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Via Overnight Mail and Electronic Delivery

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Re: **When 403(b) Annuity Contracts Are No Longer Plan Assets**

Dear Robert and Ian,

Plan sponsors and administrators urgently need guidance on when an annuity contract held under an ERISA 403(b) plan may be considered distributed and no longer a plan asset subject to ERISA reportable on the Form 5500 or the accompanying schedules, either while the plan is still in existence or upon plan termination. Because the new Form 5500 effective for the 2009 plan year requires more information for such contracts to be reported, and because the new IRS final regulations under Internal Revenue Code ("Code") section 403(b) provide guidance on both plan terminations and distributions under the Code, greater clarity on this issue – such as an information letter or field assistance bulletin – would be very helpful.[1] In this letter, we explain our views on when current law would treat 403(b) annuity contracts as distributed from the plan and no longer plan assets for ERISA reporting purposes.[2] We very much appreciate your consideration of this discussion, and urge the Department to issue guidance along these lines in the very near future.

[1] We earlier sent a letter to Joe Canary, Ian and others at the Department dated June 16, 2008 regarding certain issues in auditing certain older, grandfathered and "orphan" 403(b) contracts for 5500 purposes.

[2] Of course, many 403(b) plans are not subject to ERISA because they are governmental or non-electing church plans exempt under ERISA section 4(b), or are plans that meet the "safe harbor" of 29 CFR §2510.3-2(f) and are not treated as employee benefit plans. Further, ERISA-covered 403(b) plans may also invest in regulated investment company (mutual fund) stock held in custodial accounts. While this memorandum is primarily intended to address annuity contracts under Code section 403(b)(1), the application of existing authority under ERISA for the treatment for 403(b)(7) custodial accounts is discussed in Article III.

I. General ERISA Guidance on Distributions of Annuity Contracts from Plans

A. General Rule

Generally, all assets of a plan subject to ERISA must be held in trust, though that does not apply to assets of a plan which consist of insurance contracts issued by an insurance company qualified to do business in a State. ERISA section 403(a) and (b). This rule does not distinguish between "qualified" plans (i.e., plans qualified under Code section 401(a)) and 403(b) plans.

However, once a distribution of certain insurance or annuity contracts to an individual occurs, or there is a distribution of property constituting a complete distribution of the individual's interest in the plan, the individual in question ceases to be a participant in the plan. As stated in 29 C.F.R. §2510.3-3(c)(2)(ii):

> (ii) An individual is not a participant covered under an employee pension plan or a beneficiary receiving benefits under an employee pension plan if—
>
> (A) The entire benefit rights of the individual—
>
> (1) Are fully guaranteed by an insurance company, insurance service or insurance organization licensed to do business in a State, and are legally enforceable by the sole choice of the individual against the insurance company, insurance service or insurance organization; and
>
> (2) A contract, policy or certificate describing the benefits to which the individual is entitled under the plan has been issued to the individual; or
>
> (B) The individual has received from the plan a lump-sum distribution or a series of distributions of cash or other property which represents the balance of his or her credit under the plan.

As explained shortly after this regulation was adopted, the reference to "the entire benefit" in (A) means that this provision is satisfied only after the individual ceases to be an active employee accruing plan benefits, that is, after termination of employment and ceasing to accrue further benefits, when the employee receives a distribution of the total amount of his or her account. It is, thus, a counterpart to (B).

In DOL Opinion Letter 77-10, the Department explained:

> §2510.3-3(d)(2)(ii) states, inter alia, that an individual is not a participant covered under an employee pension plan if the "entire benefit rights" of the individual (1) are fully guaranteed by an insurance company licensed to do business in a state, and are legally enforceable by the sole choice of the individual against the insurance company; and (2) a contract, policy, or certificate describing the

> benefits to which the individual is entitled under the plan has been issued to the individual.
>
> The phrase "entire benefit rights" in §2510.3-3(d)(2)(ii) is not satisfied if the employee is continuing to accrue benefits. This section of the regulation *covers situations where employment has been severed, where the employee is fully vested and changes into employment not covered by the plan, or where the employee has earned the maximum benefit he can earn under the plan*. In such circumstances, a participant with an insurance contract in hand covering all of his or her benefits and providing a right of action against the insurance company would no longer look to the plan for his or her benefits. [emphasis added][3]

B. Distributions of Annuity Contracts upon Plan Termination

Similar authority regarding distributions of annuity contracts exists in the area of plan terminations. Distributions upon termination of a 403(b) plan are similar to distributions upon termination of a defined benefit plan, as plan assets in both cases will typically be distributed in the form of guaranteed annuity contracts. A 403(b) plan termination would most closely resemble a standard termination, because, as a defined contribution plan, the 403(b) plan assets will equal the 403(b) plan liabilities.

In a standard termination, the final distribution of assets can be made by purchasing "irrevocable commitments from an insurer to provide all benefit liabilities under the plan". ERISA section 4041(b)(3)(A)(i). The Title IV definition of "irrevocable commitment" requires (1) "an obligation by an insurer to pay benefits to a named participant or surviving beneficiary," which (2) "cannot be cancelled under the terms of the insurance contract (except for fraud or mistake) without the consent of the participant or beneficiary" and is (3) "legally enforceable by the participant or beneficiary." 29 C.F.R. §4001.2.

The PBGC has explained that exclusion from participant status through the distribution of an irrevocable commitment from an insurer is "based on a novation concept, wherein an insurer takes the place of a pension plan with the consent of the beneficiaries." PBGC Opin. Ltr 79-5 (March 28, 1979). The PBGC has stated its view that:

> A complete distribution of an individual's benefit in an ongoing plan satisfies, and therefore extinguishes, the obligation of both the plan and the PBGC to that

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[3] Courts have similarly applied this provision to the effect that an ERISA claim cannot be brought where the benefit has been distributed from the plan in a fully paid-up annuity. See, e.g., The Great Atlantic and Pacific Tea Company v. Wood, Civil Action No. 08-CV-3810 (DMC), 2009 WL 689734 (D.N.J. March 10, 2009). ("When a paid-up annuity has been substituted for the right to receive payments pursuant to a pension plan, the beneficiary no longer is or may become eligible to receive benefits from the plan, and the plan thereby ceases to [be] covered by ERISA."); Thompson v. The Prudential Ins. Co. of America, 795 F. Supp. 1337 (D.N.J. 1992), aff'd, 993 F.2d 226 (3d Cir. 1993) (determined that the participants' rights under an ERISA-covered pension plan were satisfied through the purchase of a paid-up annuity contract and upon plan termination the individual ceased to be a participant in an ERISA-covered pension plan); Teagardener v. Republic-Franklin Inc. Pension Plan, 909 F.2d 947 (6th Cir. 1990) (the plaintiffs accepted "the payment of everything due them" under the plan and "the plan was dissolved").

> individual, even if the plan subsequently terminates. "Participant" is defined in ERISA § 3(7) to mean an individual who is or may become eligible to receive a benefit from a plan. The agencies charged with the administration of ERISA (the Department of Labor, the Internal Revenue Service, and the PBGC) have consistently interpreted this to exclude those individuals whose benefits have been fully satisfied by the purchase from an insurer of an irrevocable commitment to pay those benefits. . . . Indeed, because the individual ceases to be a participant in the plan once an irrevocable annuity contract is purchased in complete satisfaction of his or her benefit, no further PBGC premiums are paid with respect to that individual.

PBGC Opin. Ltr 91-1 (Jan. 14, 1991).[4] Once a plan has distributed plan assets to participants and beneficiaries through the purchase of annuity contracts or other form of distribution (e.g., a lump sum payout), the PBGC's guarantee is also extinguished. PBGC Opin. Ltr. 90-3.

The relevant regulations concerning distribution of annuity contracts upon plan termination under ERISA section 4041 address a variety of matters:

> (c) (1) In General. The plan administrator must, in accordance with all applicable requirements under the Code and ERISA, distribute plan assets in satisfaction of all plan benefits by purchase of an irrevocable commitment from an insurer or in another permitted form.…
>
> (3) Selection of insurer. In the case of plan benefits that will be provided by purchase of an irrevocable commitment from an insurer, the plan administrator must select the insurer in accordance with the fiduciary standards of Title I of ERISA….
>
> (d) Provision of annuity contract. If plan benefits are provided through the purchase of irrevocable commitments-
>
> (1) Either the plan administrator or the insurer must, within 30 days after it is available, provide each participant and beneficiary with a copy of the annuity contract or certificate showing the insurer's name and address and clearly reflecting the insurer's obligation to provide the participant's or beneficiary's plan benefits….
>
> 29 C.F.R. §4041.28.

[4] The PBGC has noted that the definition of "participant" in the PBGC premium regulation "is not necessarily the same as the definition of 'participant' in section 3(7) of ERISA, or the definition of 'participant' under the Internal Revenue Code." Preamble to PBGC premium regulation, 46 Fed. Reg. 27328 (May 19, 1981). However, for the purposes of whether a distribution has occurred, there would appear to be no distinction in the definitions or a reason for such a distinction.

In addition, the PBGC regulations impose certain notice provisions relating to distributions of annuity contracts. In general, the plan administrator must provide notices to each affected party entitled to plan benefits other than an affected party whose plan benefits will be distributed in the form of a nonconsensual lump sum, including information regarding the identity of the insurers, and certain State guaranty association coverage information. 29 C.F.R. §4041.27.

The selection of the annuity contract is subject to fiduciary duties. The Department recently provided guidance as a "safe harbor" on how a fiduciary should select an annuity provider for the purpose of benefit distributions from a defined contribution plan when the pension plan intends to transfer liability for benefits to the annuity provider. 29 CFR 2550.404a-4 (Oct. 7, 2008). Of course, the general fiduciary duties under ERISA section 404 apply to such investment decisions in any event.

For the vast majority of ERISA-covered 403(b) defined contribution plans, which allow for individual participants to select investments among approved annuity vendors, or among mutual funds under a variable annuity of a vendor,[5] ERISA section 404(c) will apply.

Under that section, where a plan which provides for individual accounts permits participants and beneficiaries to exercise control over assets of his or her account, the participant or beneficiary is not deemed to be a fiduciary by reason of such exercise, and no person, such as the employer, who is otherwise a fiduciary, is liable for any loss or by reason of any breach, which results from such exercise of control. The regulations under ERISA section 404(c) impose a number of requirements to ensure the independent exercise of control in order to claim the relief of that provision, including requirements as to the information to be provided to participants, the frequency of trading, and offering of a broad range of investment alternatives. 29 C.F.R. §2550.404c-1. However, as proposed regulations make clear, 404(c) does not serve to relieve a fiduciary from its duty to prudently select and monitor any designated investment manager or designated investment alternative offered under the plan. Prop. 29 C.F.R. §2550.404c-1(d)(2)(iv).

C. When Distributions May be Made From a 403(b) Annuity Contract

ERISA generally does not provide separate rules on when a participant may take a distribution from a plan subject to ERISA. However, the Internal Revenue Code provides a number of rules on plan distributions. Generally, in the case of a 403(b) annuity contract, distributions of contributions (and earnings thereon) attributable to pre-tax salary reduction contributions can only be made upon:

- attainment of age 59 and ½;
- severance from employment;
- death;

[5] See, e.g., Field Assistance Bulletin 2007-2, Treas. Reg. §§1.403(b)-3(b)(3), 1.403(b)-8.

- disability;
- hardship (though not including earnings); and
- events that would be qualified reservist distributions.

Code section 403(b)(11).

In the case of pre-tax employer, nonelective contributions, distributions from a 403(b) annuity contract can only be made upon the earlier of:

- the participant's severance from employment;
- upon the occurrence of some event, such as after a fixed number of years;[6]
- the attainment of a stated age; or
- disability.

Treas. Reg. §1.403(b)-6(b).

Further, prior to normal retirement age (which may be as early as age 62), 403(b) benefits cannot be distributed without the consent of the participant, unless the value of the nonforfeitable accrued benefit does not exceed $5,000. ERISA section 203(e).

D. Distributions upon 403(b) Plan Termination under the Treasury Regulations

The Department has not issued guidance on termination of 403(b) plans under ERISA. However, Treas. Reg. §1.403(b)-10(a)(1) provides that a 403(b) plan is permitted to contain provisions that allow accumulated benefits to be distributed on plan termination, subject to a requirement not permitting a distribution of elective deferrals if there is a successor 403(b) plan (in order to prevent a termination and reestablishment of a plan to circumvent the in-service prohibition for such contributions). Under those regulations, "[i]n order for a section 403(b) plan to be considered terminated, 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 this purpose, delivery of a fully paid individual insurance annuity contract is treated as a distribution." Though the 403(b) regulations do not expressly address the question, representatives of the Service have informally indicated that the distribution of the contract is not itself a taxable event. Rather, the participant is to be taxed as amounts are paid to the participant under the annuity contract, consistent with the longstanding rule for distributions of annuity contracts from 401(a) qualified plans under Treas. Reg. §1.402(a)-1(a)(2).[7]

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[6] The IRS has held in the past that the term "fixed number of years" is considered to mean at least two years. Rev. Rul. 71-295.

[7] "If a trust described in section 401(a) and exempt under section 501(a) purchases an annuity contract for an employee and distributes it to the employee in a year in which the trust is exempt, and the contract contains a cash

II. Application of the Foregoing Authority to 403(b) Annuity Contracts

We believe that ERISA section 403 and the Department's own regulations provide that annuity contracts under ERISA-covered 403(b) plans are plan assets, and would therefore be treated as plan assets for purposes of the Form 5500 filing and audit requirements, prior to the distribution of the "entire benefit rights" of the participant by distribution of the contract. Typically, such a distribution will not occur until severance from employment, attainment of age 59 and ½, death, or disability. However, a distribution of a 403(b) annuity contract can occur upon earlier plan termination and without the consent of the participant.

In some cases, distribution of the contract will occur by delivering the annuity contract or certificate to the individual.[8] Where the employee already has the individual contract or certificate under a group annuity in hand, in order to "distribute" the contract, nothing more need be distributed, and nothing need be done other than the plan to treat the contract as distributed. A common example of this prior to the final 403(b) Treasury regulations would be a request by a participant who had terminated employment for a transfer of his or her benefit to another annuity contract under IRS Revenue Ruling 90-24. (Revenue Ruling 90-24 has been mooted by the final regulations, which impose different rules for contract exchanges and transfers.) Thus, in the event of such a distribution, nothing further will, in fact, physically occur, and the employee will have an ability to withdraw monies from the distributed contract in accordance with the Treasury regulations, which distribution rules are necessarily part of the contract.[9] Typically, the insurer will ask the employer to confirm that the employee has had a separation from employment or other event permitting such a withdrawal under the terms of the contract (if the insurer does not already have an information-sharing agreement with the employer and have access to that information).

Thus, where (1) prior to termination of the plan, the participant is eligible for and has requested a distribution of his or her entire account balance (or the account, excluding amounts rolled over into the account, has a value of less than $5000 and is involuntarily distributed) or (2), upon plan termination, one or more contracts representing the participant's entire account balance in the 403(b) plan are distributed, the contracts will meet all of the requirements of 29 C.F.R. §2510.3-3(c)(2)(ii) to be considered distributed and no longer part of the plan. Those contracts:

- are obligations of the insurer to pay benefits to the participant or beneficiary;

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surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered."

[8] For purposes of such plan distribution the distribution of certificates in group annuity contracts has in all other circumstances been treated for purposes of ERISA as the same as the distribution of an individual contract. See, e.g., 29 C.F.R. §2510.3-3(c)(2)(ii)(A)(2) and §4041.28(d). We believe there is no reason this treatment should be any different for a 403(b) plan, and it would be helpful if the Department were to confirm that.

[9] See, Treas. Reg. § 1.403(b)-3(a).

- cannot be cancelled under their terms (except for fraud or mistake) without the consent of the participant or beneficiary;
- are fully guaranteed by an insurance company, insurance service or insurance organization licensed to do business in a State;
- are legally enforceable by the sole choice of the individual against the insurance company, insurance service or insurance organization;
- are reflected in written contracts, policies or certificates describing the benefits to which the individual is entitled under the plan; and
- represent an irrevocable commitment from an insurer selected in accordance with the fiduciary standards of ERISA.

In the case of a 403(b) plan termination, even though 403(b) plans are not subject to Title IV of ERISA, participants are typically notified of the termination of their rights in the contracts, including the identity of the insurers. In the case of fixed annuities, the plan sponsor could provide notice of state guaranty association coverage information if that were required.

In these cases, the individual will have received a distribution of property which represents the balance of his or her credit under the plan. Employment will have been severed or the employee has earned the maximum benefit he or she can earn under the plan, as described in DOL Advisory Opinion 77-10. The "entire benefit rights" of the participant will have been distributed because the employee is no longer continuing to accrue benefits and will look solely to the insurance company for payment.

III. 403(b)(7) Custodial Accounts

While contributions to 403(b) plans may be, and probably most frequently are, contributed to annuity contracts under Code section 403(b)(1), contributions may also be made to custodial accounts invested in regulated investment company shares (mutual funds) under Code section 403(b)(7). Contributions to such custodial accounts are treated as contributed to annuity contracts for purposes of section 403(b) of the Code and the Treasury regulations thereunder. See, Code section 403(b)(7) and Treas. Reg. § 1.403(b)-8(d). There is no similar "treated as" annuity contracts language under ERISA, though a policy argument can certainly be made that such 403(b)(7) custodial accounts should also be treated as annuity contracts for purposes of ERISA. However, it is also not evident that it is necessary to do so in order to achieve such similar treatment. That is because the principal authority regarding when a plan asset is considered distributed, as noted above, is 29 C.F.R. §2510.3-3(c)(2)(ii). While part (A) of that provision concerns annuity contracts, and thus literally may not apply if the "treated as" provision of Code section 403(b)(7) is not carried over into ERISA, part (B) is not limited to annuity contracts and applies where "[t]he individual has received from the plan a lump-sum

distribution or a series of distributions of cash or other property which represents the balance of his or her credit under the plan."

Thus, where (1) prior to termination of the plan, the participant is eligible for and has requested a distribution of his or her account balance (or the account, excluding amounts rolled over into the account, has a value of less than $5000 and is involuntarily distributed) or (2), upon plan termination, 403(b)(7) custodial accounts representing the participant's entire account balance in the 403(b) plan are distributed, the accounts will meet all of the requirements of 29 C.F.R. §2510.3-3(c)(2)(ii) to be considered distributed and no longer part of the plan.

We note that a 403(b)(7) custodial account is also typically under an individual agreement (though group account agreements exist, and may become more common), and is required to contain the relevant restrictions under Code section 403(b)(7), such as in-service distribution limitations, plus the "exclusive benefit" requirement.[10] Thus, in many cases, no further action by the employer will be necessary to consider the custodial account to be distributed. Pursuant to the "treated as" provision of the Code and regulations, presumably, the distribution of such a 403(b)(7) custodial account contract should be treated for tax purposes the same as the distribution of a 403(b)(1) annuity contract, though the IRS has not issued clear guidance in that regard.

IV. Recommended Guidance

Where an eligible participant requests and receives a distribution from the 403(b) plan (or, if the participant's account is less than $5000, receives an involuntary distribution under the terms of the plan), or receives a distribution upon 403(b) plan termination, the distribution of annuity contracts or annuity certificates which represent the entire benefit rights of the participant, and otherwise satisfies the Department's rules means the annuity contracts are no longer plan assets subject to ERISA reportable on the Form 5500 or the accompanying schedules.

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Thank you for your consideration of this request. We would urge the Department to issue general information or other guidance in this area as soon as possible. We would be happy to meet to discuss this further, if you would find that helpful. If you have any questions, or if we can be of any assistance, please do not hesitate to call.

Yours sincerely,

David W. Powell

[10] Treas. Reg. §§1.403(b)-8(d)(1), (2); 1.403(b)-3(a).

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