

This Alert follows up on new distribution rules for qualified plans. Our October Alert described that involuntary distributions in excess of \$1,000 must be rolled over to an individual retirement account (“IRA”) when a terminated participant fails to elect a distribution and summarized the Department of Labor (“DOL”) final regulations providing a safe harbor for plan sponsors. The mandatory rollover rules are effective for qualified plan distributions beginning March 28, 2005. IRS Notice 2005-5 was recently issued and provides IRS guidance on implementing the automatic rollover rules.

The Internal Revenue Code (“Code”) allows qualified plans to distribute small benefits of \$5,000 or less without the consent of the participant. The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) amended these rules to require that distributions of \$1,001-\$5,000 made without participant consent be automatically rolled over to an IRA. Final guidance issued by the DOL in September set March 28, 2005 as the deadline for compliance. The IRS recently issued IRS Notice 2005-5 clarifying compliance requirements.

**DOL Guidance.** The DOL final regulations provide plan sponsors with a safe harbor for satisfying fiduciary duties under the Employee Retirement Income Security Act of 1974 (“ERISA”). Plan sponsors that comply with the DOL safe harbor are deemed to satisfy their ERISA fiduciary responsibilities with respect to the selection of the IRA provider and investments. Further, the individual for whom the rollover is made is no longer considered a plan participant, and is treated as the IRA owner from the rollover date. See our October Alert for a summary of the DOL safe harbor conditions.

**IRS Guidance.** The IRS guidance addresses plan amendments and prospective compliance with the automatic rollover rules.

**Plans Covered.** The IRS guidance makes it clear that in addition to plans qualified under Section 401(a) of the Code, governmental plans, non-

electing church plans, Section 457(b) plans of governments (but not those of tax-exempt organizations) as well as Section 403(b) plans are all subject to the mandatory rollover rules. Note, however, that the DOL safe harbor covers only plans subject to ERISA fiduciary standards.

**Mandatory Distributions.** The IRS provided further clarification as to what types of distributions are covered by the automatic rollover rules. Any involuntary distributions in excess of \$1,000 are required to be rolled over to an IRA. A mandatory distribution is defined as one made without the participant’s consent before the later of age 62 or normal retirement age under the plan.

If the plan excludes rollover contributions previously made to the plan and earnings thereon from the valuation of a participant’s account for cashout purposes, involuntary distributions of amounts in excess of \$5,000 will also be required to be rolled over to an IRA under the automatic rollover rules. The DOL safe harbor extends to distributions in excess of \$5,000 for these types of distributions.

The IRS offered examples of distributions *not* subject to the mandatory distribution rules, including:

1. Distributions to a surviving spouse or to an alternate payee pursuant to a qualified domestic relations order; and

2. Deemed distributions following a participant's default on a plan loan.

**Anti-Cutback Issues.** As mentioned in our October Alert, some plan sponsors may want to consider eliminating the involuntary cashout of benefits in excess of \$1,000 to avoid the automatic rollover requirements and the additional administrative expenses associated with these requirements. The IRS guidance makes it clear that an elimination of such cashout distributions will not violate the anti-cutback rules.

Defined benefit and other plans subject to the joint and survivor annuity requirements may offer voluntary distributions of amounts less than \$5,000 without having to comply with the spousal consent rules. However, until further IRS guidance is issued, the most conservative view is that such distributions must comply with all other annuity distribution rules, including offering an immediate annuity, along with any applicable relative value disclosure as may be required.

Plan sponsors need to weigh the administrative savings against the ongoing expense of maintaining these benefits in the plan, including administrative fees and, for defined benefit plans, premiums payable to the Pension Benefit Guaranty Corporation. Under DOL guidance on plan fees, it may be possible to pass on administrative expenses to terminated participants with small account balances.

**IRS Grace Period.** The IRS guidance does not change the compliance deadline of March 28, 2005. However, it does provide plan sponsors with a grace period during which a plan that contains involuntary cashout provisions may suspend such distributions until automatic rollover procedures can be established with an IRA provider. If all such cashout distributions are made on or before December 31, 2005, the plan will not be deemed to violate either the automatic rollover rules or its own terms.

Government and non-electing church plans may have until some time in 2006 to comply with the automatic rollover rules in operation and to amend the plan to allow for legislative or church

convention (respectively) bodies to assemble if such bodies are necessary to amend the plans.

**Plan Amendment Deadline.** For plans that have and will continue to have involuntary cashout distribution provisions, the IRS clarified that plans must be amended to reflect the automatic rollover requirements no later than the end of the first plan year ending on or after March 28, 2005. For calendar year plans, the amendment deadline is December 31, 2005, but the deadline is earlier for many fiscal year plans.

The IRS guidance includes model language for amending plans to comply which reads:

“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.”

No model amendment language is provided for plans to eliminate or reduce involuntary cashout distributions, but such amendments should be adopted on or before March 28, 2005 to avoid having to comply with the automatic rollover requirements.

**Participant Notice.** The IRS confirms the plan sponsor requirement to provide participants with notice of the automatic rollover rules and makes it clear that delivery of a notice to the most recent address available to the plan and the employer is sufficient in satisfying the notice requirements. In addition to including these rules in the summary plan description or summary of material modification, a sponsor must provide a participant with written notice that without the participant's affirmative distribution election, his benefits will be rolled over to an IRA. This notice may be included

in the special tax notice required under Section 402(f) of the Code or in a separate notice provided to participants with distribution materials.

**IRA Provider Guidance.** The IRA account can be established by the plan in the name of the participant with the last known address available to the plan and the employer. The IRA provider, in accordance with ordinary IRA rules, must provide a notice to the individual regarding cancellation rights. If such notice is returned as non-deliverable, the IRS makes it clear the IRA provider will have satisfied its disclosure obligation by using the last known address.

The IRS guidance provides that automatic rollover distributions may be made to deemed IRAs that have been included in an employer's qualified plan.

**Action.** Sponsors with involuntary cashout terms in the plans should finalize all pending cashout distributions immediately before the mandatory rollover rules are effective on March 28, 2005. Qualified retirement plans must be amended and summary plan descriptions and distribution forms must be updated to reflect the final automatic rollover rules. Now that we have IRS guidance and a model amendment, we can begin amending plans

to comply with these requirements. Although an extension is available for sponsors who are not prepared to make automatic rollovers beginning March 28, 2005 by simply holding such distributions until the procedures can be put in place, such distributions must be made before the end of the year. Therefore, plan sponsors should begin the process of selecting an IRA provider or providers and the investment vehicles for the IRA proceeds and update administrative practices for mandatory rollovers for distributions on and after March 28, 2005 or as soon as practicable thereafter. No cashout distributions should be made after March 28<sup>th</sup> until such procedures are in place.

For sponsors wishing to eliminate cashout distributions in excess of \$1,000 to avoid the automatic rollover rules, a plan amendment should be adopted before March 28, 2005. Participants must be informed of the change through a summary of material modification or updated summary plan description, and the administrative forms and processes of the plan will need to be updated to reflect the new distribution provisions.

Please contact the Kirkland & Ellis LLP employee benefits attorney with whom you normally work, or any of the following for assistance with compliance with this important change in the law.

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