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The Automatic Rollover Rules: A Practical Primer

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You have probably already heard about the new automatic rollover rules. With the March 28, 2005 compliance deadline fast approaching, we thought it would be helpful to answer some common questions about the automatic rollover requirements, including how to comply and the steps you might consider that eliminate the need to comply.

1. What are the automatic rollover rules?

The Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") added a new Section 401(a)(31)(B) to the Internal Revenue Code, which imposes an automatic rollover requirement on certain Mandatory Distributions from qualified plans. A Mandatory Distribution is generally a distribution of $5,000 or less that is made before the terminated participant's normal retirement age and without the participant's consent. Under the new rule, Mandatory Distributions in excess of $1,000 must be rolled over to an individual retirement account ("IRA"). Prior to this change, if a participant failed to make an affirmative election either to receive cash or make a rollover, plans could simply cash out the participant by issuing a check in the amount of the Mandatory Distribution. The automatic rollover requirement was added by Congress to address a concern that such non-elective cash-outs had the effect of significantly reducing retirement savings, especially where someone changed jobs frequently. The automatic rollover rules do not apply to distributions made after normal retirement age, on death or pursuant to a QDRO.

2. When do the new rules apply? Who do they apply to?

The rules generally apply to Mandatory Distributions in excess of $1,000 that are made on or after March 28, 2005. The rules apply to qualified plans and 403(b) plans of taxable and tax-exempt private sector employers. The rules also apply to retirement plans sponsored by governmental entities, including qualified plans, eligible section 457(b) plans, and 403(b) plans, but these governmental plans have until 2006 to comply. In the questions and answers that follow, governmental employers may disregard the March 28, 2005 date, but should keep in mind that they will need to modify the operation of their plans, and amend their plans, on, or soon after, January 1, 2006.

3. What options do you have in responding to the new rules?

You must take one of the following two basic approaches:

a. You can reduce the Mandatory Distribution amount limit to $1,000, which will eliminate any need to comply with the new rules. See question 4 below.

b. You can comply with the new rules. See question 5 below.

In either case, you can delay making your decision until later in the year, as long as you do not, in the interim, cash out a benefit of between $1,000.01 and $5,000 without a Participant's consent. If you do not adopt either approach, generally by December 31, 2005, you will be in violation of the law, and risk plan disqualification. (Note: December 31, 2005 is the applicable date for calendar year plans. If your plan year is not the same as the calendar year, you will have to be in compliance as of the last day of the plan year that includes March 28, 2005. This means that if you will have a plan year end between March 28, 2005 and December 31, 2005, you will have to be in compliance and have the plan amended before December 31, 2005.)

4. Can the plan be amended to eliminate the need to comply with the automatic rollover rules? What are the pros and cons? When does that have to be done?

Yes, the plan can be amended to reduce the limit for Mandatory Distributions from $5,000 to $1,000. If you do this, distributions of $1,000.01 to $5,000 will still be permitted, but will only be made pursuant to a participant's affirmative election. If you take this action, your plan will have no Mandatory Distributions in excess of $1,000, and therefore the new rules requiring an automatic rollover will be inapplicable.

The "pro" of this approach is that you will <u>not</u> need to complete the steps outlined in Question 5 below. However, you will still need to do the following:

a. Do not make any distribution, on or after March 28, 2005, that is in excess of $1,000 without the participant's consent.

b. Alert your third party administrator (TPA) of this change.

c. Amend the plan (generally by December 31, 2005).

d. Update the summary plan description (SPD) or provide a summary of material modifications (SMM) to indicate that amounts between $1,000.01 and $5,000 will no longer be paid out from the plan as Mandatory Distributions. This should be done as soon as practicable after you decide to reduce the Mandatory Distribution limit.

e. Update your distribution election forms to reflect that Mandatory Distributions in excess of $1,000.01 will no longer occur.

The "con" of this approach is that the plan may end up with small account balances for former employees. These individuals can become increasingly difficult to locate over time, resulting in administrative burdens down the road. In addition, some TPAs assess a per account charge, and these small accounts could therefore increase your expenses. In the case of a defined benefit plan, you will be charged a PBGC premium for each of these small benefits. Currently, the flat-rate PBGC premium is $19 per participant for a fully funded single employer plan.

5. What steps are needed to implement the new automatic rollover provision? What are the pros and cons?

If you have decided to implement the automatic rollover provision, there are a number of steps you need to take to comply with the requirements for making an automatic rollover:

a. Locate a vendor to provide the IRAs and enter into a written agreement with the vendor. (Your TPA most likely will either offer this service or be able to help you obtain it.) This agreement should be reviewed for compliance with the new fiduciary safe harbor rules announced by the Department of Labor in order to give you maximum fiduciary protection.

b. Beginning on March 28, 2005, provide a notice to any terminated participant who is scheduled to receive a Mandatory Distribution to indicate that an automatic rollover will occur absent his or her affirmative election to receive cash or to roll over the distribution. This can be a separate notice, or it can be made part of the 402(f) rollover notice that you already must provide. This notice will have to specifically describe the terms of the IRA that will receive the automatic rollover.

c. Update your distribution election forms to reflect the automatic rollover.

d. Update the summary plan description (SPD) or provide a summary of material modifications (SMM) to (i) explain the new automatic rollover rules generally, (ii) state that the funds will be invested in an investment product designed to preserve principal and ensure a reasonable rate of return, and (iii) identify the plan contact for vendor and fee information when an automatic rollover has occurred. The SPD or SMM should be distributed before you make your first automatic rollover on or after March 28, 2005.

e. Amend the plan to reflect the automatic rollover requirements (generally by December 31, 2005). The IRS has provided a sample plan amendment for this purpose.

The “pro” of this approach is that, by completing this one-time process, you eliminate any further responsibility for dealing with these small accounts. Once you pick a vendor who is in the automatic rollover business, sign a written agreement, and roll over the distribution, you have no further fiduciary responsibility regarding what happens to the rolled over account. Getting rid of these amounts will reduce your administrative burdens and possibly reduce plan fees. In the case of a defined benefit plan, an automatic rollover will eliminate the PBGC premium because the terminated participant’s benefit ceases being part of the Plan.

The “con” of implementing the automatic rollover provision is the initial hassle, in 2005, of establishing the new vendor relationship, and setting up the appropriate procedures. If you rarely make Mandatory Distributions in the first place (i.e. you always obtain the consent of the participant prior to making a distribution), you may not wish to go through this one-time process.

6. ***For how long can you delay making a decision or complying with the new rules?***

If you are not certain how you want to proceed, simply freeze any Mandatory Distributions between $1,000.01 and $5,000 that would otherwise be made on or after March 28, 2005. Before the end of 2005 (the deadline for plan years that use the calendar year), you will have to decide to either reduce the Mandatory Distribution limit to $1,000 (question 4 above) or comply with the new rules (question 5 above.) Keep in mind that unless you are a governmental employer, each of the action items listed in questions 4 and 5 generally needs to be completed in 2005. Therefore, it is probably not a good idea to delay your decision for too long. We suggest that clients make their decisions by September, 2005, to allow ample time to complete the necessary steps.

7. ***Can automatic rollovers be used for people you can't find?***

Yes, in fact, the automatic rollover provision presents a helpful way to handle a missing participant's account, if the balance does not exceed $5,000. Both the IRS and the DOL have cleared the way for the use of the automatic rollover where a participant either cannot be found or is unresponsive. For example, the notice of the automatic rollover can be mailed to the Participant's address on file and an IRA can be established using that address, even when the mailing is returned and the plan administrator does not have a more current address.

If you have any questions, please contact any one of us.

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