

Distribution of individual custodial accounts in kind upon termination of a § 403(b) plan

ISSUES

Whether a § 403(b) retirement plan funded through the use of § 403(b)(7) custodial accounts that takes the actions described in this revenue ruling has been terminated in accordance with the rules of § 1.403(b)-10(a), and whether distributions made to participants or beneficiaries in connection with termination of the plan are includible in gross income.

FACTS

Situation 1. Plan A is a defined contribution plan that includes both nonelective employer contributions and elective deferrals. Section 205 of the Employee Retirement Income Security Act of 1974, P.L. 93-406, 88 Stat. 829, as amended (ERISA), applies neither to Plan A generally nor to any participant under Plan A.¹ Plan A satisfies the requirements of § 403(b) and §§ 1.403(b)-2 through 1.403(b)-10. Plan A permits benefits to be paid only after termination from employment or upon plan termination. Plan A is funded solely through the use of § 403(b)(7) custodial accounts maintained under individual agreements.² All amounts held under Plan A are attributable to employer contributions, including elective deferrals as defined in § 1.403(b)-2(b)(7), and no amounts held under Plan A are attributable to designated Roth contributions or after-

¹ Section 205 of ERISA includes annuity and spousal rights provisions that are parallel to the annuity and spousal rights provisions under §§ 401(a)(11) and 417 of the Internal Revenue Code. Section 205(a) of ERISA generally provides that a distribution must be provided either as a qualified joint and survivor annuity in the case of a participant who does not die before the annuity starting date, or as a qualified preretirement survivor annuity in the case of a participant who dies before the annuity starting date. Because section 205 of ERISA does not apply to Plan A generally or to any participant under Plan A, this revenue ruling does not address any annuity and spousal rights issues that may arise under section 205 of ERISA in connection with distributions of individual custodial accounts in kind. Notice 2020-80, 2020-47 I.R.B., issued contemporaneously with this revenue ruling, requests comments relating to these annuity and spousal rights issues.

² Pursuant to § 8 of Rev. Proc. 2007-71, 2007-51 I.R.B. 1184, certain contracts issued before 2009 are not required to be covered by the terms of a § 403(b) plan document. This revenue ruling does not apply to those contracts.

tax contributions. Neither the sponsoring employer, nor any other entity that is treated as the same employer under § 414(b), (c), (m), or (o) on the date of plan termination, makes contributions to any § 403(b) contract that is not part of Plan A, including during the period beginning on January 1, 2021, and ending on the date that is 12 months after distribution of all assets from Plan A.

On January 1, 2021, the employer sponsoring Plan A takes action to terminate Plan A. That action includes the employer executing a binding resolution to cease future contributions to custodial accounts under Plan A and to terminate Plan A, effective January 1, 2021 (the date of plan termination). The resolution also provides that all benefits held under Plan A are fully vested and nonforfeitable as of January 1, 2021, and directs that all benefits be distributed as soon as practicable thereafter. Participants and beneficiaries in Plan A are notified of the plan termination.

Distributions pursuant to the terms of Plan A and the termination resolution are made as soon as administratively practicable after the date of plan termination. For a participant or beneficiary who affirmatively elects to receive a distribution, depending on the participant's or beneficiary's election, a distribution equal to that participant's or beneficiary's account balance is made either to that participant or beneficiary, or to an individual retirement account or annuity under § 408 (an IRA) established for that participant or beneficiary, or another eligible retirement plan (in accordance with the rules of § 1.403(b)-7(b)(1) under which an eligible rollover distribution may be made to an IRA established for the participant or beneficiary or to another eligible retirement plan). Each custodial account provider permits any distribution that is an eligible rollover distribution (as described in § 402(c)(4)) to be paid by a direct transfer to an IRA or other eligible retirement plan (as defined in § 401(a)(31)(E)) in a manner that satisfies § 401(a)(31), including to an IRA established by the same provider that permits investment in the same mutual funds in which the participant's or beneficiary's custodial account is or may be invested. The plan administrator provides a notice to each participant describing the participant's rollover rights, as required by § 402(f) and § 1.403(b)-7(b)(3), withholds in accordance with § 3405 and § 1.403(b)-7(g), and reports the distribution on Form 1099-R, Distributions From Pensions, Annuities,

Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., as required by § 6047(d).

For a participant or beneficiary who does not affirmatively elect to receive a distribution, so that a distribution of the participant's or beneficiary's account balance is not made as described in the preceding paragraph, a distribution pursuant to the terms of Plan A and the termination resolution is made as soon as administratively practicable after the date of plan termination and is effectuated by the distribution of an individual custodial account (ICA) in kind to the participant, beneficiary who is an alternate payee, or beneficiary of a deceased participant.

As part of the process of distributing an ICA in kind to a participant or beneficiary, the plan administrator notifies the participant or beneficiary that, after the distribution of the ICA in kind, the custodial account is being maintained as an ICA of the participant or beneficiary and is no longer part of Plan A. The distributed ICA is maintained by the custodian as a § 403(b)(7) custodial account that adheres to the requirements of § 403(b) in effect at the time of the distribution of the ICA until amounts are actually paid to the participant or beneficiary. Additionally, the employer has no material retained rights under the distributed ICA after it has been distributed.

Situation 2. The facts are the same as in Situation 1, except that Plan A is funded not only by custodial accounts maintained under individual agreements, but also by custodial accounts maintained under group agreements. With respect to custodial accounts maintained under individual agreements, the facts are the same as in Situation 1.

With respect to custodial accounts maintained under group agreements, distributions pursuant to the terms of Plan A and the termination resolution are made as soon as administratively practicable after the date of plan termination. For a participant or beneficiary who affirmatively elects to receive a distribution, depending on the participant's or beneficiary's election, a distribution equal to the participant's or beneficiary's account balance is made either to the participant or beneficiary or to an IRA established for the participant or beneficiary or another eligible retirement plan (in accordance with the rules of § 1.403(b)-7(b)(1)).

For a participant or beneficiary whose account balance is held all or in part in custodial accounts maintained under a group agreement and who does not affirmatively elect to receive a distribution described in the prior paragraph, a distribution of an amount from the custodial accounts maintained under the group agreement is made as soon as administratively practicable after the date of plan termination and is effectuated by the distribution of an ICA in kind to each participant, beneficiary who is an alternate payee, or beneficiary of a deceased participant in the custodial accounts maintained under a group agreement. Distribution of an ICA in kind from the custodial accounts maintained under a group agreement is accomplished by distributing a document that evidences the ICA, including the accumulated nonforfeitable value of the participant's or beneficiary's interest in the custodial accounts maintained under a group agreement, and associated rights and responsibilities of the participant or beneficiary and custodian. A distributed ICA is maintained by the custodian as a § 403(b)(7) custodial account that adheres to the requirements of § 403(b) in effect at the time of the distribution of the ICA until amounts are actually paid to the participant or beneficiary. Additionally, the employer has no material retained rights under an ICA after it has been distributed.

LAW

Section 403(b) – In General

Section 403(b) applies to contributions made for employees who are performing services for a public school of a State or a local government or for employees of employers that are tax-exempt organizations under § 501(c)(3). Section 403(b) also applies to contributions made for certain ministers. Under § 403(b)(1), (7), and (9), contributions are excluded from gross income only if made to one or more of the following funding arrangements: (1) contracts issued by an insurance company qualified to issue annuities in a State that includes payment in the form of an annuity, (2) custodial accounts that are exclusively invested in stock of a regulated investment company (as defined in § 851(a) relating to mutual funds), or (3) retirement income accounts for employees of a church-related organization (as defined in § 1.403(b)-2) (collectively referred to as § 403(b) contracts). Additionally, under § 403(b)(1)(C), an employee's rights under the § 403(b) contract must be nonforfeitable.

Final regulations under § 403(b) (TD 9340) were published in the Federal Register (72 FR 41128) on July 26, 2007. Subject to a number of special applicability date rules, § 1.403(b)-11(a) provides that those final regulations generally apply for taxable years beginning after December 31, 2008.

Freezing and Terminating § 403(b) Plans

Section 1.403(b)-10(a) provides that an employer may amend its § 403(b) plan to eliminate future contributions for existing participants or to limit participation to existing participants and employees (to the extent consistent with § 1.403(b)-5). A § 403(b) plan also may include provisions that provide for plan termination and that allow accumulated benefits to be distributed on plan termination.

Under § 1.403(b)-10(a), in the case of a § 403(b) contract that is subject to the distribution restrictions in § 1.403(b)-6(c) or (d) (relating to custodial accounts and § 403(b) elective deferrals), termination of a § 403(b) plan and distribution of accumulated benefits is permitted only if the employer (taking into account all entities that are treated as the same employer under § 414(b), (c), (m), or (o) on the date of termination) does not make contributions to any § 403(b) contract that is not part of the plan (these contracts are referred to in this revenue ruling as "another § 403(b) plan"). For rules relating to entities that are treated as the same employer under § 414(c), see § 1.414(c)-5; for controlled group rules relating to governmental entities, see Notice 89-23 (1989-1 CB 654), as modified by Rev. Rul. 2009-18, 2009-2 C.B. 1; and, for special rules applicable to church plans for entities under common control, see § 414(c)(2).

For purposes of the requirement that, after plan termination, the employer make no contributions to any other § 403(b) plan, the employer makes contributions to another § 403(b) plan only if the employer makes contributions to a § 403(b) contract during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. However, if at all times during the period beginning 12 months before the plan termination and ending 12 months after distribution of all assets from the terminated plan, fewer than two percent of the employees who were eligible under the terminating § 403(b) plan as of the date of plan termination are eligible under another § 403(b) plan, that other § 403(b) plan is

disregarded. To the extent a contract fails to satisfy the nonforfeitability requirement of § 1.403(b)-3(a)(2) as of the date of plan termination, the contract is not, and cannot later become, a § 403(b) contract.

For a § 403(b) plan to be terminated under § 1.403(b)-10(a), all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan.³ For this purpose, delivery of a fully paid individual insurance annuity contract is treated as a distribution. The mere provision for, and making of, benefit distributions to participants or beneficiaries upon plan termination does not cause a contract to cease to be a § 403(b) contract. Section 1.403(b)-7 provides rules regarding the tax treatment of benefit distributions, including rules in § 1.403(b)-7(b)(1) under which an eligible rollover distribution is not included in gross income if paid in a direct rollover to an eligible retirement plan or if transferred to an eligible retirement plan within 60 days.

Rev. Rul. 2011-7, 2011-10 I.R.B. 534, provides that a plan may be terminated in accordance with the rules of § 1.403(b)-10(a) by the delivery to participants or beneficiaries of a fully paid individual annuity contract or an individual certificate evidencing fully paid benefits under a group annuity contract. Rev. Rul. 2011-7 further provides that the delivery of a fully paid individual annuity contract to a participant or beneficiary, or of an individual certificate evidencing fully paid benefits under a group annuity contract, is not included in gross income until amounts are actually paid to the participant or beneficiary out of the contract, so long as the contract maintains its status as a § 403(b) contract. Finally, Rev. Rul. 2011-7 provides that any other distribution to a participant or beneficiary to effectuate plan termination is included in gross income, except to the extent the amount is rolled over to an IRA or other eligible retirement plan by a direct rollover or by a transfer made within 60 days.

Section 110 of the SECURE Act

Section 110 of Division O of the Further Consolidated Appropriations Act, 2020, Pub. L. 116-94, 133 Stat. 2534 (2019) known as the Setting Every Community Up for

³ For rules relating to the requirement that distributions to all participants and beneficiaries be made as soon as administratively practicable after plan termination in the case of a plan qualified under § 401(a), see Rev. Rul. 89-87, 1989-2 C.B. 81.

Retirement Enhancement Act of 2019 (SECURE Act), provides that the Secretary of the Treasury shall issue guidance providing that, if an employer terminates a plan under which amounts are contributed to a custodial account under § 403(b)(7), the plan administrator or custodian may distribute an ICA in kind to a participant or beneficiary of the plan. It also provides that the distributed custodial account will be maintained by the custodian on a tax-deferred basis as a § 403(b)(7) custodial account, similar to the treatment of fully paid individual annuity contracts under Rev. Rul. 2011-7, until amounts are actually paid to the participant or beneficiary. The legislation further directs that the guidance provide (1) that the § 403(b)(7) status of the distributed custodial account generally is maintained if the custodial account thereafter adheres to the requirements of § 403(b) that are in effect at the time of the distribution of the account, and (2) that a custodial account is not considered distributed to the participant or beneficiary if the employer has any material retained rights under the account (but the employer is not treated as retaining material rights merely because the custodial account was originally opened under a group contract). Finally, the legislation directs that the guidance be retroactively effective for taxable years beginning after December 31, 2008.⁴

ANALYSIS

The employer in Situation 1 adopts a resolution to cease contributions and terminate the plan at a specified date, including full vesting for all benefits as of that date. Because the plan satisfies the applicable requirements under § 403(b) and the employer takes action to fully vest any participants with respect to amounts not otherwise fully vested as of the date of plan termination, all custodial accounts under the plan are § 403(b) contracts upon plan termination. See § 1.403(b)-10(a)(1).

Distributions of accumulated benefits under the plan in Situation 1 are made either (1) by payment to the participant or beneficiary, or to an IRA established by the participant or beneficiary or another eligible retirement plan (in accordance with § 1.403(b)-7(b)); or (2) by distribution of an ICA in kind to each participant or beneficiary as soon as administratively practicable after the date of plan termination. Because the

⁴ Because SECURE Act section 110 provides that the guidance is retroactively effective only for taxable years beginning after December 31, 2008, this revenue ruling does not apply to any action that occurred in taxable years beginning on or before December 31, 2008.

plan is funded solely through custodial accounts maintained under individual agreements, no further action is required to be taken in order to distribute the ICA in kind. In addition, neither the sponsoring employer nor any other entity that is treated as the same employer under § 414(b), (c), (m), or (o) on the date of plan termination makes contributions to any § 403(b) contract that is not part of Plan A, including during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. Accordingly, the employer's actions to terminate the plan and distribute accumulated benefits satisfy the requirements of § 403(b) and § 1.403(b)-10(a) for plan termination. Following termination of the plan, a participant or beneficiary who holds an ICA is entitled to payments in accordance with the terms of the ICA (which may permit single-sum payments in connection with plan termination).

In Situation 2, the same actions are taken, except that the employer distributes an ICA in kind to a participant or beneficiary whose accumulated benefits are funded by a custodial account maintained under a group agreement by providing a document to the participant or beneficiary that evidences the ICA, including the accumulated nonforfeitable value of the participant's or beneficiary's interest in the custodial accounts maintained under the group agreement, and associated rights and responsibilities of the participant or beneficiary and custodian. The distribution of the ICA in kind to the participant or beneficiary constitutes a distribution of the participant's or beneficiary's accumulated benefit in the custodial accounts maintained under a group agreement for purposes of § 1.403(b)-10(a).

In both Situation 1 and Situation 2, the employer has no material retained rights under an ICA after it has been distributed (and the employer is not treated as retaining material rights merely because the ICA was originally opened under a group contract). Accordingly, with respect to Situation 1 and Situation 2, the distribution of an ICA in kind to a participant or beneficiary is not immediately includible in gross income, but rather amounts are includible in income only when actually paid to the participant or beneficiary from the custodial account, so long as the ICA maintains its status as a § 403(b)(7) custodial account; the § 403(b)(7) custodial account status of the ICA generally is maintained if the ICA continues to adhere to the requirements of § 403(b)

that are in effect at the time of the distribution of the ICA. Any other amount paid to a participant or beneficiary, such as a single-sum payment, is includible in the gross income of the participant or beneficiary, except to the extent the amount is rolled over to an IRA or other eligible retirement plan by a direct rollover or by a transfer made within 60 days.

HOLDING

In Situation 1 and Situation 2, Plan A is terminated in accordance with the rules of § 1.403(b)-10(a). Distribution of an ICA in kind to a participant or beneficiary is not includible in gross income until amounts are actually paid to the participant or beneficiary out of the ICA, so long as the ICA maintains its status as a § 403(b)(7) custodial account. Any other amount distributed from a custodial account to a participant or beneficiary to effectuate plan termination is includible in gross income, except to the extent the amount is rolled over to an IRA or other eligible retirement plan by a direct rollover or by a transfer made within 60 days.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 2011-7 is modified.

DRAFTING INFORMATION

The principal author of this revenue ruling is Patrick T. Gutierrez of the Office of Associate Chief Counsel, Employee Benefits, Exempt Organizations, and Employment Taxes. For further information regarding this revenue ruling, please contact Patrick T. Gutierrez at (202) 317-4148 (not toll-free).