

# PCS Compliance Alert

Spring 2005

## IRS Provides Automatic Rollover Guidance

This guidance affects sponsors of and participants in qualified plans that currently have an automatic cash-out provision, including multiemployer plans, state and local governmental plans, and non-electing church plans. It also affects governmental section 457(b) plans and 403(b) plans or programs that provide for automatic cash-outs. These rules do not apply to non-governmental section 457(b) plans.

### BACKGROUND AND SUMMARY

Qualified plans generally cannot distribute a benefit prior to normal retirement age without a participant's consent and many plans provide that no such involuntary distribution will be made prior to a participant's attainment of age 70-1/2. However, the law does permit a plan to provide for an automatic distribution or "cash-out" to a participant of amounts less than \$5,000. Many plans provide for these automatic cash-outs to avoid administering the small accounts of those no longer employed by the plan sponsor.

Although participants have the right to rollover the distribution to an IRA or another qualified plan, the common perception is that many if not most participants fail to rollover these relatively small amounts. This causes "leakage" in the system - that is, retirement savings are depleted through the distribution of small cash-outs from qualified plans. ***In order to help stem this leakage, as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), Congress enacted a requirement that involuntary cash-outs in excess of \$1,000 be mandatorily rolled over to an Individual Retirement Account ("IRA") unless the participant affirmatively elects otherwise.***

Specifically, EGTRRA made changes to require that certain mandatory distributions be automatically rolled over to an individual retirement account (IRA), unless the participant makes an election to take cash or make a different direct rollover. On September 28, 2004, the Department of Labor (DOL) issued final rules providing plan fiduciaries with a safe harbor for making decisions about default rollover IRA providers, as well as initial IRA investments, effective for mandatory distributions made on or after March 28, 2005. At that time, many tax-related questions regarding these rules remained unanswered.

On December 29, 2004, the IRS issued Notice 2005-5 to answer many of these questions. Highlights of this guidance include:

- Delayed effective dates for certain governmental and non-electing church plans;
- A grace period, until December 31, 2005, for processing mandatory distributions that are delayed due to a lack of administrative procedures including the failure to establish an IRA;
- Requirements for the notice that must be provided to plan participants regarding the default rollover IRA; and
- A sample plan amendment that may be used by qualified plan sponsors to reflect the automatic rollover rules.

### ACTION AND NEXT STEPS

PCS has updated our procedures, as well as our administrative and recordkeeping systems to accommodate the automatic rollover rules.

**As required by these new regulations, effective March 28, 2005, we will no longer make automatic cash-out distributions. Of course, participants will still be able to affirmatively elect to receive these distributions in cash or make direct rollovers to specified IRA providers or retirement plans.** Once all necessary information is received and updates are completed, distributions will be processed for those participants who have not made affirmative distribution elections.

Most qualified defined contribution plans will have to be amended to reflect the automatic rollover rules. In addition, most sponsors of qualified plans, section 457 plans, and 403(b) plans or programs with an automatic cash-out provision will have to select an automatic rollover IRA provider. PCS will work with you to ensure your plan is administered appropriately.

### OVERVIEW

In general, the automatic rollover rule applies to all mandatory distributions made on or after March 28, 2005, which exceed \$1,000, and are eligible rollover distributions that are subject to 20% federal income tax withholding. For these purposes, a mandatory distribution is a distribution that is made without the participant's consent, and before the participant reaches the later of age 62 or the plan's normal retirement age.

As a result, a participant who retires after reaching the later of age 62 or the plan's

normal retirement age is not subject to the automatic rollover requirement and the plan may require automatic cash-outs of benefits valued at \$5,000 or less. The automatic rollover rule also does not apply to small benefits payable to a surviving spouse or to an alternate payee under a Qualified Domestic Relations Order.

In addition, a plan loan offset amount that is an eligible rollover distribution is not subject to the automatic rollover rule. However, if a plan disregards rollover contributions in determining if the plan's cash-out threshold has been met, amounts attributable to rollover contributions must be rolled over to an IRA with all other amounts.

Some plan sponsors may want to avoid the automatic rollover rules entirely, and lower their plan's automatic cash-out threshold to \$1,000, thereby requiring participant consent for all distributions exceeding \$1,000. The IRS has clarified that plans that are subject to the spousal consent rules (e.g., defined benefit plans and money purchase pension plans) do not need to obtain spousal consent to distributions of benefits valued between \$1,000 and \$5,000, even if participant consent is required for these distributions.

**Plans may delay processing mandatory distributions during 2005, if sufficient administrative procedures for making automatic rollovers, including the establishment of rollover IRAs, are not in place. This type of delay will not be considered an operational defect, as long as the distributions are made by December 31, 2005.**

### Establishing IRAs

The plan sponsor may set up an IRA on behalf of a participant who does not make an election to take cash or make a different direct rollover. A plan sponsor has the authority to execute documents to establish the IRA, using the participant's most recent mailing address in the records of the employer and plan administrator. The trustee or issuer of the IRA must provide a disclosure statement to the participant and provide a revocation period. An automatic rollover may be made to an account under a group IRA arrangement established by an employer for its employees, or a "deemed IRA" that is part of the plan making the distribution.

At this point, the main problem is locating a provider that is willing to accept small IRA rollovers. When choosing a default IRA provider, you will need to ensure that the following requirements are met:

- First, the fees and expenses charged for the default IRA cannot exceed the fees and expenses charged by the provider for comparable IRAs not established as default IRAs. (This is a major improvement over the proposed regulations, which would have limited the fees to the IRA's investment earnings.)
- The default investment product offered under the IRA must seek to preserve the dollar value of the amount rolled into the IRA (for example, a money market, CD, or stable value type of investment), must provide a reasonable rate of return, and must be offered by a state or federally regulated financial institution.
- The document governing the IRA must provide rights that are enforceable by the participant without further involvement by the plan.
- All of these requirements need to be covered in a written agreement between the plan and the IRA provider.

### Notice Requirements

A plan administrator must notify a participant in writing that, unless the participant makes an affirmative election otherwise, the mandatory distribution will be paid to an IRA. The notice: May be provided as part of the 402(f) Rollover Distribution Notice, or separately. (Note: The IRS has not yet provided a revised Safe Harbor 402(f) Notice reflecting this information.)

- Must identify the IRA trustee or issuer; and
- May be sent via electronic media, as allowed for the distribution of 402(f) Notices.

The plan sponsor will be treated as meeting this requirement even if the notice is returned by the US Postal Service as undeliverable, if it was mailed to the participant's most recent mailing address in the employer's records. This notice is in addition to the updated summary plan description (SPD) or summary of material modifications (SMM) that must be provided to participants in a qualified plan once the plan is amended. PCS will provide this notice to participants.

### Effective Dates

Generally, the automatic rollover rules apply to mandatory distributions made on or after March 28, 2005. However, special effective dates apply to certain governmental and non-electing church plans:

- Governmental Plans (qualified, 457(b), and 403(b)): The automatic rollover rules are effective for all mandatory distributions made on or after the close of the first regular legislative session of the legislative body with authority to amend the plan that begins on or after January 1, 2006.
- Non-electing Church Plans where the authority to amend the plan is held by a church convention: The automatic rollover rules are effective for all mandatory distributions made on or after 60 days after the close of the earliest church convention that occurs on or after January 1, 2006.

### Plan Amendment Issues

Plans providing for mandatory distributions exceeding \$1,000 that do not already include an automatic rollover provision must adopt a good faith plan amendment by the end of the first plan year ending after March 28, 2005. For calendar year plans, this will be December 31, 2005.

However, non-calendar year plans may need to adopt the amendment much sooner. ***For example, plans with an April 1 plan year would need to adopt an amendment by March 31, 2005.*** The IRS has provided a sample amendment that may be adopted (or used as the basis of a good faith amendment) by individual plan sponsors or sponsors of prototype or volume submitter plans to address mandatory distributions greater than \$1,000. Employers that use PCS-sponsored plan documents should not take any action at this time to amend their documents to reflect the automatic rollover requirements, since such amendments could take their plans out of preapproved status. We will provide you with additional plan amendment information in the near future.

In fact, other plan design alternatives may also be available for plan sponsors. For example, plan sponsors may amend their plans to eliminate mandatory distributions without violating the anticutback rules. Additionally, plan sponsors may choose to lower their plan's cash-out threshold to \$1,000 and continue making cash distributions for those amounts under \$1,000. These alternatives may be attractive for plan sponsors that do not want to set up IRAs for participants who do not make affirmative elections. For employers that use PCS-sponsored plan documents, more information regarding plan design alternatives will be included in the additional plan amendment information mentioned above. Employers that do not use a PCS-sponsored document should consult their attorneys to ensure the plan document is updated in a timely manner, and then provide us a copy of the updated plan document so we can appropriately administer the plan.

### Coming Soon: The Roth 401(k)

EGTRRA also included a provision effective January 1, 2006 introducing the Roth 401(k) account (all of the same concepts apply to 403(b) plans). A Roth 401(k) is very much like a conventional 401(k) with at least two critical exceptions: (i) Unlike elective deferrals to a conventional 401(k) plan, the employee must include elective deferrals that are contributed to the plan in current income and (ii) if applicable conditions are met, the distributee (whether it be the employee or beneficiary) is not required to pay income tax at the time of receipt on either the elective deferrals amounts or on the earnings and appreciation attributable to those amounts. We anticipate that the Roth 401(k) will be very popular, particularly among highly compensated and younger employees. Unlike Roth IRAs, there is no income threshold beyond which participation is barred. The Roth IRA limit for 2006 is \$4,000 (\$5,000 for those entitled to make catch-up contributions) versus a Roth 401(k) limit of \$15,000 (\$20,000 for those entitled to make catch-up contributions). Assuming a reasonable rate of growth in invested assets over time and assuming a reasonable period of time to accumulate those assets, the tax free distribution has a far greater financial value for most savers than does the tax deduction at the front end on the deferral amount. Employers that use PCS-sponsored plan documents, more information regarding plan design alternatives will be forwarded later in 2005. Employers that do not use a PCS-sponsored document should consult their attorneys to ensure the plan document is updated in a timely manner, and then provide us a copy of the updated plan document so we can appropriately administer the plan.