Pension ANALYST

Important Information | Distributions and Withdrawals | March 1999*

IRS Issues Cash-Out and Consent Rules For Defined Contribution Plans

WHO'S AFFECTED These rules apply to all qualified defined contribution plans and to employer contributions made to section 403(b) programs. They do not apply to governmental plans or to nonelecting church plans.

BACKGROUND AND SUMMARY 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. However, TRA'97 did not address explicitly whether or not plan sponsors could apply the new limit retroactively. On December 21, 1998, the IRS published temporary rules confirming that plan sponsors could apply the increased limit retroactively in certain situations. The IRS has also revised the "look-back rule" that applied when determining if a participant's account balance could be cashed-out without consent.

On December 18, 1998, the IRS also published final rules concerning the timing requirements for certain distribution and consent notices. Under these rules, a participant must receive a notice describing his payment options and, if applicable, his spouse must receive notification about the qualified joint and survivor annuity form of payment no less than 30 days and no more than 90 days before the date a distribution is made. However, the 30-day minimum notice rule is waived if the participant, with applicable spousal consent, makes an affirmative election to begin receiving payments and payments do not begin before the eighth day following the day the notices were received. In addition, the final rules permit plans to provide the notices after the annuity starting date and then make retroactive annuity payments.

ACTION AND NEXT STEPS Plan sponsors should review these changes and determine the appropriate involuntary cash-out limit for their plans. If you want to change your plan's cash-out limit, please contact your Prudential Retirement representative.

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Prudential Financial

PRUDENTIAL RETIREMENT

Pension ANALYST

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In December 1998, the IRS published rules regarding qualified plan distributions. One set of rules provides guidance regarding involuntary plan cash-outs and the new $5,000 threshold set by the Taxpayer Relief Act of 1997 (TRA '97). The other rules finalize the timing requirements for providing distribution and consent notices to plan participants who take voluntary distributions.

The TRA '97 Involuntary Cash-Out Rules

On December 21, 1998, the IRS published temporary rules regarding involuntary cash-outs from qualified plans. TRA'97 increased the involuntary cash-out threshold from $3,500 to $5,000 for plan years beginning after August 5, 1997. However, the law did not address explicitly whether a plan sponsor, upon amending its plan to reflect the $5,000 limit, could apply the increased limit retroactively. That is, could the plan now cash-out a participant whose vested account balance at the time he terminated employment exceeded the plan's cash-out limit but was less than the new $5,000 limit? The IRS has now provided guidance on this issue and other related concerns.

Applying the New Cash-Out Limit Retroactively

The new IRS rules allow plan sponsors to apply the new limit retroactively. Plans that adopt the new limit may now cash-out a terminated participant whose vested account balance at the time of termination was greater than $3,500, but is now $5,000 or less. In general, a terminated participant's account may be cashed-out even if his vested account balance at the time of termination exceeded $5,000, but has since dropped to $5,000 or less.

For example: In 1995, Joe Q. Participant terminated employment with ABC Company. At that time, Joe's vested account balance in the ABC Company 401(k) Plan was $4,200. Since the Plan applied the $3,500 cash-out threshold, it could not force Joe to take a distribution. Joe left his money in the Plan and has not touched it since his termination. Effective as of the first day of the 1998 plan year, ABC Company amends the 401(k) Plan to increase the plan's cash-out limit to $5,000. Due to investment earnings, Joe's vested account balance is now $4,800. Since this is $5,000 or less, the ABC Company 401(k) Plan may now cash-out Joe's account without his consent or his spouse's consent. However, the Plan must still provide Joe with the eligible rollover distribution notice.

Also in 1995, Jane Q. Participant terminated her employment with ABC Company. At that time, Jane's vested account balance in the ABC Company 401(k) Plan was $7,500. Due to the $3,500 cash-out limit, the Plan could not automatically cash-out Jane's account. Jane left her money in the Plan and has not touched it since her termination. As of April 1, 1999, Jane's vested account balance has dropped to $4,900, due to poor investment results. Since ABC Company raised the 401(k) Plan's cash-out threshold to $5,000 and Jane's vested account balance is now less than $5,000, the Plan may cash-out her account without her consent or her spouse's consent. However, the Plan must still provide Jane with the eligible rollover distribution notice.

Plans may even cash-out terminated participants who are receiving annuity or installment payments, if their remaining vested account balances are $5,000 or less. However, a plan may only cash-out remaining annuity or installment payments if the participant's vested account balance at the time distributions began was $5,000 or less.

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For example: In 1996, John Q. Participant terminated employment with ABC Company. At that time, John's vested account balance in the ABC Company 401(k) Plan was $4,700. Since the Plan applied the $3,500 cash-out threshold, it could not force John to take a distribution. At that time, John elected to immediately begin receiving installment payments. Effective as of the first day of the 1998 plan year, ABC Company amends the 401(k) Plan to increase the plan's cash-out limit to $5,000. Since John's vested account balance at the time the installment payments began was $5,000 or less, and his current remaining vested account balance is less than $5,000, the 401(k) Plan may now cash-out his remaining vested account balance without his consent. However, the Plan must still provide John with the eligible rollover distribution notice.

A plan sponsor's decision to apply the increased cash-out limit retroactively must apply to all similarly-situated participants and should ultimately be reflected in the plan document. Until your document is formally amended, we will need to know how to administer your plan. Please contact your Prudential Retirement representative.

Removal of the Look-Back Rule

Under the look-back rule, if a participant's vested account balance exceeded the cash-out limit at the time of any distribution (either on account of retirement, termination of employment, or in-service withdrawal), it would always be deemed to exceed the limit. It could not later be cashed-out without participant and, if applicable, spousal consent. It appears that the IRS finally recognized the administrative difficulties in applying this rule. The new rules remove the look-back rule with respect to single sum distributions made after March 21, 1999.

For example: In 1998, Suzy Q. Participant had a vested account balance in the ABC Company's 401(k) Plan of $7,000. At that time, she took a hardship distribution of $3,000. This left Suzy with a vested account balance of $4,000. On April 1, 1999, Suzy terminates employment with ABC Company, with a vested account balance of $4,200. Under the old look-back rule, the 401(k) Plan could not have cashed-out Suzy's account without her consent. However, under the new rules, the Plan may cash-out her account since her vested account balance is now $5,000 or less.

However, these rules do not repeal the look-back rule with respect to annuity or installment payment situations where the participant's vested account balance at the time distributions began exceeded the new $5,000 cash-out limit.

Plan Amendments

Plan sponsors may amend their plan documents to apply the increased cash-out limit for plan years beginning after August 5, 1997. However, these amendments generally do not have to be made until the last day of the 1999 plan year. In the meantime, plans may operate under the new rules, as long as the amended plan indicates the appropriate retroactive effective date for this provision. Plan sponsors that use a Prudential prototype plan document may operationally comply with changes to this cash-out limit, even though the base plan document has not yet been amended to reflect the new provisions.

Note that if you choose a cash-out threshold of less than $5,000, you will have to obtain both participant and, if applicable, spousal consent to distributions for which such consent is not legally required.

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We will file our amended prototype plan document with the IRS before the end of 1999, and it is our understanding that adopting employers will have 12 months following our receipt of IRS approval letters to re-adopt the revised document. Volume submitter documents will follow a similar amendment process. Since these plan readoptions may not occur until 2000 or 2001, you may want to document any changes through a Board of Directors' resolution.

Plan sponsors that use individually designed plan documents and have not yet amended them to provide for the increased cash-out limit, may do so at any time.

So that we can administer your plan appropriately before it is actually amended, you will need to contact your Prudential Retirement representative.

Consent Rules for Voluntary Distributions

On December 18, 1998, the IRS issued final rules regarding the timing requirements for providing distribution and consent notices to a participant and, if applicable, his spouse. Specifically, the IRS confirmed that distribution notices and qualified joint and survivor annuity (QJSA) notices, when necessary, must be provided to a participant and his spouse no less than 30 days and no more than 90 days before the date of distribution. The 30-day minimum notice requirement may be waived by a participant's affirmative election to receive a distribution and a plan may make the distribution as soon as that election is received, as long as the participant's spouse does not have to consent to the distribution. If the spouse's consent is needed, the plan may make distributions upon receiving the participant's election and the spouse's consent to that election within the 30-day period but no earlier than the eighth day after the notices were provided.

If a distribution is going to be made in the form of an annuity, these final rules now permit notices to be provided after the official "annuity starting date." This permits plans to make retroactive annuity payments in situations where a participant has retired and distribution of the appropriate election and consent notices is delayed until after that retirement date.

These final rules apply to distributions made after September 21, 1995.

If you have questions about any of these distribution rules or their application to your plan, please contact your Prudential Retirement representative.

Compliance Clips

Notifying Participants of Reductions in Future Benefit Accruals

The IRS recently published final rules regarding ERISA §204(h) Notices. These rules require the sponsor of a money purchase pension plan (including a target benefit plan) to notify affected parties if it intends to significantly reduce future benefit accruals. This notice requirement *does not apply* to profit sharing plans (including 401(k) plans), to tax-sheltered annuity programs, or to governmental plans or nonelecting church plans.

A plan amendment "significantly reduces future benefit accruals" if it is reasonably expected to lower the amount allocated in the future to participants' accounts. Changes made to vesting

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schedules and optional forms of benefit are not taken into account when making this determination. *Plan administrators need to be especially aware of the §204(h) Notice rules in plan merger and termination situations. The most common situation in which a §204(h) Notice is needed is where a money purchase pension plan is being converted into a 401(k) or other profit sharing plan.*

In these situations, the plan administrator must notify affected plan participants, beneficiaries, and employee organizations. The §204(h) Notice must be provided after the plan amendment is adopted but at least 15 days *before* the amendment's effective date. The plan administrator may hand-deliver these notices or mail them via first class mail. If the notices are mailed, the date of the U.S. postmark is considered the notification date. Currently, these notices may *not* be provided electronically and it is not clear if a bulletin board posting would be acceptable.

The §204(h) Notice must contain a summary of the plan amendment and note its effective date. It does not need to include the actual amendment or explain how the individual participant will be affected.

The penalty for not complying with these rules is substantial. If a plan administrator does not provide §204(h) Notices on time, the amendment reducing future allocations will not be effective. If notices are provided on time but are not provided to all affected parties, the amendment will generally apply as intended only to the individuals who received notices. However, if only a "de minimis" percentage of affected parties did not receive notices, the amendment may still apply to all affected parties.

The final §204(h) Notice rules apply to plan amendments adopted after December 11, 1998. For more information regarding these rules, please contact your Prudential Retirement representative.

Pension Analyst by Prudential Retirement
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