

MEMORANDUM

To: Firm Clients and Interested Persons

From: Darrell A. Lindman

Re: New IRS Rules Regarding Automatic Rollovers of Mandatory Distributions

Date: March 18, 2005

The New Automatic Rollover Requirements

Most qualified retirement plans contain a provision requiring that if a participant terminates employment at a time when the value of the participant's plan benefit is less than \$5,000, the participant's benefit will be automatically distributed to the participant in a single sum. (This is referred to as a "mandatory distribution.") This is a permitted exception to the general rule that a participant's plan benefit may not be distributed without the participant's consent prior to the later of age 62 or the plan's normal retirement age. A terminated participant who is to receive such a mandatory distribution may either receive the cash payment directly (subject to a 20 percent automatic withholding requirement) or roll over the mandatory distribution to an individual retirement account ("IRA") of his or her choice. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") added a provision to the Internal Revenue Code which will require all qualified retirement plans to automatically roll over to an IRA certain mandatory lump sum distributions that are greater than \$1,000 and less than or equal to \$5,000. EGTRRA will require the plan fiduciary (typically the plan sponsor) to establish an IRA for an affected participant and to roll over the participant's distribution into the IRA, unless the participant elects otherwise.

Under the new EGTRRA rules, a qualified plan may still make a mandatory distribution to a participant if the participant consents to receive the distribution. However, if the participant does not consent to receive the mandatory distribution and the qualified plan requires that a mandatory distribution be made, the plan fiduciary will have to roll over the participant's distribution to an IRA account for the participant. Again, this automatic rollover requirement applies only if the amount of the mandatory distribution is greater than \$1,000 and less than or equal to \$5,000.

Because of the numerous fiduciary issues associated with a plan sponsor choosing and establishing an IRA account on behalf of a participant, the new EGTRRA provision requiring automatic rollovers specified that it was to become effective only after the Department of Labor ("DOL") issued regulations on these requirements. The DOL issued these regulations in September 2004 with a specified effective date of March 28, 2005. The IRS issued its guidance on these requirements pursuant to Notice 2005-5, which was issued on December 28, 2004.

Under the DOL and IRS guidance, the new automatic rollover rules will apply to mandatory distributions occurring on and after March 28, 2005.

The new automatic rollover rules apply to mandatory distributions of small benefits from all plans that are qualified under Section 401(a) of the Internal Revenue Code, including defined benefit plans, 401(k) plans, profit sharing plans, money purchase pension plans, stock bonus plans and employee stock ownership plans. These new rules also apply to 403(b) plans and governmental 457(b) plans.

Plan sponsors will need to decide if they want to retain their plan's existing mandatory distribution provisions for accounts valued at \$5,000 or less. A plan sponsor could amend its plan to lower the threshold for mandatory distributions to \$1,000 (and therefore not be required to provide for automatic rollovers where the participant has not consented to receive the distribution), or the plan sponsor could amend its plan to remove the mandatory distribution provision. Regardless of what decision a plan sponsor makes, the Plan will have to be amended prior to the end of the first plan year ending on or after March 28, 2005 (December 31, 2005 for a plan whose plan year is the calendar year).

The DOL Safe Harbor Requirements

A plan fiduciary will be deemed to have satisfied his or her fiduciary responsibilities in choosing an IRA provider and the investments for automatic rollovers of mandatory distributions if the following five conditions are met:

1. The present value of the participant's vested benefit that is to be distributed can not be in excess of \$5,000.
2. The automatic distribution must be to an individual retirement plan (an IRA or an individual retirement annuity).
3. The plan sponsor and the IRA provider must enter into a written agreement which provides for each of the following:
 - A. The funds transferred to the IRA account must be invested in a product designed to preserve principal and provide a reasonable rate of return.
 - B. The investment product used must seek to maintain over the term of the investment the dollar value of the rolled over amount. A money market fund, interest bearing savings account or a certificate of deposit issued by a bank will generally meet this requirement.
 - C. The investment product must be offered by one of the following entities:
 - (1) A bank or savings association whose deposits are FDIC-insured;
 - (2) A credit union whose member accounts are insured;
 - (3) An insurance company whose products are protected by state law;

or

(4) An investment company registered under the Investment Company Act of 1940, such as a mutual fund.

D. The fees charged by the IRA provider must not be in excess of the fees charged by the IRA provider for comparable IRAs established for reasons other than rollovers.

E. The person whose plan account is rolled over to the IRA must have the contractual right to enforce the terms of the IRA agreement against the IRA provider.

4. Notification requirements.

Participants must be given a Summary Plan Description (“SPD”) or Summary of Material Modifications (“SMM”) describing the automatic rollover provisions of the Plan. These documents must contain the following specific information:

A. An explanation that the automatic rollover will be invested in an investment product designed to preserve principal and provide a reasonable rate of return;

B. A statement explaining whether the IRA fees will be paid out of the rolled over funds in the IRA account (this is specifically permitted), or whether the plan sponsor will pay any of these fees; and

C. The name, address and telephone number of a contact person for the plan for further information concerning these provisions.

These new rules also require that the plan administrator of the plan notify a participant in writing that if the participant does not elect to receive his or her mandatory distribution or to roll it over to an IRA or other eligible rollover plan elected by the participant, the distribution will be paid to an IRA account created by the employer under these new automatic rollover rules. If the notice is mailed and the Postal Service returns the notice as undeliverable, the plan sponsor will have satisfied the new automatic rollover rules, provided that the plan sponsor used the participant’s most recent mailing address on file. The notice can be a separate notice, or it can be included in the Section 402(f) rollover notice that is currently provided to participants who are scheduled to receive a lump sum distribution. The notice that is currently provided is usually called a “Special Tax Notice.” The Section 402(f) notice must be provided between 30 and 90 days before the participant’s distribution date.

5. The plan sponsor may not engage in a prohibited transaction in connection with the selection of an IRA provider or the investment products used in the IRA.

What should plan sponsors do, and when must they do it?

The first choice that plan sponsors need to make is to determine if they want their retirement plan to provide for mandatory distributions of small accounts or if they want to eliminate this provision from their plan to avoid the new administrative burdens associated with these automatic rollover rules. The IRS Notice issued in December 2005 provides that if a plan contains a mandatory distribution provision and the plan sponsor has not established administrative procedures to comply with the new automatic rollover rules by March 28, 2005, the plan sponsor may discontinue making mandatory distributions in those situations where the participant has failed to give his or her consent to the distribution. If the plan sponsor does this, however, it must establish the necessary administrative procedures by December 31, 2005, and any mandatory distributions that would otherwise have been made between March 28, 2005 and December 31, 2005 must be made by December 31, 2005. If the plan sponsor chooses not to eliminate the mandatory distribution provision from its plan pertaining to distributions in excess of \$1,000, it needs to find an IRA provider willing to accept the automatic rollovers from the plan. A written agreement will need to be entered into between the IRA provider and the plan sponsor. The plan sponsor will also need to amend its plan to include the new automatic rollover provisions. For this purpose, the IRS has provided a model amendment that can be added to the plan to incorporate these new rules. I want to repeat again that plan sponsors who want to retain a mandatory distribution provision in their retirement plan but who do not want to incur the administrative burdens of complying with the new automatic rollover rules may amend their plan's mandatory distribution provision to provide that mandatory distributions will only apply to account balances of \$1,000 or less, or they may amend the plan to remove the mandatory distribution provision. The necessary amendment must be made not later than the end of the first plan year ending on or after March 28, 2005. Plan sponsors will also need to amend their SPDs and prepare an SMM which includes the necessary disclosures required by the DOL and IRS regulations.

I would be pleased to assist you in bringing your plan(s) into compliance with these new automatic rollover rules. Please feel free to contact me at 377-0844. Thank you.

DAL/mlh