

MEMO# 32905

November 9, 2020

IRS Issues Guidance Implementing SECURE Act Provision on 403(b) Plan Termination

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TO: ICI Members

Pension Committee

Pension Operations Advisory Committee SUBJECTS: Pension RE: IRS Issues Guidance Implementing SECURE Act Provision on 403(b) Plan Termination

The IRS and Treasury issued Revenue Ruling 2020-23,[\[1\]](#) providing guidance to implement section 110 of the Setting Every Community Up for Retirement Enhancement Act of 2019 (“SECURE Act” or “Act”).[\[2\]](#) Section 110 of the Act directs the Secretary of the Treasury to issue guidance providing that if an employer terminates the plan under which amounts are contributed to a 403(b) custodial account, the plan administrator or custodian may distribute an individual custodial account in kind to a participant or beneficiary of the plan and the distributed custodial account shall be maintained by the custodian on a tax-deferred basis as an Internal Revenue Code (“Code”) section 403(b)(7) custodial account, until amounts are actually paid to the participant or beneficiary.[\[3\]](#)

In conjunction with Revenue Ruling 2020-23, the IRS and Treasury also issued a request for comments (Notice 2020-80)[\[4\]](#) on the protection of annuity and spousal rights under section 205 of ERISA with respect to a terminating 403(b) plan funded through custodial accounts. Both releases are described further below.

Background

Section 110 of the SECURE Act aims to address the problem of how to complete the termination of a 403(b) plan that includes individually-owned custodial accounts under Code section 403(b)(7), where neither the custodian nor the sponsoring employer has the authority or desire to force the participant to take a distribution. The participant’s failure to consent to a distribution upon the plan’s termination can occur for various reasons, including for example, if the participant is nonresponsive to outreach, simply unwilling to liquidate or move the assets to another vehicle or, much less frequently, that the participant is “missing” (unable to be located or reached). Treasury and IRS have provided guidance in the past on 403(b) plan termination issues, including Revenue Ruling

2011-7,[\[5\]](#) but have not addressed the problem of a lack of consent to a distribution from a section 403(b)(7) custodial account by the participant or beneficiary.

ICI provided input to the IRS and Treasury on the implementation of SECURE Act section 110 in a letter earlier this year.[\[6\]](#)

Revenue Ruling 2020-23

Revenue Ruling 2020-23 specifically addresses whether a 403(b) plan funded through the use of section 403(b)(7) custodial accounts and that takes certain specified actions, has been terminated in accordance with the rules of Treasury Regulation section 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.

The ruling involves the following two factual situations.

Situation 1

The plan is a non-ERISA 403(b) plan that includes both nonelective employer contributions and elective deferrals, and permits benefits to be paid only after termination from employment or upon plan termination. The plan is funded solely through the use of section 403(b)(7) custodial accounts maintained under individual agreements and no amounts are attributable to designated Roth contributions or after-tax contributions. All other requirements of section 403(b) and the regulations thereunder are satisfied.

On January 1, 2021, the plan sponsor takes action to terminate the plan. That action includes the employer executing a binding resolution to cease future contributions to custodial accounts under the plan and to terminate the plan, effective January 1, 2021 (the date of plan termination). The resolution also provides that all benefits held under the plan 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 are notified of the plan termination.

Distributions pursuant to the terms of the plan and the termination resolution are made as soon as administratively practicable after the date of plan termination, including distributions to participants or beneficiaries who affirmatively elect to receive a distribution or rollover to another plan or IRA. For a participant or beneficiary who does not affirmatively elect to receive a distribution, a distribution pursuant to the terms of the plan 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 or beneficiary.

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 the plan. The distributed ICA is maintained by the custodian as a section 403(b)(7) custodial account that adheres to the requirements of section 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 the plan 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 group agreements, distributions pursuant to the terms of the plan and the termination resolution are made as soon as administratively practicable after the date of plan termination.

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, 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 and beneficiary. 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 section 403(b)(7) custodial account that adheres to the requirements of section 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.

Holding

The Ruling provides that in Situations 1 and 2, the plan is terminated in accordance with the rules of Treasury Regulation section 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 section 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.

Notice 2020-80

The Notice requests comments on the application of the annuity and spousal rights provisions of section 205 of ERISA, in connection with a distribution of an ICA in kind from a terminating 403(b) plan.[\[7\]](#)

Because the factual situations described in Revenue Ruling 2020-23 involve non-ERISA plans, the ruling does not address a situation in which annuity and spousal rights under section 205 of ERISA apply. Accordingly, the Notice explains that issues remain regarding the application of section 205 of ERISA in connection with a distribution of an ICA in kind for a 403(b) plan with at least one participant to whom section 205 of ERISA applies,[\[8\]](#) including if a participant cannot be reached, a participant does not elect to waive the QJSA and QPSA form of benefit, or a married participant elects to waive the QJSA and QPSA form of benefit but the participant's spouse does not consent to the waiver.

Notice 2020-80 requests comments on any administrative or other burdens that may arise in connection with the application of annuity and spousal rights, and any potential methods or rules that could minimize or eliminate those burdens.[\[9\]](#) The Notice specifically requests

the following input:

- Information on current practices and arrangements (including sample language from custodial account agreements and 403(b) plan documents, if relevant) that may affect the termination of 403(b) plans that are funded through section 403(b)(7) custodial accounts and that are subject to section 205 of ERISA;
- Views regarding the administrability of alternative points in time (which continue to be evaluated by Treasury and IRS for consistency with applicable law) for when rights under section 205 of ERISA might be required to be protected, for example, at the time of the termination of a 403(b) plan (by obtaining the participant's waiver and the spouse's consent, pursuant to section 205(c) of ERISA, to a distribution in kind of an ICA), or at the time payments are made from the ICA (analogous to Treasury Regulation section 1.401(a)-20, Q&A-2, which provides that the requirements of Code sections 401(a)(11) and 417 are applied to payments under distributed annuity contracts);
- Views on whether the Pension Benefit Guaranty Corporation's missing participants program for defined contribution plans might be a destination for transferring, without participant and spousal consent, the cash value of custodial accounts that are subject to section 205 of ERISA; and
- Views on the type(s) of transition relief, if any, that would assist with the termination of an existing 403(b) plan that is funded through the use of section 403(b)(7) custodial accounts in a way that protects rights under section 205 of ERISA.

Comments on the Notice are due by February 3, 2021.

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endnotes

[1] Revenue Ruling 2020-23 is available here: <https://www.irs.gov/pub/irs-drop/rr-20-23.pdf>.

[2] For a summary of the SECURE Act, see ICI Memorandum No. 32118, dated December 20, 2019. Available here: https://www.ici.org/my_ici/memorandum/memo32118.

[3] Section 110 further instructs that the guidance shall provide (i) that the section 403(b)(7) status of the distributed custodial account is generally maintained if the custodial account thereafter adheres to the requirements of section 403(b) that are in effect at the time of the distribution of the account and (ii) that a custodial account would not be considered distributed to the participant or beneficiary if the employer has any material retained rights under the account (but the employer would not be treated as retaining material rights simply because the custodial account was originally opened under a group contract). Finally, Section 110 provides that the guidance shall be retroactively effective for taxable years beginning after December 31, 2008.

[4] Notice 2020-80 is available here: <https://www.irs.gov/pub/irs-drop/n-20-80.pdf>.

[5] Revenue Ruling 2011-7 is available here: <https://www.irs.gov/pub/irs-drop/rr-11-07.pdf>.

[6] See ICI Memorandum No. 32467, dated May 19, 2020. Available here: https://www.ici.org/my_ici/memorandum/memo32467.

[7] The Notice explains that although no 403(b) plans are subject to the annuity and spousal rights provisions of Code sections 401(a)(11) and 417, some 403(b) plans that are subject to ERISA (such as a plan of a non-church tax-exempt employer that provides for matching contributions) are subject to the parallel annuity and spousal rights provisions of section 205 of ERISA. The IRS has interpretive authority over section 205 of ERISA pursuant to the Reorganization Plan No. 4 of 1978, 5 U.S.C. App.

[8] Section 205 of ERISA generally requires distributions in the form of either a qualified joint and survivor annuity (QJSA) or a qualified preretirement survivor annuity (QPSA), unless the plan is not a defined benefit plan or money purchase pension plan and under the plan: (i) a full death benefit is provided to the surviving spouse, (ii) no participant election of a distribution in the form of a life annuity is made (and a life annuity is not the normal form of benefit), and (iii) no part of the distribution is the result of a transfer from a defined benefit plan or a money purchase pension plan. Section 205(c) of ERISA provides that a participant may elect to waive the QJSA or QPSA form of benefit, but spousal consent is needed for a waiver by a married participant.

[9] Our May 2020 letter to the IRS and Treasury requested clarification of the implications for distributed custodial accounts where the terminated plan may be subject to QJSA and QPSA requirements, such as might be the case where the plan offered annuity distribution options through some (but not all) vendors. See ICI Memorandum No. 32467, dated May 19, 2020. Available here: https://www.ici.org/my_ici/memorandum/memo32467.