JULY/AUGUST 2004

Automatic Rollovers May Ease Missing Participant Problems

John Smith terminated employment in 1997, leaving a vested account balance of $4,000 in the 401(k) plan. As part of the GUST restatement, you amended your plan to increase the level of involuntary cash-outs from $3,500 to $5,000. When you tried to contact John, it was discovered that he moved without leaving a forwarding address. You then tried contacting John through the IRS's mail forwarding program, but there has been no response.

Mary Jones recently terminated with a vested account balance of $1,500. Mary was sent the requisite distribution forms, but she refuses to complete them. What, if anything, can be done about John and Mary?

Missing and uncooperative plan participants are a nightmare for employers attempting to cash out small account balances. Such participants can create significant problems, especially when a retirement plan is being terminated and distributions must be completed within a comparatively short time.

Three years ago, Congress tried to help. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) authorized automatic, direct rollovers of account balances of between $1,000 and $5,000. The Department of Labor (DOL) was ordered to issue regulations within three years of EGTRRA's enactment to implement this change.

New Proposed Regulations

One month before the deadline, the DOL finally issued Proposed Regulations. Under the proposal, an employer may create an IRA for the benefit of a missing or unresponsive participant without incurring additional fiduciary liability if six "safe harbor" preconditions are followed. Unfortunately, the regulations will not become effective until six months after they are published in final form in the Federal Register.

Under the DOL proposal, plan sponsors and trustees will be safe-harbored from fiduciary liability for missing and unresponsive participants' accounts *if* automatic direct rollovers are used *and* the following requirements are met:

1. The present value of the participant's vested account must be at least $1,000 but no more than $5,000. Present value is measured as of the date of the proposed distribution. For example, if a participant's account had a value of $5,600 on the date of termination, and, due to investment performance, subsequently declined to $4,600 on the distribution date, the participant may be involuntarily

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HIGHLIGHTS

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Retirement Plan Services

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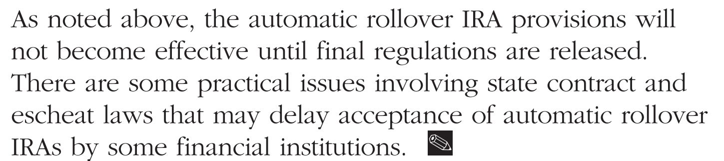
cashed out. However, if the present value of the account is over $5,000, the participant cannot be cashed out.

2. The rollover must be to a *traditional* IRA account or annuity sponsored by either a bank or an IRS-approved non-bank entity.
3. The automatic rollover IRA must be invested in a product that preserves principal and liquidity and minimizes risk. The investment product must be offered by a "regulated financial institution," such as an insured bank, a savings and loan or credit union, an insurance company, or a money market mutual fund. Examples of acceptable investments include money market and stable value funds and certificates of deposit.
4. Fees charged to establish and maintain the automatic rollover IRA cannot exceed the fees and expenses the provider charges for a comparable rollover IRA. These fees can be charged only against the income generated by the automatic rollover IRA and cannot invade the principal. A small, one-time establishment fee, similar to one the provider charges for a typical rollover IRA, may be charged against the initial principal amount.
5. The features of the automatic rollover IRA and the investment products that are used must be disclosed in either the Summary Plan Description (SPD) or a Summary of Material Modifications (SMM). The disclosure must be made before automatic rollovers occur, and it must identify a plan contact who will be able to answer participants' and beneficiaries' questions.
6. The automatic rollover may not be a prohibited transaction unless an exemption exists for the transaction. A class exemption from ERISA's prohibited transaction rules would be provided that would allow a "regulated financial institution" to select itself as the IRA provider and use its own investment vehicles for the investment of affected accounts.

Other Issues

Customer Identification and Verification (CIP) Requirements of the Patriot Act. The Patriot Act requires that CIP information be provided when the account is opened. Recognizing the difficulties in providing such information, the proposal allows the CIP to be provided only when the participant or beneficiary first contacts the institution. Thus, the automatic rollover may be made without violating the requirement that the CIP be provided when the account is established.

As noted above, the automatic rollover IRA provisions will not become effective until final regulations are released. There are some practical issues involving state contract and escheat laws that may delay acceptance of automatic rollover IRAs by some financial institutions.



Pension Funding Equity Act of 2004

On April 10, 2004, President Bush signed the Pension Funding Equity Act of 2004 (PFEA '04) into law. This new law is intended to provide defined benefit plans with temporary relief from funding requirements.

Urgent relief was needed because of the elimination of the 30-year Treasury bond. (The interest rate on the 30-year Treasury bond had been used as the index for defined benefit plan funding calculations.) The substitution of a hybrid interest rate by the IRS along with three years of economic reverses resulted in an increase in pension plan funding costs for many employers.

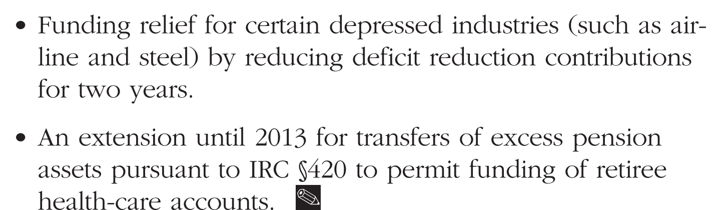
A new methodology based on a composite of the interest rates of high-quality corporate bonds will be used as a temporary substitute for the 30-year Treasury rate. The IRS will publish the new composite rate on a monthly basis.

PFEA '04 also modifies the rules that determine whether an underfunded defined benefit plan is required to make quarterly instead of annual contributions for the current plan year. These changes are applicable to the 2004 plan year.

Because of the urgent need for funding relief, PFEA '04 serves as a temporary fix through the 2005 plan year. Without further Congressional action in 2005, the old law will go back into effect for the 2006 plan year.

Other highlights of PFEA '04 include:

- Funding relief for certain depressed industries (such as airline and steel) by reducing deficit reduction contributions for two years.
- An extension until 2013 for transfers of excess pension assets pursuant to IRC §420 to permit funding of retiree health-care accounts.

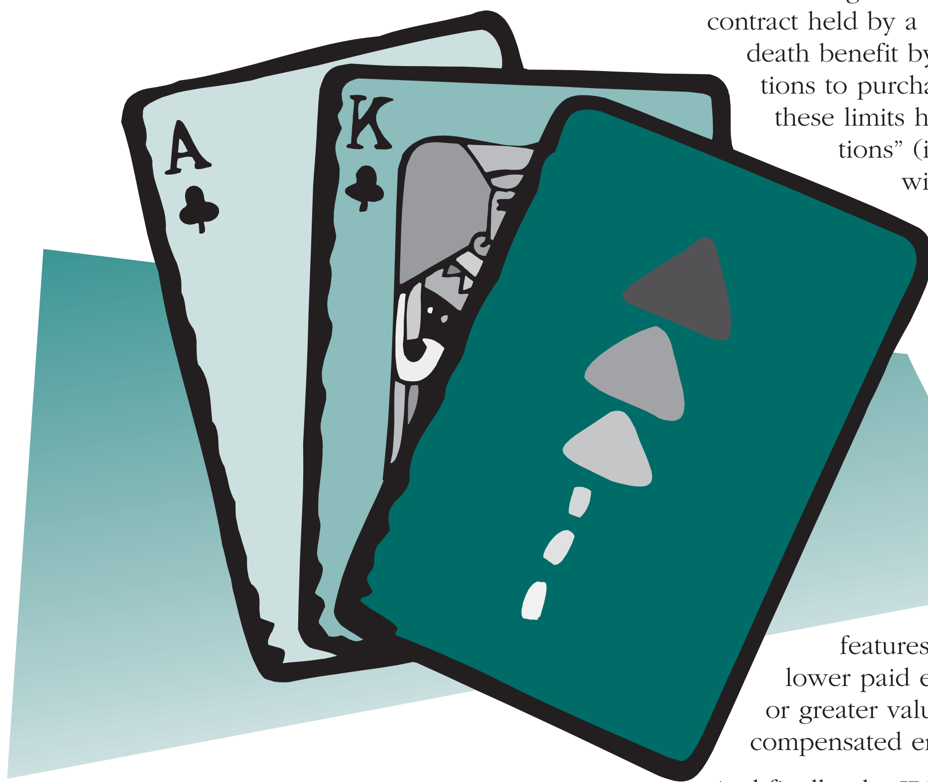


IRS Attacks Insurance Policy Abuse in Pension Plans

Have you ever been pitched a deal that seems too good to be true? We've all laughed at three-card monte dealers and bogus Rolex© watch salespeople in sitcoms. They have their peers in the financial industry, too. The IRS and many in the retirement plan industry have had serious concerns about the inappropriate marketing of certain insurance products to what are commonly known as "Section 412(i) plans."

What is a 412(i) Plan?

Section 412(i) plans are qualified defined benefit retirement plans that are funded entirely by insurance and annuity contracts. Since all the investments are in insurance products, there is no separate trust fund.



Recently, the IRS issued guidance specifically targeting insurance contracts that provide "springing cash values" far in excess of the benefits the plan is allowed to provide.

The IRS's Position

Under a springing cash value policy, the cash surrender value of the insurance policy is temporarily suppressed to a much lower amount than the premiums used to purchase the policy. This means it can be purchased from the plan, usually by a highly compensated employee, at a greatly reduced value. Once the policy is out of the plan, its cash value "springs back" to the higher cash surrender value.

The IRS has taken the position that such transactions are inherently discriminatory and are used solely to promote illegitimate tax avoidance. As a result, it has issued formal guidance to stop these transactions by requiring that any life insurance contract transferred from a tax-qualified plan to an employee be taxed at its *full fair market value*.

And More Guidance

In addition, the IRS released a Revenue Ruling stating that a qualified pension plan cannot hold life insurance or annuity contracts for the benefit of a participant that provide a greater benefit than the plan-calculated benefit at normal retirement age. Additionally, the value of a life insurance contract held by a qualified plan may not exceed the plan's death benefit by more than $100,000. And lastly, deductions to purchase life insurance benefits in excess of these limits have been designated as "listed transactions" (i.e., tax avoidance transactions) that will result in additional taxation for the employer. Even though you may not have a Section 412(i) plan, the amount of deductible contributions that can be used to purchase life insurance in a defined benefit plan may be limited.

To further complicate the use of such springing value policies, the IRS ruled that the right to purchase a life insurance contract from a retirement plan must be made available on a nondiscriminatory basis to all participants. According to this ruling, the features of life insurance contracts provided to lower paid employees must be of "inherently equal or greater value" compared to the contracts that highly compensated employees have the right to purchase.

And finally, the IRS has issued an interim procedure for establishing the fair market valuation of life insurance products, which will remain in effect until final valuation regulations are issued. Initial comments from within the retirement plan consulting community indicate that there may be potential problems in using the proposed rules, especially when valuing whole life policies.

The Best Approach

What do you do when you hear about a deal that's too good to be true? The best policy is probably to simply walk away!

EGTRRA Restatements Are Coming — But Not Quite Yet!

The IRS recently issued a Revenue Procedure that gives us a hint as to the timing of when retirement plans will have to be restated — yet again — to incorporate changes required by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Based on this IRS release, the restatement process probably will not begin before the end of 2005.

What the IRS Said

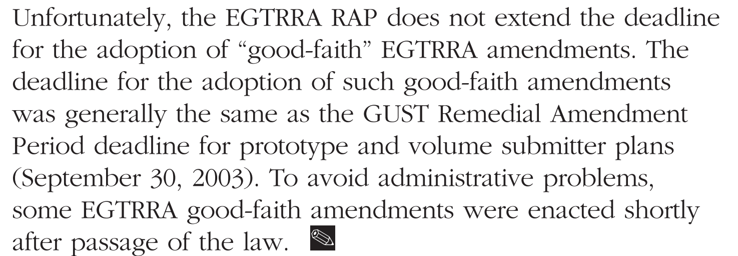
The immediate ruling concerns Section 401(b) of the Internal Revenue Code. This provision permits a plan whose document text does not satisfy all the retirement plan qualification rules to be amended retroactively to cure the defect(s). Such a retroactive amendment must be adopted by the end of the plan's Remedial Amendment Period (RAP) and must apply to the entire period in question.

A provision in EGTRRA originally provided an extended RAP, but the provision was dropped from the final version of that law due to certain Senate rule requirements for enacting a budget bill. The IRS procedure supplies this missing provision and establishes an extended amendment period for the adoption of EGTRRA amendments through the end of the 2005 plan year. The extended RAP applies to disqualifying plan document defects in *new* plans with effective dates after December 31, 2001. It also applies to amendments to existing plans that were adopted after December 31, 2001.

What This Means to You

The extended RAP means that an employer who currently adopts a new plan does not have to submit its plan for an IRS determination letter until after the IRS opens its Determination Letters Program for all EGTRRA provisions. For example, if an IRS agent finds defective language while reviewing a new plan document, the employer will be permitted to amend its plan retroactively to its original adoption date. Similarly, the sponsor of an existing plan that was amended after December 31, 2001, will also be allowed to adopt a curative amendment retroactive to the effective date of the amendment.

Unfortunately, the EGTRRA RAP does not extend the deadline for the adoption of "good-faith" EGTRRA amendments. The deadline for the adoption of such good-faith amendments was generally the same as the GUST Remedial Amendment Period deadline for prototype and volume submitter plans (September 30, 2003). To avoid administrative problems, some EGTRRA good-faith amendments were enacted shortly after passage of the law.



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