

# Henson & Efron

PROFESSIONAL ASSOCIATION

## NOTICE OF CHANGES AFFECTING BENEFIT PLANS

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Sponsors of qualified retirement plans must take immediate action in response to new rules effective March 28, 2005 that require the rollover to an IRA of benefits that are automatically distributable upon a participant's termination. Immediate action may also be required with respect to employee benefit plans affected by a change to the definition of "dependent" effective January 1, 2005. This Notice describes the changes and the actions required.

### **Automatic Rollovers of Mandatory Distributions**

Effective March 28, 2005, qualified retirement plans that provide for the automatic distribution of vested benefits or account balances of \$5,000 or less to terminated participants must begin rolling such distributions (if they exceed \$1,000) over to an IRA unless the participant elects to take cash or makes a different rollover election.

### **Sponsors of plans that provide automatic distributions must take the following immediate actions to comply with the new automatic rollover requirement:**

- select an IRA provider and the investment products for automatic rollovers;
- issue a revised SPD or SMM before the first automatic rollover occurs (can be as early as March 28, 2005 or as late as December 31, 2005);
- modify the special tax notice provided to separating participants to include an explanation of the automatic rollover procedures; and
- amend the plan by the end of the first plan year ending on or after March 28, 2005 (i.e., calendar-year plans must be amended by December 31, 2005).

Selecting the IRA provider and the investment products gives rise to fiduciary duties of the plan administrator. The following safe harbor conditions have been established by the U.S. Department of Labor that, if satisfied, will protect a plan administrator from liability:

- the present value of the distribution must not exceed \$5,000 (not including amounts rolled over from another plan);
- the distribution must be rolled directly over into a tax-qualified IRA (the plan sponsor may rely on the provider's written statement that the IRA is tax-qualified);
- the plan administrator must enter into a written agreement with an IRA provider that specifies that (i) the rolled over funds be invested in a product designed to preserve

principal, provide a reasonable rate of return and seek to maintain the dollar value of the investment, (ii) the IRA provider's fees will not be greater than the fees charged for similar IRAs established for nonmandatory rollovers, and (iii) the participant has the right to enforce the terms of the agreement;

- the plan administrator must, prior to the first automatic rollover, give participants an SPD or SMM that describes the plan's provisions for automatic rollovers, how the rolled over funds will be invested and the expenses allocated, and the name and address of a plan official that the participants may contact for additional information. Participants must also be given notice that they may transfer the automatically rolled over funds to another IRA (this may be included in the special tax notice); and
- the plan administrator must not engage in a prohibited transaction in selecting the IRA provider and the investments (e.g., the administrator receives consideration in return for selecting a particular IRA provider).

As an alternative to taking these actions, plan sponsors may amend their affected plans to reduce the amount automatically distributed to \$1,000 or less. This action would eliminate the obligation to comply with the new automatic rollover rules but will likely result in additional administrative expenses.

**If you have a plan that makes mandatory distributions of accounts of \$5,000 or less, you must decide now whether to provide automatic rollovers and you must take immediate action to implement your decision.**

Please call Steve Hopkins or Kristin Staffanson at (612) 339-2500 if you would like our help with your decision and the actions required to implement it.

### **Change in Definition of Dependent**

Effective January 1, 2005, the definition of "dependent" has been changed for several tax purposes. In addition to affecting a taxpayer's filing status and the availability of certain individual federal income tax credits and exemptions, the new definition may affect certain employee benefit plans.

Under the new definition, a "dependent" includes a "qualifying child" or a "qualifying relative." Included within the new definitions: (i) a "qualifying child" must now have the same principal place of abode as the taxpayer for more than one-half of the year and (ii) a "qualifying relative" may not have gross income in excess of the exemption amount for a taxable year (\$3,200 for 2005). These new requirements may affect employer-provided benefits for dependents.

The new law includes an exception to the new income limit for purposes of determining dependent status for group health plan benefits and reimbursements. However, there is no exception to the income limitation for purposes of excluding the value of a dependent's health benefits from an employee's gross income. The IRS has fixed this problem, however, by issuing a Notice that provides an exception to the income limit of a qualifying relative for this purpose. Thus, the tax treatment of health care benefits and reimbursements of health care expenses for dependents has generally not changed under the new law.

The exception to the income limitation for employer-provided health care has not currently been extended to dependent care assistance program (“DCAP”) reimbursements. A bill has been introduced which would provide an exception to the income limitation for purposes of determining who is a dependant for the dependent care credit and for DCAPs. However, employees may have elected in 2004 to contribute to a DCAP for 2005 on behalf of an individual who will not qualify as a dependent under the new definition. In order to avoid the potential forfeiture of these contributions, the IRS has informally indicated that a change in election should be permitted under these circumstances.

In addition to DCAPs, the new legislation may also affect distributions from (i) certain qualified retirement plans (including 401(k) plans) for hardship and unforeseeable emergencies due to a dependent’s qualified medical or education expenses or (ii) a health savings account for a dependent’s qualified medical expenses. Specifically, tax-favored distributions from these plans may not be available for individuals who no longer qualify as a dependent, including children who do not live with the employee for more than one-half of the year (except certain children of divorced parents) and disabled individuals with income in excess of the limitation. The bill referenced above would provide an exception to the income limitation for these distributions.

**Action Required: You should review your employee benefit programs and procedures, plan documents, SPDs, contracts with providers and enrollment materials to determine how the new definition may impact them. In addition, you may want to communicate the new definition to participants in DCAPs and allow affected participants to revoke or revise their elections.**

Please call Steve Hopkins or Kristin Staffanson at (612) 339-2500 for assistance in this process.