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IRS Issues Guidance on Section 403(b) Plan Terminations

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On February 22, 2011, the Internal Revenue Service ("IRS") issued Revenue Ruling 2011-7 which provides long-awaited guidance on terminating a plan that is governed by Section 403(b) of the Internal Revenue Code of 1986, as amended ("Section 403(b)"). A Section 403(b) plan is a tax-advantaged retirement plan available for certain tax-exempt employers, public education organizations, cooperative hospital service organizations, and self-employed ministers.

Prior to the issuance of the final Treasury Regulations under Section 403(b) in 2007 (the "Section 403(b) Regulations"), no rules existed as to whether a Section 403(b) plan could be terminated for tax purposes and, if so, how to do it. Thus, while employers could freeze their Section 403(b) plans, employers arguably could not terminate their responsibilities under Section 403(b) plans. The Section 403(b) Regulations specifically permitted a Section 403(b) plan to contain a provision allowing for the plan's termination and the distribution of accumulated benefits upon termination. However, questions on implementation remained.

Revenue Ruling 2011-7 answers some of those questions by concluding that when an employer terminates a Section 403(b) plan, the accumulated benefits under the Section 403(b) plan can be distributed to participants in a variety of ways without triggering adverse tax consequences. If accumulated benefits are distributed through delivery of a fully paid individual annuity contract or an individual annuity certificate acknowledging fully paid benefits under a group annuity contract, the amounts are not includable in income until amounts are actually paid to the participant from the contract. Any other method of distribution to a participant or beneficiary, such as a lump-sum payment, from a group custodial account, must be included in gross income in the year in which it is distributed, unless it is rolled over to an IRA or eligible retirement plan within 60 days after distribution.

Revenue Ruling 2011-7, however, does not address the distribution of individually-owned custodial accounts. Since an individually-owned custodial account is a contract between the custodian and the individual employee, the employer may not have the right to compel a surrender of the account for cash on a plan termination. If, on the other hand, the individually-owned custodial account itself could be distributed, the control issue could be avoided. The IRS, however, did not address this issue and, therefore, has left open the question of the ability to terminate Section 403(b) plans with individually-owned custodial accounts without impacting the tax status of the underlying custodial account as well as the issue of whether such termination can, in fact, be accomplished. Thus, the question of whether and how an employer may terminate a Section 403(b) plan containing individual custodial accounts invested in mutual funds plan remains unanswered. Hopefully, further guidance on this issue will follow.

The restrictions contained in the Section 403(b) Regulations prohibiting an employer from contributing to any other Section 403(b) plan after terminating a Section 403(b) plan continue to apply. Under the Section 403(b) Regulations, an employer is permitted to terminate its Section 403(b) plan and distribute the accumulated benefits *only* if the employer makes no contributions to any Section 403(b) contract that is not part of the terminated Section 403(b) plan for twelve months after all accumulated benefits are distributed from the terminated Section 403(b) plan, if any amounts distributed in the termination would otherwise have been subject to a withdrawal restriction. However, this rule does not apply if at all times during the period beginning 12 months before the termination of the Section 403(b) plan and ending 12 months after the distribution of all accumulated benefits under the Section 403(b) plan, fewer than 2 percent of the employees who were eligible to participate under terminating Section 403(b) plan are eligible to participate under alternative Section 403(b) plans of the employer.

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- **Jacob I. Friedman**