

Terminating 403(b) Plans: IRS Rules, Fiduciary Liability, Distribution of Assets, Required Notices to Participants

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Today's faculty features:

David Levine, Principal, **Groom Law Group**, Washington, D.C.

Sarah Mysiewicz Gill, Attorney, **Groom Law Group**, Washington, D.C.

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Terminating 403(b) Plans

IRS Rules, Fiduciary Liability, Distribution of Assets, &
Required Notices to Participants

Presented by:

David N. Levine
Sarah M. Gill
Groom Law Group, Chartered
Washington, DC

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Part I: Introduction and Background

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Overview: 403(b) Basics

- 403(b) plans are a unique type of retirement plan, generally available to:
 - Public schools
 - Certain tax-exempt organizations
 - Churches
- A 403(b) plan must have a written plan document containing (Rev. Rul. 2011-7):
 - All the terms and conditions for eligibility, benefits, and limitations;
 - The form and timing of distributions and contracts available under the plan; and
 - The party responsible for plan administration.

Overview: 403(b) Basics cont'd

- Contributions are excluded from a participant's gross income only if made to certain funding arrangements:
 1. contracts issued by an insurance company qualified to issue annuities;
 2. custodial accounts that are exclusively invested in stock of a regulated investment company;
 3. a retirement income account for employees of a church-related organization; or
 4. a broader range of arrangements for specific groups of grandfathered plans.
- Employee contributions to a 403(b) plan may consist of:
 - Elective deferrals
 - Nonelective employer contributions
 - After tax contributions
 - Designated Roth contributions

Overview: Reporting and Disclosure Requirements

- Many 403(b) plans are subject to ERISA, but exceptions apply.
- 403(b) plans that are subject to ERISA are treated the same as any other defined contribution plan for purposes of the annual ERISA reporting requirements:
 - File Form 5500s and provide pension benefit statements
 - Provide a summary annual report (SAR) to each participant and beneficiary
 - Provide a summary plan description (SPD) to each participant and beneficiary
 - If the plan is materially modified, the plan administrator must provide a summary of material modifications (SMM) to each participant and beneficiary

Overview: ERISA Exemption

- Some types of 403(b) plans are exempt from ERISA:
 - Governmental plans (e.g. those sponsored by a state or municipality)
 - Church plans
 - Supplemental 403(b) plans if certain DOL requirements are met

Freezing a 403(b) Plan

- A 403(b) plan can be frozen by amending the plan to cease contributions or to limit participation to existing participants and employees. 26 C.F.R. § 1.403(b)-10(a).
 - A frozen plan must continue to satisfy the applicable IRC requirements and, if applicable, ERISA requirements.
 - The plan sponsor must also provide notification to plan participants of the amendment.

Part II: Terminating a 403(b) Plan

Right to Terminate a 403(b) Plan

- In 2007, the IRS explicitly authorized 403(b) plan terminations in Treasury Regulations § 1.403(b)-10.
 - Practice note: the plan sponsor should confirm that it has the authority to amend the plan to add such provisions (e.g., no conflict with a state statute, collective bargaining agreement, or employment contract)
- Rev. Rul. 2011-7 built off of the 2007 403(b) regulations by:
 - Allowing plans funded with individual annuity contracts to be terminated by distributing the individual annuity contracts to participants in kind as an alternative to making lump sum distributions;
 - Providing that payment obligations under a group annuity contract may be assumed by the issuer of the contract and the plan termination may be implemented by issuing to each participant a certificate evidencing a fully paid interest in his or her benefits under the group annuity contract;
 - Providing that participants will not be taxed on their benefits until the benefits are paid out; and
 - Allowing a terminating plan to make distributions in cash or in kind where the plan is funded with custodial accounts.

Termination Requirements

- A plan sponsor must adopt a binding resolution that:
 - Establishes a plan termination date;
 - Ceases plan contributions;
 - Fully vests all benefits on the termination date; and
 - Authorizes the distribution of all benefits as soon as administratively practicable after the termination date. Rev. Rul. 2011-7.
- As all accounts must be distributed, an initial step in terminating the plan is identifying all accounts and determining method of distribution. Plan sponsors must:
 - Notify all plan participants and beneficiaries about the plan's termination
 - Provide a 402(f) rollover notice to participants and beneficiaries
 - Distribute all plan assets within 12 months of the plan's termination date to participants and beneficiaries.
 - File a final 5500, if an ERISA plan

Termination Requirements: Vesting and Distribution

- A plan may be terminated by the delivery of a fully paid individual insurance annuity contract or an individual certificate evidencing fully paid benefits under a group annuity contract.
 - An employee for whom an annuity contract is purchased must have, at all times, a fully vested and nonforfeitable right to all benefits provided under the contract. IRS Reg. §1.403(b)-3(a)(2).
- All accumulated benefits must be distributed to all participants and beneficiaries as “as soon as administratively feasible” after termination of the plan. 26 C.F.R. § 1.403(b)-10(a).
 - IRS generally defines this as 12 months following the plan termination date. Rev. Rul. 89-87.

How to Distribute a Terminated 403(b) Plan's Assets

- Individual annuity contracts
 - Can terminate by distributing these annuity contracts to participants
 - Can make a lump sum distribution if allowed under contract
- Group annuity contracts
 - Certificates reflecting participation in a group annuity contract can be distributed to participants
- Custodial accounts
 - Can make a complete distribution in cash or kind
 - Can be rolled over into an IRA or other eligible retirement plan

Challenges Associated with Identifying 403(b) Plan Accounts

- All of the accounts required to be included in the plan must be included in the termination or the termination generally cannot occur.
- A contract or account may be properly excluded from a plan for tax purposes, but may not be properly excluded according to ERISA requirements
 - Example: An ERISA plan changes providers and some plan accounts remain with the deselected provider
 - Unlikely for the assets to be excludable from the plan under ERISA unless a carve out applies
 - For a plan termination, distribution would need to include the accounts associated with the deselected provider

Limits on Employers with Terminated 403(b) Plans

- Plan sponsor can't contribute to another 403(b) plan following the plan termination date for 12 months after the distribution of all the assets from the terminated plan. Rev. Rul. 2011-7.
 - Applies to all entities within common control of the employer
 - If an employer maintains multiple 403(b) plans, and wishes to terminate one but not all of its plans, any remaining plan(s) must be frozen with respect to new contributions for 12 months following the last termination distribution.

Taxation of Distributions of a Terminated 403(b) Plan

- Fully paid individual annuity contract, individual certificate with fully paid benefits, or an individual custodial account under SECURE guidance:
 - Not included in gross income until amounts are paid to the participant or beneficiary if the contract maintains its status as a 403(b) contract. Rev. Rul. 2011-7.
- Other types of distributions:
 - Included in gross income except for amount included in an IRA or other eligible retirement plan by a direct rollover or by a transfer made within 60 days after the distribution.

Obstacles to Distribution

- Employer may not have the authority to require a distribution from a participant's account (e.g., contracts and accounts under the plan do not include any authority for the plan sponsor to require a distribution)
- If the employer is a private tax-exempt employer utilizing an ERISA exclusion for the plan, the employer may not have plan contractual rights
 - Exercising such plan contractual rights could raise concerns about lack of filing Form 5500 among other potential ERISA violations (e.g., loan limitations and spousal consent requirements)

The SECURE Act

- Because 403(b) plans are generally invested in annuity contracts and custodial accounts holding mutual funds, there is a question of whether those assets can be distributed in kind, and what the tax consequences of that distribution are – whether immediately taxable, or taxable upon a later distribution from the annuity or account.
- The Setting Every Community Up for Retirement Enhancement Act of 2019 (“SECURE Act”), directed that guidance be issued providing that a section 403(b)(7) custodial account could make distributions in kind upon a plan termination.
 - Before SECURE, custodial accounts were required to be distributed in cash or be exchanged for an annuity contract before distribution. This requirement created a problem for plan sponsors who could not terminate a 403(b) without participant agreement. Revenue Ruling 2011-7.

Promulgation of Regulations for SECURE: Revenue Ruling 2020-23

- Revenue Ruling 2020-23 provides that:
 - (1) the section 403(b)(7) status of distributed custodial account generally is maintained if the custodial account thereafter adheres to the requirements of section 403(b) that are in effect at the time of the distribution of the account, and
 - (2) a custodial account is not considered distributed to the participant or beneficiary if the employer retains any material rights under the account
- Documentation to participants
 - Where a 403(b) plan is funded solely through 403(b)(7) custodial accounts maintained under individual agreements, the individual custodial account (“ICA”) may be distributed in kind without additional steps.
 - Where custodial accounts are maintained under a group agreement, plan termination requirements for distributing the ICA in kind are met by distributing a document that evidences the ICA
- Taxation
 - An ICA distributed in kind under these rules is not included in the gross income of the participant or beneficiary until amounts are actually paid to the participant or beneficiary, so long as the contract maintains its 403(b)(7) custodial account status.

ERISA § 205 Overview: Annuity and Consent Rules

- ERISA § 205 generally provides that a distribution must be provided either as
 - Qualified joint and survivor annuity (“QJSA”) - participant is alive upon the annuity beginning date; or
 - Qualified preretirement survivor annuity (“QPSA”) - participant dies before the annuity beginning date.
- § 205(c) of ERISA provides that a participant may elect to waive the QJSA or QPSA form of benefit, but spousal consent is needed for a waiver by a married participant.
- Inapplicable to a participant under a plan that is not a defined benefit plan or money purchase pension plan if:
 - (i) a full death benefit is provided to the surviving spouse,
 - (ii) no participant election of a distribution in the form of a life annuity is made, and
 - (iii) no part of the distribution is the result of a transfer from a defined benefit plan or a money purchase pension plan

IRS Notice 2020-80

- IRS requested comment on the applicability of ERISA § 205 annuity and spousal rights provisions to the distribution of an individual custodial account in kind from a terminating 403(b) plan. This includes when:
 - A participant cannot be reached,
 - A participant does not elect to waive the QJSA and QPSA form of benefit, or
 - A married participant elects to waive the QJSA and QPSA form of benefit but the participant's spouse does not consent to the waiver

IRS Notice 2020-80

- The Treasury Department and the IRS specifically requested comment on
 - Information on current practices and arrangements that may affect the termination of 403(b) plans that are funded through § 403(b)(7) custodial accounts and that are subject to ERISA § 205
 - Views regarding the administrability of alternative dates for when rights under ERISA § 205 might be required to be protected
 - Views on whether the Pension Benefit Guaranty Corporation's missing participants program for defined contribution plans might be a destination for transferring, without participant and spousal consent, the cash value of custodial accounts that are subject to ERISA § 205
 - Views on the type(s) of transition relief, if any, that would assist with the termination of an existing 403(b) plan that is funded through the use of § 403(b)(7) custodial accounts in a way that protects rights under ERISA § 205
- Comments were due February 3, 2021.



Questions?

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