Independent Directors Council
Promoting Excellence in Fund Governance

ICI Letter on Plan Termination Under the Final 403(b) Regulations

Via Electronic Delivery

November 12, 2008

Mr. W. Thomas Reeder
Benefits Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 3050 MT
Washington, DC 20220

Re: Plan Termination Under the Final 403(b) Regulations

Dear Mr. Reeder:

I am writing on behalf of the Investment Company Institute (the "Institute")[1] to urge the Treasury Department and the Internal Revenue Service (collectively, the "Service") to issue guidance on 403(b) plan termination before January 1, 2009. There is enormous confusion within the 403(b) community about a range of fundamental issues related to plan termination. These issues have significant tax implications for participants and beneficiaries, employers, and vendors. Guidance is urgently needed because some employers have already terminated their plans, others have announced plan terminations, and many employers are making decisions about whether to terminate their 403(b) plans before the looming January 1, 2009 effective date of the final 403(b) regulations.

The notion of 403(b) plan termination is a new one. The final 403(b) regulations provide for the first time that a 403(b) plan may be terminated but provide only limited guidance about plan termination. Among other requirements, the final regulations provide, in relevant part, that:

In order for a section 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan. For this purpose, delivery of a fully paid individual insurance annuity contract is treated as a distribution.

Treas. Reg. § 1.403(b)-10(a)(1). The full import of this language is not clear and we recommend a number of clarifications below.

I. Guidance should clarify that "delivery" of a fully paid individual annuity contract is not required where participants are already invested in fully paid individual annuity contracts.

A basic point that should be clarified is the meaning of the reference to "delivery" of a fully paid individual annuity contract. It is theoretically possible that an employer would terminate its section 403(b) plan by purchasing fully paid annuity contracts and delivering these contracts to plan participants. This could, for example, occur where a plan is invested in a group annuity contract and, in fact, this is a common method of plan termination in the context of tax-qualified defined benefit plans. It is, however, much more likely in the context of 403(b) plans that participants will already be invested in fully paid individual annuity contracts and the reference in the regulation to "delivery" has raised questions about whether it is permissible to terminate a plan and leave participants in their individual annuity contracts. We believe that the delivery requirement should be deemed satisfied if a plan provides for termination and the employer takes effective action to terminate the plan, e.g., a Board resolution.[2] An issuer should be able to simply denote in its records that the contract is attributable to a terminated 403(b) plan. It would, however, be very helpful if this point was clarified.

II. Guidance should confirm that distribution of an individual custodial account is treated as a distribution for plan termination purposes.

One of the more pressing issues that has arisen under the quoted language is whether distribution of an individual custodial account is treated as a distribution of accumulated benefits for plan termination purposes. To put the issue in context, the final regulations make clear that participants and beneficiaries will be eligible to take distributions from their section 403(b) contracts upon the effective date of a plan termination. Distributions taken in connection with plan termination will be eligible rollover distributions if they otherwise meet the applicable requirements.

It is inevitable, however, that there will be participants and beneficiaries that are either not located or unwilling to voluntarily liquidate their existing 403(b) contracts, perhaps because they prefer their current investment provider or because of surrender charges or contingent deferred sales charges. The problem of missing participants is particularly problematic in the context of 403(b) plans because, as the Service is well aware, these plans are often funded through a number of different vendors. Many participants will hold contracts issued by vendors that do not have a current relationship with the employers, such as contracts issued in connection with transfers under Revenue Ruling 90-24 and contracts issued by vendors that are no longer authorized to receive contributions.

Employers ordinarily will not have the option of liquidating 403(b) contracts for missing or unwilling participants. Particularly in the context of non-ERISA plans, our experience is that the majority of section 403(b) contracts are individual annuity contracts or custodial accounts. The employer typically will not have any material retained rights under the terms of these contracts and accounts. As a result, the employer will not have the contractual right to forcibly liquidate the contracts or accounts. Similarly, vendors may not be able to comply with a direction to liquidate, even if they are inclined to do so. Thus, as a practical matter, it seems clear that 403(b) plan termination will only be viable for the vast majority of existing 403(b) plans if it is possible to terminate a plan by distributing [3] individual annuity contracts and individual custodial accounts.

As reflected above, the final 403(b) regulations state that delivery of a fully paid individual insurance annuity contract is treated as a distribution for purposes of plan termination. At times, it has been suggested that the explicit reference to individual annuity contracts creates an inference that distribution of an individual custodial account is not treated as a distribution for purposes of plan termination. It has further been suggested that a failure to liquidate a single custodial account in connection with a plan termination taints the entire termination. The notion appears to be that the concept of plan termination requires a timely liquidation of custodial account assets and that a plan may not be terminated through a “wasting trust.” This notion is, however, inconsistent with the treatment of custodial accounts as annuity contracts for section 403(b) purposes and misapprehends the law of plan termination in the context of 401(a) plans. It is also not sound tax policy. The better analysis is that the reference to delivery of a fully paid individual insurance annuity contract is illustrative and that custodial accounts may be distributed in connection with plan termination. [4]

Section 403(b)(7) provides that amounts contributed to a custodial account are treated as amounts contributed to an annuity contract if the applicable 403(b) requirements are satisfied. Further, the final 403(b) regulations state that “under section 403(b)(7), a custodial account is treated as an annuity contract for purposes of §§1.403(b)-1 through 1.403(b)-7, this section 1.403(b)-8) and §§1.403(b)-9 through 1.403(b)-11.” These references include every provision of the final regulations, including the provisions in section 1.403(b)-10(a), which deals with plan termination. Thus, there is no question that parity between custodial accounts and annuity contracts is intended and we do not see any basis in the final regulations for arbitrarily differentiating between annuity contracts and custodial accounts in the context of plan termination.

Moreover, the notion that custodial accounts must be liquidated to effect a plan termination is fundamentally inconsistent with the law that has developed around plan termination in the context of 401(a) plans. [5] Revenue Ruling 89-87 makes clear that a wasting trust is not a permitted method of plan termination and clarifies that plans do not close out unless the assets of the plan are distributed from the trust as soon as administratively feasible. Revenue Ruling 89-87 and subsequent guidance, however, does not require cash distributions from the employer’s plan and the trust. There is no requirement that a 401(a) plan that is terminated be liquidated through cash distributions. Rather, the employer and the plan fiduciaries must relinquish control over the plan’s assets and deliver those assets to participants. It is well-settled that a plan can be terminated through the distribution of property, including annuity contracts and other forms of property. In this regard, plans have liquidated by opening a bank account or escrow account in the name of each missing participant. See Veal & Mackiewicz, Pension Plan Terminations at 309-310 (2nd Ed. 1998). Another approach has been to create a taxable trust to hold the benefits of missing participants. Id. Conceptually, these are distributions of accounts or trusts as a means of plan termination. The essential point is simply that the employer must not have retained rights over the custodial account and that participants must have control over the distributed assets.

The point that plan termination is fundamentally relinquishment of employer control over the plan’s assets and delivery of control to participants is well illustrated by the very issue posed by terminations involving individual custodial accounts. The employer cannot liquidate the individual custodial accounts because the employer does not have control over the accounts. The custodial account is the property of the individual that is the beneficial and legal owner of the account. It is not the property of the plan. This is precisely why distribution of an individually owned custodial account is a distribution for purposes of plan termination.

The Department of Labor has recognized this very point. Long-standing regulations under the Employee Retirement Income Security Act of 1974 ("ERISA") define when an individual ceases to be a participant in a plan and, accordingly, when the assets attributable to that individual cease to be plan assets. 29 C.F.R. § 2510.3-3(d)(2)(ii). The guidance makes clear that an individual ceases to be a participant if (i) he or she is paid his or her entire benefit in the form of an annuity and (ii) is paid his or her entire benefit in cash or other property. [6] This is true in all circumstances, unless the participant is continuing to have contributions made upon his or her behalf. See, e.g., Advisory Opinion 77-10 (June 2, 1977). The Department has also recognized that the key to determining whether an asset is a plan asset in this context is whether the employer retains control over the asset. See Advisory Opinion 81-60A (July 21, 1981) (discussing retained rights under a group annuity contract issued in connection with plan termination). We recognize that this authority is not binding or precedential, but it is useful in illustrating the distinction between the prohibition against termination through wasting trusts (where the employer retains control over the assets) and a distribution of a custodial account (where the individual has control over the account, including the right to take a distribution at any time).

III. Guidance should confirm that a distributed custodial account is taxed in the same manner as a distributed annuity contract.

Another fundamental question upon which there has also been some uncertainty is the tax status of an annuity contract or custodial account that is distributed in connection with plan termination. The final 403(b) regulations are entirely silent on this issue, except to provide somewhat cryptically that the "mere provision for, and making of, distributions to participants or beneficiaries upon plan termination does not cause a contract to cease to be a section 403(b) contract."

We strongly recommend that the Service confirm that this language is intended to provide that a distributed contract or account remains a section 403(b) contract and continues to enjoy the benefits of tax-deferral. We believe that this is the best reading of the final 403(b) regulations. Moreover, this approach is consistent with the tax treatment of annuity contracts that are distributed from a 401(a) plan. Treasury regulation section 1.402(a)-1(a)(2) provides that the distribution of an annuity contract from a 401(a) plan is a tax-deferred distribution. A variety of other regulatory provisions dealing with plan-distributed annuity contracts provide, for example, that distributions from a distributed annuity contract are eligible rollover distributions. See, e.g., Treas. Reg. § 1.402(c)-2, Q&A-10.

We believe that the same tax treatment should apply to individual custodial accounts. We recognize that the rules governing distributions from a terminating 401(a) plan do not contemplate distributions of tax-deferred custodial accounts and are limited to distributions of annuity contracts. However, as discussed in detail above, section 403(b) accords unique status to custodial accounts and treats them in the same manner as an annuity contract. It would be wholly inappropriate to create a bias towards annuity contracts and would be inconsistent with the apparent intent of Congress in enacting section 403(b)(7). There is already precedent for "stand-alone" individual custodial accounts which were created pursuant to a transfer described in Revenue Ruling 90-24. Many of these contracts will continue to exist and be administered by custodians without any association with a 403(b) plan long after January 1, 2009. Accordingly, we believe that the tax treatment of a distributed custodial account should be the same as the tax treatment of a distributed annuity contract. [7]

IV. The guidance the Institute requests represents good tax policy.

As discussed above, there is a strong basis in the law for concluding that distribution of individual annuity contracts and custodial accounts may be treated as distributions from a terminated 403(b) plan and that distributed contracts should continue to be treated as section 403(b) contracts. The approach we recommend is also compelling from a tax policy perspective for a number of reasons.

First, the approach we recommend would conform closely to the relief that the Service has provided in Revenue Procedure 2007-71 for contracts issued by vendors that have been discontinued as authorized vendors. Section 8.01 of the Revenue Procedure provides that discontinued contracts will not fail to be section 403(b) contracts solely because they are not part of the employer's plan, provided that reasonable good faith efforts are made by either the employer to include the contracts in the plan or by the issuer to share information on a transactional basis. However, notwithstanding these reasonable good faith efforts, if it is not possible to bring the contracts into the plan or share information, the contracts will not be adversely affected. The contracts of terminated plans are a form of discontinued contract and it should be reasonable to accord these contracts parallel treatment. [8] In this regard, we note that contracts attributable to terminated plans present fewer compliance issues than other discontinued contracts since plan termination is a distributable event. As a result, coordination for purposes of determining eligibility for a hardship withdrawal or a distribution upon severance from employment will not be needed. Further, we anticipate that transfers and exchanges would not be permitted; rather, rollovers would be the exclusive means of moving out of the account on a tax-deferred basis.

Second, the approach we request would ensure that participants and beneficiaries continue to enjoy the tax benefits of section 403(b) and have the opportunity to preserve their savings for retirement. In contrast, if the Service takes the view that custodial accounts must be liquidated in order to terminate a 403(b) plan, then there will be many participants in plans that will suffer adverse tax consequences. As mentioned above, the Institute is aware that numerous 403(b) plans, including plans funded through individual custodial accounts, have been terminated and it is clear that more will be terminated in the near future. If, however, the plan termination is ineffective, it appears that the distributions would not be eligible rollover distributions and any rollovers to IRAs or other eligible retirement plans would be excess contributions. Further, the 403(b) plan typically would fail to satisfy the section 403(b) requirements prohibiting in-service distributions, raising the specter of a failed 403(b) plan, which would appear to create income tax withholding and reporting obligations for the employer. Similarly, vendors and other payors would have to deal with the tax reporting consequences of failed contracts. Taken as a whole, the consequences of an ineffective plan termination are potentially dramatic for all stakeholders.

Third, the approach we recommend also allows participants to stay in their current investments. This is significant because forced or incentivized liquidation of existing 403(b) contracts could cause participants to incur surrender charges and contingent deferred sales charges. It is also significant because a requirement that all individual custodial accounts be liquidated in order to effect a plan termination would be an effective prohibition against plan termination. Such a prohibition would place enormous pressure on the system. There would inevitably be creative attempts to find alternatives, including, for example, spin-off terminations of the portion of the plan that is not attributable to custodial accounts. It is even possible that custodians would choose to resign, rather than be a party to an ineffective plan termination and hold a taxable custodial account.

Fourth, it is also important to recognize that section 403(b) plans are part of the voluntary employer-provided system. Nothing in the Internal Revenue Code (or ERISA) requires an employer to maintain a retirement plan for its employees. One of the sources of the system's success is that employer-maintained plans are voluntary. Employers should not be coerced into maintaining plans because of the threat of adverse tax consequences to participants and beneficiaries, or concerns about income tax withholding. This is particularly true where the decision to fund a 403(b) plan through an individual custodial account will almost invariably have been made many years before the final or proposed 403(b) regulations were published. It is simply unfair to lock employers into maintaining a plan on the basis of decisions made many, many years in the past. Further, we believe that allowing plan terminations along these lines will ultimately strengthen the retirement system. Many employers that terminate their 403(b) plans will replace these plans with 401(k) plans or governmental 457(b) plans. Often the employer will already have these plans in place and facilitating plan termination will allow for consolidation and strengthening of these replacement plans.

Finally, it is widely recognized that the final 403(b) regulations represent a sea change in administrative responsibility and oversight for employers. Employers should be able to decide whether to step up to this new responsibility. This is only fair given that the rules of the game have been changed in midstream.

We greatly appreciate your attention and look forward to discussing these issues further if it would be helpful.

Sincerely,

/s/ Elena C. Barone

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cc: Robert Architect
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endnotes

[1] The Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). The Institute seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds and their shareholders, directors and advisers. Members of the Institute manage total assets of $11.2 trillion and serve almost 90 million shareholders.

[2] The preamble to the final 403(b) regulations provides that a plan may be terminated prior to the effective date of the regulations, provided that all of the regulations' requirements are satisfied other than the written plan requirement. 72 Fed. Reg. 41128 at 41139 (July 26, 2007). We assume this means that effective corporate action is all that is necessary from a documentary perspective to terminate a plan prior to January 1, 2009.

[3] Our letter refers to distributions of individual custodial accounts. We do so simply to illustrate that the account is no longer to be part of a 403(b) plan. However, we anticipate that accounts would ordinarily not be modified and that “distribution” would simply involve a change in the recordkeeping of the account. Put differently, this is the same issue discussed above with respect to “delivery” of an individual annuity contract.

[4] Similarly, it should be clear that group custodial accounts and group annuity contracts may be distributed in connection with plan termination, provided that the employer does not have any material retained rights under the group account or contract. In this regard, it is well-settled that a group contract may be distributed from a 401(a) plan in connection with plan termination. See, e.g., PBGC Op. Ltr. 93-1 (Feb. 16, 1993) (plan termination through distribution of group contract); DOL Op. Ltr. 81-60A (July 21, 1981) (same); Priv. Ltr. Rul. 8651078 (Sept. 25, 1986) (same). Further, the use of a group account or contract does not inherently reflect that the named owner of the account or contract (usually the employer) has any particular rights. The group vehicle may simply provide efficiencies without necessarily reserving control to the named owner.

[5] The 401(a) plan termination guidance is clearly the most analogous authority and is a logical place to look for direction given the sparse 403(b) plan termination guidance.

[6] Whether a plan has been terminated for purposes of the Employee Retirement Income Security Act of 1974 (“ERISA”) is an entirely different issue. We are, of course, not asking the Service to opine on plan termination for ERISA purposes.

[7] This principle would not extend outside of the 403(b) context given the absence of an analog to section 403(b)(7) for either qualified plans or governmental section 457(b) plans.

[8] In fact, it appears that an employer could accomplish something that closely approximates a plan termination, albeit without allowing participants to take a distribution in connection with plan termination, through the special transition rules for discontinued contracts. That is, an employer could discontinue contributions to all vendors before January 1, 2009 and refuse to make efforts to bring the discontinued contracts into the employer’s plan. The employer could further inform the vendors of the discontinued contracts that it will ignore requests for information sharing. It seems apparent that the vendors would be treated as satisfying their good faith efforts to share information if the employer simply refuses to share information and nothing can be accomplished by efforts to share information on a transactional basis. As a result, the contracts would continue to be section 403(b) contracts and the employer would cease to have any responsibilities in connection with the plan. This should not be a practice that the Service encourages by effectively prohibiting plan termination.
