TCRS 2004-07: Final Rules on Automatic Rollovers

Prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), if the present value of an accrued benefit from a qualified plan does not exceed $5,000, a plan may automatically distribute the benefit in cash, unless the participant or beneficiary makes an affirmative election to receive the distribution in another form of payment or elects a direct rollover to another qualified plan or individual retirement account (IRA).

EGTRRA changed this rule to require that absent an affirmative election by the participant or beneficiary to receive the distribution in cash or to roll over the distribution to an eligible retirement plan or IRA, the distribution must be directly transferred to an individual retirement plan (automatic rollover). **EGTRRA also provided that this new rule would not be effective until the Department of Labor (DOL) issues safe harbor regulations.**

On March 2, 2004, the DOL issued a notice containing a proposed safe harbor rule and proposed class exemption to address certain prohibited transactions which may result in connection with automatic rollovers.

On September 28, 2004, the DOL issued a notice containing final rules to be effective for distributions made on and after March 28, 2005.

Compliance with the final automatic rollover rules is mandatory. Under the final rules, if the conditions of the safe harbor automatic rollover are satisfied, plan fiduciaries will be protected from claims of breach of fiduciary duty under the Employee Retirement Income Security Act of 1974, as amended (ERISA), for the selection of an institution to provide the individual retirement plan and the selection of investments for such plans.

Conditions of Safe Harbor Automatic Rollover

- The amount of the distribution must not exceed $5,000. Under the proposed rules, the amount was limited to distributions between $1,001 - $5,000. The final rules extend the safe harbor to distributions of $1,000 or less.
- The distribution must be rolled over to an individual retirement plan (IRA account or annuity) of a state or federally regulated financial institution (bank, savings association, credit union, insurance company or an investment company registered under the Investment Company Act of 1940). The plan fiduciary must enter into a written agreement with the IRA provider. The agreement must address the investment of the rollover amounts, and the fees and expenses attendant to the IRA.
- Permitted investment products must be those designed to minimize risk, preserve principal while providing a reasonable rate of return, and maintain liquidity. The safe harbor rules were designed to favor retention of income and principal over growth. According to the DOL, examples of investments typically meeting these standards include money market funds, interest-bearing savings accounts, certificates of deposit and fully benefit-responsive stable value funds.
- Fees and expenses attendant to the safe harbor IRA must be reasonable and comparable to those charged by the IRA provider for other IRAs.
- Under the proposed rules, the DOL imposed limits on the fees and expenses that may be charged, e.g. fees and expenses were limited to the income earned on the safe harbor IRA investments. The DOL was later persuaded that a comparability standard is sufficient to prevent safe harbor IRAs from being assessed unreasonable fees, while avoiding the

imposition of financial disincentives for IRA providers to offer safe harbor IRAs. Therefore, the final rules do not require additional limits on fees and expenses.

- Participants must be provided with a Summary Plan Description (SPD) or a Summary of Material Modifications (SMM) that includes information concerning procedures for automatic rollovers, an explanation of the nature of the investment product, an explanation of the fees and expenses attendant to the safe harbor IRA, how the fees and expenses will be allocated (e.g. paid by the IRA holder, distributing plan or employer), and the names, addresses and phone numbers of the contacts for the plan and the IRA provider.

- The final rules condition safe harbor relief on the plan fiduciary not engaging in a prohibited transaction in selecting an IRA provider or the investment products, unless such actions are covered by a statutory administrative exemption issued under Section 408(a) of ERISA. On September 28, 2004, the DOL also published final rules dealing with a prohibited class exemption that permits a bank or other financial institution(s) that is a plan sponsor to select itself or an affiliate as the IRA provider for automatic rollovers from its own plan, select its own funds or investment products and receive fees for establishing and maintaining automatic rollover accounts. Absent this final class exemption, a bank or other financial institution could be required to direct automatic rollovers from its own plan for its own employees to another IRA provider, which could be a competitor.

Plan Sponsor/Service Provider List of Considerations:

- Plans providing for an automatic cash-out of small amounts (not more than $5000) must be reviewed and amended, as necessary, to provide for the automatic IRA rollover. It is anticipated that the IRS will be issuing a model amendment for this purpose.

- A Summary of Material Modifications (SMM) covering the automatic rollover has to be prepared for affected plans. It is not known at this time if the DOL will issue a model SMM.

- Distribution forms and Internal Revenue Code section 402(f) notices should be reviewed to ensure compliance with the EGTRRA notice requirements and these final rules.

- For plan sponsors who made the EGTRRA election to not include rollover amounts in determining if the $5,000 cash-out threshold has been satisfied, the amounts automatically rolled over could exceed $5,000.

More guidance is expected on the issues the DOL referred to the Treasury and the Internal Revenue Service, such as the application of the safe harbor to employer-sponsored plans in Puerto Rico and whether or not a participant loan would constitute a portion of the present value of the benefit subject to the safe harbor.

Another issue not addressed in the final rules relates to perceived conflicts with state laws on signature requirements and escheat, which the DOL said was beyond the scope of the final rules.