Pension ANALYST

Important Information | **Distributions and Withdrawals** | **October 2004**

DOL Issues Automatic Rollover Rules for Small Cash-Outs

WHO'S AFFECTED These rules affect qualified defined benefit plans and defined contribution plans that are subject to ERISA Title I requirements, including multiemployer plans and ERISA 403(b) plans. While the safe harbor provisions of the rules do not apply to governmental plans, non-electing church plans, and non-ERISA 403(b) programs, the issuance of the rules means that the automatic rollover rule becomes effective for those types of plans *and* for ERISA Title I plans for all small cash-outs on or after March 28, 2005. Additionally, the IRS is currently working on guidance that may address the applicability of these rules to these non-ERISA plans.

BACKGROUND AND SUMMARY Plans may automatically make distributions ("cash-outs") to terminated participants without their consent if the value of their vested accrued benefits (or vested account balances, in the case of defined contribution plans) is $5,000 or less. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made changes to these rules to require that certain small cash-outs be automatically rolled over to an IRA, unless the participant makes an election to take cash or make a different direct rollover. This automatic rollover requirement applies if the value of the participant's vested accrued benefit or account balance is more than $1,000 but less than or equal to $5,000. Plans must provide participants with a notice explaining the automatic rollover provision.

While protecting retirement savings, these requirements created concerns about plan sponsors' fiduciary responsibilities under ERISA when choosing both a default rollover IRA provider, as well as the initial IRA investments. On September 28, 2004, the Department of Labor (DOL) issued final rules describing a safe harbor for fiduciaries making such decisions. This publication discusses those rules, as well as related prohibited transaction relief also provided by the DOL.

These rules apply to cash-out distributions made on or after March 28, 2005.

ACTION AND NEXT STEPS These rules require plan administrators to distribute a summary plan description (SPD) or summary of material modifications (SMM) notifying participants of the automatic rollover provision. Additionally, plan documents will need to be amended to reflect the change to an automatic rollover provision of the cash-out amounts. The IRS will be providing guidance on these rules that may include a sample plan amendment, model participant notice language, and a revised safe harbor section 402(f) rollover distribution notice.

Plan sponsors that want to continue to require cash-outs of benefits valued between $1,000 and $5,000 will also need to take action to select an institution to receive the rollovers, as well as make a decision on how the rollovers will be invested. Prudential Retirement is committed to offering an IRA solution for plan sponsors. We will keep you informed of developments in this area over the next few months.

Prudential Financial

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Overview

On September 28, 2004, the DOL issued final rules regarding the EGTRRA provision requiring small benefits to be distributed automatically in the form of a rollover to an individual retirement account or individual retirement annuity (IRA). These rules apply to distributions of vested accrued benefits or vested account balances exceeding $1,000 but less than or equal to $5,000. In addition, plan sponsors may apply these automatic rollover rules for mandatory distributions of $1,000 or less if their plan provides for automatic rollovers of such amounts.

Safe Harbor Rules

To comply with the automatic rollover requirement, plan sponsors must designate an institution to receive the rollovers. Plan sponsors must also choose how the rollovers will be invested. These actions are subject to ERISA's fiduciary standards. The DOL final rules provide that a plan sponsor or administrator will be deemed to have satisfied this fiduciary responsibility if the following requirements are met:

- The present value of the benefit does not exceed the plan's cash-out threshold (up to a maximum of $5,000). *Note: EGTRRA allows plans to disregard rollover contributions in determining if the threshold has been met. If a plan disregards rollover contributions for these purposes, it is possible for a participant who has a significant amount of rollovers but otherwise has a small new accrued benefit, to find that his entire benefit is subject to automatic cash-out and rollover.*

- The distribution is rolled to an IRA established by a bank, insurance company, or other authorized provider (e.g., mutual fund companies). A plan may use multiple IRA providers.

- The plan fiduciary enters into a written agreement with an IRA provider that specifically addresses, among other things, the investment product holding the rolled-over dollars and the fees and expenses associated with the account. As long as the terms and conditions of the agreement meet the conditions of the safe harbor rules, the plan sponsor's fiduciary responsibility regarding the automatic rollover ends when the funds are placed with the IRA provider. The terms of the agreement must then be enforceable by the participant.

- The distribution is invested in a product designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity. This investment product must be offered by a State or federally regulated financial institution, (i.e., a bank or savings association, credit union, insurance company, or registered investment company.) Safe harbor investment products include: money market funds maintained by registered investment companies, interest-bearing savings accounts, certificates of deposit of a bank or similar financial institution, and fully benefit-responsive "stable value products" issued by a regulated financial institution (such as an insurance company).

- The fees and expenses charged to the IRA do not exceed the fees and expenses charged by the IRA provider for comparable IRAs established for reasons other than the receipt of automatic rollovers.

- Participants are provided with a summary plan description (SPD) or summary of material modifications (SMM) describing the plan's automatic rollover provision. The description must include an explanation of the investments, how fees and expenses will be charged and a contact name for further information.

- The plan sponsor does not engage in a prohibited transaction in the selection of either the IRA provider or investment product.

Prohibited Transaction Exemption

Along with the safe harbor rules, the DOL has also issued a prohibited transaction exemption, allowing a plan sponsor that is also the employer maintaining the plan to:

- Select itself or an affiliate as the IRA provider to receive automatic rollovers from its own plan;
- Select its own funds or investment products for automatic rollovers from its own plan; and
- Receive fees for these services.

To qualify for this prohibited transaction exemption, the plan sponsor must:

- Inform the participant before making the distribution that the distribution will be rolled to an IRA provided by the plan sponsor or affiliate and that the plan sponsor may select its own proprietary investment as the initial investment under the plan.
- Allow the participant, within a reasonable period of time after his or her request and without penalty to the principal amount of the investment, to transfer his IRA balance to a different investment or different financial institution.
- Only charge fees and expenses against income earned by the IRA for other than the initial establishment fees.
- Maintain records verifying that it met the requirements for the exemption for a period of six years.

This exemption is not available to financial institutions that have not previously provided a comparable IRA product.

Miscellaneous Issues

USA PATRIOT Act

The customer identification and verification procedures of the USA PATRIOT Act will not be required at the time the plan established an account and transfers the funds to an IRA provider. These requirements would not be triggered until the former participant first contacts the IRA provider to claim the account. Guidance on this matter is available in question and answer form at the following Website: http://www.occ.treas.gov/10.pdf.

ERISA Section 404(c)

Once the safe harbor conditions are satisfied, the participant is deemed to be exercising control over the assets of the IRA immediately following the rollover. Therefore, the plan sponsor's fiduciary responsibilities end at the time the dollars are rolled into the IRA.

Beneficiary Designations

Once the benefit is distributed from the plan to the IRA, any beneficiary designations made or default beneficiary provisions applicable under the plan no longer apply. The participant will need to designate a beneficiary under the IRA. The IRA may provide default beneficiary language that will apply until the owner makes an affirmative designation.

Effective Date

The final rules apply to involuntary cash-out distributions made on or after March 28, 2005. Plan sponsors may rely on the rules before the effective date for purposes of satisfying their fiduciary responsibilities of choosing an IRA provider, as well as the initial investment. However, plan sponsors cannot rely on the related prohibited transaction relief prior to the effective date of the regulations.

The IRS is expected to provide revisions to the section 402(f) safe harbor rollover distribution notice before this effective date, as well as other guidance regarding automatic rollovers. We will keep you informed as additional guidance is issued.

COMPLIANCE CLIPS

Guidance on Missing Participants in Terminated Defined Contribution Plans

The Department of Labor (DOL) has recently issued guidance for handling missing participants in certain terminating defined contribution plans and the eventual distribution of their account balances. This guidance does not apply to:

- Governmental and church plans that are not subject to the ERISA Title I fiduciary responsibility rules;
- Terminating defined contribution plans that offer annuities and require spousal consent to certain types of distributions, unless the plan is able to eliminate the annuity options at plan termination; and
- Defined contribution plans where the employer sponsors another qualified plan *to which the account balances for the terminating plan's missing participants may be transferred.*

Locating Missing Participants

The DOL has listed acceptable search methods for locating missing participants. Some of these search methods are required for the plan sponsor to satisfy ERISA's fiduciary responsibility rules; other methods are optional. Search-related expenses may be charged to a participant's account provided those expenses are reasonable and the method of allocating those expenses is consistent with the terms of the plan.

The four *required* search methods are as follows. Of course, a plan fiduciary is not obligated to take all of these steps if one or more of them is successful in locating the missing participant.

- Use of certified mail.
- Review of related plan records. For example, the review of the employer's group health plan records, for more up-to-date participant information, such as an address.
- Checking with a designated beneficiary. Plan sponsors must either ask designated beneficiaries under the terminating plan and any related employee benefit plans for more up-to-date information on the participant, or ask a designated beneficiary to contact the participant or forward a letter to the participant regarding the benefits due under the plan.
- Use of a letter-forwarding service. Both the Internal Revenue Service (IRS) and the Social Security Administration (SSA) have programs for locating missing participants. Both programs impose a fee for their use.

A plan sponsor may use other search methods such as the Internet, commercial locator services, and credit reporting agencies. However, a plan sponsor is not required to use private locator services if the cost for that service is not reasonable in view of the actual facts and circumstances.

Distributing Plan Assets for Missing Participants

If a good faith effort to locate the participant fails and as a result, the plan sponsor has no participant direction on how to distribute the benefit, the plan sponsor may establish an IRA on behalf of the participant. The DOL guidance for selecting IRAs for mandatory cash-outs may be followed, regardless of the distribution amount, when distributing benefits to missing participants. However, a plan sponsor selecting himself as the IRA provider may not rely on the prohibited transaction exemption if the participant's vested account balance exceeds the plan's mandatory cash-out threshold (generally, $5,000).

A plan sponsor that does not want to set up an IRA, may set up an interest-bearing account in the participant's name in a federally insured bank, or escheat the money to the state of the participant's last known residence or work site. Both options will generate taxable income for the participant. However, they will not conflict with the USA PATRIOT Act customer identification and verification provisions (CIP) since a financial institution holding a missing participant's account may defer implementing the CIP rules until the participant takes ownership or exercises control over the account.

This guidance makes it clear that sending the entire account balance to the IRS as 100% federal tax withholding is not an acceptable distribution method.

Miscellaneous Issues

While plans offering annuity options generally may not take advantage of these missing participant distribution options, it would seem reasonable to follow these rules when a missing participant's vested account balance falls under the plan's mandatory cash-out threshold.

A plan sponsor considering the termination of a defined contribution plan, who is confronted with missing participants should discuss the plan termination process with the plan's ERISA counsel.

Pension Analyst by Prudential Retirement
The Pension Analyst is published by Prudential Retirement, a Prudential Financial business, to provide clients with up-to-date information on current legislation and regulatory developments affecting qualified retirement plans.

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