Pension ANALYST

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PRUDENTIAL RETIREMENT

IRS Provides Automatic Rollover Guidance

WHO'S AFFECTED This guidance affects sponsors of and participants in qualified defined benefit and defined contribution plans that currently have an automatic cash-out provision, including multiemployer plans, state and local governmental plans, and non-electing church plans. It also affects governmental section 457(b) plans and 403(b) plans or programs that provide for automatic cash-outs. These rules do not apply to non-governmental section 457(b) plans.

BACKGROUND AND SUMMARY The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made changes to require that certain mandatory distributions be automatically rolled over to an individual retirement account (IRA), unless the participant makes an election to take cash or make a different direct rollover. On September 28, 2004, the Department of Labor (DOL) issued final rules providing plan fiduciaries with a safe harbor for making decisions about default rollover IRA providers, as well as initial IRA investments, effective for mandatory distributions made on or after March 28, 2005. At that time, many tax-related questions regarding these rules remained unanswered.

On December 29, 2004, the IRS issued Notice 2005-5 to answer many of these questions. Highlights of this guidance include:

- Delayed effective dates for certain governmental and non-electing church plans;
- A grace period, until December 31, 2005, for processing mandatory distributions that are delayed due to a lack of administrative procedures including the failure to establish an IRA;
- Requirements for the notice that must be provided to plan participants regarding the default rollover IRA; and
- A sample plan amendment that may be used by qualified plan sponsors to reflect the automatic rollover rules.

ACTION AND NEXT STEPS Prudential Retirement has already begun updating our procedures, as well as our administrative and recordkeeping systems to accommodate the automatic rollover rules. As required by these new regulations, effective March 28, 2005, we will no longer make automatic cash-out distributions. Of course, participants will still be able to affirmatively elect to receive these distributions in cash or make direct rollovers to specified IRA providers or retirement plans. Once all necessary information is received and updates are completed, distributions will be processed for those participants who have not made affirmative distribution elections.

Most qualified defined contribution and defined benefit plans will have to be amended to reflect the automatic rollover rules. In addition, most sponsors of qualified plans, section 457 plans, and 403(b) plans or programs with an automatic cash-out provision will have to select an automatic

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rollover IRA provider. Prudential will work with you to ensure your plan is administered appropriately.

IN THIS ISSUE

Overview

In general, the automatic rollover rule applies to all mandatory distributions made on or after March 28, 2005, which exceed $1,000, and are eligible rollover distributions that are subject to 20% federal income tax withholding. For these purposes, a mandatory distribution is a distribution that is made without the participant's consent, and before the participant reaches the later of age 62 or the plan's normal retirement age.

As a result, a participant who retires after reaching the later of age 62 or the plan's normal retirement age is not subject to the automatic rollover requirement and the plan may require automatic cash-outs of benefits valued at $5,000 or less. The automatic rollover rule also does not apply to small benefits payable to a surviving spouse or to an alternate payee under a Qualified Domestic Relations Order.

In addition, a plan loan offset amount that is an eligible rollover distribution is not subject to the automatic rollover rule.

However, if a plan disregards rollover contributions in determining if the plan's cash-out threshold has been met, amounts attributable to rollover contributions must be rolled over to an IRA with all other amounts. *For example, Participant B has an account balance in Plan Y consisting of a $15,000 rollover contribution from his prior employer's plan, and new contributions under Plan Y totaling $4,000. Participant B terminates employment. Plan Y disregards rollover contributions for purposes of determining the plan's cash-out threshold . Unless Participant B makes an affirmative election otherwise, the entire account balance of $19,000 will be automatically rolled over to the IRA designated by the plan sponsor.*

Some plan sponsors may want to avoid the automatic rollover rules entirely, and lower their plan's automatic cash-out threshold to $1,000, thereby requiring participant consent for all distributions exceeding $1,000. The IRS has clarified that plans that are subject to the spousal consent rules (e.g., defined benefit plans and money purchase pension plans) do not need to obtain spousal consent to distributions of benefits valued between $1,000 and $5,000, even if participant consent is required for these distributions.

Plans may delay processing mandatory distributions during 2005, if sufficient administrative procedures for making automatic rollovers, including the establishment of rollover IRAs, are not in place. This type of delay will not be considered an operational defect, as long as the distributions are made by December 31, 2005.

Establishing IRAs

The plan sponsor may set up an IRA on behalf of a participant who does not make an election to take cash or make a different direct rollover. A plan sponsor has the authority to execute documents to establish the IRA, using the participant's most recent mailing address in the records of the employer and plan administrator. The trustee or issuer of the IRA must provide a disclosure statement to the participant and provide a revocation period.

An automatic rollover may be made to an account under a group IRA arrangement established by an employer for its employees, or a "deemed IRA" that is part of the plan making the distribution.

Prudential's Automatic IRA Product

Prudential Retirement has developed an integrated IRA solution to help plan sponsors meet the automatic rollover requirements. Under Prudential's Automatic IRA Product:

- Money is invested in a FDIC Insured Bank Statement Savings IRA through Prudential Bank & Trust, FSB ("Prudential Bank");
- Interest accrues daily and is paid monthly;
- The interest rate is monitored weekly and benchmarked off of the Bankrate Monitor National Index for money market funds;
- There is no fee for plan sponsors;
- A $40.00 annual fee is assessed for accounts over $1,000, with an additional $40.00 fee assessed if the account balance falls below $1,000.
- A $50.00 fee is assessed for closing the account. If the account is closed within the first 90 days, there is an additional $40.00 early termination fee.

If the plan sponsor selects the Prudential Bank IRA, we will establish the IRA with Prudential Bank and transfer each participant's records and assets. To take advantage of our solution, a plan sponsor will need to sign an IRA Agreement with Prudential Bank, even if Prudential Bank is already the trustee for the plan.

If the plan sponsor chooses to use an IRA trustee other than Prudential Bank, Prudential will send individual rollover IRA checks to the plan sponsor made out to the IRA Trustee, FBO the participant. The plan sponsor will then work with the plan's IRA Trustee to set up the individual accounts.

In the near future, you will receive additional information regarding Prudential's Automatic IRA Product, along with a copy of the IRA Agreement, in case you are interested in pursuing this option.

Notice Requirements

A plan administrator must notify a participant in writing that, unless the participant makes an affirmative election otherwise, the mandatory distribution will be paid to an IRA. The notice:

- May be provided as part of the 402(f) Rollover Distribution Notice, or separately. *(Note: The IRS has not yet provided a revised Safe Harbor 402(f) Notice reflecting this information.)*
- Must identify the IRA trustee or issuer; and
- May be sent via electronic media, as allowed for the distribution of 402(f) Notices.

The plan sponsor will be treated as meeting this requirement even if the notice is returned by the US Postal Service as undeliverable, if it was mailed to the participant's most recent mailing address in the employer's records.

This notice is in addition to the updated summary plan description (SPD) or summary of material modifications (SMM) that must be provided to participants in a qualified plan once the plan is amended.

For defined contribution plans that use Prudential Retirement's notification letter with the Distribution Education Center service, and defined benefit plans that use our Outsourcing Services, we will provide this notice to participants.

Effective Dates

Generally, the automatic rollover rules apply to mandatory distributions made on or after March 28, 2005. However, special effective dates apply to certain governmental and non-electing church plans:

- Governmental Plans (qualified, 457(b), and 403(b)): The automatic rollover rules are effective for all mandatory distributions made on or after 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 where the authority to amend the plan is held by a church convention: The automatic rollover rules are effective for all mandatory distributions made on or after 60 days after the close of the earliest church convention that occurs on or after January 1, 2006.

Plan Amendment Issues

Plans providing for mandatory distributions exceeding $1,000 that do not already include an automatic rollover provision must adopt a good faith plan amendment by the end of the first plan year ending after March 28, 2005. For calendar year plans, this will be December 31, 2005. However, non-calendar year plans may need to adopt the amendment much sooner. *For example, plans with an April 1 plan year would need to adopt an amendment by March 31, 2005.* (As we go to press, the IRS has received requests to delay this amendment deadline. Additionally, there is a question in the industry regarding whether this amendment could be considered an EGTRRA amendment that would not need to be adopted until year end. In the event the date is delayed, we will notify you.) Sponsors of governmental plans have 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, to adopt this amendment. Sponsors of non-electing church plans where the authority to amend the plan is held by a church convention have until the 60 days after the close of the earliest church convention that occurs on or after January 1, 2006, to amend the plan.

The IRS has provided a sample amendment that may be adopted (or used as the basis of a good faith amendment) by individual plan sponsors or sponsors of prototype or volume submitter plans to address mandatory distributions greater than $1,000. Employers that use Prudential-sponsored plan documents should not take any action at this time to amend their documents to reflect the automatic rollover requirements, since such amendments could take their plans out of pre-approved status. We will provide you with additional plan amendment information in the near future.

In fact, other plan design alternatives may also be available for plan sponsors. For example, plan sponsors may amend their plans to eliminate mandatory distributions without violating the anti-cutback rules. Additionally, plan sponsors may choose to lower their plan's cash-out threshold to $1,000 and continue making cash distributions for those amounts under $1,000. These alternatives may be attractive for plan sponsors that do not want to set up IRAs for participants who do not make affirmative elections. However, they may not be practical for defined benefit plan sponsors since PBGC premiums would still be required for former participants who did not make an election. For employers that use Prudential-sponsored plan documents, more information regarding plan design alternatives will be included in the additional plan amendment information mentioned above.

Employers that do not use a Prudential-sponsored document should consult their attorneys to ensure the plan document is updated in a timely manner, and then provide us a copy of the updated plan document so we can appropriately administer the plan.

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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