The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

February 17, 2005

ICI Comment Letter to IRS on Efforts to Simplify 403(b) Rules, February 2005

February 14, 2005

Internal Revenue Service
CC:PA:LPD:PR (REG-155608-02)
1111 Constitution Avenue, N.W.
Washington, DC

Re: Proposed Regulations Under Code Section 403(b)

Ladies and Gentlemen:

The Investment Company Institute,[1] on behalf of its investment company members, commends the Service on its comprehensive proposed regulations under section 403(b) of the Internal Revenue Code. This section provides a unique retirement savings vehicle for employees of public educational institutions and certain non-profit organizations.[2]

The mutual fund industry's interest in these proposed regulations is substantial, because Institute members offer eligible employees the ability to save for retirement in custodial accounts invested in mutual fund shares.[3] According to Institute estimates, $263 billion of 403(b) assets were invested in mutual funds as of December 31, 2003.[4]

The Institute for many years has advocated simplification and harmonization of the rules governing various types of retirement plans. Thus, we generally support the Service's efforts to make the rules governing 403(b) arrangements more consistent with those governing 401(k) plans. In developing these rules, however, the Service should keep in mind the distinctive characteristics of the employers that offer 403(b) arrangements.

As detailed below, we recommend that the Service take affirmative steps to assist employers in complying with the proposed plan document requirement. Specifically, we urge that the Service provide a delayed effective date, model forms, and detailed guidance (along with the Department of Labor) as to the effect of the new rules upon ERISA coverage. We also advocate that the Service retain, rather than curtail, the ability of 403(b) participants to transfer assets among 403(b) annuity contracts and custodial accounts. Finally, we support the proposal to allow employers to freeze or terminate their 403(b) plans, and request additional options.

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The Unique Nature of the 403(b) Arrangement

>The 403(b) arrangement is unique among retirement vehicles, and was developed to serve a particular segment of the workforce. The public school systems and non-profit organizations that sponsor 403(b) programs typically have limited administrative budgets. Most of these programs involve only salary reduction contributions by the employee, and each participant's contributions are directed to an annuity contract or custodial account in his or her name.5 Section 403(b) of the Code requires that each underlying annuity contract and custodial account include particular provisions, including restrictions on contributions and limitations on distributions and withdrawals.

Because the individual's account is maintained in his or her name, the participant typically retains the account upon termination of employment. The portable nature of these accounts is especially important to providing retirement security to these employees. Indeed, in some cases, such a participant can make additional contributions to the contract or account at a new place of employment. In addition, under the terms of Revenue Ruling 90-24, participants have been able to change the investments under their 403(b) arrangement via a transfer to another 403(b) annuity contract or custodial account.

Important differences exist among 403(b) sponsors. Many such employers are governmental entities. As such, they are not subject to the provisions of ERISA under any circumstances.6 Private 403(b) sponsors, on the other hand, may be considered to maintain plans subject to the requirements of ERISA as well as the Code, unless they limit their involvement to certain activities.7 Any increased involvement in these plans could subject the plans to additional substantive and administrative rules, and subject the plan sponsor and other officials to ERISA fiduciary responsibility.

The unique nature of the 403(b) arrangement, and the mutual fund industry's experience with 403(b) sponsors and participants strongly suggest that the Service and the Department of Labor must balance regulatory requirements against the limited ability of such sponsors to devote financial resources to administering complex rules. Additional rules and requirements may cause 403(b) sponsors to discontinue their plans, and thus limit retirement savings opportunities for their employees. We recommend that the Service improve upon the proposed regulations by providing more support to these employers and encouraging them to continue to maintain 403(b) arrangements.

Plan Document Requirement

Section 1.403(b)-3(b)(3) of the proposed regulations would provide for the first time that a section 403(b) contract does not satisfy the Code requirements unless it is maintained pursuant to a plan. The proposed regulations further would define the term "plan" as a "written defined contribution plan, which, both in form and operation, satisfies the requirements" of the regulations. Specifically, the proposed regulations would require that the plan contain all the material terms and conditions for

- Eligibility;
- Benefits;
- Applicable limitations;
- The contracts available under the plan; and
- The time and form under which benefit distributions would be made.8

The plan document requirement will have a substantial impact upon employers offering 403(b) plans.

Given the significance of this change, the Institute urges the Service to delay the plan document requirement so that employers will be able to bring their plans into compliance. The Service also should provide assistance to employers in complying with this requirement.

Impact of Plan Document Requirement on Employers

The impact of the plan document requirement on a particular employer generally will depend upon the plan's status under Title I of ERISA. Generally, if a plan is already covered under ERISA, then, under the requirements of ERISA section 402(a)(1),9 a written plan document requirement currently applies. ERISA coverage only attaches, however, if the plan is sponsored by a nongovernmental entity that exerts sufficient control over the plan to trigger ERISA coverage.10

For other entities sponsoring 403(b) plans, the written plan requirement could cause a substantial increase in administrative responsibilities and costs. In light of the limited budgets of public school systems, governmental employers may opt not to offer such plans to their employees in the future. In addition, any uncertainty concerning their plans' coverage under ERISA (and their corresponding fiduciary and administrative responsibilities 11) could discourage non-governmental 403(b) sponsors from continuing to maintain these plans.

We therefore recommend that the Service take affirmative steps to assist employers in complying with the new plan document requirement. First, we urge that the effective date of this aspect of the proposed regulations be delayed at least a year in order to allow employers sufficient time to put their plans in place. For most plans, the recommended effective date should be no earlier than January 1, 2007.

Second, we urge that the Service assist employers by developing a model form similar to Form 5305-SEP. Form 5305-SEP is used widely by employers that establish Simplified Employee Pension arrangements and includes only a limited number of provisions. The underlying IRA accounts contain the majority of the required provisions, and are maintained in the names of the individual employees.

A new model form for 403(b) plans could be similarly streamlined because, as noted above, the underlying annuity contracts and custodial agreements already include many of the requirements of section 403(b). Thus, the plan document could consist of the executed model form "wrapped around" the existing provisions of the individual annuity contracts and custodial agreements.

In particular, we recommend that the model form include the following provisions:

- Employee eligibility;

- Permitted contributions;
- Approved annuity contract and custodial account vendors;12
- Whether loans will be permitted;
- Whether hardship withdrawals will be permitted;
- Contributions after termination of employment;
- Transfers to other investment options during and after employment;13
- Purchase of permissive service credits under a qualified defined benefit governmental plan;
- Plan termination; and
- Missing participants.14

We also recommend that the Service work with the Department of Labor, in developing the form, to provide concrete guidance as to the effect of the new plan document requirement upon a nongovernmental plan's coverage under ERISA.15 According to the preamble to the proposed regulations, the Service has discussed this issue with the Department of Labor, but the DOL has not provided definitive guidance as to its impact upon the plan's status under ERISA.

We specifically recommend that the new model form follow the approach taken in the current Form 5305-SEP16 by incorporating into the form guidance on the rules determining ERISA coverage. For example, these rules might address the significance of loan provisions and acceptable limits on the number of investment providers. Such guidance might reassure employers by providing certainty on this important issue.

Through the extended effective date, the model form, and concrete guidance on ERISA coverage, the Service could accomplish its goals of consistency among retirement plans and, at the same time, encourage employers to maintain their 403(b) arrangements.17 The Institute would be pleased to take a leading role in assisting the Service and the Department of Labor in developing the model form and related ERISA guidance.

Transfers Among Accounts

The preamble to the proposed regulations states that they would repeal Revenue Ruling 90-24, which currently allows 403(b) participants to transfer among accounts under certain circumstances. Although the proposed regulations would permit certain transfers, they should be revised so that participants retain their current rights to transfer among investments.

The Institute was instrumental in the development of Revenue Ruling 90-24 as a result of a Securities and Exchange Commission proceeding that allowed certain 403(b) participants to change their 403(b) investments for the first time. The proposed repeal of this revenue ruling, and its replacement with the transfer provisions of the proposed regulations, may unduly restrict investment choice for 403(b) participants. The consequences of this change would be especially severe for those who no longer worked for an employer that maintained (or could maintain) a section 403(b) plan.

We therefore request that the final regulations incorporate the transfer rules of Revenue Ruling 90-24. If the final rules retain restrictions on transfers, however, we urge the addition of a "grandfathering" rule that would allow transfers after the effective date for those currently holding section 403(b) accounts. We also request the elimination or clarification of the proposal's restrictions against reduction in the participant's benefit as a result of a transfer.

History of Revenue Ruling 90-24

Revenue Ruling 90-24 was requested by a diverse group of organizations and institutions that sought clarification of the circumstances under which 403(b) participants could transfer assets among 403(b) accounts. Prior to this 1990 guidance, existing general precedent under section 1035 of the Code suggested that participants could not accomplish tax-free partial exchanges. In addition, certain differences between 403(b) annuity contracts and custodial accounts raised issues concerning the treatment of exchanged amounts under the new vehicle. More details about the requested ruling and the considerations leading up to the request are included in the attachments to this letter.

Employers as well as participants viewed the expansion of participants' investment options positively. In light of this generally positive reaction and the absence of significant concerns, we strongly recommend that the Service allow transfers to continue under the final regulations.

Transfers Under the Same Plan[18]

Under the proposed regulations, a current employee can transfer to another 403(b) "under the same 403(b) plan" if the plan "provides for the exchange."[19] The final regulations should clarify that employers may allow for such transfers to any annuity contract or custodial account that qualifies under section 403(b). This is the typical arrangement for public school 403(b) plans in many states. Although such employers may limit, for administrative reasons, the number of investment vehicles to which they will send salary reduction contributions, they often do not limit the vehicles into which employees may transfer their existing balances. The final regulations should accommodate such provisions.[20] For example, the final regulations could state that any account to which transfers are permitted under the plan (including those permitted under a "blanket" authorization) would be considered "under the same 403(b) plan."

Transfers After Termination of Employment

A separate section of the proposed regulations provides for plan-to-plan transfers. Under this provision, 403(b) participants who changed employers could transfer their 403(b) assets to their new employer's 403(b) plan. The provision, however, is unduly restrictive in that it would only permit terminated participants to accomplish a transfer if (1) their current employer was eligible to sponsor a 403(b) plan; and (2) the new employer's plan provided for the receipt of transfers.

The proposed rules thus would not allow a former employee the same transfer rights currently permitted under Revenue Ruling 90-24. First, a former employee who was not reemployed by an entity eligible to sponsor a 403(b) plan would have no transfer rights under the proposed regulations. Similarly, an individual who was reemployed by an eligible entity that opted not to allow transfers would lose his or her transfer rights.

The proposed requirement that a former employee must be employed by a 403(b) plan sponsor is not essential to the account's satisfaction of the requirements of section 403(b). An individual's 403(b) annuity contract or custodial agreement contains all the restrictions and limitations that are necessary for the contract or agreement to continue to qualify under section 403(b). These same provisions would be included in any new 403(b) contract or agreement. Other provisions relevant to a particular employer's plan, such as

nondiscrimination provisions and contribution limits, are largely irrelevant to a transfer of existing 403(b) assets, especially if the individual is no longer employed by a 403(b) sponsor.

In order to avoid “locking” such individuals into investments, the final regulations should allow transfers by former employees.[21]

Alternative “Grandfathering” Protection for Current 403(b) Account Owners[22]

If the Service does not make sufficient changes to the transfer provisions in the final regulations to allow for 403(b) account transferability, then the Service should provide specific protection for current account holders. Participants who currently hold 403(b) accounts made their contributions and chose their investments with the understanding that they could later change investments through a transfer under Revenue Ruling 90-24. Such a rule change would be especially unfortunate in the context of a former employee of a public school or non-profit entity who has not been reemployed by a similar entity. As noted above, the former employee could not qualify to transfer to another 403(b) investment under the proposed regulations.

We recommend, therefore, that if the final regulations repeal Revenue Ruling 90-24, they should include a “grandfather” provision that would allow current 403(b) account holders to transfer their assets pursuant to Revenue Ruling 90-24 after the effective date of the final regulations. At a minimum, the rules should grandfather 403(b) accountholders no longer employed by 403(b) sponsors.

Limitation on Fees

The Service similarly should reconsider its proposed requirement that the participant’s accumulated benefit after the exchange or transfer must equal the accumulated benefit before the transfer. In the custodial account context, certain mutual fund redemptions may involve contingent deferred sales charges or redemption fees. Such charges and fees are disclosed in the fund’s prospectus, and generally may apply in a variety of contexts, including 401(k) plans, other defined contribution plans, and IRAs. Thus, the rule contained in sections 1.403(b)-10(b)(2)(ii) and 1.403(b)-10(b)(3)(iv) of the proposed regulations would be inconsistent with those applied in other retirement plan contexts, and should therefore not be included in the final regulations. In the alternative, the final regulations should clarify that they would not prohibit contingent deferred sales charges or redemption fees upon a transfer or exchange.

Plan Terminations

Section 1.403(b)-10(a) of the proposed regulations would allow 403(b) plans to provide for “freezing” of benefits and for plan termination.[23] This change would benefit those employers that wish to establish section 401(k) or other qualified plans for their employees and discontinue future contributions to their 403(b) plans.

The proposed guidance in its current form, however, would not accommodate an employer that wished to retain a frozen 403(b) plan’s assets under a new 401(k) plan. Under the proposed regulations, the only reference to transfers from 403(b) plans to qualified plans

occurs in the context of purchases of permissive service credit under certain defined benefit plans.24

For some employers, the ability to transfer the 403(b) assets to a 401(k) plan would eliminate the additional administrative expense involved in maintaining two plans simultaneously. The Institute therefore requests that the final regulations allow the assets of a frozen 403(b) plan to be directly transferred to the employer's 401(k) plan.

* * *

The Institute would welcome the opportunity to provide further assistance to the Service in finalizing the proposed regulations. Please feel free to contact the undersigned at (202) 371-5432, or Keith Lawson, Senior Counsel, at (202) 326-5832 with any comments or questions.

Sincerely,

Kathy D. Ireland
Senior Associate Counsel

Attachment 1
Attachment 2
Attachment 3

cc: Robert Architect
R. Lisa Mojiri-Azak
John Tolleris
William Sweetnam
William Bortz
W. Thomas Reeder
Ann Combs
Robert Doyle

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,553 open-end investment companies ("mutual funds"), 633 closed-end investment companies, 141 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about $7.830 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 87.7 million as of mid 2004, representing 51.2 million households.

2 The Institute's comments do not address church retirement income accounts under section 403(b)(9) of the Code.

3 See § 403(b)(7) of the Code.

4 Mutual Funds and the U.S. Retirement Market in 2003, Fundamentals, Vol. 13, No. 2, Investment Company Institute (June 2004).

5 For purposes of the balance of this letter, the term "account" generally refers to both annuity contracts and custodial accounts, unless otherwise indicated.

6 29 U.S.C. § 1002(32).

7 See 29 C.F.R. § 2510.3-2(f).

8 The plan also could contain certain optional features such as hardship withdrawal distributions, loans, plan-to-plan or contract-to-contract transfers, and acceptance of rollovers to the plan.

9 29 U.S.C. § 1102(a)(1).

10 See 29 C.F.R. § 2510.3-2(f).

11 Coverage under ERISA could have substantive effects upon the plans as well. For example, 403(b) arrangements are not generally subject to any Code requirement to provide benefits in the form of a joint and survivor annuity, but if the plan were covered by ERISA, the joint and survivor annuity requirement would attach pursuant to section 205 of ERISA. 29 U.S.C. § 1055.

12 We recommend that the employer be able to list the approved vendors on an attachment to the form, so that any future changes could be accomplished in the attachment without amending the form.

13 We specifically recommend that the model form's provisions on transfers permit employers on a "blanket" basis to allow employees, former employees, and/or beneficiaries of former employees to transfer their assets to any annuity contract or custodial account that satisfies the requirements of section 403(b). See discussion of transfers, infra.

14 In this regard, the form could include language similar to that contained in the model 457 plan amendments published in Notice 2004-57, 2004-35 I.R.B. 376.

15 As noted above, ERISA coverage is a critical issue for nongovernmental employers that have not in the past been covered by ERISA because of their limited involvement with the plan. See 29 C.F.R. § 2510.3-2(f).

16 Page 2 of the Form 5305-SEP describes the Form 5500 filing requirements applicable to employers sponsoring SEPs.

17 From time to time, the Service has raised the possibility of establishing a determination letter-type program for review of section 403(b) plans. The Institute notes that the model plan approach recommended here could reduce substantially the number of employers that would use such a program. Nevertheless, we recommend that the Service explore the establishment of a determination letter (or similar) program to allow employers to receive assurance that their plans satisfy the requirements of section 403(b). The program might be especially helpful for those employers that maintain more complex plans than those that could be accommodated under the model form, such as those plans that include employer contributions.

18 The relevant provision of the proposed regulations refers to "exchanges" rather than transfers in this context. We recommend that the final version of this provision specifically include a reference to transfers.

19 Prop. Reg. § 1.403(b)-10(b)(2).

20 This type of option would be similar to “brokerage window” arrangements under many 401(k) plans. According to the Profit Sharing/401(k) Council of America’s latest annual survey, 13.0% of the profit sharing and 401(k) plans surveyed include a brokerage window as an investment option. Profit Sharing/401(k) Council of America, 47th Annual Survey of Profit Sharing and 401(k) Plans (Reflecting 2003 Plan Year Experience).

21 It is unclear under the final regulations whether such an individual could change investments via a rollover to another 403(b) account, because the proposed regulations do not discuss whether such an account can exist outside of a 403(b) plan.

22 In addition to current and former employees, beneficiaries of deceased employees and former employees, who are specifically mentioned in Revenue Ruling 90-24, would be impacted negatively by its repeal.

23 We note that the proposed regulations provide that a distribution upon plan termination “includes delivery of a fully paid individual insurance annuity contract,” but does not describe a distribution in the context of a custodial account. We request that the Service either (1) explicitly discuss the treatment of custodial accounts, or (2) clarify that the annuity contract reference serves merely as an example of a permitted distribution.

A similar uncertainty concerning the application of the proposed rules to custodial accounts arises under section 1.403(b)-3(b)(2). This provision discusses the treatment of excess annual additions, and requires that annuity contracts create a separate 403(c) account for such excesses. The final regulations should explain how these rules apply to custodial accounts.

24 Prop. Reg. § 1.403(b)-10(b)(1)(i).
