

Employee Relations

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Stopping Pension Leaks: New Rules Requiring Default IRA Rollovers Go Into Effect In 2005

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One of the primary concerns of pension policymakers has been the tendency of plan participants to spend their retirement savings as soon as such funds can be distributed. With a mobile workforce, plan distributions can occur well before retirement age, because employees who change jobs often have the option of receiving their retirement plan accounts at termination. The government wants to encourage those who are receiving pension distributions and can otherwise afford to do so to continue to save these funds for retirement, and so enjoy the miracle of compound interest rather than the pleasures of a boat, car, or high-definition television. Because this battle is a difficult one to win in our consumer-oriented world, policymakers use a variety of methods to encourage plan participants to preserve their retirement benefits until they reach retirement age. For example, although it does not seem to stop the popularity of lump sum distributions, the law requires use of annuities as the automatic form of benefit in defined benefit plans (absent an election), and imposes a 20 percent withholding tax on lump sums from all plans that are not rolled over.

The most recent actions by the policymakers occurred in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and took two forms. First, Congress authorized the establishment of "deemed IRAs" as part of a qualified retirement plan or 401(k) plan. This measure allows plans to use their administrative procedures to give participants "one-stop shopping" for both their IRAs and qualified plans, thus, encouraging

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additional savings. Second, Congress required that small cash-outs of accrued benefits or vested account balances exceeding \$1,000 be distributed automatically in the form of a rollover to an individual retirement account or individual retirement annuity unless the participant elects affirmatively to have the distribution transferred to a different IRA or qualified plan or to receive it directly. In essence, Congress is taking more steps to encourage and require employers to act as “plumbers” to fix the potential leaks in the retirement system. This column discusses both of these developments and the steps employers must take to implement them.

Deemed IRAs

Retirement plans are not required to contain deemed IRAs. Rather, final regulations issued by the Internal Revenue Service (IRS) provide a roadmap for employers who might wish to establish additional savings opportunities for their employees. Section 408(q) of the Internal Revenue Code (Code) provides that a qualified employer plan may allow employees to make voluntary contributions to a separate account or annuity established under the plan, which, if stipulated under the terms of the plan, will be treated as an individual retirement account or individual retirement annuity (hereinafter IRA). The specific requirements for IRAs must be stated in the plan document. Proposed IRS regulations had required that a separate trust be established for the IRAs but the final regulations do not require a separate trust for individual retirement accounts, as long as separate accounting is maintained for each account, although separate trusts are required for individual retirement annuities. However, employers may wish to establish separate trusts in any event because the regulations also provide that unless separate trusts exist, if either the IRA or qualified plan portion of an employer’s plan has a disqualification problem, both portions of the plan are disqualified.¹ This decision may seriously deter many employers from establishing “deemed IRAs.” At the very least, employers who establish deemed IRAs in their plans will likely use separate trusts.

The IRS has provided sample language that plan sponsors can adopt to add a “deemed IRA” to the plan in Revenue Procedure 2003-13.² In the preamble to final regulations, the Service made it clear that the references to separate trusts in the previously provided model language (based on the proposed regulations) can be disregarded.

Currently, it does not appear that many employers have adopted a deemed IRA in their plan. Despite their potential advantages to employees, the employer may feel too much “on the hook” for compliance and employees’ investment decisions, and the added risk of disqualification may provide further deterrence.

The Labor Department has also advised the IRS and Treasury Department that deemed IRAs will not be treated as part of the qualified plan except for purposes of ERISA’s exclusive benefit and fiduciary and co-fiduciary responsibilities, as well as enforcement authority. Thus, the Department of Labor expects fiduciaries to take appropriate steps to monitor the activity of deemed IRAs to prevent disqualification of the deemed IRA or underlying plan.³ Again, these added responsibilities are unlikely to encourage establishment of deemed IRAs.

Automatic Rollover Requirements

Employers will be required to adopt procedures to accommodate the new automatic rollover requirements of the law, and this must be done before March 28, 2005. Prior to amendment by EGTRRA, qualified plans could automatically “cash-out” amounts under \$5,000 and thus relieve sponsors the liability for and cost of maintain-

ing small accounts. EGTRRA added Section 401(a)(31)(B) to the Code to require that plans automatically provide for rollovers to an IRA for accrued benefits or account balances exceeding \$1,000 unless a participant elects otherwise. The law makes it clear that plan rollovers are not counted for purposes of this calculation.⁴ This requirement essentially guts the simplification rules Congress enacted in 1984 and 1997 to permit plans to cash out small benefits. The initial \$1,750 cash-out amount had been raised twice—from \$1,750 to \$3,500 under the Retirement Equity Act of 1984,⁵ and from \$3,500 to \$5,000 under the Taxpayer Relief Act of 1997.⁶

Most employers are not enthusiastic about the new requirement, as it will likely leave more employees with small accrued benefits in the plans. As one set of comments stated: “While plan sponsors are becoming more willing to be responsible for the assets of retired workers, there is still resistance to assuming financial costs and fiduciary liabilities for assets of former workers who may now be working for their competitors.”⁷

In addition to the administrative burdens, employers expressed concern that the requirement that they establish such IRAs in their qualified plans could make them a fiduciary with respect to the IRAs established for participants who have a very tenuous relationship to the plan and the employer. In response, the Labor Department (which has jurisdiction over fiduciary issues) issued a safe harbor for the plan fiduciary’s selection of IRA providers as the automatic default investment that will occur in the absence of a participant’s election.⁸ The safe harbor covers mandatory distributions of all plans subject to ERISA’s fiduciary requirements (Title I of ERISA) that are rolled over under the new law. It also covers rollovers of amounts under \$1,000 which are not required to be rolled over to an IRA, but could be (if the plan permits them). However, the safe harbor does not cover rollovers exceeding \$5,000.

To take advantage of the safe harbor, a plan sponsor must enter into a written agreement with one or more IRA providers. The provider must be a state or federally regulated institution, such as a bank, credit union, mutual fund or investment company. The agreement must set forth the fees and expenses and sets forth how the fund will be invested. Moreover, the plan participant must be able to enforce the agreement on his own behalf.

The fees must be no greater than comparable fees charged for “stand alone” IRAs that the provider offers. These fees can include checking establishment charges, investment fees, maintenance fees, and termination charges and can be charged against the account.

The allowable investments are not specified under the regulation, but they must be investments which are designed to preserve principal and provide a reasonable rate of return and liquidity so that the initial investment will be maintained over the term of the investment. In other words, the investment must be designed so that fees are not so high that they “eat up” the rollover amount. Individuals who have attempted to set up small bank accounts that are liquid may be able to testify that in an era of low interest rates, finding such an investment will not be simple, although it is presumed that financial institutions will begin to design products to meet the safe harbor.

The Labor Department makes it clear that an employer cannot select an institution to provide the IRA for plan participants if the selection or process constitutes a prohibited transaction. This means, for example, that employers cannot benefit from the selection of an IRA provider, or receive kickbacks or rebates in connection with the selection of provider. Moreover, under the ERISA prohibited transaction rules, employers could not even use an affiliate to provide IRA services themselves, even if they were a bank or financial institution that provided IRAs to others and even if the cost were at market value, unless an exemption existed. The Labor Department thus published an ERISA “class exemption” simultaneously with its regulations that allows an employer

to use itself or an affiliate to act as an IRA provider for the employer's plan, to choose its own or an affiliate's funds or investment products and services, and to receive fees in connection with these activities, without engaging in a prohibited transaction, if certain conditions are met. Of course the provider must meet the other regulatory requirements of an IRA provider under the safe harbor described above. In addition, to qualify for the class exemption, fees and payments must be limited to the income earned by the IRA (in other words, the IRA cannot lose money due to fees). This is an absolute requirement that is not contained in the safe-harbor rules for non-affiliated IRAs, which must invest in plans designed to preserve principal but need not guarantee that result. This could become an issue if earnings drop to a very low level. Also, participants must be informed that the distributions will be rolled to an IRA offered by the plan sponsor or affiliate, and the participant must be given a reasonable period of time to transfer the IRA to another provider without charge. Finally, records showing compliance with the class exemption must be kept for at least six years.

Safe Harbor Conditions

If the safe harbor conditions are satisfied, the Labor Department states that the plan fiduciary "is deemed to have satisfied his or her duties under Section 404(a) of [ERISA] with respect to both the selection of an individual retirement plan provider and the selection of funds in connection with the rollover of mandatory distributions." Thus, the participant will be considered to be responsible for control over the IRA and its investment, and theoretically the employer/plan sponsor will be off the hook.

The administrative responsibilities for maintaining the IRA are divided between the plan sponsor and the IRA providers. The plan sponsor must provide notice to participants of their rights to an automatic rollover (either in the plan's summary plan description or summary of material modifications). In addition to describing the eligibility criteria and procedures for electing out of the rollover, the notice must describe the investment product (including an explanation that the automatic investment chosen is one designed to preserve principal and provide a reasonable rate of return and liquidity). The notice must also describe fees and expenses and how they were allocated. In addition, the notice must specify a plan contact from whom the participant can obtain information; apparently providing a contact at the IRA provider is not sufficient.

Note that theoretically, once the rollover occurs, the IRA is separate from the plan. The IRA will be owned by the plan participant, and he will be able to take distributions and change investments pursuant to the rules governing IRAs in general and this particular IRA. There is concern that any prior plan elections, in particular the beneficiary election, will not apply to the IRA (although the IRA may arguably provide by contract that a default beneficiary can apply before a designation is made), but this may be difficult to communicate to the participants. Presumably too, once a rollover is made a former participant ceases to be a participant in the plan for 5500 and other purposes.

Responsible Providers

The IRA provider will become responsible for administering the IRA after the rollover. The IRS regulations explain that the proof of identify and verification procedures necessary under the Patriot Act are not required until the former participant first contacts the IRA provider to claim the account. Thus, the employer or plan sponsor is not required produce signatures of plan participants who are difficult to locate. Nonetheless, uncertainties

remain. A number of “lost participants” will now be provided with IRA accounts, and issues as to uncashed checks and impossible authorizations will continue to cause headaches for plan administrators.

The rules apply to involuntary cash-outs made on or after March 28, 2005, although plan sponsors may rely on the rules and the class exemption before the effective date. In addition, the IRS issued Notice 2005-5,⁹ which allows plans to delay amendments to reflect the new rollover procedures until the end of the first plan year ending on or after March 28, 2005 (December 31, 2005 for calendar year plans). This notice also provides a sample amendment.

Of course, employers have a choice—they can eliminate the cash-out provisions in their plans for amounts of \$1,000 or more and thus avoid the rollover rules entirely. This amendment, however, must be in place before any cash-outs are made after March 28, 2005. But that option comes at a price: more small plan accounts maintained by the plan. Whether that price is too high may depend on whether reasonable automatic rollover IRA providers are available. Although this author does not believe these accounts will be particularly attractive ones for IRA providers to offer, given the size of each account and the investment restrictions, it is hoped that some IRA rollover products aimed at helping plan sponsors satisfy the automatic rollover rules will be forthcoming.

Notes

1. See Treas. Reg. § 1.408(q)-1(f).
2. 2003-4 I.R.B. 317.
3. See Preamble to Treasury Regulations under Section 1.408(q) at 69 Fed. Reg. 43735 (July 22, 2004).
4. Code § 411(a)(11)(D).
5. Pub. Law 98-397.
6. Pub. Law 105-34.
7. Comments of Profit Sharing/401(k) Council of America, to the United States Department of Labor, April 1, 2004.
8. See 29 C.F.R. § 2550.404a-2.
9. Notice 2005-5, 2005-3 IRB (Dec. 28, 2004).

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