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March 17, 2009

VIA ELECTRONIC DELIVERY

Mr. W. Thomas Reeder
Benefits Tax Counsel
Department of the Treasury
1500 Pennsylvania Ave, NW
Room 3050 MT
Washington, DC 20220

Re: Follow-Up on Plan Termination Issues for 403(b) Plans

Dear Mr. Reeder:

On behalf of the Investment Company Institute (the "Institute")[1] and its members, thank you for meeting with us to discuss whether, and how, 403(b) plans that are funded through individual custodial accounts may be terminated. This letter follows up on issues raised during our December 2008 meeting, as well as some additional issues relating to plan termination not previously discussed.

During the meeting, we were pleased to hear your recognition and firm belief that, as a matter of tax and retirement policy, it must be possible for an employer-sponsor of a 403(b) plan that is invested in custodial accounts to terminate the plan.[2] We completely agree and strongly urge the Treasury Department and Internal Revenue Service (collectively, the "Service") to develop guidance – perhaps a revenue ruling – that describes an effective plan termination involving custodial accounts.

As you know, there is significant confusion within the section 403(b) community about plan termination. IRS representatives have repeatedly made, and continue to make, statements in

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $9.88 trillion and serve over 93 million shareholders.

[2] We believe that guidance providing a route to plan termination represents sound retirement and tax policy. Sponsors wanting to terminate a 403(b) plan do not necessarily want to exit the retirement system, but rather may want to transition to a different type of retirement plan, such as a 401(k) or governmental 457(b) plan, that is more suited to the employer's current employee benefits philosophy and workforce. In addition, employers who might be interested in offering a 403(b) plan in the future will be more likely to do so if a clear path to termination exists.

conferences and other public forums that it may not be possible as a practical matter to terminate a 403(b) plan that is invested in individual custodial accounts. The statements are based on the notion that a 403(b) plan termination depends on liquidation of all custodial accounts in the plan and a recognition that most individual custodial account agreements do not provide for involuntary distributions. As a result, in this view, a single missing or recalcitrant participant or beneficiary would prevent an effective plan termination.

Notwithstanding the informal statements from IRS representatives, we are aware of more than a few employers that have announced plan terminations involving custodial accounts and that have communicated these terminations to plan participants and beneficiaries. Under the view espoused at some conferences, these terminations will be ineffective unless all of the plan's custodial accounts are liquidated within one year of the announced termination date. This deadline is fast approaching for many of these plans and it appears unlikely that all of the accounts will be timely liquidated, at least absent guidance. The consequences of a failed plan termination could be severe, with potentially adverse income tax consequences for participants and employers, and difficult administrative challenges for custodians. As a result, we believe there is a pressing need for guidance.

Method of Plan Termination

As you know, the subject of our meeting was our letter dated November 12, 2008. The letter asked for guidance indicating that individual custodial accounts may be "distributed"[3] in connection with a 403(b) plan termination and, further, may be maintained by the custodian on a tax-deferred basis in the same manner as a grandfathered 403(b) contract. This is the same status and tax treatment that applies to annuity contracts that are distributed in connection with a plan termination.

From the meeting, we understand that you and others at the Service were highly doubtful about continuing the tax-deferred treatment of a custodial account after the 403(b) plan has been terminated. However, we understand that an account that is not timely distributed could be deemed distributed through taxation of the custodial account. We also understand that actual distribution could be accomplished through (i) participant-initiated rollovers to IRAs and other eligible retirement plans, (ii) involuntary or employer-directed rollovers to IRAs, and (iii) cash distributions at the participant's or employer's direction. When a custodial account is not liquidated in connection with a plan termination – for example, if a custodial account agreement only provides for distributions at the election of the participant and the participant is unwilling to take a distribution (or cannot be located) – the failure to liquidate would not adversely affect the plan termination. The "un-liquidated" account, however, would cease to be a 403(b) account and the tax-deferred treatment of the account would not continue after the plan termination.

[3] As discussed during the meeting, we understand that in this context, the term "distributed" is somewhat of a misnomer and that, for example, when an annuity contract already is in the name of the individual, nothing special need be done to accomplish a distribution of the contract.

As an example of an effective plan termination, we discussed the following scenario. An employer announces that its 403(b) plan will be terminated on January 1, 2010 and informs all participants that they will have until December 31, 2010 to take a distribution of their account balances.[4] Participants have the opportunity during this window to take cash distributions or to elect rollover distributions. The employer further directs the custodian to issue a Form 1099-R for any account balances that remain outstanding on January 1, 2011, and the custodian treats the account in the same manner as a taxable account after December 31, 2010. (We did not discuss income tax withholding, but presumably 20 percent mandatory withholding for eligible rollover distributions would be applicable.) Participants are informed of their rights, including the consequences of a failure to take a distribution during the one-year window, in connection with the plan termination.

We also discussed an alternative that would be available to the extent permitted by the custodial account agreement and plan. Under this alternative, a custodial account could provide for involuntary distributions or automatic rollovers to IRAs (with employer direction, if necessary) upon 403(b) plan termination, provided that participants have a reasonable opportunity to elect cash distributions or rollover distributions prior to the involuntary cash-out.[5] A custodial account that does not provide for forced liquidation or automatic rollover for missing and recalcitrant participants would be treated in the same manner as a taxable account on or after a specified date, presumably a date specified in communication materials to participants.

In discussing the possible taxable treatment of remaining accounts with Institute members, many concerns were raised. As a threshold matter, it appears that such an account likely would be subject to backup withholding on investment gain and would have annual information reporting requirements with respect to such gain. Other questions involve responsibility for providing ongoing recordkeeping services for accounts no longer associated with an employer plan and whether the accounts could remain invested in the same funds (or share classes of funds) available within the 403(b) plan.

Despite these questions, we believe guidance discussing both automatic rollovers to IRAs and taxation as valid means of plan termination would be appropriate and beneficial. As a practical matter, we believe many custodians would seek to amend their custodial account agreements to provide for

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[4] This one-year window in which participants would have the opportunity to take a distribution is based on plan termination guidance in the context of 401(a) plans, where distribution within one year of the date of plan termination is presumed to be reasonable. *See* Revenue Ruling 89-87, 1989-2 C.B. 81; *see also* Letter from Kenneth Yednock, Chief, IRS Employee Plans Project Branch, to C. Frederick Reish (Oct. 22, 1990).

[5] We note that the mandatory IRA requirements of Code section 401(a)(31)(B) apply to governmental and church plans and ERISA 403(b) plans. *See* Notice 2005-5, Q-5, Q-7, & Q-8. As a result, to the extent that an account balance exceeds $1,000, an involuntary distribution in connection with plan termination would have to be made in the form of an automatic rollover to an IRA.

automatic rollovers for missing and recalcitrant participants in a plan termination. This ordinarily would be preferable to addressing the numerous income tax reporting and administrative issues that would arise from treating a previously tax-deferred account as a taxable account. We also have heard from some of our members that Service guidance addressing plan termination, including guidance that specifically addressed the use of automatic rollovers, would facilitate amendments to custodial account agreements to permit automatic rollovers to IRAs in connection with plan termination. In this regard, some custodians have the authority to unilaterally amend their custodial account agreements, but only within certain bounds, including, for example, to the extent appropriate to comply with the requirements of section 403(b). Thus, published guidance addressing automatic rollovers would almost certainly encourage amendments to provide for such rollovers. Further, even if a vendor did not or could not provide for automatic rollovers, we believe that a discussion of the tax consequences to the participant at the end of the plan termination period would be helpful. At a minimum, it would encourage participants and beneficiaries to make an affirmative election as to the disposition of their accounts prior to the end of the plan termination period.

Guidance addressing these two options also would allow custodians to rely upon an employer's direction that a plan is being terminated. Currently, some custodians have been reluctant to honor plan terminations and allow for in-service distributions because of the risk of adverse tax consequences to participants and beneficiaries. This guidance, however, would provide custodians comfort that a plan would in fact be terminated in a timely manner.

Finally, we note that guidance describing a plan termination that is accomplished through an automatic rollover could help to indirectly ease concerns about fiduciary liability in the context of 403(b) plan termination. For non-ERISA 403(b) plans, automatic IRA rollovers could raise fiduciary considerations under state law. The Department of Labor has published guidelines for automatic rollovers in connection with involuntary cash-outs and missing participants. These guidelines for ERISA plans establish a framework for compliance that custodians of non-ERISA accounts could follow, particularly since the Department's guidance generally is viewed as establishing a minimum standard for fiduciary compliance.[6] Published guidance from the Service specifically describing an automatic rollover accomplished in accordance with the Department's guidelines in connection with a 403(b) plan termination might serve to mitigate state law concerns by providing an example of a prudent termination process for employers and custodians.

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[6] For ERISA plans, the Department of Labor has issued guidance establishing a process for locating missing participants and selecting an IRA product for the automatic rollover, in the context of both mandatory cash-outs and plan termination distributions. *See* 29 CFR §§ 2550.404a-2 and 2550.404a-3; Field Assistance Bulletin 2004-02 (Sept. 30, 2004). In addition, we note that if the custodial account is subject to the qualified joint and survivor annuity requirements of ERISA, it is possible that involuntary distributions would have to be made in the form of an annuity, absent appropriate consents to a distribution.

Other Issues

It is important that any guidance also address a number of other issues in connection with 403(b) plan termination. It would be helpful for the Service to confirm the status of grandfathered 90-24 contracts, discontinued pre-2005 orphan contracts, and contracts covered by the reasonable good-faith relief of Revenue Procedure 2007-71. One natural resolution would be for the Service to confirm that grandfathered 90-24 and pre-2005 orphan contracts do not need to be terminated since they are not subject to the plan requirement. In this regard, these contracts are not affected by the terms of the plan and, therefore, should not be affected by plan termination.

Similarly, it would be logical if the reasonable good-faith contracts described in section 8 of Revenue Procedure 2007-71 remained subject to that standard in connection with plan termination. That is, the employer would have an obligation to make reasonable, good-faith efforts to include the accounts described in section 8 in the plan termination so that the custodian would either liquidate the account through an automatic rollover or report the account as subject to taxation. If, notwithstanding these efforts, the account was not liquidated or tax reported, the plan termination would not be adversely affected.

Another issue that has been raised is whether a plan that is terminated during 2009 must adopt a written plan document. Relief from the written plan requirement was provided for plan terminations prior to the 2009 effective date of the regulations under section 403(b). In light of the delay in the written plan requirement provided in Notice 2009-3, we believe there is similar reason to exempt plans terminating in 2009 from the written plan requirement.

Form of Guidance

At the December meeting, you raised the possibility of issuing a revenue ruling that describes an effective 403(b) plan termination. We suggest a revenue ruling describing the different approaches outlined above (including automatic rollovers to IRAs and taxation of remaining accounts) and concluding that each results in an effective plan termination. The ruling could include examples involving grandfathered and orphan contracts as appropriate, as well as an example of a plan terminating in 2009.

Regardless of the form, we strongly encourage the Service to provide guidance as soon as possible. Some employers already have begun the process of terminating their 403(b) plans, including plans invested in individual custodial accounts. The time for distributing assets of these plans is running out. Guidance along the lines of what we describe above will reduce the likelihood of failed terminations and the necessity for correction methods to deal with such failures.

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We greatly appreciate your attention to these issues and look forward to continuing to work together on them.

Sincerely,

/s/ Elena C. Barone

Elena C. Barone
Associate Counsel – Pension Regulation

cc: Robert Architect, Internal Revenue Service
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March 17, 2009

VIA ELECTRONIC DELIVERY

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Re: Follow-Up on Transition Issues for 403(b) Plans

Dear Ms. Alexander:

On behalf of the Investment Company Institute (the "Institute")[1] and its members, thank you for meeting with us in December 2008 to discuss issues affecting section 403(b) plans under the Employee Retirement Income Security Act of 1974 ("ERISA"). This letter follows up on several questions raised during the meeting.

We discussed the circumstances in which section 403(b) annuity contracts and custodial accounts (collectively, "contracts") are considered plan assets. As you know, we recommended in our letter dated November 12, 2008, and in the meeting, that the Department of Labor issue guidance clarifying that contracts held by vendors that are no longer authorized to receive contributions under a plan after January 1, 2009 are not ERISA plan assets, if the employer or other plan fiduciary does not retain any material rights under the terms of the contracts. This guidance would be consistent with the Department's regulation defining a "participant covered under the plan" and guidance defining plan assets based on ordinary notions of property rights. It would also have the virtue of reflecting the underlying economics of 403(b) contracts where the employer or plan fiduciaries have no material role or authority over contracts. Further, this approach would conform closely to transition guidance that the Internal Revenue Service has issued for so-called orphan and grandfather contracts. Finally, this

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guidance is urgently needed in light of the new 2009 Form 5500 filing requirements for 403(b) plans, including the new Schedule C, as well as other pending regulatory projects that will impact contracts that are considered plan assets.

You and others from the Department asked a number of questions about how such a rule would operate. In particular, you asked whether the substantive rights of a participant would be materially affected if a contract ceased to be subject to ERISA because the employer discontinued contributions before January 1, 2009. You asked whether spousal consent requirements, rights under domestic relations orders, or bankruptcy protections would be affected if a contract that was a plan asset ceased to be a plan asset, for example, because a vendor was no longer authorized to receive contributions.

Consequences for Participants

In general, the only parties to a section 403(b) contract that does not reserve rights to the plan sponsor or other fiduciary are the vendor and the participant. Pursuant to state and federal law, the custodians of section 403(b)(7) custodial accounts and the issuers of section 403(b)(1) annuity contracts are obligated to honor the terms of the contracts (including terms relating to ERISA rights) regardless of whether the contracts remain subject to ERISA. Moreover, in general, it is well-settled that a contract could not be amended to eliminate any rights that would have been protected while the contract was part of an ERISA plan, because the anti-cutback rule appears to apply to distributed contracts.[2]

With respect to the specific issues you raised in our meeting, there is authority that the spousal consent provisions of ERISA, to the extent otherwise applicable, continue to apply to a contract that has been distributed from an ERISA plan.[3] Further, although a non-ERISA section 403(b) plan is not required to accept a qualified domestic relations order ("QDRO"), these orders are binding under state law and our experience is that vendors honor QDROs whether or not the plan is subject to ERISA. Finally, as a result of amendments to the bankruptcy code in 2005, a debtor's 403(b) contract may be exempted from the debtor's bankruptcy estate without regard to whether the contract is subject to ERISA.[4]

Consequences for Plan Sponsors

As described above, there would appear to be very little difference in the rights of a participant after a contract ceased to be part of the employer's plan, at least where the plan fiduciary has no control

[2] Treas. Reg. § 1.411(d)-4, Q&A-2(a)(3)(ii).

[3] Treas. Reg. § 1.401(a)-20, Q&A-2.

[4] *See* 11 U.S.C. §§ 522(b)(3)(C) and 522(d)(12).

over the contract or its terms. At the same time, guidance confirming the status of such contracts as outside of ERISA would have a very significant and beneficial effect for employers. As we discussed, it would mean that these contracts would not need to be reported on the Form 5500 annual return, thus resolving the myriad of issues related to assembling the necessary information on these contracts. Further, the requested guidance would resolve the potential quandary of a plan fiduciary having obligations with respect to assets over which the fiduciary has no control. For example, it would make little sense to apply the proposed service provider disclosure regulations under ERISA section 408(b)(2) to contracts for which the employer has no supervisory authority or control. Finally, as we discussed, the scope of the rule we are proposing is appropriately limited – it would apply only to contracts that were discontinued from receiving new contributions under a plan prior to January 1, 2009. For contracts receiving contributions after that date, the new IRS 403(b) regulations would appear to require that plan fiduciaries retain at least some rights over the contracts.

We note that employers do have some familiarity with the different status of various section 403(b) contracts. As you know, it is not uncommon for a nonprofit employer to maintain both a section 403(b) or section 401(a) program that receives employer contributions and is subject to ERISA, while also maintaining a section 403(b) program that is exempt from ERISA under the safe harbor for programs with limited employer involvement. We are not aware of issues arising because of the differential status of the two classes of contracts. Also, as we discussed, the notion of plan assets migrating in and out of the ERISA system is not a novel one, with rollovers between ERISA plans and IRAs being the most common change in status.

In recognition of the fact that some employers maintain separate 403(b) plans with differing ERISA status, the guidance we request on plan assets clearly should apply where an employer formerly maintained a non-ERISA 403(b) arrangement in the past, freezes that plan, and establishes or continues an ERISA-covered 403(b) plan going forward. Assets held in contracts solely within the confines of the frozen non-ERISA plan should retain their non-ERISA status, even though employees may contribute to separate contracts with the same vendor under the ERISA plan.

Other Relief

We also discussed the possibility of a delay in the effective date of the changes to the Form 5500 annual return for 403(b) plans. We understand, however, from our conversation that this is very unlikely to be a workable solution, in part because of the Form 5500 change to electronic filing for 2009 and the related systems work that has been done. Further, we understand that providing relief from the audit requirement may be challenging because of professional responsibility concerns of the auditing profession. We believe the challenges of finding a vehicle for providing relief from the Form 5500 audit requirement argue strongly for the plan asset relief we suggest. More generally, however, we will continue to consider other avenues for relief from the Form 5500 audit requirement.

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We greatly appreciate your attention to these issues and look forward to continuing to work together on them.

Sincerely,

/s/ Elena C. Barone

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Associate Counsel – Pension Regulation

cc: John J. Canary
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