



Electronic Dispatch

Employee Benefits Law Action Memo

February 2005

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INTERNAL REVENUE SERVICE ISSUES GUIDANCE REGARDING NEW AUTOMATIC ROLLOVER RULES

In November of 2004, we issued an Employee Benefits Law Action Memo ("EBAM") entitled "Most Retirement Plans Must Comply With New Automatic Rollover Rules By March 28, 2005," which addressed final regulations issued by the United States Department of Labor that provided retirement plan fiduciaries with a regulatory "safe harbor" for satisfying their fiduciary responsibilities in connection with the new automatic rollover rules. In the November 2004 EBAM, we indicated that it was expected that the Internal Revenue Service ("IRS") would issue additional guidance regarding the implementation of the automatic rollover rules. Recently, the IRS issued this guidance in Notice 2005-5 ("Notice"). The most significant aspect of the Notice is the postponement of the effective date for complying with the new automatic rollover rules from March 28, 2005 to December 31, 2005 for plans that lack sufficient administrative procedures for completing automatic rollovers by March 28, 2005. The Notice also sets forth a requirement that most plans must be amended to reflect the automatic rollover rules by the end of the first plan year ending on or after March 28, 2005.

Background

Many retirement plans provide that, if the present value of a participant's benefit under the plan is \$5,000 or less upon termination of employment, the plan will automatically distribute the participant's benefit in a single sum payment, without the participant's consent. This is known as an automatic or mandatory cash-out provision. While a participant generally must be given the opportunity to roll the distribution over into another retirement plan or individual retirement account ("IRA"), the participant's benefit is distributed directly to the participant, if the participant does not make an affirmative rollover election. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") amended the rollover rules to require that mandatory cash-outs of amounts between \$1,001 and \$5,000 must be automatically rolled into an IRA created for the participant, unless the participant affirmatively makes a different election. As a result, plan administrators must select an IRA provider and make an initial election regarding the investment of the assets rolled into the IRA in connection with the automatic rollover of a cash-out distribution.

What Plans Are Subject To the Automatic Rollover Requirement?

The automatic rollover rules apply to most retirement plans that provide for automatic cash-outs, including: (i) defined contribution plans (e.g., 401(k) and profit sharing plans); defined benefit plans; Internal Revenue Code ("Code") Section 403(b) plans; governmental plans (including governmental Code Section 457(b) plans); and church plans (including non-electing church plans). The automatic rollover requirements do not apply to non-governmental Code Section 457(b) plans.

What Distributions Are Subject To the Automatic Rollover Requirement?

The automatic rollover rules apply to any mandatory distribution (i.e., distributions made without the participant's consent and prior to the date the participant attains the later of age 62 or normal retirement age) that is more than \$1,000 and is an eligible rollover distribution. The Notice provides that an eligible rollover distribution in the form of a plan loan offset amount is not subject to the automatic rollover rules.



When Must Plans Comply With the Automatic Rollover Requirement?

The Notice provides that the automatic rollover rules will apply to mandatory cash-out distributions made on or after March 28, 2005. However, the Notice also provides transitional rules that postpone the effective date with respect to certain plans.

Transition Rule For All Plans That Fail To Timely Establish Sufficient Administrative Procedures: The Notice provides a grace period for all plans to establish sufficient administrative procedures to satisfy the automatic rollover rules. Under this general transition rule, if a plan lacks sufficient administrative procedures for completing automatic rollovers (including establishing IRAs to accept automatic rollovers), the plan will not be treated as violating the automatic rollover requirements provided the distributions are made on or before December 31, 2005.

Special Transition Rule For Government and Non-Electing Church Plans: The Notice also establishes special transition rules for governmental plans and non-electing church plans. Governmental plans are not required to comply with the automatic rollover requirements until the close of the first regular legislative session of the legislative body with authority to amend the plan that begins on or after January 1, 2006. Non-electing church plans with amendment authority held by a church convention are not required to comply with the automatic rollover requirement until the 60th day after the close of the earliest church convention that occurs on or after January 1, 2006.

When Must Plans Be Amended To Reflect the Automatic Rollover Requirement?

Plans that provide for mandatory distributions and that do not already include the automatic rollover provisions must adopt a "good faith" plan amendment reflecting the automatic rollover requirements by the end of the first plan year ending on or after March 28, 2005. Thus, the deadline for calendar year plans is December 31, 2005. For non-calendar year plans, a shorter time frame may apply. For example, a plan with a July 1 – June 30 plan year must be amended no later than June 30, 2005. An exception to this time frame applies to governmental plans and certain non-electing church plans, which need not be amended until the end of the transition periods described above. The Notice includes a sample plan amendment that plan sponsors may adopt. The adoption of the sample plan amendment, or a materially similar amendment, will be considered by the IRS to be a good faith amendment.

What Notification Requirements Apply?

A plan sponsor is required to notify an affected participant in writing (either separately or as part of the special tax notice required under Section 402(f) of the Code) that, absent an affirmative election by the participant, the cash-out distribution will be paid to an IRA. This notice must identify the trustee or issuer of the IRA. The notice may be sent by using electronic media. The notice should be sent to the participant's most recent mailing address in the records of the employer and plan administrator.

Required Action

A plan sponsor that maintains a plan that provides for mandatory cash-outs must decide whether it wishes to (i) continue to make mandatory cash-out distributions without any modifications and comply with the new automatic rollover rules, or (ii) amend its plan to reduce the mandatory cash-out limit to \$1,000 or less, or to eliminate mandatory cash-outs completely, thereby eliminating the requirement to comply with the automatic rollover rules altogether. Plan sponsors that wish to continue to make mandatory cash-out distributions should begin to take steps to implement the new automatic rollover requirements by the March 28, 2005 deadline. However, plan sponsors that are unable to establish sufficient administrative procedures by the March 28 compliance deadline will have a grace period until December 31, 2005 in order to comply with the new rules. Plan sponsors that wish to continue to make mandatory cash-out distributions should also take steps to amend their plans to provide for the new automatic rollover requirement. Plans (except for governmental plans and certain non-electing church plans as described above) must be amended by the end of the first plan year ending on or after March 28, 2005. Plan sponsors that retain mandatory cash-out distributions should also ensure that their summary plan descriptions and administrative procedures are updated appropriately. Additionally, either the plan's special tax notice must be revised to reflect the automatic rollover rules or a separate notice must be prepared.

A plan sponsor that does not wish to comply with the new automatic rollover rules may either amend its plan to lower its mandatory cash-out limit to \$1,000 or less, or eliminate mandatory cash-outs altogether. The Notice confirms that the elimination of a plan's mandatory cash-out provision is permissible without violating IRS rules regarding the elimination of protected benefits. However, a plan sponsor should also consider the administrative costs and fiduciary issues associated with retaining small account balances. Although not addressed in the Notice, the IRS has indicated that a plan sponsor that chooses to eliminate mandatory cash-out distributions, or reduce such distributions to \$1,000 or less, must amend its plan within the same time frame required for plan sponsors that wish to amend their plans to provide for the new automatic rollover requirement (i.e., for most plans, the amendment must be made by the end of the first plan year ending on or after March 28, 2005.)

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