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IRS Provides Additional Guidance on 403(b) Plan Terminations

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In late February, the Internal Revenue Service (the "IRS") issued Revenue Ruling 2011-7, providing much-needed guidance on how to implement the termination of a plan that is governed by Section 403(b) of the Internal Revenue Code of 1986, as amended (the "Code"), often referred to as a "403(b) plan." Although previous guidance promulgated by the IRS allowed 403(b) plans to be terminated, that guidance did not address the practicalities of carrying out such a termination.

A 403(b) plan may only be established by certain types of entities, such as public educational organizations, organizations that are tax-exempt under Section 503(c) of the Code, and churches. Prior to 2007, no rules existed regarding whether a 403(b) plan could be terminated (for tax purposes), or how such a termination would be accomplished. Employers could freeze their 403(b) plan (i.e., by ceasing contributions to the 403(b) plan), but simply freezing the 403(b) plan did not allow the 403(b) plan to make in-service distributions to its participants.

The 2007 Final Regulations

In 2007, the IRS published final regulations, effective beginning in 2009 (the "2007 Final Regulations"), that, among other things, allowed employers sponsoring a 403(b) plan to (i) amend the 403(b) plan to eliminate future contributions for existing participants, or to limit participation to existing participants and employees; (ii) amend the 403(b) plan to provide for plan termination; and (iii) amend the 403(b) plan to allow accumulated benefits to be distributed upon such termination. Under the 2007 Final Regulations, the following requirements must be met for a 403(b) plan to be terminated:

1. The employer sponsoring the 403(b) plan being terminated (taking into account all of the employer's affiliates under Section 414 of the Code) may not make contributions to any other 403(b) contract during the period that begins on the date the 403(b) plan is terminated and ends 12 months after distribution of all assets from the terminated 403(b) plan, *except* where fewer than 2% of the employees eligible for the 403(b) plan being terminated (as of the termination date) are eligible under the other 403(b) plan; and

2. All accumulated benefits under the 403(b) plan being terminated must be distributed to all participants in the 403(b) plan as soon as administratively practicable after the 403(b) plan's termination (a "distribution," for these purposes, includes delivery of a fully-paid individual insurance annuity contract).

INSIGHT. The 2007 Final Regulations did not state that vendors had to cooperate with the 403(b) plan sponsor to effectuate a termination and distributions. As a result, some vendors pointed out that the contracts they had entered into prior to 2009 did not allow for distribution upon a 403(b) plan termination, and others refused to distribute custodial

accounts to participants upon a 403(b) plan termination unless each participant under the 403(b) plan consented to the distribution.

Revenue Ruling 2011-7

Revenue Ruling 2011-7 explains the process of terminating a 403(b) plan by providing four factual "situations," each of which illustrate the steps to be taken in terminating a distinctive type of 403(b) plan. For each of the four situations, the IRS assumes the following:

1. First, the IRS assumes that the 403(b) plan permits benefit payments to be made after termination from employment or upon the 403(b) plan's termination, and that the 403(b) plan includes nonelective employer contributions and elective deferrals and holds no amounts from designated Roth contributions or after-tax contributions. The IRS also assumes that the sponsoring employer will not make contributions to another 403(b) plan during the 12-month period discussed above;

2. Second, the sponsoring employer adopts a binding resolution (either effective immediately or prospectively) under which (i) the employer halts future purchases of annuity contracts under the 403(b) plan, and terminates the 403(b) plan; (ii) all benefits under the 403(b) plan become fully vested and nonforfeitable as of the 403(b) plan's termination date; and (iii) all benefits will be distributed as soon as practicable after the 403(b) plan's termination;

3. Third, the 403(b) plan participants and beneficiaries are notified of the 403(b) plan termination; and

4. Fourth, distributions pursuant to the terms of the 403(b) plan and the binding resolution are made as soon as administratively practicable after the termination date. (NOTE: Revenue Ruling 2011-7 suggests that Rev. Rul. 89-89's interpretation of the meaning of "as soon as practicable" apply, which generally means within 12 months.)

Aside from the above assumptions and steps, which are necessary for the termination of any 403(b) plan in accordance with Revenue Ruling 2011-7, additional considerations and necessary steps for such termination depend on the type of 403(b) plan being terminated. These considerations and steps are outlined below.

Fact Situation 1: Individual Annuity Contracts. In Fact Situation 1, the 403(b) plan is funded solely through fully-paid individual annuity contracts issued by an insurance company. In this situation, Revenue Ruling 2011-7 indicates that the 403(b) plan termination would be effectuated by:

1. Distributing (as soon as practicable) the individual annuity contracts to all 403(b) plan participants, beneficiaries who are alternate payees, and beneficiaries of deceased participants;

2. Making single-sum payments to 403(b) plan participants, where their contracts permit them to receive payments in that form upon a 403(b) plan termination (and permit such payments to be paid by direct transfer to an individual retirement account ("IRA") or other eligible retirement plan); and

3. Providing a timely 402(f) notice to 403(b) plan participants and beneficiaries.

INSIGHT. Revenue Ruling 2011-7 states that "because the [403(b)] plan is funded solely through fully-paid individual insurance annuity contracts, no further action is required to be taken in order to distribute the contracts," because once the 403(b) plan terminates, the participants and beneficiaries are entitled to payments in accordance with the terms of the contracts.

Fact Situation 2: Individual and Group Annuity Contracts. In Fact Situation 2, the 403(b) plan is funded by both individual and group annuity contracts issued by an insurance company. In this situation, Revenue Ruling 2011-7 indicates that the 403(b) plan termination would be effectuated by:

1. Following the same steps as in Situation 1, for the individual annuity contracts; and

2. Issuing "individual certificates" for the group annuity contracts to each participant and beneficiary evidencing his or her interest in the group contract. (The certificates function much like separate individual contracts for tax purposes, and constitute a distribution of the participant's or beneficiary's participant's/beneficiary's accumulated benefit in the group annuity contract.)

Fact Situation 3: Individual and Group Annuity Contracts, Plus Mutual Funds in Custodial Accounts under Either Individual or Group Agreements. In Fact Situation 3, the 403(b) plan is funded by individual and group annuity contracts, as well as mutual funds in custodial accounts under either individual or group agreements. In this situation, Revenue Ruling 2011-7 indicates that the 403(b) plan termination would be effectuated by:

1. Following the same steps as in Situation 1, for the individual annuity contracts;

2. Following the same steps as in Situation 2, for the group annuity contracts; and

3. Making distributions in cash (or in-kind) to 403(b) plan participants and beneficiaries in an amount equal to their account balances under the custodial account. Depending on the participant's or beneficiary's election, the distribution is either made to an IRA established for him, or to another eligible retirement plan, including an IRA established by the same custodial account provider that permits investment in the same mutual fund in which such participant's or beneficiary's custodial account is invested (and, in either case, the custodial account provider permits such an eligible rollover distribution to be paid by direct transfer).

Fact Situation 4: Money Purchase Pension 403(b) Plan. In Fact Situation 4, the facts are the same as in Situation 3, except that the 403(b) plan is a money purchase pension 403(b) plan that is subject to the participation and vesting requirements and minimum funding standards of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), as well as the Code's qualified joint and survivor annuity ("QJSA") rules. In this situation, Revenue Ruling 2011-7 indicates that the 403(b) plan termination would be effectuated by:

1. Following the same steps as in Situation 1, for the individual annuity contracts;

2. Following the same steps as in Situation 2, for the group annuity contracts;

3. Following the same steps as in Situation 3, for the custodial accounts;

4. Purchasing and distributing a fully-paid individual insurance annuity contract, where amounts held in the custodial accounts for participants in the 403(b) plan are to be made in the QJSA form; and

5. Filing a final Form 5500 for the plan year that includes the final distribution.

Tax Consequences to 403(b) Plan Participants of Termination. Revenue Ruling 2011-7 also discusses the tax consequences to 403(b) plan participants and beneficiaries upon termination of the 403(b) plan. Whether the termination will result in immediate inclusion in the participant's or beneficiary's income depends on the form of distribution. The delivery of a fully-paid individual annuity contract, or an individual certificate evidencing fully-paid benefits under a group annuity contract (as contemplated in Situations 1 and 2) is not included in a 403(b) plan participant's or beneficiary's gross income until amounts are actually paid to such participant or beneficiary, so long as the annuity contract continues to comply with the requirements for a 403(b) plan in effect when the contract is distributed.

Any other kind of distribution made to effectuate a 403(b) plan termination (such as amounts from a custodial account, as contemplated in Situation 3, or a lump-sum payment from an annuity contract), is includable in a participant's or beneficiary's income when distributed (except to the extent the amount is rolled over to an IRA or other eligible retirement plan by a direct rollover or timely transfer).

INSIGHT. As discussed above, Revenue Ruling 2011-7 requires the annuity contract to continue to comply with "the requirements for a 403(b) plan in effect when the contract is distributed." However, it is not clear in Revenue Ruling 2011-7 what such requirements would include.

Outstanding Issues

Several issues regarding 403(b) plan terminations remain outstanding, in spite of Revenue Ruling 2011-7's additional guidance, such as:

Distribution of Individually-Owned Custodial Accounts. Revenue Ruling 2011-7 does not address the distribution of individually-owned custodial accounts under a terminating 403(b) plan. Because such accounts are contracts between the custodian and an individual 403(b) plan participant, the employer sponsoring the 403(b) plan being terminated may not have the right to compel a surrender of the account for cash upon a termination of the 403(b) plan. Because the IRS did not address these accounts in Revenue Ruling 2011-7, it is not clear if 403(b) plans with such accounts can be terminated without impacting the tax status of the underlying custodial account (or, whether the termination of the 403(b) plan is even possible, given the 2007 Final Regulations' requirement that all accumulated benefits under the 403(b) plan being terminated must be distributed to all participants in the 403(b) plan as soon as administratively practicable after the 403(b) plan's termination).

Vendor Issues. Several vendor-related issues remain uncertain after the issuance of Revenue Ruling 2011-7. For instance, prior to the IRS's issuance of the 2007 Final Regulations, 403(b) plan participants could transfer their contracts and accounts to new vendors without notifying or coordinating with the employer sponsoring their 403(b) plan. Revenue Ruling 2011-7 does not address whether the sponsoring employer is required to notify such participants (and their new vendors) that the 403(b) plan has been terminated, nor does it explain how such notice would be provided (given that the sponsoring employer would not have contact information for the new vendors).

In conclusion, Revenue Ruling 2011-7 provides helpful guidance for sponsoring employers on many of the procedural aspects of effectuating a 403(b) plan termination, but practical questions may still arise in the implementation. As always, King & Spalding is ready to help guide you through a 403(b) plan termination, and answer any questions you may have along the way.

IRS Revises Group Trust Requirements

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The IRS recently revised the rules relating to group trusts that serve as collective investment vehicles for certain retirement plans. The revised rules (1) expand the types of plans and accounts eligible to participate in group trusts, (2) expand the documentary and operational requirements for group trusts, (3) provide model language that may be used to amend group trusts to comply with the new provisions and (4) address the participation of certain Puerto Rican plans in a group trust. The new requirements are incorporated in Revenue Ruling 2011-1, which was effective January 10, 2011.

A group trust is an arrangement under which qualified retirement plan trusts, individual retirement accounts and certain other tax exempt retirement plans or accounts pool their assets for investment, usually for the purpose of achieving diversification of investments. The group trust will be exempt from taxation like its investing plans or accounts if certain requirements are satisfied.

(1) Eligibility for Participation in a Group Trust.

Previously, eligibility for participation in a group trust was generally limited to tax-exempt qualified retirement plan trusts and individual retirement accounts and Code Section 457(b) governmental deferred compensation plans. Revenue Ruling 2011-1 expands the types of plans and accounts that may participate in a group trust to include the

following plans and accounts:

- Custodial accounts under Code Section 403(b)(7);
- Retirement income accounts under Code Section 403(b)(9); and
- Governmental plans under Code exempt under Code Section 401(a)(24), including a governmental plan providing retiree welfare benefits.

A retirement plan or account that is eligible to participate in a group trust is referred to in this article as an "eligible retirement plan."

(2) Requirements to Maintain Tax-Exempt Status.

Revenue Ruling 2011-1 also adds the following new documentary requirements:

- Each adopting eligible retirement plan document must provide that it is impossible for any part of its corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the plan participants and their beneficiaries;
- The group trust document must expressly limit the assets that may be held by the trust to assets that are contributed by, or transferred from, an eligible retirement plan (and the earnings thereon);
- The group trust document must expressly provide for separate accounts (and appropriate records) to be maintained to reflect the interest which each adopting eligible retirement plan has in the trust, including separate accounting for contributions, disbursements and investment experience.

In addition, Revenue Ruling 2011-1 reiterates the following requirements from Revenue Ruling 81-100, as clarified and modified by Rev. Rul. 2004-67:

- The group trust document must limit participation to eligible retirement plans, prohibit an assignment by an adopting eligible retirement plan of any part of its equity or interest in the trust, and prohibit any part of the group trust corpus or income that equitably belongs to an adopting eligible retirement plan from being used for, or diverted to, any purpose other than for the exclusive benefit of the participants and the beneficiaries of that plan;
- The group trust must itself be adopted as a part of each adopting eligible retirement plan; and
- The group trust must be created or organized and maintained as a domestic trust in the United States.

(3) Model Language

Revenue Ruling 2011-1 includes two model amendments group trusts may adopt, one addressing the separate account requirement and one adding the three new categories of eligible retirement plans. The separate account amendment should be adopted by January 10, 2012.

(4) Treatment of Puerto Rican Plans.

Under Section 1022(i)(1) of ERISA, a pension, profit-sharing, or stock bonus plan, all the participants of which are residents of Puerto Rico, is treated as an organization described in Code Section 401(a), and therefore generally exempt from income taxation, if the trust both forms part of such a plan and is exempt from income tax under the laws of Puerto Rico (a "Puerto Rican Plan"). Questions have been raised as to whether a Puerto Rican Plan may participate in a group trust as a result of an earlier ruling, Revenue Ruling 2008-40, which addressed transfers from a plan qualified under Code Section 401(a) to a Puerto Rican Plan. The question was whether a Puerto Rican Plan could continue to participate in a

group trust after a transfer of assets to the Puerto Rican Plan which had previously been part of a qualified plan.

Pending further IRS guidance, Puerto Rican Plans may continue to participate in a group trust without causing the group trust to fail to satisfy the requirements of Revenue Ruling 2011-1 as long as the Puerto Rican Plan (1) was participating in the group trust as of January 10, 2011 or (2) holds assets that had been held by a qualified plan immediately prior to the transfer of those assets to the Puerto Rican Plan pursuant to the transition relief provided in Revenue Ruling 2008-40. In addition, Revenue Ruling 2011-1 extends until January 1, 2012 the transition relief granted in 2008 to allow assets to be transferred from a qualified plan to a Puerto Rican Plan without being treated as a distribution from the qualified plan.

The IRS also has requested comments on whether annuity contracts and other tax-favored accounts held by qualified plans and Code Section 403(b) plans should be permitted to invest in group trusts.

Commentators have urged further clarification and expansion of the group trust rules, expressing concern that these new rules may adversely affect existing investment arrangements.

King & Spalding would be happy to assist you with any questions you may have about Revenue Ruling 2011-1.

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