



July 15, 2011

Mr. Andrew E. Zuckerman
Director, EP Rulings & Agreements
Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224-0002

Re: Distribution of Custodial Accounts on 403(b) Plan Termination

Dear Andy:

The American Society of Pension Professionals and Actuaries (“ASPPA”) and National Tax Sheltered Accounts Association (“NTSAA”) appreciate the opportunity to provide input with respect to the termination of a 403(b) plan which is funded, in whole or in part, by 403(b)(7) custodial accounts.

ASPPA is a national organization of more than 7,500 members who provide consulting and administrative services for retirement plans covering millions of American workers. ASPPA’s membership includes the members of NTSAA, a nonprofit organization that recently became part of ASPPA in order to expand both organizations’ strengths in serving the §403(b) marketplace. ASPPA and NTSAA members are retirement professionals of all disciplines, including consultants, investment professionals, administrators, actuaries, accountants and attorneys. Our large and broad-based membership gives ASPPA a unique insight into current practical applications of ERISA and qualified retirement plans, with a particular focus on the issues faced by small- to medium-sized employers. ASPPA’s membership is diverse but united by a common dedication to the employer-based retirement plan system.

Summary

ASPPA and NTSAA believe that the treatment of 403(b)(7) custodial accounts on plan termination should be consistent with the treatment of distributed annuity contracts as outlined in Revenue Ruling 2011-7. In particular, this treatment is needed for individual custodial accounts (which are contracts directly between the plan participant and the custodian) where the plan sponsor has no right under the contract to disburse assets on plan termination; and where the custodian has no legal obligation under the contract to unilaterally amend the account to provide to a plan sponsor that right of disbursement upon plan termination.

As proposed below, the distribution of the 403(b)(7) custodial accounts will be consistent with state law as well as private letter rulings previously issued by the Internal Revenue Service (“IRS”). Often custodial accounts are direct contracts between the participant and the

custodian and thus it is appropriate that they be distributable “in-kind” assets of a 403(b) plan. As an “in-kind” asset, the plan sponsor has the legal ability to distribute the custodial account upon termination of the plan. The distribution of assets of a 403(b)(7) custodial account is subject to the terms and conditions of the employer’s plan, which alleviates the potential for abuse.

In an effort to demonstrate how this would effectuate a reasonable termination process, we have included a set of fact patterns that are based on those contained in Revenue Ruling 2011-7, but have been modified to address the relevant issues in the context of a plan with 403(b)(7) custodial accounts.¹

ASPPA and NTSAA recommend that the IRS treat 403(b)(7) custodial accounts on plan termination consistently with the treatment of distributed annuity contracts as outlined in Revenue Ruling 2011-7 and, in particular, as described in the Fact Patterns in the Discussion section below.

Discussion

I. State Laws Are Consistent with the Distribution of Custodial Accounts

403(b)(7) custodial accounts are held under agreements which are subject to state laws including contract laws, where there is often privity of contract directly between the plan participant and the custodian of the 403(b) assets. The participant is actually a party to such contracts with the custodian, and the plan sponsor is not. Where there is such privity, often the 403(b) plan sponsor has no legal authority to distribute the assets in such accounts on plan termination, and some custodians have not retained any right to unilaterally amend the agreement to provide for such authority under the terms of the custodial agreement. These contracts are associated with a 403(b) plan typically for IRS compliance purposes, even though the plan sponsor has no contractual rights under the arrangements.

The “distribution” of these contracts upon the termination of the 403(b) plan does not entail the transfer of rights from the plan to the participant, as such rights are already held by the participant. Rather, it involves the transfer of plan administrative responsibility from the employer to the custodian. This transfer of responsibility effectively results in an in-kind “distribution” of the custodial account. Such a distribution would be merely preserving the participant’s rights under the contract, and would cause no interference with ownership rights existing under the agreement prior to termination. After distribution as suggested below, the participant would still be the owner and could exercise those rights under the custodial account. The custodian would continue to hold assets in a custodial account, subject to the underlying contract’s terms and applicable IRS requirements for tax deferral of the assets held in the custodial account, until such time as an actual distribution is requested by the participant.

¹ We would note that the inclusion of a group custodial agreement would not be adversely affected by the proposals we are recommending, provided the agreement has been updated to reflect the changes made in the final 403(b) regulations. The updated agreement would provide the employer with the option to distribute based on language in the custodial agreement.

II. Private Letter Rulings Have Recognized the Stand-Alone 403(b)(7) Contracts as a Plan

The 403(b)(7) custodial account distributed on plan termination should continue to be treated as a 403(b) plan, in the same way as the Qualified Plan Distributed Annuity² for 401(a) plans.³ This would be consistent with private letter rulings which have recognized the stand-alone 403(b)(7) contract as a “plan” and treated it as a qualified trust under 401(a) for tax purposes.

Since 1980, over 300 private letter rulings have been issued that in some way touch upon Internal Revenue Code (“IRC” or “Code”) §403(b)(7) custodial accounts. Although we recognize that private letter rulings are not authoritative guidance, the analysis in these rulings uniformly recognize that a 403(b)(7) custodial account that satisfies IRC §402(f)(2) may be treated as a IRC §401(a) plan. Most of the private letter rulings use the same lead-in to the rulings’ requested conclusions, including statements such as: “custodial accounts shall be treated as qualified trusts under section 401(a) if the assets are held by a bank, or another person who demonstrates to the satisfaction of the Secretary, that the manner in which he will hold the assets will be consistent with the requirements of section 401(a)”; “custodial accounts will be treated as a qualified trust under 401 of the Code and amounts received by the Custodian, whether as amounts paid by the Employer or as earnings thereon, will not constitute taxable income to the Custodian, the Employer or the employee”; and “amounts held in a custodial account, together with earnings thereon, will be taxable under Code section 72 to the respective employee in the year in which such amounts are actually received by the employee.”⁴

In-kind distributions of annuity contracts from IRC §401(a) plans have long been recognized as “plans” for tax purposes, even following the termination of the distributing plan.⁵ The analysis of the cited private letter rulings demonstrates that this same recognition should be afforded to 403(b)(7) custodial accounts to permit in kind distribution at plan termination. The custodial account has a similar legal structure to a distributed annuity contract in that the custodian is in position to act as the administrator to ensure compliance with the tax qualification rules of IRC §403(b), just as they currently are responsible for “grandfathered” contracts, discussed at footnote 8, *infra*. The custodian, acting as the payor, would be responsible for reporting the distribution on Form 1099-R and for providing the distributee with the written explanation contemplated by IRC §402(f). IRC §403(b)(7)(A) specifically provides that amounts paid to a qualifying custodial account shall be treated as contributed to an annuity contract. Consistency would require that there should be no distinction between an in-kind distribution of an annuity contract and an in-kind distribution of a custodial account.

² A Qualified Plan Distributed Annuity Contract is defined in Treas. Reg. §§ 1.402(c)-2, Q&A 10, 1.401(a)(31)-1, Q&A 16 and 35.3405(c)-1, Q&A 13.

³ *Id.*

⁴ *See, e.g.*, IRS Private Letter Rulings 8608078, 8819053, 9107027, 199921059, and 200317031.

⁵ *See, e.g.*, Treas. Reg. §1.402(c)-2, Q&A 10(a).

III. An Individually Owned Custodial Account is a Distributable “In-Kind” Asset of a §403(b) Plan

As previously noted, often custodial accounts are direct contracts between the individual participant and the custodian. The 403(b) individually owned custodial account is, in itself, a non-cash, “in-kind asset” of the plan, the traditional “bundle of rights” recognized under ordinary notions of state property laws. It is a financial product, like an annuity contract, under which its assets are governed by the specific terms of the custodial account.

For example, the custodial account owner has a direct legal right to the investments in the account, it is not merely the beneficial interest that a participant has under a trust associated with a plan under IRC §401(a). The custodial account’s terms specifically outline the rights the individual has vis-à-vis the custodian. Under state property laws, this package of rights is considered the property of the individual, and is unlike participant rights under a IRC §401(a) trust. In addition, the securities laws grant all prospectus and voting rights to the owner of that account, not to the “plan.”

The Internal Revenue Code recognizes the status of custodial accounts. IRC §403(b)(7) recognizes that the custodial account is an investment product which is different than an IRC §401(a) trust. IRC §403(b)(7)(B) was needed to confer upon this product the favorable tax benefits offered under plans. Under that section, a 403(b)(7) contract is treated as a “plan” for the purposes of Subchapter F (regarding tax exempt treatment of the custodial account) and Subtitle F (reporting and collection of taxes). IRC §403(b)(8)(B) further recognizes, as well as the current published 403(b) audit guidelines and the 402(f) notice,⁶ the “in-kind” product status of the custodial account by recognizing that for 402(f) purposes, the “payor” (typically the investment company or the custodian) will be considered the plan administrator.

Additionally, the final 403(b) regulations state that “under section 403(b)(7), a custodial account is treated as an annuity contract for purposes of sections 1.403(b)-1 through 1.403(b)-7, this section [referring to section 1.403(b)-8] and sections 1.403(b)-9 through 1.403(b)-11.”⁷ These references include every provision of the final regulations, including the provisions in section 1.403(b)-10(a), which deals with plan termination.

And finally, Section 8.02 of Revenue Procedure 2007-71, provides the same desired result with respect to “deselected vendors” under a 403(b) plan for certain contracts as well as 403(b)(7) custodial agreements, and so-called “grandfathered” 90-24 contracts.⁸

For example if a “contract” (defined to include a 403(b)(7) custodial agreement), was issued before 2009 but the vendor was not receiving contributions after December 31, 2008 and is a deselected vendor, then the contract is not required to be included in the employer’s 403(b) “plan”. The same requirements apply to “grandfathered” 90-24 contracts. Such contracts/accounts continue to be subject to the requirements of section 403(b) and the 2007

⁶ IRS Examination Guidelines, Section XI(A)(3)(b); IRS Notice 2009-68; 403(b)(8)(B); Treas. Reg. § 35.3405-1, Q&A A-13.

⁷ Treas. Reg. § 1.403(b)-8(d)(1).

⁸ Treas. Reg. § 1.403(b)-11(g).

final regulations; however, the vendor is responsible for making a good faith effort to validate any transaction/distribution from the contract/account, process the transaction, take on the role of the payor for tax reporting, etc.

The Revenue Procedure goes on to indicate that if a contract has been issued before January 1, 2009, under a 403(b) plan that is held on behalf of a participant who, on January 1, 2009, is a former employee or a beneficiary, then the vendor “can rely on information from the participant as to whether the participant is a former employee, assuming that reliance on that information is not unreasonable under the facts and circumstances.” In these cases if the “contract/account” is not a part of the plan and we deal with these on a level that involves the vendor and the participant/beneficiary only, this would in fact be the same as treating the account as “distributed” (not part of a plan) and all subsequent transactions/distributions would be the responsibility of the vendor.

IV. Employers Have the Legal Ability to Distribute Custodial Accounts Upon Plan Termination

As an in-kind asset, the employer has the legal ability to “distribute the custodial account” upon termination of the plan, even where a participant does not separately consent or cooperate with such distribution. Such a participant is effectively a “non-responsive participant,” for whom public policy supports making termination distributions in a manner which preserves the retirement plan characteristics of the funds.

Although ERISA does not apply to every 403(b) plan, it does establish a recognized public policy supporting preservation of retirement assets, where practicable. Generally, the distribution of assets on plan termination is governed by the fiduciary requirements of ERISA to encourage plan fiduciaries to properly wind up the affairs of a terminating plan. The Department of Labor (“DOL”) created a safe harbor that permits the transfer of non-responsive participants’ assets to an IRA custodial account. This safe harbor preserves the continued tax deferred status of the participant’s retirement assets and is a “preferred” method of distribution.⁹

If a 403(b) plan with 403(b)(7) accounts terminates, a participant would be given the option of taking a liquidating rollover distribution. If a participant with an individual 403(b)(7) custodial account doesn’t respond to the distribution notice, he or she would be considered a non-responsive participant. The 403(b) custodial account is functionally and structurally similar to an IRA custodial account. There is no effective difference between, on the one hand, liquidating the assets in a non-responsive participant’s 403(b) custodial account and establishing a tax deferred IRA custodial account in the participant’s name and, on the other hand, merely transferring a non-responsive participant’s 403(b) custodial account to that participant’s control. However, as discussed above, employers have no ability to unilaterally terminate 403(b)(7) custodial accounts in order to effectuate a distribution to an IRA custodial account.

⁹ See, DOL Field Assistance Bulletin 2004-02 and DOL Reg. § 2550.404a-3, Safe harbor for distributions from terminated individual account plans (published 4/21/2006).

The ability to preserve tax qualified retirement savings by recognizing the in-kind distribution of a custodial account as a terminating distribution furthers public policy. As noted by the DOL in Field Assistance Bulletin 2004-2:

“In our view, plan fiduciaries must always consider distributing missing participant benefits into individual retirement plans (i.e., an individual retirement account or annuity). Establishing an individual retirement plan is the preferred distribution option because it is more likely to preserve assets for retirement purposes than any of the other identified options.

Distribution to an individual retirement plan preserves retirement assets because it results in a deferral of income tax consequences for missing participants. A distribution that qualifies as an eligible rollover distribution from a qualified plan, which is handled by a trustee to trustee transfer into an individual retirement plan, will not be subject to immediate income taxation, the 20 percent mandatory income tax withholding requirement, or the 10 percent additional tax for premature distributions that may be required based on the participant’s age and related facts.”¹⁰

Thus, the position taken by the DOL is supportive of allowing the distribution of a custodial account upon the termination of a plan as it would preserve retirement savings.

V. The Current Rules Minimize the Potential for Abuse

The distribution of assets held under a 403(b)(7) custodial account is subject to the terms and conditions of the employer’s plan. This means important rules such as nonforfeitability and the required minimum distributions will be honored by the custodian holding the assets. As long as no transactions other than distributions (including rollovers) are permitted (and existing loans, which are required to be honored), there should be no further application of “plan” level rules, such as discrimination or universal eligibility.

Custodians of 403(b)(7) custodial accounts are also aware of their obligations to ensure that the terms of the custodial account agreements are maintained as required by the Code and regulations and operated in accordance with such terms in order to preserve the tax-deferred nature of the account. Many custodians recordkeep their 403(b)(7) custodial accounts on platforms that do not support current tax reporting of earnings on assets held in such custodial accounts, and distributions from 403(b)(7) custodial accounts held on such platforms are reported on Form 1099-R, consistent with their nature as retirement plan assets. If a custodian fails to maintain its 403(b)(7) custodial accounts in form and operation as required by applicable tax laws, not only would the participant be in jeopardy of current taxation of the amounts held in the custodial account, but the custodian would also be in jeopardy of significant fines and penalties from the IRS due to improper tax reporting and could potentially face lawsuits under federal and state law from owners of such 403(b)(7) custodial accounts.

¹⁰ DOL Field Assistance Bulletin 2004-02 (citations omitted).

This is the same legal framework that currently governs the “grandfathered” 90-24 contracts and deselected vendor contracts (and individual retirement accounts, generally), and no evidence of abuse has been publicly identified to date. Accordingly, as a policy matter, distributed 403(b)(7) custodial accounts pose no greater moral hazard or potential for abuse.

VI. In-Kind Distributions Should be Handled Based on the Following Fact Patterns

In an effort to simplify the process and to assure that the taxation and distribution disclosures are provided, ASPPA and NTSAA suggest that the “in-kind” distribution be handled based on the fact patterns below.

A. Elective Deferrals Only

Plan A is a defined contribution plan maintained by a public school that includes only elective deferrals. Prior to the action taken to terminate the plan as described below, Plan A satisfies the requirements of section 403(b) and Treasury Regulations §§1.403(b)-2 through 1.403(b)-9. Plan A only permits benefit payments to be made after termination from employment, attainment of age 59 ½ or upon plan termination. Plan A is funded solely through amounts held by one or more regulated investment companies (as defined in IRC §851(a) relating to mutual funds) in custodial accounts that are treated as annuity contracts for purposes of §403(b). Plan A is not subject to ERISA (because it is a governmental plan, within the meaning of section 3(32) of ERISA). All amounts held under Plan A are a result of elective deferrals as defined in Treasury Regulation §1.403(b)-2(b)(7), and no amounts are held there as a result of designated Roth contributions or after-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 the termination makes contributions to any §403(b) contract that is not part of Plan A, including during the period beginning on January 1, 2012 and ending on the date that is 12 months after distribution of all assets from Plan A.

On or before January 1, 2012, the employer sponsoring Plan A takes action to terminate Plan A. That action includes a binding resolution of the employer to cease all future elective deferral contributions under Plan A and to terminate Plan A, effective January 1, 2012. The resolution also provides that all benefits held under Plan A are fully vested and nonforfeitable as of January 1, 2012, 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 termination date and are effectuated by distribution of the 403(b)(7) custodial accounts to all participants, beneficiaries who are alternate payees, and beneficiaries of deceased participants, as if the custodial account is treated as a fully paid insurance contract.

Each custodial account that is distributed “in-kind” to the participants, beneficiaries, and alternate payees must continue to satisfy IRC §403(b) and other applicable laws (such as the minimum distribution requirements of IRC §401(a)(9)) as to form and operation.

Following termination of the plan, participants and beneficiaries who now hold the “distributed custodial accounts” (treated similar to fully paid insurance annuity contracts) are entitled to payments in accordance with the terms of the custodial agreements (which may permit single-sum payments in connection with plan termination, partial payments, substantially equal periodic payments under IRC §72(t) and rollover distributions). All rights under the custodial agreement will continue to apply after the terminated “distribution of the custodial agreement,” and therefore will not violate state law regarding the agreement.

The custodian of the “distributed custodial account” will therefore be responsible to amend the custodial agreement as to future law, regulations, or other guidance which mandates such amendments, and will be responsible to disclose to the participant, beneficiary, or alternate payee the requirements for distributions, which shall include but shall not be limited to providing the correct 402(f) notice as well as proper distribution forms. The payor, which in most cases will be the custodian, will be responsible for the proper tax reporting on the distribution, distributing the proper withholding notices, collecting the withholding amounts and remitting them on a timely basis. The payor will also, on a form acceptable to such payor, ascertain the reason for the distribution and shall have the responsibility to verify the reason unless the circumstances warrant the verification by the participant, beneficiary or alternate payee.

B. Group Custodial Agreement

The facts are the same as in the first Fact Pattern, except that Plan A is funded through a group custodial agreement. The group custodial agreement, similar to a group annuity contract, permits the Employer to terminate the agreement, which therefore does not involve state law problems with respect to the movement, or cash-out of the 403(b) custodial agreement upon termination. In these situations, the employer can require a distribution upon termination and payment can be made to the participants pending their signature on the individual distribution form.

C. Abandoned 403(b) Plan

The facts are the same as in Fact Pattern #1, except that Plan A was established by an employer that will no longer be in business on December 31, 2011 potentially creating thereby an abandoned 403(b) plan in the future.

The employer would like to terminate the plan pursuant to the 403(b) regulations and must “distribute” all assets as soon as administratively feasible, including custodial accounts under which it has no rights to distribute assets.

If this were an ERISA plan, this will also permit the employer to file a final Form 5500 return, if all custodial agreements are “distributed” by the end of 2011.

VII. Conclusion

For the reasons described above, ASPPA and NTSAA believe that allowing the distributions of 403(b)(7) custodial accounts is consistent with state law and prior guidance issued by both the IRS and DOL.

ASPPA and NTSAA recommend that the IRS treat 403(b)(7) custodial accounts on plan termination consistently with its guidance on distributed annuity contracts in Revenue Ruling 2011-7 and in accordance with the Fact Patterns described above.



These comments were prepared by ASPPA's and NTSAA's Tax-Exempt/Governmental Plans Subcommittee of the Government Affairs Committee. We welcome the opportunity to discuss these issues with you. If you have any questions regarding the matters discussed herein, please contact Craig Hoffman, General Counsel and Director of Regulatory Affairs at (703) 516-9300.

Thank you for your consideration.

/s/

Brian H. Graff, Esq., APM
Executive Director/CEO

/s/

Judy A. Miller, MSPA
Chief of Actuarial Issues

/s/

Craig P. Hoffman, Esq., APM
General Counsel

/s/

Mark Dunbar, MSPA, Co-Chair
Gov't Affairs Committee

/s/

Ilene H. Ferenczy, Esq., APM, Co-Chair
Gov't Affairs Committee

/s/

James Paul, APM, Co-Chair
Gov't Affairs Committee

cc: George H. Bostick, Benefits Tax Counsel, Department of the Treasury
William Bortz, Associate Benefits Tax Counsel, Department of the Treasury
Joyce Kahn, Manager, Voluntary Compliance (Employee Plans), Internal Revenue Service
Alan Tawshunsky, Deputy Division Counsel/Deputy Associate Chief Counsel (Employee Benefits), Internal Revenue Service