

Section 403(b) – Taxability of Certain Annuity Contracts

26 CFR 1.403(b)-10 Tax Sheltered Annuity Contracts

Rev. Rul. 2011 –7

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 distributions made to participants or beneficiaries in connection with termination of the plan are included in gross income.

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 solely through the use of fully paid individual annuity contracts issued by an insurance company. 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, 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 future purchases of annuity contracts 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 fully paid individual insurance annuities to all participants, beneficiaries who are alternate payees, and beneficiaries of deceased participants.

Some of the contracts permit single-sum payments as a form of liquidating distribution in connection with plan termination and such single-sum payments are made as soon as administratively practicable after January 1, 2012. Each insurance carrier 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 plan administrator 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 annuity contracts, but also by a group annuity contract. Distribution of amounts from the group annuity contract is effectuated by issuing individual certificates to each participant, beneficiary who is an alternate payee, and beneficiary of a deceased participant in the group annuity contract evidencing a fully paid interest in his or her benefits under the contract as soon as administratively practicable after January 1, 2012. Some participants and beneficiaries receive a single-sum payment as a liquidating distribution from the contract in accordance with the terms of the contract.

Situation 3

The facts are the same as in Situation 2, except that Plan A is funded not only by individual annuity contracts and a group annuity contract, but also by amounts held by one or more regulated investment companies (as defined in § 851(a) relating to mutual funds) in custodial accounts that are treated as annuity contracts for purposes of § 403(b). Custodial accounts are maintained either under individual or group agreements.

The distribution of amounts held in the custodial accounts is made as soon as administratively practical after January 1, 2012. Depending on the elections made by the participant or beneficiary, distributions equal to recipient's account balance under the custodial account are made (in cash or in kind) 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) 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 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), including an IRA established by the same provider that permits investment in the same mutual fund in which the participant's or beneficiary's custodial account is invested.

Situation 4

The facts are the same as in Situation 3, except that the plan is a money purchase pension plan (i.e. a defined contribution plan that is neither a profit sharing nor a stock bonus plan) that is subject to the requirements of part 2 of subtitle B of Title I of the Employee Retirement Income Security Act of 1974 (ERISA) and section 302 of ERISA. Therefore, distributions are made in accordance with section 205 of ERISA (relating to qualified joint and survivor annuities and qualified preretirement survivor annuities). If amounts held in the custodial accounts for a participant are to be paid in the form of an annuity under section 205 of ERISA, the distribution is made by purchase and distribution of a fully paid individual insurance annuity. Prior to termination, the plan otherwise complies with all the requirements of part 2 of subtitle B of Title I of ERISA. For the plan year that includes the final distribution, the plan files a final return/report (Form 5500).

LAW

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), contributions are excluded from gross income only if made to certain 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) a retirement income account for employees of a church-related organization (as defined in §1.403(b)-2).

Final regulations under § 403(b) (TD 9340) were published in the Federal Register (72 FR 41128) on July 26, 2007 (2007 Regulations). Subject to a number of special effective date rules, the 2007 Regulations are generally effective for taxable years beginning after December 31, 2008.

Section 1.403(b)-10(a) of the 2007 Regulations provides that an employer is permitted to 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 is permitted to contain

provisions that provide for plan termination and that allow accumulated benefits to be distributed on termination.

However, 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), under §1.403(b)-10(a), termination of the plan and the 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 the termination) does not make contributions to any § 403(b) contract that is not part of the plan (any such contract is referred to below 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 and, 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 CB 1.

For purposes of the requirement that, after plan termination, the employer make no contributions to any other § 403(b) plan, contributions are made to “another § 403(b) plan” if and only if contributions are made 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 termination and ending 12 months after distribution of all assets from the terminated plan, fewer than 2 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 § 403(b) plan is disregarded. To the extent a contract fails to satisfy the nonforfeitability requirement of §1.403(b)-3(a)(2) of the 2007 Regulations at the date of plan termination, the contract is not, and cannot later become, a § 403(b) contract.

In order for a § 403(b) plan to be considered 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. (For rules relating to when distributions to all participants and beneficiaries are 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. 2, and Internal Revenue Manual 7.12.1.2.3, paragraph 5.) 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 §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.

ANALYSIS

The employer in Situation 1 adopted a resolution to cease contributions and terminate the plan at a specified date, including full vesting for all benefits at that date. Since the employer took action to fully vest any participants with respect to amounts not otherwise fully vested at the date of plan termination, all contracts under the plan will be § 403(b) contracts upon plan termination. See §§ 1.403(b)-3(d)(2) and 1.403(b)-10(a)(1). Such contracts may permit benefits to begin immediately upon plan termination, or may permit the participant to begin benefits at a later date to the extent provided in the plan document and the termination resolution, subject to applicable Code (and ERISA rules where applicable.)

Distribution in Situation 1 was made by delivery of a fully paid individual annuity contract or a single-sum payment to each participant or beneficiary as soon as administratively practicable after the termination date. Because the plan is funded solely through fully paid individual insurance annuity contracts, no further action is required to be taken in order to distribute the contracts. 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 the 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 actions taken by the employer to terminate the plan and distribute accumulated benefits satisfy the requirements of § 403(b) and § 1.403(b)-10(a) of the 2007 Regulations for plan termination. Following termination of the plan, participants and beneficiaries who hold fully paid insurance annuity contracts are entitled to payments in accordance with the terms of the contracts (which may permit single-sum payments in connection with plan termination).

In Situation 2, the same actions were taken, except that the employer provided an individual certificate evidencing fully paid benefits under the contract to each participant or beneficiary whose accumulated benefits are funded by a group annuity contract. The issuance of this certificate to each participant or beneficiary constitutes a distribution of the participant's or beneficiary's accumulated benefit in the group annuity contract for purposes of §1.403(b)-10(a) of the 2007 Regulations (but no amount is included in gross income until amounts are paid out of the policy).

In Situations 3 and 4, the employer also distributed all amounts in the individual and group custodial accounts by payment either 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) of the 2007 Regulations, or by delivery of a fully paid individual annuity contract. The actions taken by the employer satisfy the requirements of § 403(b) and § 1.403(b)-10(a) of the 2007 Regulations for plan termination. The amounts paid to a participant or beneficiary from custodial accounts in connection with the termination are not included in

gross income to the extent those amounts are rolled over to an IRA or other eligible retirement plan.

With respect to Situations 1 through 4, the delivery of a fully paid individual annuity contract to participants or beneficiaries, 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. The § 403(b) status of any such contract is generally maintained if the contract thereafter adheres to the requirements of § 403(b) that are in effect at the time of the delivery of such contract. Any other amount paid to a participant or beneficiary, such as a single-sum payment, is included 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 after the distribution.

HOLDING

In each of Situations 1 through 4, Plan A has been terminated in accordance with the rules of § 1.403(b)-10(a). Delivery of a fully paid individual annuity contract to participants or beneficiaries, 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. Any other distributions to a participant or beneficiary to effectuate plan termination, whether from an insurance annuity contract, an individual certificate evidencing fully paid benefits under a group annuity contract, or a custodial account, are 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 after the distribution.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Kathleen Herrmann and Sherri Edelman of the Employee Plans, Tax Exempt and Government Entities Division. Ms. Herrmann and Edelman may be reached by e-mail at RetirementPlanQuestions@irs.gov.