rules to rollover contributions even though such contributions may not be included for purposes of calculating the \$5,000 threshold.

The guidance also sets forth a transition rule for 2005 which provides that a plan will not be treated as failing to operate in accordance with the automatic rollover rules if the processing of mandatory distributions for participants who fail to affirmatively elect direct payment or direct rollover for a mandatory distribution on or after March 28, 2005, is delayed due to a lack of sufficient administrative procedures, provided such mandatory distributions are made no later than December 31, 2005. Finally, the guidance provides a sample plan amendment that may be customized to amend a qualified retirement plan for compliance with the automatic rollover rules.

Alternative Strategies For Compliance

Despite the issuance of the automatic rollover safe harbor regulations, numerous employers remain concerned about their ability to comply with the fiduciary responsibility rules under ERISA with respect to the Automatic Rollover Transaction. Employers that have such continuing concerns may wish to implement one of the following alternative compliance strategies:

- Amend the qualified retirement plan to cease making any mandatory distributions.
- Amend the qualified retirement plan to lower the mandatory distribution dollar amount threshold from "\$5,000 or less" to "\$1,000 or less."

Even though either approach may result in the plan retaining a larger number of accounts for terminated participants, both approaches would eliminate the need for plan fiduciaries to implement the automatic rollover rules and would alleviate concerns about complying with ERISA's fiduciary responsibility rules with respect to automatic rollovers. Moreover, the cost to the plan associated with maintaining the accounts of such terminated participants could be minimized in light of a 2003 Department of Labor Field Assistance Bulletin, which provides that a plan may charge vested separated participant accounts a share of reasonable plan expenses, without regard to whether the accounts of active participants are charged such expenses and without regard to

whether the vested separated participants were afforded the option of withdrawing the funds from their accounts or the option to roll the funds over to another plan or individual retirement account.

What Should Employers Do?

An employer must take action prior to March 28, 2005 to implement, on an operational basis, either (i) the automatic rollover rules or (ii) one of the alternative compliance approaches described above. However, pursuant to Notice 2005-5 and subsequent guidance from the IRS and, except with respect to certain governmental and church plans, a good faith amendment reflecting the automatic rollover requirements or one of the alternative compliance approaches is not required to be made until the end of the first plan year ending on or after March 28, 2005.

For further assistance, please consult one of our attorneys in the Employee Benefits Practice Group.