KELLEY DRYE

Client Advisory

Required Automatic Rollovers of Small Benefit Cash-Outs

November, 2004

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") revised the Internal Revenue Code to provide that qualified plans that provide for the immediate cash-out of benefits to a terminating employee when the benefit does not exceed $5,000, can no longer distribute such benefits to a participant who fails to make an affirmative election as to the distribution or rollover of such benefit. Rather, such small benefits are now required to be automatically rolled over to an IRA established by the employer to accept such mandatory rollovers. These automatic rollovers, however, raise issues under ERISA's fiduciary responsibility rules with respect to the employer's selection of an IRA provider and determination of investment vehicles for the IRAs. Final rules recently issued by the U.S. Department of Labor ("DOL") provide a safe harbor that employers can rely on to ensure compliance with the new automatic rollover rules and ERISA's fiduciary requirements.

As a result of the new rules, all employers whose Plans provide for mandatory cash-outs of benefits not exceeding $5,000, will need to provide for automatic rollovers to IRAs no later than March 28, 2005.

In order to rely on the safe harbor provisions of the new DOL rules, affected employers will need to take all of the following actions no later than March 28, 2005:

- Adopt procedures for automatically transferring small benefits to an IRA meeting the requirements of the new rules in cases where the participant has not elected to make a direct rollover or to receive payment of the benefit directly.

- Locate appropriate IRA sponsor(s) to accept required automatic rollover distributions, determine appropriate investment vehicles for the IRAs, and review and sign the necessary written agreements with the IRA sponsor(s) to assure compliance with the new DOL rules.

- Prepare and distribute revised summary plan descriptions or summaries of material modifications notifying participants of the automatic rollover procedures.

- Prepare a form of individual notice or a revised "Section 402(f)" notice advising recipients of eligible rollover amounts of the implications of failing to affirmatively elect whether a small benefit shall be distributed or rolled over to an IRA or another qualified plan.

- Plan amendments will also need to be adopted to conform Plans' terms to the new rules, although the written amendments generally do not need to be finalized by March 28, 2005.

To satisfy the safe harbor under the new rules, the following conditions must all be satisfied:

1. The amount of the distributable benefit cannot exceed $5,000. Whether or not this amount needs to include any outstanding loans to the participant from the Plan, needs to be clarified in future IRS guidance.

2. The IRA must be a qualified one under the provisions of the tax code. In addition, there must be a written agreement between the employer and the IRA provider that expressly addresses investments and fees and expenses under the IRA. This agreement must also be enforceable by the participant. The new rules clarify that the employer may rely on the written commitments of the IRA provider in the agreement, and therefore has no obligation to monitor the IRA on an ongoing basis.

3. Investments under the IRA must be designed to preserve principal and provide a reasonable rate of return consistent with liquidity. The investments must be offered by a bank or savings institution, a credit union, an insurance company, or a registered investment company. Such investments would typically include money market funds, interest-bearing savings accounts, certificates of deposit, or "stable value products." It is not necessary that the IRA provider be the same entity as the investment entity. Fees and expenses of the IRA must be comparable to those charged for IRAs holding rolled over assets that were not automatically rolled over.

4. The new rules require that, in addition to the individual notice EGTRRA requires Plans to provide participants regarding the eligibility of benefit distributions for rollover, the employer must also provide participants with a summary plan description or summary of material modification that includes an explanation of the automatic rollover process, as well as the rate of the investment product and an explanation of how the expenses and fees will be allocated. Participants must also be provided with the name or title and address and phone number of a Plan contact for any questions they have regarding the administration of automatic rollovers.

5. Finally, the employer's selection of an IRA provider and investment options may not otherwise constitute a prohibited transaction under ERISA or the Code. (Simultaneous with issuing the new rules, the DOL also issued a class exemption for prohibited transactions resulting from an IRA provider's designating itself as the IRA sponsor or investment vehicle. Please let us know if you would like further information on this new class exemption.)

We note that it is not clear how many potential IRA sponsors will be offering IRAs that will meet the requirements of the new DOL rules. If it turns out to be the case that such IRAs are not readily available, employers will need to consider whether their small benefit cash-out provisions should instead be deleted from their Plans entirely (an option that is available to employers in any event). Alternatively, employers could also elect to revise their Plans to provide for small benefit cash-outs only if the value of the benefit is under $1,000 (these benefits are not required by EGTRRA to be automatically rolled over).

If you would like assistance in reviewing and revising your Plans' documents as necessary for the new automatic rollover requirements, or in taking the actions outlined above in order to rely on the new DOL safe harbor rules, please contact:

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