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***HOW CAN I MISS YOU WHEN YOU WON'T GO AWAY?
NEW RULES COMPLICATE MANDATORY CASH-OUTS FROM RETIREMENT PLANS***

Under final regulations published on September 28, 2004, sponsors of qualified retirement plans who want to “cash-out” small accounts will have to jump through some additional hoops for distributions made on or after March 28, 2005. Sponsors should begin planning now to make sure that they have time to implement their decisions before the effective date.

Background

Although consent of the participant is normally required before a retirement plan can distribute retirement benefits before the participant’s normal retirement date, an exception exists where the present value of the participant’s vested benefit is \$5,000 or less. In this situation, the plan can distribute the entire benefit in a single lump sum without the participant’s consent, and the participant does not need to be given the option of leaving the money in the plan until the participant’s normal retirement date.

Although the plan can “force” a distribution, the participant must be given the choice of (1) receiving the distribution directly (and paying tax) or (2) rolling the distribution over to an eligible retirement plan or individual retirement account or annuity (“IRA”) (and deferring taxation on the distribution). If the distribution is not rolled over, not only must the participant pay income tax on the distribution, but in many cases the participant is also subject to a 10% “early” distribution tax. If the participant does not affirmatively elect a rollover, the current “default” distribution for most plans is a taxable distribution to the participant.

As part of the Economic Growth and Tax Relief Recovery Act of 2001 (“EGTRRA”), Congress changed the default distribution where the participant’s vested benefit is between \$1,001 and \$5,000. Unless the participant affirmatively elects a taxable distribution (or a rollover to an eligible retirement plan or account designated by the participant), EGTRRA requires the plan to automatically rollover the participant’s vested benefit to an IRA. In other words, under EGTRRA, the default distribution is a rollover to a sponsor-designated IRA rather than a taxable distribution to the participant.

The effective date of this EGTRRA provision was delayed until the Department of Labor could issue regulations establishing a “safe harbor” for fiduciaries who, because of EGTRRA, now must undertake the fiduciary acts of selecting an IRA provider and designating the investment vehicle for the rolled over funds. The Department of Labor published the regulations September 28, 2004, and designated an effective date of March 28, 2005.

Summary of Regulations

The regulations establish five conditions that must be satisfied for a plan fiduciary to qualify for the “safe harbor” from fiduciary liability. If the safe harbor is satisfied, the plan fiduciary is protected with respect to the selection of the IRA provider and the investment vehicles in which

the account is invested. Church and governmental plan sponsors should note that the safe harbor applies only to plans governed by ERISA. Also, plans are not required to comply with the safe harbor, but fiduciaries are not protected from liability if they do not incorporate each of the following five conditions into their default rollover procedures:

1. The present value of the vested accrued benefit is \$5,000 or less. (In the regulations, the Department extended the safe harbor protection to default rollovers of less than \$1,000 even though, under the law, plans can continue to use a taxable distribution as the default distribution form for these “very small” benefits.)
2. The rollover is made to a traditional IRA.
3. The fiduciary has entered into a written agreement with an IRA provider. The agreement must be enforceable by the participant. Generally, the agreement must provide that the rolled-over funds will be invested in an investment product designed to preserve principal and provide a reasonable rate of return (whether or not guaranteed) consistent with liquidity. The IRA provider must be a regulated financial institution. Fees must be comparable to fees charged by the IRA provider for comparable IRAs that are not the recipients of default rollovers.
4. The participant receives a summary plan description describing the default rollover provisions, including investment and cost information, and the name of a plan contact for further information.
5. The selection of the IRA provider and the investment funds cannot result in a “prohibited transaction.”

Action Steps for Plan Sponsors

If a plan contains a \$5,000 mandatory cash-out provision, the plan sponsor will have to take action promptly to comply with the March 28, 2005, effective date. A number of decisions will have to be made, including:

- Should we reduce the cash-out threshold to \$1,000? The default rollover issue can be avoided entirely by reducing the cash-out threshold to \$1,000. Plan sponsors will want to weigh the cost of keeping small accounts in the plan against the cost and administrative burdens of implementing the default rollover rules.
- If we keep the \$5,000 threshold, who should we choose as an IRA provider? Because these small accounts generally are not attractive to IRA providers, there is concern that the universe of willing IRA providers will be limited.
- What should we designate as the default investment? The fiduciary will want to make sure the default investment is one that falls within the safe harbor.

- What should we say to plan participants? A summary plan description (or summary of modifications) will have to be furnished to participants before fiduciaries can qualify for the safe harbor.

Lane Powell's Employee Benefits team is prepared to assist with this decision-making process and to implement the decisions once they are made.

For more information, please contact the Employee Benefits Practice Group at Lane Powell Spears Lubersky LLP:

(206) 223-7000 Seattle
(503) 778-2100 Portland
employeebenefits@lanepowell.com

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