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NEW RULE FOR MANDATORY CASH-OUTS FROM QUALIFIED PLANS

This memorandum summarizes a new rule that applies to mandatory cash-outs from qualified plans, effective March 28, 2005.

Generally a qualified plan can not require a participant to receive his benefit when he terminates employment. The plan must allow the participant to keep his benefit in the plan until he reaches normal retirement age (usually age 65). If, however, the participant's vested account balance is under \$5,000, the plan can compel the benefit to be paid right away ("mandatory cash-out"). The participant must be allowed to choose between making a rollover to another tax-deferred account (such as an IRA), or receiving a cash lump sum, less 20% income-tax withholding. At present the default rule, if the participant fails to choose the manner of payment, is the cash payment less the income-tax withholding.

Congress has imposed a new default rule, which applies whenever a participant fails to elect the form of payment of a mandatory cash-out, and the amount involved is more than \$1,000: *the benefit must be distributed in the form of a rollover to an IRA in the participant's name selected by the plan administrator.*

The new rule applies to all mandatory cash-outs occurring on or after March 28, 2005. The IRS has announced that if a plan does not have an administrative procedure in place by March 28 it can wait until it has the procedure in place, but not beyond December 31, 2005, to implement the new rules. But that only allows a delay in applying the new rule; it does not allow continuing to apply the old rule. After March 27 the plan's trustee will no longer be allowed to pay in cash a mandatory cash-out in excess of \$1,000, unless the participant requests that form of distribution.

To bring a plan into compliance it will be necessary to do the following: (1) amend the plan document; (2) amend the summary plan description; (3) amend the forms provided to a participant who has terminated employment; and (4) make arrangements for the IRAs into which the automatic rollover will be made.

If a plan is a defined-contribution plan the entity – bank, brokerage firm, mutual fund, etc. – through which the plan assets are invested will probably make available IRAs that the plan can use. If that is not the case it may take a while to locate a third party that will provide the vehicle for these rollover IRAs. The Department of Labor has set forth "safe-harbor" rules to follow in order to assure that the plan administrator will be deemed to have been prudent in the selection and funding of the rollover IRAs.

If a plan does not have mandatory cash-outs of more than \$1,000, the new rule will not apply. A plan that has mandatory cash-outs could be amended to eliminate them for over-\$1,000 amounts. However, the reasons for putting mandatory cash-out provision in a plan – to avoid indefinite administration of small accounts and possible difficulty in locating participants when they reach the retirement age at which the plan requires that they receive their benefits – continue to apply.

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Sometimes plan administrators delay or forget to compel distribution of under-\$5,000 account balances to terminated participants. If a plan has undistributed account balances of less than \$5,000 and more than \$1,000, and the plan administrator would prefer to pay the benefits in cash rather than go to the trouble of setting up rollover IRAs for participants who fail to make a choice, the plan administrator should start now to take the steps necessary to pay those benefits before the March 27 deadline.

The new rule will actually be beneficial, in those cases where a plan has under-\$5,000 account balances of participants whom the plan administrator has lost contact with. Rollover IRAs will provide a means of ridding the plan of account balances that it otherwise was stuck with.

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. In addition, any of the authors of this summary will be happy to field your questions, at the following telephone numbers:

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