TRISTAR PENSION CONSULTING

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DOL Provides Guidance for Automatic Rollovers & Lost Participants

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Retaining account balances for terminated participants in a qualified retirement plan often increases the plan's administration expenses and fiduciary responsibility. Therefore, many plans include what is known as a "mandatory distribution" or "cash-out" provision to force the distribution of small account balances to terminated participants who fail or refuse to make an election either to receive the distribution in cash or roll it over to an Individual Retirement Account (IRA) or another qualified plan.

In order to preserve retirement savings for participants, effective March 28, 2005, new Department of Labor (DOL) regulations require that mandatory distributions between $1,000 and $5,000 be rolled over to an IRA on behalf of the participant rather than distributed in cash. These rules will also provide a means of rolling over small account balances for participants that cannot be located. The DOL has also extended reliance on these rules to lost participants in a terminating defined contribution plan.

This newsletter summarizes the new automatic rollover procedures and how they will ease the problem of making distributions to certain participants who cannot be found or refuse to make an election.

BACKGROUND

One of the provisions included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) is the requirement that plans providing for mandatory distributions must automatically roll over the distribution to an IRA on behalf of the participant, unless the participant affirmatively elects to receive the distribution in cash. This requirement is applicable if the vested account balance is between $1,000 and $5,000.

These rules were not to become effective until the DOL drafted safe harbor provisions that would protect plan fiduciaries from liability. On September 28, 2004 the DOL issued final regulations outlining the safe harbor rules which apply to mandatory distributions made on or after March 28, 2005.

SAFE HARBOR REQUIREMENTS

Complying with the safe harbor requirements provides fiduciary protection for both the selection of an IRA provider and the investment of the funds. The safe harbor relief is contingent upon the plan fiduciary satisfying the following conditions:

ROLLOVER AMOUNT: An automatic rollover is required for mandatory distributions that are $5,000 or less but more than $1,000. The amount is determined as of the date the distribution is to be made. If the plan disregards amounts that the participant previously rolled over to the plan in determining whether the cash-out limit has been exceeded, it may also disregard these rollover contributions for automatic rollover purposes. If the plan so elects, the automatic rollover rules may also be applied to distributions of less than $1,000.

INDIVIDUAL RETIREMENT PLAN: The rollover must be made to a traditional IRA (not a Roth IRA) or an individual retirement annuity offered by a bank, insurance company or other financial institution.

WRITTEN AGREEMENT: The plan fiduciary must enter into a written agreement with the IRA provider that addresses, among other things, the investment of the rollover funds and the fees and expenses to be charged to the account. One or more IRA providers may be selected. The plan fiduciary may rely on the IRA provider's commitments set forth in the agreement and is not required to monitor the IRA provider's compliance with the terms of the agreement once the rollover has occurred.

PERMISSIBLE INVESTMENTS: The rollover funds must be invested in a vehicle "designed to preserve principal, and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity," such as money market funds, interest-bearing savings accounts, certificates of deposit or other "stable value products" offered by a bank, savings association, credit union, insurance company or mutual fund.

FEES AND EXPENSES: The fees assessed against the IRA cannot exceed the amounts charged by the IRA provider for comparable IRAs established for rollover distributions that are not automatic rollovers.

NOTICE TO PARTICIPANTS: All participants are required to receive notification of the automatic rollover provisions. This information must be included in the plan's Summary Plan Description (SPD) or a Summary of Material Modifications (SMM).

PROHIBITED TRANSACTIONS: The fiduciary may not engage in a prohibited transaction, such as a plan fiduciary receiving consideration from a financial institution in exchange for selecting that financial institution as the IRA provider. A class exemption permits a bank or other financial institution to select itself to receive automatic rollovers from its own qualified plan and utilize its own funds or investment products.

If the automatic rollover safe harbor requirements have been satisfied, the plan sponsor's fiduciary responsibilities end immediately upon the transfer of the participant's benefit to the IRA, and the distributed amount ceases to be a plan asset.

LOST PARTICIPANTS

In these times of high employee turnover, many retirement plans find themselves owing benefits to former employees whose whereabouts are unknown. This can be troublesome for ongoing plans since, in many cases, the administrative costs are high related to the participants' account balances. If the plan permits mandatory distributions and the distribution is $5,000 or less, the new automatic rollover procedures provide a method of distributing the vested account balance from the plan (mandatory distributions from an ongoing plan are not permitted if the vested balance exceeds $5,000).

WELCOME RELIEF FOR TERMINATING DEFINED CONTRIBUTION PLANS

A terminated defined contribution plan is required to distribute all plan assets as soon as administratively feasible after the date of plan termination. Participants are required to be notified of the plan termination and given a choice of receiving a distribution or having it directly rolled over to an IRA or another qualified plan. When participants are lost or do not respond to written notices, plan administrators often are faced with an array of fiduciary issues and are unable to effectively wind-up the plan's financial affairs.

Recognizing this problem, the DOL released Field Assistance Bulletin 2004-02 on September 30, 2004 outlining the fiduciary obligations for a terminated defined contribution plan, including mandatory search methods for locating a missing participant and steps for distributing an account balance when efforts to locate the missing participant fail. The DOL guidance for terminated defined contribution plans is effective immediately.

MANDATORY SEARCH METHODS

The DOL requires that every plan must employ the following search methods regardless of the size of the missing participant's account balance. The plan should retain documentation to prove that attempts to contact the participant were unsuccessful. Reasonable expenses incurred attempting to locate missing participants may be charged to the participant's account.

USE CERTIFIED MAIL: Sending certified mail to the participant's last known address can easily ascertain whether the participant can be located in order to distribute benefits.

CHECK RELATED PLAN RECORDS: Determine whether the employer's records or the records of another plan maintained by the employer, such as a group health plan, has a more current address.

CHECK WITH DESIGNATED PLAN BENEFICIARY: Attempt to identify and contact any individual that the missing participant has designated as a beneficiary.

USE A LETTER-FORWARDING SERVICE: Use either the IRS or the Social Security Administration (SSA) letter-forwarding program in an attempt to locate missing participants. A Social Security number is required to use these programs. In general, both the IRS and SSA search their records for the most recent address of the participant and forward a letter from the plan fiduciary to the participant. The IRS and SSA cannot provide the plan with any information concerning the results of their efforts. Hopefully, the letter from the plan will cause the participant to contact the plan directly.

OTHER SEARCH OPTIONS

If none of the four mandatory search methods is successful in locating the participant, the plan fiduciary needs to consider whether, under the facts and circumstances, it would be prudent to use other methods, such as Internet search tools, commercial locator services and credit reporting agencies. If the cost of using these services will be charged to the participant's account, the plan fiduciary will need to consider the size of the participant's account balance in relation to the fees that would be incurred when deciding whether to use any of these alternatives.

DISTRIBUTION OPTIONS

If the fiduciary is unable to obtain a participant's election concerning the distribution of benefits or a prudent search does not locate a missing participant, the plan may proceed with the distribution of the participant's account balance. The preferred method is to roll the participant's account balance into an IRA, and fiduciaries may rely on the automatic rollover safe harbor rules described above. In general, if all of the safe harbor rules are satisfied, the amount rolled over may exceed $5,000, unless the plan offers an annuity option or the employer, or a related company, sponsors another defined contribution plan.

If a plan offers an annuity option, such as required in a money purchase pension plan, distributions in excess of $5,000 must be in the form of an annuity contract or irrevocable insurance commitment. If the employer maintains another defined contribution plan (other than an ESOP), accounts of missing participants are required to be transferred to the other plan.

If the plan fiduciary is unable to locate an IRA provider willing to accept the rollover distribution on behalf of the missing participant, e.g., because of a very small account balance, two alternative distribution methods are available. The missing participant's account balance may be transferred to either a federally-insured interest-bearing bank account in the name of the participant or to state unclaimed property funds in the state of the missing participant's last known address. Both of these methods will result in immediate tax liability for the participant.

CONCLUSION

Plans that provide for mandatory distributions will need to begin making automatic rollovers effective March 28, 2005. The delayed effective date provides time for amending the plan document, notifying participants, determining how rollovers will be invested and selecting an IRA provider. A plan that does not currently provide for mandatory distributions of more than $1,000 is not subject to the new rules and does not need to take any action.

Plan fiduciaries must make reasonable efforts to locate lost participants to fulfill their obligations under ERISA. The automatic rollover safe harbor rules provide a solution for dealing with lost participant account balances of $5,000 or less. These rules also provide welcome relief for terminating defined contribution plans.

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