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Re: Automatic Rollover of Cash-Out Distributions

Dear Clients and Other Friends:

Most tax-qualified retirement plans provide for the automatic, involuntary distribution of small benefits to terminating participants. Such distributions, commonly referred to as "cash-out" distributions, may be made only if the participant's nonforfeitable accrued benefit at the time of distribution does not exceed \$5,000.

Typically, cash-out distributions have been accomplished by simply issuing a check to the participant. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), however, added new rules requiring qualified plans¹ to automatically roll over cash-out distributions greater than \$1,000 to an individual retirement plan, unless the participant elects otherwise. In response to fiduciaries' concerns about potential liability for those required rollovers, Congress delayed the effective date of the automatic rollover rules until the Department of Labor prescribed safe harbors protecting the plan fiduciaries who choose the individual retirement plan provider and decide how the involuntary distribution will be invested.

Last week the Department of Labor issued final regulations creating the necessary safe harbor and triggering the rollover requirement. Those regulations go into effect on March 28, 2005. By that date, all tax-qualified plans that make involuntary distributions of small benefits will need to have made arrangements to make automatic rollovers and to satisfy the safe harbor rules if they want to use the safe harbor to avoid fiduciary liability.

The safe harbor rules are fairly simple:

- Rollovers must be made to an IRA, i.e., an individual retirement account or an individual retirement annuity. Any IRA provider may be used, so long as the selection does not result in a prohibited transaction. On the same date as the final regulations, the Labor Department issued a prohibited transaction class exemption that explicitly authorized fiduciaries to use themselves or an affiliate as the IRA provider, to invest automatic rollovers in their own (or their affiliates') qualifying investment products, and to receive

¹ The preamble to the regulations states that IRS and Treasury staff believe the automatic rollover rules apply to a broad range of retirement plans, including pension, profit sharing, and stock bonus plans subject to the qualification rules under Code §401(a), 401(k) plans, qualified annuity plans subject to Code §403(a), annuity contracts and custodial accounts subject to Code §403(b), and governmental plans subject to Code §457. Some of these plans may not be subject to ERISA (e.g., governmental plans and nonelecting church plans). Non-ERISA plans will not, directly at least, derive any benefit from the safe harbors, since the safe harbors apply only to ERISA-covered plans.

certain related fees, when the assets come from a plan maintained for employees of the fiduciary or an affiliate.²

- The fiduciary must enter into a written agreement with the IRA provider regarding the manner in which the mandatory distribution will be invested and the fees and expenses that will be charged. That agreement must be enforceable against the IRA provider by the participant whose benefit is being rolled over.
- The rolled-over funds must be invested in a product that:
 - preserves capital,
 - provides a reasonable rate of return consistent with liquidity, and
 - seeks to maintain, over the term of the investment, the dollar value originally invested.

Eligible investments include money market funds, savings accounts, certificates of deposit, and certain stable value products that have an adequate liquidity guarantee.

- The investment product must be offered by a state or federally regulated institution that is:
 - a bank or savings association with FDIC insured deposits,
 - a credit union with FCUA insured member accounts,
 - an insurance company whose products are protected by state guaranty associations, or
 - a registered investment company.
- Fees and expenses for the IRA and its investments, cannot exceed those charged by the IRA provider for comparable IRAs that do not receive mandatory rollovers.
- Participants must have been furnished a summary plan description (SPD) or summary of material modifications (SMM) that describes the plan's automatic rollover provisions including:
 - an explanation of the statutory criteria for selection of the investment product,
 - a statement of how fees and expenses will be allocated (i.e., whether they will be paid entirely by the IRA assets, or shared with the plan and/or plan sponsor),
 - the name, address and phone number of a plan contact for more information about automatic rollovers, the IRA provider and the fees and expenses under the IRA.

While the statute literally applies only to involuntary distributions in excess of \$1,000, the regulations provide that involuntary distributions of that amount or less that are rolled over subject to these same rules will also benefit from the safe harbor. The preamble to the regulations further indicates that fiduciaries who implement the safe harbor prior to its effective date can rely on it for protection, but the related prohibited transaction class exemption cannot be relied on before that date.

² Interestingly, the class exemption imposes a limitation on fees that was dropped from the regulations generally. Under the class exemption, not only must fees and expenses be comparable to those charged for IRAs that do not hold cash-out distributions, but they also cannot exceed the income earned by the IRA. The latter restriction appeared in the proposed safe harbor regulation but was dropped in the final version.

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Since plans do not have to provide cash-out distributions and existing cash-out rules may be removed from plans without violating the accrued benefit protections of Code §411(d), some sponsors may decide to avoid the automatic rollover rules by reducing their threshold amount to \$1,000 or less, or by eliminating cash-outs entirely. Any such amendments should be made before March 28, 2005.

Plans that retain their cash-out distributions of amounts over \$1,000 will likely need to be amended in order to incorporate the automatic rollover requirements. Under existing guidance regarding EGTRRA “good faith” amendments, such amendments should not be needed prior to the end of the plan year that includes March 28, 2005, and could be delayed further depending on the employer’s tax year. Since IRS has issued model amendments for other EGTRRA changes, it may decide to issue model amendments for the automatic rollover rules. Sponsors may want to delay plan amendments in anticipation of such guidance.

Plan fiduciaries have less time, though, to work out their rollover procedures and to prepare for the advance notice requirements imposed by the safe harbor regulations. Cash-out distributions made on or after March 28, 2005 will need to be made to a default IRA, absent a contrary instruction from the participant, and such rollovers processed on or after March 28, 2005 will not qualify for the safe harbor unless the participant previously received the required SMM or revised SPD. Moreover, advance notice requirements under the Internal Revenue Code will also need to be met before automatic rollover distributions are made. Tax notices provided pursuant to Code §402(f) will need to address automatic rollovers, and distributees will need to be given advance notice in writing, either separately or as part of the 402(f) tax notice, that any automatic rollover may later be transferred to another IRA. Since the current model tax notices do not address automatic rollovers, we expect IRS to revise those notices and possibly provide additional guidance regarding the information that must be provided and the procedures that must be used in connection with automatic rollovers. In order to be ready with rollover procedures and the necessary notices, the process of selecting an IRA provider and the appropriate investment product will need to begin soon.

If you would like our help in complying with these new rules, or in drafting a summary of material modifications or revisions of your summary plan description in order to satisfy the safe harbor’s notice requirements, or if you are an IRA provider and need help with the preparation of a model written agreement for the acceptance of automatic rollovers, please let us know.

Sincerely,

John Haine

JWH/hgn