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IRS Ruling Addresses Termination of 403(b) Plans; Practical Problems Remain

IRS Revenue Ruling 2011-7 addresses the tax rules governing distributions when 403(b) plans terminate. The Revenue Ruling answers most of the tax questions that have arisen since 2007, when the IRS first expressly allowed 403(b) plan sponsors to terminate their plans. However, practical problems remain, many of which are not within the authority of the IRS to resolve.

Background

Public educational organizations and tax-exempt organizations described in Internal Revenue Code (Code) Section 501(c)(3) may establish plans for their employees under Code Section 403(b), as may churches for their ministers. Section 403(b) plans are funded by annuity contracts (individual and group) issued by insurance companies, custodial accounts solely invested in mutual funds, and, in the case of churches, retirement income accounts.

In 2007, the Department of the Treasury issued final regulations governing 403(b) plans (2007 regulations). The 2007 regulations require all 403(b) plans, whether or not subject to the Employee Retirement Income Security Act (ERISA), to have a written plan document. The 2007 regulations allow the written plan document to include provisions providing for plan termination.

> ***BUCK COMMENT.*** *One of the purposes of the 2007 regulations was to move 403(b) plans closer to 401(k) plans in formal plan structure.*

The 2007 regulations generally permit a distribution on plan termination if the employer does not make contributions to any other 403(b) plan for a period running from 12 months before plan termination to 12 months after distribution of all plan assets. The prohibition on distributions does not apply if the participants in the terminating plan and other 403(b) plans overlap less than two percent. “Employer” is determined on a controlled group basis (but based on a special rule). The 2007 regulations provide that the employer must distribute all accumulated benefits as soon as administratively practicable after plan termination.

Rev. Rul. 2011-7

In Rev. Rul. 2011-7, the Internal Revenue Service (IRS) provides basic guidance on the tax consequences of termination distributions.

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Rev. Rul. 2011-7 describes four fact situations. The first three situations involve a government plan, and the IRS varies the funding vehicle as follows:

- Situation 1. Individual annuity contracts.
- Situation 2. Individual and group annuity contracts.
- Situation 3. Individual and group annuity contracts plus mutual funds in custodial accounts under either individual or group agreements.

BUCK COMMENT. *There has always been some uncertainty whether the IRS would recognize group custodial accounts. The Revenue Ruling eliminates that concern.*

Situation 4 has the same funding vehicles as Situation 3, but the underlying 403(b) plan in Situation 4 is a non-government money purchase plan. Distributions from this type of 403(b) plan are subject to the qualified joint and survivor annuity rules.

In each of the four situations, the employer sponsoring the plan adopts, prior to the plan's termination date, a binding resolution to cease purchases under the plan and terminate the plan. The resolution also fully vests all benefits under the plan as of the termination date and directs that all benefits be distributed as soon as practicable thereafter. In all cases, the sponsor makes distributions as soon as practicable and, when required, timely provides Code Section 402(f) eligible rollover notices.

BUCK COMMENT. *The IRS interpreted the meaning of "as soon as practicable" for qualified plans in Rev. Rul. 89-87 as generally being within 12 months. Rev. Rul. 2011-7 suggests that the same interpretation applies for 403(b) plans.*

In Situation 1, the employer implements the resolution by distributing the fully-paid individual annuity contracts to all participants, alternate payees (pursuant to a qualified domestic relations order), and beneficiaries of deceased participants (collectively, participants). In addition, participants whose contracts permit them to receive single-sum payments on plan termination receive payments in that form. In Situation 2, participants also receive individual certificates based on the group annuity contract.

In Situation 3, the sponsor also makes distributions in cash or in kind to participants equal to their account balances under the custodial account. Each provider of a custodial account permits direct rollovers to IRAs or to plans that will accept direct rollovers. The IRS states that the direct rollover of cash may be made to an individual retirement arrangement (IRA) established by the same custodial account provider and that the participant may invest the rolled over amount in the same mutual fund in which the participant's 403(b) custodial account had been invested.

BUCK COMMENT. *Rev. Rul. 2011-7 does not appear to allow the distribution of a certificate from the 403(b) plan evidencing the custodial account. The process of a direct rollover and investment in the same mutual fund allows the participant to duplicate the 403(b) plan's custodial account investment.*

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In Situation 4, the joint and survivor annuity rules apply. Thus, any distribution from a custodial account in the form of an annuity must be made by the purchase and distribution of a fully-paid individual annuity contract providing for a qualified joint and survivor annuity.

Under Rev. Rul. 2011-7, the delivery of a fully-paid individual annuity contract or an individual certificate evidencing fully-paid benefits under a group annuity contract is treated as a distribution from the 403(b) plan. However, so long as the contract continues to comply with the requirements for a 403(b) plan in effect when the contract is distributed, the value of the contract is not included in gross income until the amounts are actually paid to the participant. Any other plan termination distributions – such as amounts from a custodial account or a lump sum payment from an annuity contract – are included in gross income when distributed unless they are rolled over to an IRA or other eligible plan.

BUCK COMMENT. *The IRS is aware that Rev. Rul. 2011-7 leaves open many practical problems. Many agreements pre-date the 2007 regulations and do not contain termination language. Some custodial accounts require participant agreement to any distribution when the participant owns the account.*

In the case where the annuity contract or individual certificate is distributed, the IRS does not address what Rev. Rul. 2011-7 means by the requirement that the contract or certificate continues to follow the 403(b) rules in effect at the time of the distribution. Besides the problem of monitoring what those requirements were, there remain practical problems. For example, vendors are not allowed to rely on participant certification of loan eligibility, but the employer, who normally would certify, is now removed from the process. In addition, prior to the 2007 regulations, participants could transfer their contracts and accounts to new vendors without notifying or coordinating with the sponsoring employer. Does the sponsor have to let these participants and vendors know that the 403(b) plan has been terminated, and, if so, how is the sponsor to give notice without any records or addresses?

Conclusion

Rev. Rul. 2011-7 clarifies much of the tax treatment of 403(b) plan termination distributions, but many practical problems remain. Many of these problems are governed by state contract law and the IRS cannot provide a solution. In addition, there is no indication that the IRS coordinated Rev. Rul. 2011-7 with the Department of Labor, which enforces ERISA Title I, so there may be unaddressed fiduciary and other ERISA Title I issues.

Buck's consultants are available to help you with the termination process and provide advice as to the meaning of the guidance.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.

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