

March 1, 2011

IRS Rules on 403(b) Plan Terminations

In [Rev. Rul. 2011-7](#), to be published on March 7, 2011, the Internal Revenue Service elaborated the circumstances in which a §403(b) plan will be treated as terminated for tax purposes. The 2007 tax regulations under §403(b) permit the distribution of accumulated benefits on plan termination, generally subject to a moratorium on contributions by the plan sponsor and certain affiliates to any §403(b) contract or account from the date to termination until 12 months after distribution of all assets from the terminated plan. In order for a plan to be considered terminated under those regulations, “all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively feasible after termination of the plan.” For this purpose, “delivery of a fully paid individual insurance annuity contract” is treated as a distribution. The §403(b) nonforfeiture requirement must also be satisfied at the date of termination. Treas. Reg. §1.403(b)-10(a).

Rev. Rul. 2011-7 considers the application of these rules to four fact situations, summarized below. The differences in the four situations relate to (i) the type of §403(b) product used to fund the plan, and (ii) the applicability of the ERISA qualified joint and survivor and preretirement survivor annuity (QJSA/QPSA) rules (in Situation 4 only). In each case, the Service ruled that:

- The plan was duly terminated in accordance with §1.403(b)-10(a);
- Values credited under annuity contracts or certificates are not taxable until actually paid to the participant or beneficiary, so long as the contract adheres to the requirements of §403(b) as in effect at the time of delivery of the contract to the participant or beneficiary; and
- All other amounts are currently taxable to the participant or beneficiary, unless rolled over to an IRA or other eligible retirement plan.

Situation	1	2	3	4
Plan characteristics				
▪ Subject to ERISA, including QJSA/QPSA rules				X
▪ Pre-tax contributions only; no after-tax or Roth contributions	X	X	X	X
Prior to termination, plan funded with:				
▪ Individual annuity contracts	X	X	X	X
▪ Group annuity contract		X	X	X
▪ Individual or group §403(b)(7) accounts			X	X
Termination procedure				
▪ Binding resolution of the employer to (i) cease future §403(b) purchases, (ii) vest all benefits, (iii) terminate the plan and (iv) distribute all benefits as soon as practicable.	X	X	X	X
▪ Post-termination contribution moratorium observed.	X	X	X	X
▪ Participants and beneficiaries notified of plan termination.	X	X	X	X
▪ Employees receive §402(f) notice.	X	X	X	X

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Situation	1	2	3	4
▪ Funding provider permits direct rollovers where applicable.	X	X	X	X
▪ Fully paid individual annuities distributed to participants and beneficiaries; where contract permits, contract is liquidated in a lump sum as soon as practicable.	X	X	X	X
▪ Individual certificates issued for group annuity; where contract permits, participant or beneficiary's interest is liquidated in a lump sum as soon as practicable.		X	X	X
▪ Custodial account balances are paid out in cash or in kind.			X	X
▪ Distributions made in accordance with ERISA §205 QJSA/QPSA rules; if applicable to a custodial account, an individual annuity contract is purchased.				X
▪ Final Form 5500 filed for the plan year that includes the final distribution.				X

Comments

While not comprehensive, the guidance provided in Rev. Rul. 2011-7 is useful and addresses a number of the outstanding issues about §403(b) plan terminations. Among other things:

- For individual §403(b) annuity contracts, the employer resolution and notice to employees effects the “delivery” of the contract for §1.403(b)-10(a) purposes; no further action is required.
- Similarly, issuance of individual certificates, along with the employer resolution and notice to employees, effects the “delivery” of a group contract.
- Account balances may continue to be held in annuity form without (i) deferring the date of distribution of all plan assets pursuant to the termination (for purposes of the contribution moratorium) or (ii) resulting in immediate taxation of participants. This position makes it possible to accommodate ERISA QJSA/QPSA requirements in a §403(b) plan termination.
- The ruling adopts at least two qualified plan termination concepts:
 - Distributions must be made “as soon as administratively practicable,” as stated in Rev. Rul. 89-87. Under these rules, whether a distribution is made as soon as administratively practicable is to be determined under all the facts and circumstances but, generally, a distribution which is not completed within one year following the date of plan termination specified by the employer will be presumed not to have been made as soon as administratively practicable. Where action by both the employer and the participant is required under the terms of a §403(b) product to authorize a distribution, this rule may produce complexities for §403(b) plans not encountered in §401(a) plans; and
 - Distributed annuities need only observe the requirements of §403(b) at the time of distribution from the plan, and do not have to be updated for subsequent changes in the tax law. While this is a helpful rule on its face, it creates the possibility of different §403(b) requirements – for grandfathered contracts or accounts, for contracts or accounts in ongoing plans on or after January 1, 2009, and for contracts distributed at different times from terminated plans – but, in the termination setting, without the qualified plan mechanism of newly issued terminal funding annuities to deal with those differing requirements. Also, the ruling does not speak to the terms, conditions and processes for adhering to §403(b) after the contract has passed out of “plan” solution.

- The ruling specifically and sensibly acknowledges group §403(b)(7) custodial accounts.
- While the ruling does not explicitly provide any ERISA guidance on behalf of the Department of Labor, there is an interesting suggestion that final distribution of the terminated §403(b) plan for tax purposes permits the filing of a final Form 5500.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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