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INVOLUNTARY CASH-OUT/ AUTOMATIC IRA ROLLOVERS

by

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A. Involuntary Cash-Out Rule/Automatic Rollovers.

1. A mandatory distribution is a distribution made to a participant without the participant's consent before he or she reaches the later of age 62 or normal retirement age. A plan may provide for a mandatory distribution of a participant's benefit only if the present value of the vested total accrued benefit does not exceed the \$5,000 cash-out limit. IRC §§411(a)(11), 417(e). EGTRRA amended IRC §401(a)(31)(B) to provide that mandatory distributions of more than \$1,000 from a qualified retirement plan to a plan participant (but not to a surviving spouse or alternate payee) must automatically be rolled over into an IRA unless the participant elects to have the distribution rolled over to another retirement plan or to take it in cash. The automatic rollover rules are effective March 28, 2005.
2. IRS Notice 2005-5 notes that the automatic rollover rules apply only to mandatory distributions. The rules do not apply to eligible rollover distributions made to a surviving spouse or a former spouse who is an alternate payee, nor do they apply to involuntary cash-outs made to a participant who has reached the later of age 62 or normal retirement age under the plan.
3. Under EGTRRA, the plan administrator must notify the participant in writing that the distribution may automatically be rolled over into an IRA. The IRS guidance clarifies that this information must be included in the section 402(f) tax notice that is provided to participants within 30 to 90 days of a distribution. If a participant receiving a mandatory distribution fails to elect a direct rollover or a cash payment, the plan administrator may execute the necessary documents to establish an individual retirement plan on the participant's behalf and select a financial institution.

Department of Labor final regulations establish a safe harbor for automatic rollovers. Information about the automatic rollover procedures must be provided in the distributing plan's summary plan description (SPD) or in a summary of material modifications (SMM). Such information must describe the investment product, indicate how fees and expenses will be allocated among the IRA, the distributing plan and the plan sponsor; and identify a plan contact. These disclosures must be made before the plan's first automatic rollover.

4. Compliance Alternatives.

There are three alternatives to complying with the automatic rollover rules:

- a. Continuing to provide mandatory distributions and implementing the automatic rollover rules;
 - b. Lowering the mandatory distribution limit from \$5,000 to \$1,000; or
 - c. Eliminating mandatory distributions altogether.
5. Plans subject to the direct rollover rules have until December 31, 2005 to establish administrative procedures for automatic rollovers and to process automatic rollovers for 2005. This operational compliance deadline does *not* vary based on the plan year. Special effective dates apply to governmental plans, church plans, and section 403(b) plans.

Plans must revise SPDs and the section 402(f) special tax notice to include information regarding the automatic rollover requirements. Plan sponsors must adopt a good-faith plan not later than the later of: (i) December 31, 2005, or (ii) if the employer's tax year and the plan year are the same, the due date of the employer's tax return (plus extensions) for the tax year ending after March 28, 2005. Notice 2005-5 contains IRS model language for the good-faith amendment.

As noted above, a plan sponsor may amend a plan to eliminate a provision that requires the plan to make mandatory single-sum distributions to participants or reduce the amount of the mandatory cash-out to \$1,000 and thereby avoid the application of the automatic rollover rules to its plan. Plans that adopt such changes may continue to provide an exception from the Qualified Joint and Surviving Annuity (QJSA) requirements for accrued benefits of \$5,000 or less.

6. Rollover IRA Investment Product Requirements.

The DOL Regulations provide that the investment product for the rollover IRA for involuntary distributions must comply with the following requirements:

- a. The IRA must be designed to preserve principal, provide a reasonable rate of return, be liquid and minimize risk;
- b. The IRA must seek to maintain, on an on-going basis, the original principal amount rolled over into the IRA;
- c. The IRA must be established with a bank, savings association, credit union, insurance company, or mutual fund provider;
- d. Fees and expenses charged shall not exceed the fees and expenses charged by the individual retirement plan provider for comparable individual retirement plans established for reasons other than automatic rollovers; and

- e. The participant for whom the automatic rollover is made must have the right to enforce the terms of the contractual agreement with regard to his or her funds.

7. Prohibited Transaction Exemptions for Certain Employers.

DOL Prohibited Transaction Exemption 2004-16 creates a class exemption for employers (such as a bank, insurance company, or mutual fund provider) that choose their own or an affiliate's investment product for the rollover IRA.

8. IRS Sample Amendment for Automatic Rollovers.

In the event of a mandatory distribution greater than \$1,000 in accordance with the provisions of section _____, if the participant does not elect to have such distribution paid directly to an eligible retirement plan specified by the participant in a direct rollover or to receive the distribution directly in accordance with section(s) _____, then the plan administrator will pay the distribution in a direct rollover to an individual retirement plan designated by the plan administrator.

9. Application of Automatic IRA Rollover Rules to Distributions From Terminated Plans.

- a. Department of Labor Field Advice Bulletin (FAB) 2004-02 is entitled: Fiduciary Duties and Missing Participants in terminated Defined Contribution Plans.
- b. The FAB provides that the circumstances giving rise to relief under the safe harbor regulations for involuntary IRA rollovers of amounts less than \$5,000 are similar to those confronting fiduciaries of terminated defined contribution plans.
- c. Therefore, the FAB states that rollovers to IRAs of amounts from terminated plans in accordance with the provisions of the safe harbor regulations will be deemed to be in satisfaction of the fiduciary duties for the Plan.
- d. Until the DOL issues final regulations on IRA rollovers of amounts from terminated plans, however, it may be difficult to get a bank or mutual fund to accept such rollover amounts.