

COMMENT LETTER

May 19, 2020

ICI Sends Letter to Treasury Regarding Guidance on 403(b) Termination under SECURE Act (pdf)

1 May 18, 2020 Mr. William Evans Attorney-Advisor, Office of Benefits Tax Counsel U.S. Department of the Treasury 1500 Pennsylvania Ave, NW Washington, DC 20220 Re: In-Kind Distribution of Custodial Accounts under Terminating 403(b) Plans Dear Mr. Evans: The Investment Company Institute¹ and American Retirement Association² write in follow up to our March 24, 2020 teleconference regarding Section 110 of the Setting Every Community Up for Retirement Enhancement Act of 2019 (“SECURE Act” or “Act”), which was enacted on December 20, 2019 as part of the Further Consolidated Appropriations Act of 2020. This letter reiterates several points we discussed relating to the in-kind distribution of custodial accounts upon termination of a 403(b) plan, as contemplated by Section 110. 1 The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s members manage total assets of US\$22.1 trillion in the United States, serving more than 100 million US shareholders, and US\$6.5 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC. 2 The ARA is the coordinating entity for its five underlying affiliate organizations representing the full spectrum of America’s private retirement system, the American Society of Pension Professionals and Actuaries (“ASPPA”), the National Association of Plan Advisors (“NAPA”), the National Tax-Deferred Savings Association (“NTSA”), the American Society of Enrolled Actuaries (“ASEA”), and the Plan Sponsor Council of America (“PSCA”). ARA’s members include organizations of all sizes and industries across the nation which sponsor and/or support retirement saving plans and are dedicated to expanding on the success of employer- sponsored plans. In addition, ARA has nearly 28,000 individual members who provide consulting and administrative services to sponsors of retirement plans. ARA’s members are diverse but united in their common dedication to the success of America’s private retirement system. 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 custodial account under subparagraph (A) of section 403(b)(7), 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 a section 403(b)(7) custodial account, similar to the treatment of fully-paid individual

annuity contracts under Revenue Ruling 2011-7, until amounts are actually paid to the participant or beneficiary. 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. As you know, the problem that Section 110 aims to address is how to complete the termination of a 403(b) plan when the plan 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). The Department of the Treasury ("Treasury") and Internal Revenue Service (the "Service") have provided guidance in the past on 403(b) plan termination issues, including Revenue Ruling 2011-7, but have not addressed the problem of a lack of consent to a distribution from a 403(b)(7) custodial account by the participant or beneficiary. We appreciate that you reached out to our organizations as you and your colleagues at Treasury and the Service begin developing guidance to implement Section 110. Prior to our March 24 teleconference, you asked for our views on a range of questions, including the possible mechanics of distributing individual custodial accounts in kind; pre-SECURE Act practices with respect to these kinds of terminating 403(b) plans; to what extent Revenue Ruling 2011-7 could serve as a model for the guidance required by Section 110; and whether additional issues should be addressed in guidance.

A. Key Points On our March 24 teleconference, we made the following key points with respect to implementing Section 110.

1. Guidance should be simple. We recommended following the approach used in Revenue Ruling 2011-7 (particularly Situations 1 and 2) which describes circumstances in which plan termination distributions are effectuated by distributing fully-paid individual insurance annuities (or issuing individual certificates under a group annuity contract) to all participants and beneficiaries.
2. Guidance should be permissive. We recommended that the in-kind distribution of custodial accounts should be one tool among many to choose from when terminating a 403(b) plan. In other words, it should be up to the employer (or vendor if the employer no longer exists) to determine whether to employ in-kind distribution of custodial accounts as part of a plan termination.
3. Guidance should be flexible in terms of the mechanics of distribution and application to different situations (including application to plans funded through group custodial accounts).
 - a. We recommended a recognition that some arrangements may require amendment of the custodial agreement prior to distribution, while others may only require notification to the participant that the account is being "distributed" in kind.
 - b. We recommended that the guidance make clear that plans funded through group custodial accounts can also use this approach, much like plans with group annuity contracts could distribute an individual certificate as described in Situation 2 of Revenue Ruling 2011-7.
 - c. We recommended a recognition that different custodians may encounter different implications in creating a new individual custodial account agreement to be distributed from a plan funded with a group annuity contract. Such implications could include changes to available investment options or applicable fees under the agreement. The guidance should not introduce obstacles in handling these issues.
4. Guidance should not create

adverse inferences with respect to years prior to 2009. We recommended that the guidance should be presented in a way that does not create adverse inferences for time periods prior to the effective date of the guidance. The fact is that employers offering 403(b) arrangements prior to 2009, when the ability to terminate a 403(b) plan became officially recognized, had to find ways to terminate the arrangements and providers had to make choices in how to handle custodial accounts attributable to those arrangements. In many cases, the most logical approach would have been to maintain the custodial account as an “orphaned” 403(b) account not associated with any employer. The guidance should not create an inference that this approach would have been unlawful simply because it occurred prior to 2009.

B. Mechanics of In-Kind Distributions As noted in our third key point above, it is important that the guidance take into account (implicitly or explicitly) different approaches to the mechanics of effectuating an in-kind distribution of a custodial account. The mechanics of in-kind distribution could vary from firm to firm. Generally, the distribution will be memorialized by either a notice sent to the participant or beneficiary or an amended (or entirely new) account agreement sent to the participant or beneficiary. In some cases, it will be necessary to create a new individual custodial account agreement, such as where the plan is funded through a group custodial account. Because the approaches for effectuating an in-kind distribution will vary, the guidance should not specify either the mechanics of creating a new individual custodial account agreement where there was no such agreement in place before, or the mechanics of distributing the agreement to the participant. Instead, the guidance should indicate the appropriate tax treatment that would apply to the in-kind distribution, assuming the method used for effectuating the in-kind distribution is permissible under applicable state or federal law. As a technical matter, the individual custodial account “agreement” is the item that would be distributed in kind in this context. The custodial account holding the assets, and the rights of the custodian and participant, are governed by the terms of the agreement. The “agreement” would be the equivalent of the “contract” or “certificate” in the context of the distribution of an individual annuity contract. But, for purposes of the guidance needed to implement Section 110, we do not think this distinction between the “account” and the “agreement” is relevant to the final disposition of the account, especially given that the statutory language refers to the distribution of the custodial account rather than the agreement. As discussed during our call, the guidance must be flexible enough to apply to plans that are funded with group custodial accounts. As noted, some group custodial accounts may have limitations on the sponsoring employer’s ability to force cash distributions to individual participants. In other cases, the in-kind distribution of an individual account may simply be preferable to participants and beneficiaries. In order to effectuate the in-kind distribution of an individual custodial account, either the individual custodial account or group account (as applicable) may need to be amended first. The terms of the existing custodial account agreement will determine the steps necessary before issuing individual agreements. After any needed amendments to the existing custodial agreement, the individual custodial account agreements would be issued. In some cases, it may be necessary for the participant to at least consent to establishment of the individual account. Ultimately, we reiterate that the specific steps needed to effectuate the distribution should not dictate the applicability of the guidance. With the foregoing considerations in mind, we developed suggested sample language that could be used in guidance implementing Section 110, based on the structure and language of Revenue Ruling 2011-7. The sample language is included at the end of this letter as an Appendix.

C. Other Potential Issues for Guidance During our call, we discussed whether the guidance implementing Section 110 should address issues that were not specifically addressed in Revenue Ruling 2011-7. We urge you to consider including the following issues:

1. Confirm specific tax treatment implications. Revenue Ruling 2011-7 provided that the delivery of fully-paid individual annuity contracts (or individual certificates

under a group annuity contract) is not included in gross income until amounts are actually paid out of the contract to the participant or beneficiary, so long as the contract maintains its status as a 403(b) contract. The same guidance should apply here, and the guidance should further provide that the in-kind distribution of an individual custodial account is not reportable on Form 1099-R, is not a distribution requiring a 402(f) notice, and does not require withholding.

2. Offer relief for previously terminated plans. In addition to being retroactively effective for taxable years beginning after December 31, 2008, the guidance should offer comfort that reasonable good-faith efforts previously taken to terminate a plan funded through individually- 5 owned custodial accounts will not be questioned, given the absence of clear rules at the time. This also could be an opportunity to clarify certain questions that may linger with respect to those previously-distributed accounts, such as confirming that any retained withdrawal restrictions can be discontinued.

3. Confirm or otherwise address other plan termination-related issues. Although not directly related to the in-kind distribution question, it would be helpful for guidance to confirm that, upon termination of a 403(b) plan, (a) there is no need to accelerate repayment of outstanding loans unless required by the plan (that is, repayments can continue to be made directly to the custodial account vendor, if acceptable to the vendor); (b) participant accounts in the plan must be fully vested; and (c) certain 403(b) accounts that under prior guidance were considered orphaned or grandfathered³ are outside of the plan and not part of the termination. The guidance also could address the treatment of existing plan-level beneficiary designations after the plan terminates and the governing plan document no longer exists. For example, the guidance might simply recognize that existing beneficiary designations could be carried over to the distributed account, whether those designations were previously made at the account or at the plan level.

4. Clarify 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. It should be made clear that, to the extent applicable, spousal consent requirements may be applied either at the time of the in-kind distribution, or when distributions from the distributed custodial account actually occur. Furthermore, with respect to assets held in custodial accounts at the time of the plan termination, QJSA and QPSA requirements should not be required as terms of the distributed custodial account agreements, even if an annuity was the normal form of distribution under the plan. There are a number of reasonable justifications for this approach: (a) the terms of the plan (e.g., the normal form of distribution and other annuity options) are not included in the custodial account agreement; (b) after plan termination, there will be no plan administrator to select and purchase the annuity on behalf of the participant; (c) custodial accounts cannot hold annuities, because they are restricted under section 403(b)(7) to holding only shares of mutual funds; and (d) bank custodians are not licensed to sell annuities.

* * * We appreciate the opportunity to provide our input as you work to implement Section 110 of the SECURE Act. If we can provide you with any additional information regarding these issues, please do.

3 Such accounts would include grandfathered pre-September 24, 2007 contracts/accounts exchanged pursuant to Revenue Ruling 90-24 and contracts/accounts issued by vendors discontinued or “de-selected” prior to 2005.

6 not hesitate to contact Elena Chism at 202/326-5821 (elena.chism@ici.org) or Martin Pippins at 703/516-9300 (ext:146) (mpippins@usaretirement.org).

Sincerely, /s/ Elena Barone Chism /s/ Martin L. Pippins

Elena Barone Chism Martin L. Pippins Associate General Counsel – Retirement Policy Director of Regulatory Policy Investment Company Institute American Retirement Association

Attachment 7 APPENDIX Sample Facts for Possible Revenue Ruling

ISSUE Whether a retirement plan that takes the actions described below has been terminated in accordance with the rules of § 1.403(b)-10(a) of the Income Tax Regulations and whether in-kind distributions of custodial accounts described under

subparagraph (A) of Section 403(b)(7) made to participants or beneficiaries in connection with termination of the plan are included in gross income (and treated similarly to the distribution of fully-paid individual annuity contracts under Revenue Ruling 2011-7). FACTS Situation 1 Plan A is a defined contribution plan that includes both nonelective employer contributions and elective deferrals. Prior to the action taken to terminate the plan as described below, Plan A satisfies the requirements of § 403(b) and §§ 1.403(b)-2 through § 1.403(b)-9. Plan A only permits benefit payments to be made after termination from employment or upon plan termination. Plan A is funded through the use of individual custodial accounts described in § 403(b)(7) and treated as annuity contracts under §1.403(b)-8(d)(1). 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 employer contributions, including elective deferrals as defined in §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, 2021 and ending on the date that is 12 months after distribution of all assets from Plan A. On or before January 1, 2021, the employer sponsoring Plan A takes action to terminate Plan A. That action includes a binding resolution of the employer to cease future contributions to custodial accounts under Plan A and to terminate Plan A, effective January 1, 2021. 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, a number of participants fail to liquidate and withdraw assets from their custodial accounts prior to the date of termination, and the employer either has no authority to liquidate and distribute the custodial account assets without the participant's consent or chooses not to exercise its right to do so. 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 notifying all participants, beneficiaries who are alternate payees, and beneficiaries of deceased participants that the assets held in their individual custodial accounts are available for withdrawal as a result of the termination of the plan on and after January 1, 2021, and all assets not withdrawn by participants within a reasonable period of 8 time after January 1, 2021 will be distributed in the form of a distributed individual custodial account governed by an individual custodial account agreement between the custodian and the participant. The custodial account agreement permits a single-sum cash payment as a form of liquidating distribution in connection with plan termination at the direction of the participant and such single- sum payments can be elected by the participant after January 1, 2021. Each custodial account agreement permits any such payment that is an eligible rollover distribution (as described in §402(c)(4)) to be paid by a direct transfer to an individual retirement account or annuity under § 408 (IRA) or other eligible retirement plan (as defined in §401(a)(31)(E)) in a manner that satisfies § 401(a)(31). The custodian provides a notice to employees describing their rollover rights, as required by § 402(f). Situation 2 The facts are the same as in Situation 1, except that Plan A is funded not only by individual custodial accounts, but also by a group custodial account. Distribution from the group custodial account of amounts which have not been otherwise liquidated and distributed to participants by the termination date will be distributed, to the extent permitted under the terms and procedures of the group custodial account agreement, in the form of a distributed individual custodial account governed by an individual custodial account agreement between the custodian and each participant, beneficiary who is an alternate payee, and beneficiary of a deceased participant with assets remaining in the group custodial account as soon as administratively

practicable after January 1, 2021.

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