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Client Alert

A report for clients and friends of the firm

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Cashout Regulations on Automatic Rollovers of Mandatory Distributions Issued

The Department of Labor (the "DOL") has published final regulations that require the automatic rollover of certain mandatory cashout distributions from retirement plans to individual retirement accounts or individual retirement annuities (collectively, "IRAs"). The regulations apply to a broad range of retirement plans, including Internal Revenue Code Section 401(a) plans, 401(k) plans, 403(a) annuities, 403(b) plans and 457(b) governmental plans. The regulations, which establish a safe harbor for retirement plan fiduciaries to satisfy their responsibilities under the Employee Retirement Income Security Act of 1974 ("ERISA") for the rollover of certain mandatory distributions to IRAs, will require prompt action by sponsors of retirement plans with mandatory cashout provisions in order to ensure compliance with the qualification requirements of the Internal Revenue Code.

Background

Upon termination of employment of an individual who participates in a retirement plan, the Internal Revenue Code allows for the immediate distribution of a participant's vested accrued benefit without consent, if the present value of such vested accrued benefit does not exceed $5,000. This type of distribution is referred to as a mandatory or automatic distribution or cashout. A participant whose accrued benefit is cashed out may elect to rollover the distribution to another employer's qualified retirement plan or to an IRA. Previously, if a participant did not make a rollover election with regard to a mandatory distribution, the distribution would be made directly to the participant as a taxable distribution (or, in the case of a missing participant, held in the plan until the participant could be located or such other time as specified in the plan).

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) amended the Internal Revenue Code to provide that if a participant does not make an affirmative election, mandatory distributions from a retirement plan which exceed $1,000 must automatically be rolled over to an IRA established for the participant by the plan administrator. However, due to the fiduciary issues associated with picking an IRA provider and IRA investments, EGTRRA also provided that the new requirement would not be effective until the DOL issued safe harbor regulations. The newly-issued DOL regulations are effective March 28, 2005 and set forth the conditions required for a retirement plan fiduciary to be insulated from liability in connection with the rollover of a mandatory cashout distribution to an IRA.

Conditions

A fiduciary's responsibility under ERISA with respect to a mandatory rollover will end at the time funds are placed with an IRA provider and the fiduciary will have no duty to monitor the provider if the following conditions are satisfied:

Amount of Mandatory Distributions. The amount that may be rolled over to an IRA by automatic rollover may not exceed $5,000. Although EGTRRA does not require a plan to automatically roll over vested benefits of $1,000 or less, it may elect to do so, in which case the safe harbor relief would still apply to the distribution. In addition, if amounts rolled over to the distributing plan are disregarded for purposes of calculating a participant's nonforfeitable accrued benefit, the safe harbor applies to the automatic rollover of a mandatory distribution that includes such prior rollover contributions, even if it causes the total distribution to exceed $5,000.

IRA. The mandatory distribution must be rolled over to either a traditional individual retirement account or a traditional individual retirement annuity. The IRA trustee must either be a bank, insurance company or other provider approved by the Internal Revenue Service.

Written Agreement. The fiduciary must enter into a written agreement with the IRA provider that specifically addresses the investment of the rolled over funds and the fees and expenses that will be charged with respect to the IRA. The regulations clearly provide that the terms of this agreement must be enforceable by any participant on whose behalf the fiduciary makes the automatic rollover. The fiduciary's responsibility with respect to the rollover will end at the time the funds are placed with the IRA provider, and, after that time, it has no duty to monitor the provider's compliance with the agreement.

Investment Products. The rolled over funds must be invested in an investment product that is designed to preserve principal and provide a reasonable rate of return, whether or not guaranteed, while maintaining liquidity. The investment product must be offered by one of the following:

- a bank or savings association subject to the Federal Deposit Insurance Corporation;
- a credit union subject to insurance under the Federal Credit Union Act;
- an insurance company, whose products are protected by state guaranty associations; or
- an investment company registered under the Investment Company Act of 1940.

Some examples of safe harbor investment products explicitly approved by the regulations are money market funds maintained by registered investment companies, interest-bearing savings accounts, certificates of deposit of a bank or similar financial institution and "stable value products" issued by a regulated financial institution.

Fees and Expenses. Fees and expenses charged by the IRA provider may not exceed amounts charged by it for comparable IRAs established for other reasons.

Disclosure Requirements. Plan participants must be provided with a summary plan description (SPD) or a summary of material modifications (SMM) that explains (i) the nature of the investment product in which mandatory distributions will be invested, and (ii) how fees and expenses associated with the IRA will be allocated. The disclosure must also identify a plan contact for further information concerning the plan's automatic rollover procedures, IRA provider and the fees and expenses associated with the IRA.

No Prohibited Transaction. The fiduciary's selection of an IRA provider and the investment of rollover funds must not result in a prohibited transaction under ERISA. Simultaneous with the release of the final regulations, the DOL published a prohibited transaction class exemption that allows a financial institution to select itself or an affiliate to serve as an IRA provider for automatic rollovers from its own plan and to use its own investment products for the investment of automatic rollovers.

Patriot Act Implications. The regulations note that customer identification procedures of the USA Patriot Act (which, in the past, were thought to prevent financial institutions from opening accounts in the name of participants unless it performed certain identification and verification procedures) do not apply when the plan establishes an account and transfers funds in the name of a participant.

Required Action

The regulations are effective with respect to any mandatory distribution of more than $1,000 but $5,000 or less made on or after March 28, 2005. This gives plan sponsors less than six months to select a provider and bring their retirement plans into compliance with the conditions set forth above. The IRS has indicated that it will issue a model amendment that may be adopted by plans to comply with the new requirements. As an alternative to satisfying the safe harbor conditions, plan sponsors may consider amending their plans to eliminate mandatory distributions completely or to reduce the mandatory cashout threshold from $5,000 to $1,000. Because distribution election forms must typically be available to participants ninety days in advance of the distribution date, any amendment with respect to mandatory distributions should be adopted no later than December 28, 2004. Sponsors that cannot meet this deadline but do not wish to eliminate mandatory cashouts altogether could amend their plans to suspend their cashout provisions temporarily until such time as they can comply with the new regulations.

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