

# Employee Benefits Bulletin



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## Automatic Rollover, Beethoven (and every- one else): DOL Releases Final Automatic Safe Harbor Rollover Regulations

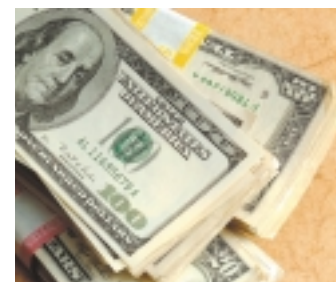
### Background and Overview of Automatic Rollover Rules

When an employee with a vested retirement benefit quits or is laid off before retirement age, a question arises: what happens to the employee's benefit? Will it be paid in a lump sum immediately or will the plan hold on to the benefit and pay it at some future date? The answer to this question will be buried in the details of a plan's governing document.

Some plans, particularly defined benefit plans, do not permit the employee to begin benefits until the employee reaches retirement or early retirement age, but most plans today—and virtually all defined contribution plans—permit a participant to elect an immediate lump sum distribution at the time the employee separates from service.

In addition, virtually all plans take advantage of an Internal Revenue Code provision that permits a plan to cash out all former employees whose benefits are worth no more than \$5,000. (This is to spare plans the recordkeeping and expense of holding small benefit amounts for former employees.) These payments are generally called mandatory distributions or mandatory cash-outs.

A former employee has options respecting a mandatory cash-out. The employee can direct the plan to transfer the mandatory distribution directly to an individual retirement account (or in some circumstances a qualified retirement plan of her new employer) or the employee can take a cash distribution (less 20% withholding tax). The employee who takes a cash distribution has the additional option of rolling over all or a portion of the benefit to an individual retirement account, thereby deferring tax on the distribution.



*Most plans today permit a participant to elect an immediate lump sum distribution at the time the employee separates from service.*

What happens, though, to the benefits of an employee who does not tell the plan what to do with a mandatory distribution? In the past, the plan could send the employee a check, or if the plan provided, rollover the distribution into an individual retirement account. (Few plans took advantage of this option.) In 2001, as part of the first Bush tax bill, however, Congress decided that if a former employee does not give the plan distribution instructions concerning a mandatory distribution over \$1,000, the plan must automatically rollover the distribution to an individual retirement account that the plan selects for the participant.

The person who selects the individual retirement account is acting as a fiduciary and is legally responsible for the selection of both the IRA provider and the investment choice. To protect fiduciaries from being sued for choosing imprudently, Congress directed the Department of Labor to promulgate regulations creating a safe harbor individual retirement account for automatic rollovers. The selection of an individual retirement account meeting the safe harbor requirements will essentially immunize the fiduciary from liability arising from the selection.

Recognizing the important role that the safe harbor conditions would play in the statutory scheme, Congress provided that the automatic rollover rule would not become effective until the Department of Labor issued final regulations specifying the safe harbor conditions. The Department proposed such regulations in March and issued final regulations on September 28, 2004, which will become effective on March 28, 2005.

Also on September 28th, the Department released a class exemption from the prohibited transaction rules, which will permit a plan sponsor (that is also a financial institution) to use its own products for an automatic rollover individual retirement account if certain conditions are satisfied.

This article provides, in question and answer format, a discussion of the automatic rollover requirements and rules. The questions are grouped into four groups:

- (1) questions concerning necessary plan amendments;
- (2) questions concerning the requirements for safe harbor rollover IRAs;
- (3) questions concerning whether an employer that is a financial institution that sponsors IRAs can use its own products for rollover IRAs; and
- (4) questions concerning other issues related to safe harbor rollover IRAs.



***To protect fiduciaries from being sued for choosing imprudently, Congress directed the Department of Labor to promulgate regulations creating a safe harbor individual retirement account for automatic rollovers.***

## **1. Automatic Rollover Regulations and Plan Amendments.**

*Most important question first: do plan sponsors need to amend their plans, and if so, by what date?*

The answer for any plan sponsor whose plan provides for mandatory cash-outs for participants with plan benefits worth less than \$5,000 is yes. The amendment must be made by March 28, 2005, the effective date of the automatic rollover regulations.

*Are there choices on how the plan can be amended?*

Yes, most plans will have three basic choices, which are as follows:

1. The plan sponsor can amend the plan to provide that automatic rollovers will be made for all former employees whose benefits are worth more than \$1,000 and less than \$5,000.
2. The plan sponsor can amend the plan to eliminate mandatory cash-outs.
3. The plan sponsor can amend the plan so that mandatory cash-outs are paid only to former employees whose benefits are worth no more than \$1,000.

*Which of these approaches is the best one?*

It depends. Because most plans will not want to hang on to small accounts, we anticipate that the first option will generally be the most attractive. Some plans, particularly smaller plans that cannot offer financial institutions repeat business, however, may find it is difficult to find a financial institution that will want to accept automatic rollovers. In that case, the second or third plan-amendment option might be more attractive.

*But doesn't choosing the second or third option mean that the plan will end up holding small accounts, often for decades, and may later be confronted with plan accounts for former employees who cannot easily be located when they attain retirement age?*

In theory the answer is yes, but plans can still permit employees to elect to be cashed out and in our experience most employees who are given this choice take it. Thus, a plan can still largely rid itself of the burden of maintaining small accounts for former employees, even without mandatory distributions.

Moreover, a plan sponsor who eliminates mandatory cash-outs or cash-outs over \$1,000 can always re-amend the plan to restore them at a later date.

*What if I want to continue offering mandatory distributions but am concerned that the plan might not be able to locate an IRA vendor willing to accept such distributions in a safe harbor IRA?*

Although it is not entirely clear, we believe that it would be permissible for a plan to provide that mandatory distributions of amounts in excess of \$1,000 will only be made if the plan can find a financial institution willing to establish a safe harbor IRA to accept a mandatory distribution.

## **2. Safe harbor Individual Retirement Accounts**

*What is a safe harbor individual retirement account?*

It is an individual retirement account that satisfies the conditions in the recently released Department of Labor Regulations on automatic rollovers.

*What are the advantages of using a safe harbor individual retirement account for automatic rollovers of mandatory cash-outs?*

The advantage is simple: it protects the plan fiduciary from claims that its choice of a rollover individual retirement account was imprudent or otherwise violated ERISA's fiduciary standards. In other words, it protects the fiduciary from a lawsuit contending, for

example, that the fiduciary chose a rollover individual retirement account that was inappropriate for the participant or whose fees were too high. This is, of course, an important benefit for a plan fiduciary.

*What are the conditions that an IRA must satisfy to be a safe harbor IRA?*

To be a safe harbor IRA, the IRA must reflect a written agreement between the IRA provider and the plan fiduciary. The written agreement must provide:

1) limitations on the type of investments that the IRA can make;

2) limitations on fees that the IRA can charge; and

3) a right of the former plan participant in whose name the IRA is established to enforce the terms of the agreement against the IRA provider.

In addition, the plan must make certain disclosures to participants for the IRA to be considered a safe harbor IRA.

*Safe Harbor Investment Requirements.*

*What are the limitations on the type of investments that a safe harbor IRA can hold?*

The investment product invested in the IRA must:

1) be designed to preserve principal and provide a reasonable rate of return, consistent with liquidity;

2) the investment product selected for the rollover IRA shall seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product by the IRA; and

3) the investment assets shall be offered by a state or federally regulated financial institution, which may be a bank or savings association, whose assets are insured by the FDIC; a credit union, whose accounts are insured under the FCUA; an insurance company whose products are protected by a state guaranty association; or an investment company registered under the Investment Company Act of 1940.

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***One advantage of using a Safe harbor IRA for automatic rollovers is that it protects the plan fiduciary from claims that its choice of a rollover individual retirement account was imprudent or otherwise violated ERISA's fiduciary standards.***

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*What does this mean, in effect?*

That the investment product will be a money-market fund, a certificate of deposit, or similar investment product.

*Does this mean that a plan cannot choose an IRA that, for example, invests in a balanced stock fund?*

A plan can choose such an IRA, but the plan will not have the protection of the safe harbor.

*Suppose that a participant in a 401(k) plan has directed that her 401(k) plan account be invested in a particular growth fund? If the plan rolls over the account balance to an IRA that will continue this investment, will the safe harbor protections apply?*

No. Again, a plan fiduciary might do this, but the IRA will not be considered a safe harbor IRA.

*Do these investment conditions make a whole lot of sense?*

They didn't make sense to a number of people who commented on the regulations, who argued that (i) a balanced stock fund might be a better default investment than a low-earning but secure investment; and (ii) a plan should be able to respect the investment wishes that a participant had already expressed. But the Department of Labor rejected these arguments and stuck to a pretty much unyielding position that the safe harbor protections should only apply in cases where the principal was secure.

#### *Safe Harbor Fee Requirements.*

*What are the limits on fees that an IRA can charge?*

The IRA may charge fees and expenses charged by the individual retirement plan provider for comparable individual retirement plans established for reasons other than the receipt of a rollover distribution.

*Does this mean that fees might, in fact, exceed IRA income?*

It is possible.

*Does the plan fiduciary have to investigate to determine whether the fee conditions are satisfied?*

No. It is sufficient if the written agreement between the plan fiduciary and the IRA provider states that the fees and expenses shall not exceed those for comparable individual retirement plans established for reasons other than receipt of a rollover distribution. The idea is that the participant can enforce these provisions if the IRA fees are higher than permitted.

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***Safe harbor rollover IRAs must provide each participant either a summary plan description or a summary of material modifications that describes the plan's automatic rollover provisions.***

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*Does this mean that a financial institution that does not offer regular IRAs cannot qualify for a rollover IRA?*

Apparently.

*Are there any ambiguities in the fee language?*

There are at least two ambiguities: first, the regulations do not define what is meant by a comparable plan; and second, the regulations do not indicate whether the safe harbor and "comparable IRA" fees and expenses are compared in the aggregate or whether each individual safe harbor fee or expense is compared to each individual "comparable IRA" fee and expense.

#### *Disclosure Requirements.*

*What are the disclosure requirements for a safe harbor rollover IRA?*

The plan must provide each participant either a summary plan description or a summary of material modifications that describes the plan's automatic rollover provisions, including a description of the safe harbor investment criteria, a statement indicating how expenses will be allocated between the account holder and plan or plan sponsor, and the name, address and phone number of a plan contact for further information about the plan's automatic rollover provisions, the individual retirement plan provider, and the fees and expenses of the individual retirement plan.

In addition, the plan will have to provide the employee with the otherwise required notice (under IRC § 402(f)) about the distribution options.

### 3. Prohibited Transaction Exemption

*If the plan sponsor is itself an IRA vendor, can it use its own products as a safe harbor IRA for mandatory distributions from its own plan?*

This would be a prohibited transaction. The Department of Labor, however, released a prohibited transaction exemption that permits IRA vendors to use their own IRA products as safe harbor IRAs if certain conditions are met. The most important of these conditions relates to fees, which except for establishment fees cannot exceed income.

### 4. Other Safe Harbor IRA Issues

*May a plan use a safe harbor IRA for a rollover of a mandatory distribution of \$1,000 or less?*

The original regulations did not so provide, but in response to comments, the final regulations extend the protections of safe harbor IRAs to mandatory distributions of \$1,000 or less. Thus, if a plan sponsors wishes, it can design its plan to provide for mandatory rollovers of amounts of \$1,000 or less and use safe harbor IRAs to accept such rollover distributions.

*Are there situations in which a mandatory distribution can exceed \$5,000?*

Yes. In determining whether a participant will receive a mandatory distribution, plans may ignore the value of any participant rollover contributions to the plan. Thus, assume that a participant has a regular plan account balance of \$4,000 and an additional rollover account balance of \$3,000. The plan may still pay the participant a mandatory distribution, which could include both the \$4,000 and \$3,000 account balances.

*Can the plan use a safe harbor IRA to accept a distribution in excess of \$5,000?*

The final regulations say no, that the safe harbor protections will not extend to distributions in excess of \$5,000.

*Is a plan fiduciary responsible for monitoring safe harbor IRAs after a mandatory rollover?*

The regulations provide that there is no duty to monitor. Once amounts are rolled over into a safe harbor IRA, the plan participant is responsible for enforcement of the terms of the safe harbor agreement between the plan and the IRA vendor.

*Are there issues not covered by the regulations?*

Yes. The regulations do not address state law considerations, such as escheat and signature laws.

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*The regulations do not address state law considerations, such as escheat and signature laws. Neither do they address possible issues under the Internal Revenue Code, missing participant issues, or other ERISA Title I or plan interpretation issues.*

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Neither do they address possible issues under the Internal Revenue Code, missing participant issues, or other ERISA Title I or plan interpretation issues. The preamble to the regulations does speak to issues under the USA Patriot Act, which imposes on financial institutions customer identification and verification procedures. The preamble indicates that the Department of Treasury has advised the Department of Labor that financial institutions implement such procedures only when the former participant or beneficiary first contacts the institution to assert control over the IRA.

*Remind me again by when a plan sponsor needs to have amended its plan, revised its plan notices and summary plan descriptions (or issued a summary of material modification) and located appropriate and willing IRA vendors?*

March 28, 2005.

*And who did sing the original version of "Rollover, Beethoven?"*

Chuck Berry, in 1955. The Beatles released an almost-as-famous version in 1963.

## Individual Insurance Policies Offered Through a Section 125 Cafeteria Plan

Many employers are familiar with offering group health insurance coverage through a Section 125 Cafeteria Plan. However, some employers may not be as familiar with the possibilities for allowing employees to purchase individual supplemental policies through a Cafeteria Plan. For example, cancer policies, accident-only policies, and hospital indemnity policies are often purchased by individuals as qualified benefits through their employer's Cafeteria Plan. Under such an arrangement, employees receive the benefit of paying the premiums on a pre-tax basis, and employers benefit from reduced FICA tax costs.

If certain requirements are satisfied, then the individual supplemental policies will not be considered to be employee welfare benefit plans governed by the requirements of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). The Department of Labor has set forth four requirements that must be satisfied in order to avoid application of Title I of ERISA to the individual policies:

(i) No contributions are made by an employer or employee organization;

(ii) Participation in the program is completely voluntary for employees or members;

(iii) The sole functions of the employer or employee organization with respect to the program are, without endorsing the program, to permit the insurer to publicize the program to employees or members, to collect premiums through payroll deductions or dues check-offs and to remit them to the insurer; and

(iv) The employer or employee organization receives no consideration in the form of cash or otherwise in connection with the program, other than reasonable compensation, excluding any profit, for administrative services actually rendered in connection with payroll deductions or dues check-offs.

Application of these four criteria must be assessed on a facts and circumstances basis; As general examples, it would be acceptable for an employer to collect and remit premiums to an insurance company and to permit insurance agents to publicize the program, but an employer should not pay any portion of the individual premiums, reimburse the employees for any of the cost of the policies, or exercise any control over the design and operation of the policies.

Although close attention to detail in the offering of

individual policies through a Cafeteria Plan can avoid the implication of Title I of ERISA, the Cafeteria Plan must still satisfy the requirements of Section 125 of the Internal Revenue Code, a key component being the various nondiscrimination requirements (e.g., nondiscrimination in eligibility, nondiscrimination in benefits and contributions, and a concentration test for key employees).

In consideration of the compliance issues outlined above, service providers generally provide the following types of documents to employers seeking to establish a Cafeteria Plan that includes individual insurance policies:

- An explanation of the tax savings that may be realized by both employers and employees through implementation of the plan;
- Questions and Answers concerning how the plan works with a summary of potential recordkeeping and reporting issues that may be of concern to employers, including how the Cafeteria Plan will affect the employer's payroll and tax reporting processes;
- An implementation guide setting out the steps necessary to establish and maintain the Cafeteria Plan (for example, selecting the benefits to be offered under the plan, documenting employee elections, testing the plan for compliance with the Internal Revenue Code's nondiscrimination requirements, etc.);
- A plan document to be adopted by the employer;
- A summary of the plan's terms for distribution to participants; and
- An agreement for the employer to withhold and remit premiums to the insurer on behalf of the participating employees.

Employers who intend to avoid Federal compliance requirements, other than the Section 125 requirements, should verify that all documentation related to the individual policies and the Cafeteria Plan is drafted in a manner intended to avoid the application of ERISA by satisfying the four requirements discussed above. With due consideration given to the legal issues involved, individual policies offered through a Cafeteria Plan can be a win-win situation for both employers and employees.

## TIPS, TIDBITS and BENEFIT TALK

### *2005 Retirement Plan Limits Released*

A number of retirement plan limits will be increased for 2005. Some of the limits were adjusted to reflect 2004 increases in the Consumer Price Index, while others were adjusted in accordance with phased-in increases enacted by the 2001 tax legislation. The most significant of the 2005 increases are indicated below:

	2004	2005
Dollar Limit for Defined Benefit Plans	\$165,000	\$170,000
Dollar Limit for Defined Contribution Plans	\$41,000	\$42,000
401(k) Plan Elective Deferral Limit	\$13,000	\$14,000
Catch-Up Limit for Elective Deferrals	\$3,000	\$4,000
Limit on Included Compensation	\$205,000	\$210,000
Highly-Compensated Employee Compensation	\$90,000	\$95,000

### *President Signs Legislation With New Nonqualified Deferred Compensation Rules*

On October 22nd, President Bush signed the American Jobs Creation Act of 2004. The Act replaces more than half a century of cases and rulings on nonqualified deferred compensation with new Section 409A, a codification of various principles (some new) that will dictate the treatment of various deferred compensation arrangements. The new rules, which are effective on January 1, 2005, cover most traditional nonqualified deferred compensation arrangements, as well as stock appreciation rights, certain severance plans, long-term incentive plans and many other types of arrangements that result in deferral of compensation. The legislation does not, however, apply to benefits in deferred compensation plans that are already earned and vested (so long as there are no material modifications to the arrangement after October 3, 2004).

The next issue of this newsletter will provide detailed coverage of the new rules and any IRS guidance, which the legislation requires be issued within 60 days.

### *IRS Rules that Certain Holiday Gift Coupons Are Taxable Compensation*

Getting into the Christmas spirit early this year, the IRS issued a Technical Advice Memorandum on facts involving an employer who gave employees \$35 holiday grocery coupons in lieu of the traditional holiday turkey or ham. Given that the value of the coupons was ascertainable, the value was taxable to the employees who received them.

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### **Drop us a note...**

If you have a question or would like to see a particular topic addressed, please let us know by emailing us at [leeann.jordan@adamsandree.com](mailto:leeann.jordan@adamsandree.com) or by writing to us at:

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We will try to address your question or topic in a future newsletter.

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