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Terminating 403(b) Arrangements: IRS Guidance Answers Some Questions, Avoids Others

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The legal requirements and practical mechanics for terminating Section 403(b) plans maintained by tax-exempt entities have always been uncertain, and are still not fully resolved. Nonetheless, for a variety of reasons, employers that sponsor Section 403(b) plans are sometimes interested in terminating these plans, and the regulations governing these arrangements contemplate that a termination of the plan is permissible. The regulations set forth some general principles governing plan termination and, in response to requests from plan sponsors and practitioners, the Internal Revenue Service issued additional guidance in early 2011. The regulations and guidance, discussed below, address some, but not all, of the issues generated by a termination of a 403(b) arrangement.

Overview

Section 403(b) plans are arrangements covering employees of entities exempt from tax under IRC Section 501(c)(3), or of state educational institutions as well as certain ministers. Initially, these arrangements were primarily designed to defer a portion of the employee's salary until retirement, and were often funded through individual annuity contracts which were deemed to belong to the employee.

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For years before 1997, tax-exempt entities generally could not establish new 401(k) plans, so the 403(b) plans were the logical substitute. Employers began to provide matching and non-discretionary contributions in addition to salary deferral opportunities under those plans, and they used individual annuities, group annuities, or custodial accounts invested solely in mutual funds to fund these arrangements. As these arrangements started to resemble "plans" such as traditional 401(k) plans and to require more employer involvement, the Internal Revenue Service (IRS) and Department of Labor (DOL) sought to regulate them more extensively. These agencies imposed plan document, reporting, and other rules that are similar to those governing 401(k) plans. Stricter documentation and distribution rules were reflected in lengthy regulations revised and finalized by the IRS in July 2007 and effective in 2009.[1] The DOL has expanded the information that must be included in the plan's annual report (Form 5500), and requires that most larger 403(b) plans (other than arrangements not subject to ERISA) include an audit report with their Form 5500 filing, beginning with reports filed in 2010 for the 2009 plan year.

These new rules for 403(b) plans, as well as the availability of 401(k) arrangements as an alternative, have tempted some employers to consider terminating their 403(b) plans. Termination is also an attractive option when a small tax-exempt entity is acquired or merged into a larger entity that sponsors a 401(k) plan. But the rules for terminating such plans are not clear. This is in large part because 403(b) plans historically have been established and treated as a collection of individual contracts that belong to the employee/participant. These contracts are often administered and controlled by the insurers or mutual fund providers (vendors) that fund the arrangements, rather than by plan trustees who generally take direction from the employer. These contracts often did not specifically contemplate or authorize termination of the plan.

General Termination Rules

Prior to 2007 employers that needed to terminate 403(b) plans had little guidance. In cases where the terminations were the result of employers going out of business, if all employees lost their jobs as a result, the existing 403(b) rules could often be used to permit distribution due to "severance from employment" and a rollover to a new plan. But that approach does not work in all circumstances. Other approaches, such as freezing such plans, were used, but this was not always appropriate and left the employer as an involved party. Absent guidance, an employer that wanted to terminate a 403(b) plan would generally adopt a corporate resolution doing so, notify the participants and the insurer or financial institution that funded the plan that all contracts were to be deemed distributed, and indicate that the plan was terminated when it filed its annual report (the Form 5500, if required).

In 2007, as part of its comprehensive set of regulations governing 403(b) arrangements, the IRS specifically authorized 403(b) plan terminations in Treasury Regulations § 1.403(b)-10, which was entitled "Miscellaneous provisions." Specifically, the regulation stated that "[(a)] Section 403(b) plan is permitted to contain provisions that provide for plan termination and that allow accumulated benefits to be distributed upon termination." This has been interpreted to require that the written plan document must authorize the plan termination and a distribution of assets upon termination. In addition, the regulation contains other conditions for a proper termination, as follows:

- Arrangements that are subject to ERISA must fully vest all benefits at termination; this requirement also appears to apply to non-ERISA plans under the tax regulations and other IRS guidance.
- Neither the sponsoring employer nor any member of the employer's "controlled group" (determined under special rules aggregating tax-exempt employers that are related other than through stock or asset ownership) may contribute to any other 403(b) plan during the period beginning on the date of plan termination and ending 12 months after all plan assets were distributed, although one can ignore for this purpose 403(b) arrangements in which fewer than 2 percent of the employees eligible under the 403(b) plan to be terminated are eligible to participate.[2]
- All plan participants and beneficiaries should be notified of the plan's termination, and a 402(f) rollover notice must be provided where applicable (generally, if lump-sum–type distributions are authorized).

As with qualified plan terminations, all accumulated benefits must be distributed to participants and beneficiaries as soon as administratively practicable after plan termination. Under prior IRS guidance, this has generally been interpreted to require complete distribution within 12 months of a plan's termination date.[3]

These rules were quite general and did not answer a number of crucial points. Many commentators have noted that the main issue is whether employers can require distributions from arrangements funded by individual or group annuity contracts that were not subject to their direct control and/or do not authorize a termination. In addition, numerous questions were raised about implementing plan distributions.

Additional Guidance

In February 2011, the IRS issued Revenue Ruling 2011-7, which seeks to clarify how distributions can be made when a 403(b) plan is terminated. In March 2011, the IRS updated its Web site to summarize the ruling and the general procedures for terminating a 403(b) plan.[4]

Revenue Ruling 2011-7 describes four scenarios in which terminations can occur: (1) a government plan funded by individual contracts; (2) a government plan funded by individual and group annuity contracts; (3) a government plan that also includes amounts held by regulated investment companies in custodial accounts (as permitted under IRC Section 403(b)(7)); and (4) a non-government money purchase plan subject to the joint and survivor requirements of ERISA.

Although the first three scenarios relate to government plans, their principles apply to plans of non-government, tax-exempt employers, with the caveat that ERISA may impose additional requirements, as illustrated by the fourth scenario. The following general principles can be extracted from the revenue ruling:

- Plans with individual annuity contract can terminate by distributing these annuity contracts to participants (employees, alternate payees, and beneficiaries). If permitted by the contract, the plan can make a lump sum distribution as soon as practicable after termination.

- Certificates reflecting participation in a group annuity contract can be distributed to participants as a means of implementing a termination.

- With respect to amounts funded by custodial accounts, plans can make a complete distribution in cash or kind to implement the termination. This view appears to reflect an informal IRS position that custodial accounts are not fully paid annuity contracts which can be evidenced by a document such as a certificate. In the situation described in the revenue ruling, each custodial account provider permitted direct rollovers to IRAs or to other plans eligible to receive such rollovers. In this example, participants were able to roll over amounts to an IRA that permitted investment in the same mutual funds authorized under the terminated plan, thus allowing the participant, in effect, to maintain his or her prior investment choices.

- The ERISA money purchase plan must comply with rules requiring distributions in the joint and survivor form for married individuals. The IRS illustrates compliance with this requirement by having the plan purchase and distribute fully paid individual annuity contracts providing for a qualified joint and survivor annuity. (Note that although relatively rare among 403(b) plans, there could be ERISA plans that do not provide for annuity forms of distributions, in which case a joint and survivor annuity would presumably not be needed; the guidance does not address this.)

Revenue Ruling 2011-7 provides specific information as to the effect of the distributions at termination:

- As long as the contracts continue to comply with the 403(b) rules in effect at the time the contract is distributed, such contracts continue to qualify as 403(b) plans and their value is not included in income until amounts are actually paid from the contracts;
- Distributions from the plan other than distributions of the contracts or certificates themselves (*e.g.*, distribution from a custodial account or an actual payment from the annuity contract) are taxable when paid unless they are eligible for, and are in fact, rolled over to an IRA or other permitted arrangement that accepts rollovers;
- The plan is deemed to have distributed its assets if it is funded solely through annuity contracts and certificates and all of them are distributed; and
- Plans subject to ERISA must file a final Form 5500 for the plan year that includes the final distributions. Note that the DOL generally takes the position that as long as amounts remain undistributed in the plan, a Form 5500 must be filed for that year, so it is important to make sure that *all* participants' interests (whether as contracts, certificates, or payments) are distributed in a manner that leaves no plan assets or obligations behind.

Remaining Uncertainties

Despite this guidance, plan sponsors continue to encounter significant difficulties when terminating their 403(b) plans.

First, both plan sponsors and the issuers of annuity contracts still question whether a plan can be terminated if the contracts do not specifically permit "plan termination" or if the plan spouses do not have unilateral amendment authority to provide for a termination. By contrast, qualified retirement plan documents generally authorize the plan sponsor to amend or terminate the plan. This issue may require review of the contract language itself. These contractual concerns, which are the result of the prior language in the outstanding 403(b) agreements, are difficult for the IRS to address in the tax regulations.

Another concern is whether the vendors that fund the plan (the issuer of the annuity contract or the mutual fund custodian) will permit unilateral distribution of the underlying annuity contracts. Some of these entities take the position that annuity contracts cannot be distributed (or mutual fund accounts cannot be liquidated and paid) without participant consent. By contrast, qualified plan termination distributions are generally authorized in the plan. A related issue is whether the employer can ensure that all plan assets are distributed. In some cases, only the financial institutions or the 403(b) plan vendors have access to the account information for participants. If they will not release this information to employers (due to privacy or other concerns), it is difficult for the employers themselves to authorize a distribution of the annuity contracts. They must rely on the financial institution or vendor. It is also unclear what, if anything, the employers or vendors must do with older, inactive, but outstanding annuity contracts that were eligible to be excluded from reporting on the Form 5500 under the DOL's Field Assistance Bulletin 2009-02.[5]

Finally, some vendors have questioned the extent of their responsibility to maintain the contracts after termination. Annuity contracts or certificates providing rights in a group contract have been distributed, and Revenue Ruling 2011-7 requires merely that these contracts satisfy IRC Section 403(b) as of the date of plan termination. From the employer's point of view, if the plan has been terminated, and it has filed its final Form 5500, the contract should be a mere funding device (like an IRA or a nonqualified annuity) that should be administered solely by the annuity issuer or the mutual fund custodian. This would be similar to the procedures that govern when an annuity is purchased after a qualified plan terminates. Consistent with that approach, it would seem that any plan loans or other administrative features of these contracts should be administered and interpreted by the annuity provider or custodian, not the employers. Yet it is our understanding that some vendors still maintain that the question of who authorizes plan loans or distributions remains open. There is no reason to terminate a plan if the employer must continue to administer the contracts. Moreover, if the employer has such a role in authorizing distributions, it is debatable whether it can take the position that the plan is terminated and no plan assets exist.

Conclusion

The IRS and the DOL recognized the uncertainty governing 403(b) plan terminations and have attempted to provide some new guidance. However, until the agency guidance addresses the fact that older annuity contracts which fund such arrangements do not contemplate plan terminations, and until some sort of creative mechanism is reached for coordinating these contracts with the termination rules, plan terminations will remain challenging.

Notes

1. Certain unique features of 403(b) plans still remain (most significantly, the absence of nondiscrimination testing rules for employee pre-tax deferrals coupled with a "universal availability requirement" for such employee deferrals that is often misunderstood by employers that sponsor 403(b) plans).

2. Technically, this rule applies to contracts subject to the distribution restrictions for elective deferrals or arrangements funded by custodial accounts, but as a practical matter these categories include almost all 403(b) plans.

3. *See* Rev. Rul. 89-87, 1989-2 C.B. 2.

4. *See http://www.irs.gov/retirement.*

5. This Field Assistance Bulletin provided transition relief for 403(b) plans that were required to include with the Form 5500s more detailed financial information and an audit report beginning in 2010 (for the 2009 year). The bulletin took the position that certain contracts before 2009 that had not had contributions since 2009 and which could be enforced by the participant without employer involvement did not have to be treated as plan assets for purposes of Form 5500 reporting.