Pension ANALYST

Important Information | Distributions and Withdrawals | October 2000*

PRUDENTIAL RETIREMENT

IRS Relaxes Protected Benefit Rules

WHO'S AFFECTED These rules apply to all qualified defined contribution plans. They do not apply to 403(b) tax-sheltered annuity programs.

BACKGROUND AND SUMMARY Qualified plans are subject to special rules that limit a plan sponsor's ability to change or eliminate certain types of benefits. In defined contribution plans, the primary type of protected benefit is the optional form of benefit. Optional forms of benefit are the forms in which benefits are paid (e.g., single sum distributions, installment payments, annuity payments). In many situations, such as plan mergers, the protected benefit rules simply make plan administration more difficult as plan sponsors are forced to continue to offer payment options that plan participants rarely choose.

In response to the current environment, where plan mergers are more frequent and rollover rules have already been expanded, the IRS has published new regulations providing additional exceptions to the protected benefit rules. These regulations make it easier for defined contribution plan sponsors to eliminate periodic payment options that are rarely used (such as annuities). They also provide new transfer options that should be especially useful in merger situations. These new rules apply to plan amendments that are adopted and effective on or after September 6, 2000.

ACTION AND NEXT STEPS Plan sponsors should review their plans' current benefit payment options and determine if they might be able to simplify plan administration by taking advantage of the new rules.

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Prudential Financial

Qualified plans are subject to special rules that limit a plan sponsor's ability to change or eliminate certain types of benefits. In defined contribution plans, the primary type of protected benefit is the optional form of benefit. In general, optional forms of benefit are the forms in which benefits are paid (e.g., single sum payments, installment payments, annuity payments).

The IRS has now acknowledged that given the current business environment and other new benefit payment rules, the existing protected benefit rules may have outlived their usefulness.

As a result, they have published new regulations providing additional exceptions to the protected benefit rules. These regulations make it easier for defined contribution plan sponsors to eliminate periodic payment options (such as annuities) that are rarely used. They also make it possible for plan sponsors to eliminate particular mediums (e.g., in-kind) of distribution. In addition, the rules provide new transfer options that should be especially useful in merger situations. All of these new rules apply to plan amendments that are adopted and effective on or after September 6, 2000.

Elimination of Periodic Payment Options

In general, plan sponsors may now amend defined contribution plans to remove periodic payment options, such as installments and annuities, subject to the following limitations:

- A money purchase pension plan *may not* be amended to remove the Qualified Joint and Survivor Annuity (QJSA) form of payment, but other annuity and installment forms of payment may be removed.
- A profit sharing plan that is a “transferee plan” (e.g., it holds assets transferred from a pension plan) also may not be amended to remove the QJSA form of payment with respect to the transferred assets.
- Any other profit sharing plan, including a 401(k) plan, may be amended to eliminate *all* annuity and installment forms of payment, as long as the plan meets specific requirements.

To remove periodic payment options, the plan must provide a single sum payment option post-amendment. This form of payment must:

- Be available on the same payment beginning dates as the eliminated forms would have been available;
- Be available in the same medium as the eliminated forms of payment (e.g., cash or in-kind); and
- Not impose any eligibility requirement not imposed on the eliminated forms of payment.

If an annuity or installment option is removed, that form of payment must remain available to any participant who has an Annuity Starting Date (generally, this means "payment date") that precedes the earlier of:

- The 90th day after the date the participant is given a Summary of Material Modifications (SMM) reflecting the amendment, or
- The first day of the second plan year following the amendment adoption date.

For example: Plan X is a profit sharing plan, with a calendar plan year, which permits distributions to be made in a single sum or in installment payments. On May 15, 2001, the plan sponsor adopts an amendment to Plan X to remove the installment payment option, effective that same date. On December 14, 2001, the Plan Administrator provides all participants with an SMM

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describing this amendment. If Joe Q. Participant elects to start receiving payments before March 14, 2002 (90 days after the 12/14/01 SMM distribution date), he may still choose the installment payment option. However, if he elects to start receiving payments on or after March 14, 2002, he will only be able to take a single sum payment.

Elimination of In-Kind Distributions

The right to a particular form of investment offered under a plan *is not* a protected benefit. However, the right to take distributions from a particular form of investment in-kind (e.g., shares of employer stock, annuity contracts, marketable securities, or other property), *is* a protected benefit, if offered by a plan.

The new rules allow plan sponsors to amend their plans to remove in-kind distributions of marketable securities other than employer securities, and require cash distributions in their place. Mutual funds are an example of “marketable securities other than employer securities.”

Plan sponsors *may not* amend their plans to substitute cash distributions for in-kind distributions of non-marketable securities (such as interests in limited partnerships), employer securities, or other in-kind distribution options (such as real estate investments).

New Transfer Options

The IRS has provided two new options for moving account balances directly from one plan to another plan without having to preserve protected benefits. The following four “transfer” options are now available.

Direct Rollover. To make a direct rollover, the participant must have a distributable event and the dollars being distributed must be eligible for rollover. While most plan distributions are eligible for direct rollover, gaps do remain. For example, distributions of employee post-tax contributions are not eligible for rollover. In addition, the "same desk rule" may prevent distributions from being made in a merger or acquisition situation (i.e., no “distributable event”).

Elective Transfer. The “elective transfer” is the original exception to the protected benefit rules, provided in the 1988 regulations. It has been slightly modified by the new rules. To make this type of transfer and not have to protect optional forms of benefit provided under the transferor plan:

- The participant must be eligible to receive an immediate distribution of plan benefits;
- The participant must make a voluntary fully-informed election to transfer;
- The participant must be 100% vested in his transferred benefit; and
- The amount transferred plus the amount of any simultaneous direct rollover must equal 100% of the participant’s vested benefit.

In addition, the new rules provide that:

- Elective transfers are available to amounts that are distributable only in the form of periodic payments beginning immediately (e.g., immediate annuities).
- If part of a distribution is directly rolled-over and the other part is only eligible for an elective transfer, the entire transaction is treated as an elective transfer.
- Most importantly, elective transfers are *not available* on or after *January 1, 2002*, if the

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participant can directly roll over his entire vested account balance.

Transaction Transfer. A "transaction transfer" is a new type of transfer that can be made only in connection with an asset acquisition, a stock acquisition, a merger, or another similar transaction involving a change in the employer of the employees or a trade or business. This type of transfer may be made only between defined contribution plans, with the following additional limitations:

- A transfer from a money purchase pension plan must be made to another money purchase plan.
- A transfer from a 401(k) plan must be made to another 401(k) plan.
- A transfer from an ESOP must be made to another ESOP.
- A transfer from a non-401(k) profit sharing plan may be made to any type of defined contribution plan.
- A transfer from a non-ESOP stock bonus plan may be made to any type of defined contribution plan.

In addition:

- If the QJSA rules apply to the transferor plan, but not to the receiving plan, the receiving plan must provide QJSA benefits on the transferred assets.
- The change in vesting schedule rules (election of vesting schedule if three or more years of service) apply to these transferred assets, since participants do not have to be 100% vested to make such transfers.

Employment Change Transfer. The second new type of transfer provided by these regulations is the "employment change transfer." This type of transfer is made in connection with a change in a participant's employment status such that in his new status he is not entitled to additional allocations under the transferor plan. For example, the following situations would be eligible for employment change transfers:

- Participant changes job class from hourly-paid to salaried and the employer maintains separate plans for each of these job classes.
- Participant goes to work for a different division or subsidiary of the controlled group employer, which has its own plan.
- Participant leaves the employer to go to work for an unrelated employer.

All of the requirements for, and limitations on, making a transaction transfer, as discussed above, also apply to employment change transfers.

Next Steps

Sponsors of plans that have acquired many optional forms of benefit payment over the years due to plan mergers or conversions from one form of document to another form of document should review those options to determine how many are actually used.

Sponsors of profit sharing plans that provide annuity forms of payment simply because they do not provide a 100% death benefit to surviving spouses might consider changing their death benefit provisions. If the plan is amended to provide a 100% spousal death benefit, it can also be amended to eliminate the annuity payment options and, as a result, the need for spousal consent to loans and distributions.

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Currently, many plan sponsors are in the process of restating their plan documents to reflect recent legislation ("GUST amendments"). Some of these restatements may not be adopted until 2001 or 2002. In the meantime, a plan sponsor may make an amendment eliminating optional forms of benefit, as permitted by these new rules, in accordance with the amendment procedures established by the plan (for example, by adopting a Board of Directors Resolution authorizing the change.

If you are interested in exploring the possibility of removing unused or unwanted optional forms of benefit from your plan, please contact your Prudential Retirement representative.

COMPLIANCE CLIPS

Final Rules Eliminate Involuntary Cash-Out Look-Back Rule

The Taxpayer Relief Act of 1997 (TRA '97) increased the involuntary cash-out threshold from $3,500 to $5,000 for plan years beginning after August 5, 1997. In 1998, the IRS published rules revising the "look-back rule" that applied when determining if a participant's vested account balance could be cashed-out without consent. Additional rules, issued in July 2000, generally eliminate the look-back rule altogether.

If a participant's vested account balance does not exceed $5,000, the plan can distribute the account balance to the participant in a single sum, without the participant's consent. Under the look-back rule, if a participant received a distribution at any time when his vested account balance exceeded the involuntary cash-out threshold, he would have to consent to all later distributions.

The new rules generally eliminate this look-back rule. Thus, a plan may distribute a participant's vested account balance without his consent if it does not exceed the plan's cash-out limit at the time of the current distribution.

In addition, if periodic payments (e.g., installment or annuity payments) are being made and the current vested account balance is less than $5,000, the remaining balance may be distributed without consent. However, this rule only applies to plans that are not subject to the joint and survivor annuity rules (e.g., plans that do not require spousal consent). This type of cash-out may not be made by money purchase pension plans.

Vested account balances below the plan's cash-out limit can be forced out before the Annuity Starting Date even if the plan is subject to the joint and survivor annuity rules. However, participants still need to receive rollover distribution notices before payment may be made.

The final rules apply to distributions made after October 16, 2000. For more information regarding these rules, please contact your Prudential Retirement representative.

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