

Publications

IRS Guidance Provides More Detail on Terminating 403(b) Plans

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The [Setting Every Community Up for Retirement Enhancement Act of 2019](#) (“SECURE Act”), directed that guidance be issued providing that a section 403(b)(7) custodial account could make distributions in kind upon a plan termination. On November 5, the IRS issued Revenue Ruling 2020-23 and a related Notice, 2020-80, in response to this directive.

Distributions on 403(b) Plan Termination

For a 403(b) plan (or any 401(a) or 457(b) plan) to be terminated, accumulated benefits under the plan must be distributed to participants and beneficiaries. Because 403(b) plans, with a couple of exceptions, are only invested in annuity contracts and custodial accounts holding mutual funds, the question arises as to whether those assets can be distributed in kind, and what the tax consequences of that distribution are – whether immediately taxable, or taxable upon a later distribution from the annuity or account.

Revenue Ruling 2011-7 was issued to provide that a 403(b) plan meets the distribution requirements upon plan termination through the delivery to participants or beneficiaries of a fully paid individual annuity contract or an individual certificate evidencing fully paid benefits under a group annuity contract, similar to a distribution of a fully allocated annuity contract on a 401(a) defined benefit plan termination – i.e., the distribution of the annuity is not the taxable event, a later distribution from the annuity is. On plan termination, 403(b) participants or beneficiaries may also elect to receive a distribution in cash or roll over the amount to an IRA or another eligible retirement plan.

Revenue Ruling 2020-23 expands on these distribution options and satisfies the SECURE Act’s directive by providing guidance for satisfying the distribution requirements in a plan termination where a 403(b)(7) custodial account is distributed as an individual custodial account (“ICA”) “in kind” to a participant or beneficiary, generally where the participant or beneficiary does not affirmatively elect a distribution. The guidance is retroactively effective for taxable years beginning after December 31, 2008.

Consistent with Section 110 of the SECURE Act, Revenue Ruling 2020-23 provides that (1) the section 403(b)(7) status of the distributed custodial account generally is

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 (2) a custodial account is not considered distributed to the participant or beneficiary if the employer retains any material rights under the account.

Where a 403(b) plan is funded solely through 403(b)(7) custodial accounts maintained under individual agreements, the ICA may be distributed in kind without additional steps. For custodial accounts maintained under a group agreement, the plan termination requirements for distributing the ICA in kind are met 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 the group agreement and associated rights and responsibilities of the participant or beneficiary and the custodian. Providers of 403(b)(7) group custodial accounts may have questions concerning how that is to be accomplished, but the ruling provides little detail.

An ICA distributed in kind under these rules is not included in the gross income of the participant or beneficiary until amounts are actually paid to the participant or beneficiary, so long as the contract maintains its 403(b)(7) custodial account status. A participant or beneficiary may request a distribution in accordance with the terms of the ICA at a later time, which will be taxable.

Annuity and Consent Rules

Contemporaneously with Rev. Rul. 2020-23, the IRS issued Notice 2020-80 to request comments on the application of the annuity and spousal rights provisions of section 205 of ERISA as applied to a distribution of an individual custodial account in kind from a terminating 403(b) plan. Not all 403(b) plans are subject to ERISA, of course, and even if the plan is subject to ERISA, the Notice also recognizes that section 205 does not apply to a participant under a plan that is not a defined benefit plan or money purchase pension plan if (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 (which is sometimes called the "profit-sharing exception"), which many 403(b) plans meet.

The IRS identified issues with such a distribution where ERISA section 205 applies to at least one participant under the plan, including the inability to reach a participant, a participant who does not elect to waive the QJSA/QPSA form of benefit, or a married participant who elects to waive the QJSA/QPSA form of benefit but spousal consent is not provided.

Comments are specifically requested on: current practices that may affect the termination of 403(b)(7) custodial account plans that are subject to ERISA section 205; the protection of section 205 rights as of alternative dates (e.g., at the time of an in kind distribution of an ICA or upon payment from the ICA); the transfer of the cash value of custodial accounts subject to section 205 to PBGC's missing participants program without participant and spousal consent; and transition relief for terminating 403(b)(7) custodial accounts while protecting section 205 rights. Comments are due by February 3, 2021.

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