IRS Provides Guidance on Termination of 403(b) Plan

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In Revenue Ruling 2011-7, the Internal Revenue Service (IRS) provided long-awaited guidance addressing the requirements for a plan sponsor to terminate a 403(b) plan and the tax consequences to plan participants of doing so. Particularly, the IRS addresses termination of 403(b) plans consisting of employee deferrals and employer contributions whose assets are invested in individual annuity contracts, custodial accounts and regulated investment companies, as well as termination of a 403(b) money purchase pension plan. The guidance is helpful in administering the final 403(b) regulations, as the specific requirements to terminate a 403(b) plan were not addressed in detail in those regulations.

On February 22, 2011, the Internal Revenue Service (IRS) published Revenue Ruling 2011-7, which provides long-awaited guidance regarding the application of the final 403(b) regulations that were published in 2007. (See Final 403(b) Regulations Offer Planning Opportunities and Some Surprises for Plan Sponsors for a summary regarding the final 403(b) regulations.) The Revenue Ruling clarifies the requirements for a sponsor to terminate a 403(b) plan, as well as the tax consequences to plan participants if the sponsor terminates such an arrangement. In particular, 2011-7 addresses the termination of 403(b) plans consisting of employee deferrals and employer contributions that are invested in annuity contracts, custodial accounts and regulated investment companies. 2011-7 also addresses termination of 403(b) plans structured as money purchase pension plans. While certain of the fact patterns presented in the Revenue Ruling address government 403(b) plans and non-ERISA 403(b) plans, the overall principles of the ruling appear to be intended to apply to all 403(b) plans.

Fact Patterns

In 2011-7 the IRS presents four specific fact patterns, each intended to illustrate the termination principles applicable to 403(b) plans. The first three fact patterns concern the types of investment vehicles in which plan assets are held: annuity contracts, custodial accounts and regulated investment companies. The fourth fact pattern addresses a specific type of 403(b) plan, the money purchase 403(b) plan. While this latter type of plan is less prevalent in recent years, the structure is not uncommon in older plans.

Under each of the various investment vehicles, treatment of participant benefits differ. Under certain circumstances, a termination of the plan results in a liquidation of assets, with payment of each participant's plan benefit as soon as possible thereafter. Under other circumstances, particularly in the event of individual or group annuity contracts, a termination of the plan results in either the delivery of an annuity contract or a certificate being issued to each participant in the plan, reflecting his or her interest in the plan. The annuity contract or certificate can then be liquidated and paid at a later date. Finally, if subject to the qualified joint and survivor annuity requirements of the Employee Retirement Income Security Act of 1974, as amended (ERISA), the plan may be required to distribute a participant's assets in the form of an annuity. Plan participants may also be eligible to roll over their accrued benefit at the time of plan termination to another tax-qualified retirement vehicle.

The fact patterns also address various categories of 403(b) plans, including plans subject to ERISA, plans that are exempt from ERISA, tax-exempt plans and government 403(b) plans. The variety of investment vehicles described, as well as the various categories of plans, indicates 2011-7 appears to be intended to address terminations of all 403(b) plans, not just ERISA plans or those maintained by government entities. Thus, whether a government entity or a tax-exempt organization, whether subject to ERISA or not, sponsors of 403(b) plans should consider 2011-7 when terminating a plan.

Requirements for Termination

2011-7 describes the requirements to terminate a 403(b) plan, including those reflected in the final 403(b) regulations. Treasury Regulations Section 1.403(b)-10(a) included the following:

- A plan sponsor may amend its plan to include a provision that allows the plan sponsor to terminate the plan.
- Certain plans investing assets in custodial accounts or that allow for elective deferrals cannot be terminated if the plan sponsor or a member of its controlled group (as determined under Internal Revenue Code Section 414) contributes to a 403(b) plan during the 12-month period following the date of final distribution of participant assets held under the plan.
- All accumulated benefits must be distributed to participants and beneficiaries as soon as practicable after termination of the plan.

In addition, 2011-7 also indicates the following:

- Termination of the plan must be by binding action of the duly empowered body of the organization that maintains the plan.
- Termination of the plan must satisfy applicable law, including the requirements of the final regulations as well as applicable vesting requirements (*e.g.,* full vesting upon plan termination), and any requirements imposed under the terms of the plan or the applicable investment vehicle.

- Plan assets must be disposed of as soon as possible following the effective date of the termination, although distribution of such assets may be in the form of a certificate and not necessarily in the form of cash.
- If the plan document and the applicable investment vehicle allows a participant to rollover their benefit to another qualified investment vehicle, participants must be provided appropriate notice of their rollover rights and they must be allowed to elect to do so.

Thus, employers intending to terminate their 403(b) plans should not only review and understand the requirements under the applicable Treasury Regulations, but those under 2011-7 as well.

Consequences of Termination

2011-7 presents the principle that assets held under a 403(b) plan are not treated as income to a participant until such assets are paid to the participant. Generally, if a plan sponsor terminates a 403(b) plan and the plan requires distribution of assets upon termination, then a participant's distributed assets will be taxable to the participant at the time of distribution, unless the participant rolls the distributed assets to another tax-qualified vehicle (*i.e.,* an individual retirement account or IRA) within 60 days following distribution.

Under certain circumstances, a plan sponsor may terminate a 403(b) plan without triggering a taxable distribution to participants. For example, if a plan sponsor terminates a 403(b) plan and delivers to a participant a fully paid individual annuity contract or a certificate evidencing fully paid benefits under a group annuity contract, the amounts held under the individual or group contract are not taxable to the participant until those amounts are actually distributed to the participant (*i.e.*, receiving the certificate is not a taxable event). Therefore, depending on the terms of a particular contract, specifically whether the assets held under the contract must be distributed upon termination of the 403(b) plan, it may be possible for a plan sponsor to terminate the 403(b) arrangement, either transfer the individual annuity contract or a certificate with respect to a group annuity contract to a participant and will not trigger immediate taxation to the participant.

What Employers Should Do Now

Employers sponsoring 403(b) plans should consider whether they want to terminate their 403(b) plan in light of the final 403(b) regulations and current guidance, and prior to doing so should also consider whether their plans must or should be amended to allow for and effectuate the termination. Important in evaluating the decision to terminate are a number of factors. The sponsoring employer should pay particular attention to whether the terms of the plan allow the employer to terminate the 403(b) plan and, if so, whether participant accounts can be "rolled over" to an IRA so that a distribution event resulting in the inclusion of income of each participant's distributed amount does not occur.

Further, the sponsoring employer should consider the impact of terminating the 403(b) plan on particular funding arrangements, specifically whether doing so results in a taxable distribution event or a possible transfer of an individual certificate or annuity contract such that a participant's benefit is not immediately taxable to the participant. Absent the ability to roll a participant's benefit to an IRA, transfer of the asset underlying the investment without taxation would likely be preferable.

The sponsoring employer should also consider whether it or any member of its controlled group maintains a 403(b) plan, and whether the entity sponsoring the other 403(b) plan will make contributions to that arrangement during the 12-month period following distribution of all of the 403(b) plan's assets. If so, the sponsor desiring to terminate its 403(b) plan may be limited in its ability to do so depending on the nature of the investment vehicles offered under its plan and whether the plan holds elective deferrals.

Finally, the sponsoring employer should consider whether the termination of the 403(b) plan results in any unintended consequences. For example, termination of a 403(b) plan may result in surrender charges against the accounts of participants. Surrender charges are typically a percentage of a participant's account and are assessed in decreasing amounts over a period of years based on duration of participation in the plan. Termination of 403(b) plans can occur, but doing so must comply with the final 403(b) regulations, the application of which requires advance planning and awareness of the various legal requirements and the consequences of doing so.