

# ADVISORY

## SULLIVAN & WORCESTER EMPLOYMENT & BENEFITS ADVISORY

### Plan Sponsors Must Now Comply With New Automatic Rollover Rules

Beginning on March 28, tax-qualified plans and Section 403(b) arrangements must comply with new Internal Revenue Code rules concerning automatic rollovers. (Government and church plans are afforded extended compliance deadlines.)

For several years now, qualified plans have been allowed to provide for the mandatory distribution following termination of accounts of participants that do not exceed \$5,000. The participant must be provided with a choice of receiving cash or making a direct rollover to an IRA or other employer plan. In the absence of an affirmative election by the participant, a plan may provide for a default distribution option--generally a cash distribution.

#### NEW AUTOMATIC ROLLOVER REQUIREMENT

Under the new law, if a plan provides for mandatory cashouts of amounts in excess of \$1,000, then the account of a participant who does not affirmatively elect between cash and a direct rollover must be rolled over by the plan administrator to an individual retirement account or individual retirement annuity (together, an individual retirement plan or "IRP") in the name of the participant.

The new law is not relevant in the case of a plan that does not provide for automatic cashouts of amounts in excess of \$1,000. For all other plans, two compliance choices are now presented.

*Eliminate Cashouts in Excess of \$1,000:* A plan can be amended to eliminate automatic cashouts of amounts in excess of \$1,000 (or all automatic cashouts, if desired). Such an amendment would need to be formally adopted by the end of the plan year in which March 28 occurs--that is, by December 31, 2005 in the case of a calendar year plan. Meanwhile, beginning March 28, 2005, automatic cashouts of amounts in excess of \$1,000 should cease.

*Establish Automatic Rollover Procedures:* Under this alternative, beginning on March 28, 2005 a plan may no longer automatically distribute cash to a participant who fails to elect either a cash distribution or a direct rollover. Instead, in the case of a participant whose account is at least \$1,000 (or less if the plan amendment so specifies) and does not exceed \$5,000 (excluding any rollover

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component that may exist) and who has received an appropriate distribution notice and tax notice and failed to indicate his or her preference, the plan administrator must roll over the account to an IRP established with a financial institution. For 2005, such a rollover need not take place until the end of the plan year that ends after March 28. The plan will need to be amended to provide for automatic rollovers no later than the end of the plan year in which March 28 occurs--that is, formal amendment by December 31, 2005 will be required for calendar year plans. (The IRS has supplied a sample amendment.)

The advantage of the automatic rollover alternative is that smaller account balances can continue to be swept out of the plan and, as discussed below, the plan administrator is relieved of on-going fiduciary responsibility with respect to such accounts.

As already indicated, the new rules apply to any balances that exceed \$1,000, including balances that exceed \$5,000 only because a rollover account is included. However, the rules do not apply to distributions made before the participant attains the later of age 62 or normal retirement age under the plan, nor do they apply to distributions to alternate payees under a qualified domestic relations order or distributions to beneficiaries of deceased participants.

Whichever alternative a plan administrator chooses, a new summary plan description ("SPD") or a summary of material modifications ("SMM") to the existing summary plan description will likely be necessary (either describing the new rules or explaining that the automatic cashout rules have changed). If the automatic rollover rules will be used, the updated SPD or SMM will need to be distributed prior to implementation of the new rules in order to satisfy the requirements for the fiduciary safe harbor described below.

### **FIDUCIARY SAFE HARBOR**

The Department of Labor has published final regulations that provide a safe harbor that assures that plan fiduciaries who comply with its rules will have complied with their fiduciary duties in connection with creating and funding automatic rollover accounts. (While the safe harbor is just

that, and other procedures are permissible, we expect virtually all plans that are subject to the automatic rollover rules of the Code will utilize the safe harbor provisions.) Under the safe harbor, a plan fiduciary must enter into a written agreement with a regulated financial institution concerning the establishment of IRPs to receive automatic rollover amounts. The IRPs must be funded with an investment product designed both to preserve principal of the amount and to provide a reasonable rate of return--such as a money market account or certificate of deposit. The IRP participant must have the right to enforce the terms of the agreement against the financial institution providing the product, and the details of the arrangement must be disclosed to plan participants.

Financial institutions offering such IRPs may not charge fees in excess of those they normally charge for the maintenance of IRA accounts. (A financial institution that offers such accounts for automatic rollovers from a qualified plan it sponsors for its own employees must not charge fees in excess of earnings.)

The fiduciary safe harbor afforded by the Department of Labor may also be relied upon for cashout distributions that do not exceed \$1,000, even though those distributions are not mandatorily subject to the new tax rule.

### **CONCLUSION**

Plan sponsors must now evaluate their options and decide how to administer automatic cashouts after the March 28 effective date. Initially it may be difficult to find a financial institution willing to offer IRPs for these automatic rollover purposes, since the amounts involved will typically be quite small. However, we perceive that the market is beginning to change and many of the larger service providers are about to offer this type of account.

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If you have any questions concerning automatic rollover rules, please do not hesitate to contact any of us.

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