Terminating Custodial 403(b) Plans Get Distribution Relief

The IRS has issued Revenue Ruling 2020-23 to address how employers may terminate 403(b) plans that contain custodial accounts. This guidance gives plan administrators direction on how they can distribute plan assets to participants in order to satisfy plan termination requirements. The revenue ruling also gives the option for plan participants to preserve their accounts—as 403(b) accounts—following a plan termination, or to roll them over to an eligible retirement plan.

Background

Three types of entities may adopt 403(b) plans: 1) public schools or other political subdivisions of a state (e.g., cities or townships), 2) organizations that are tax exempt under Internal Revenue Code Section (IRC Sec.) 501(c)(3), and 3) certain ministers. These eligible employers must invest plan assets in one of the following arrangements.

- An annuity contract issued by a state-approved insurance company.
- A custodial account invested exclusively in stock of a regulated investment company (mutual funds).
- A retirement income account (this is for church-related organizations only, and is not restricted to annuity or mutual fund investments).

As with other types of retirement plans, 403(b) plans can be properly terminated only by distributing the plan assets as soon as administratively feasible (Treas. Reg. Sec 1.403(b)-10(a)). In many plans, such as a 401(k) plan, the employer typically controls the plan assets when they are held in a common trust. This allows the employer to readily distribute plan assets to participants. Many 403(b) plans, however, rely on individual annuity contracts or custodial accounts that are held and controlled by the participants—not the employer. So the employer does not always have the authority to liquidate such investments. This creates a roadblock to effectively terminating such plans.

Fortunately, the IRS issued guidance (almost 10 years ago) to partially address this problem. Revenue Ruling (Rev. Rul.) 2011-7 provides that the employer can consider the plan terminated if assets are distributed by delivering to the participants (or their beneficiaries) either 1) an individual annuity contract or 2) a certificate (under a group annuity contract) that shows that the participant owns the assets. As long as the assets remain subject to the 403(b) rules, they will continue to be tax exempt until distributed to the participant or beneficiary.

Unfortunately, the IRS did not specifically address *custodial accounts* in Rev. Rul. 2011-7. The ruling applied only to *annuity contracts.* It is not entirely clear why the IRS did not follow up with similar guidance for custodial accounts soon after the 2011 ruling. Because of this guidance gap, Section 110 of the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 directed the IRS to issue similar guidance for custodial accounts. The result is Rev. Rul. 2020-23, which mirrors Rev. Rul. 2011-7.

Highlights of Rev. Rul. 2020-23

Rev. Rul. 2020-23, which applies retroactively for taxable years beginning after December 31, 2008, presents two specific situations. The two situations are identical, except that the first situation addresses custodial accounts that are maintained under individual contracts and the second situation addresses custodial accounts that are maintained under group contracts.

Custodial Accounts Maintained Under Individual Agreements – Here are the facts that Rev. Rul. 2020-23 presents in Situation 1.

- The 403(b) plan complies with all Internal Revenue Code and regulatory rules and contains both employer contributions and employee elective deferrals.
- Neither the plan nor any participant under the plan is subject to the annuity payout rules of ERISA Sec. 205 (which generally requires annuity payouts unless certain distribution alternatives are chosen with proper spousal consent).
- Plan assets can be distributed only after termination from employment or on plan termination.
- On January 1, 2021, the employer properly initiates plan termination. This includes stopping all further contributions, fully vesting all balances, and notifying participants of their rollover rights.
- Depending on each affirmative election, the employer distributes the balance to the participant or rolls over the assets to an eligible retirement plan.

There may be participants (and beneficiaries) who do not make an election. In this case, the employer may still terminate the plan by distributing an individual custodial account (ICA) in kind to the participant. This distribution involves notifying the participant that, even though the ICA is no longer part of the 403(b) plan, the 403(b) custodian is maintaining the account as a 403(b)(7) custodial account. If the ICA follows the 403(b) rules in effect at the time of the distribution, the account remains tax exempt until actually paid to the participant.

Custodial Accounts Maintained Under Group Agreements – Rev. Rul. 2020-23 then presents a second situation. All other facts are the same as in Situation 1. But Situation 2 involves a plan that also holds assets that are maintained under *group agreements*. To distribute an in-kind ICA to a participant under a group agreement, the employer must provide a document that 1) confirms the participant's (or beneficiary's) ICA ownership, 2) states that individual's nonforfeitable custodial account balance, and 3) describes the rights and responsibilities of the individual and the custodian.

As in Situation 1, the ICA (maintained in Situation 2 as a 403(b)(7) custodial account) remains tax exempt until paid to the participant or beneficiary. So the only apparent difference between the two situations is that, in Situation 2, the employer must provide sufficient documentation to the participant—documentation that provides clear evidence of the participant's asset ownership and rights under the ICA.

403(b) Accounts That Are Subject to Annuity Distribution Requirements – 403(b) plans are not subject to the annuity payout rules and spousal rights provisions under IRC Secs. 401(a)(11) or 417. And many 403(b) plans—including governmental plans and most church plans—are exempt from the parallel rules under ERISA Sec. 205. Rev. Rul. 2020-23 does not address the situation in which these annuity and spousal rights rules apply to 403(b) plans. But *some* 403(b) plans that are maintained by private tax-exempt entities must comply with ERISA Sec. 205. This section generally requires that a distribution be made as a qualified joint and survivor annuity (QJSA) or as a qualified preretirement survivor annuity (QPSA), depending on the timing of the participant's death. Some exceptions apply to this distribution requirement, including a different form of payment if a participant (and a married participant's spouse) consents to the QJSA/QPSA waiver.

But obtaining these waivers can complicate or impede the plan termination process. To address this concern and others, the IRS released Notice 2020-80 concurrently with Rev. Rul. 2020-23. This notice requests comments from interested parties regarding how ERISA's annuity and spousal rights provisions interact with an in-kind distribution outlined in Section 110 of the SECURE Act and in Rev. Rul. 2020-23. As the IRS considers how best to create guidance on this concern, it seeks input on special administrative burdens that may arise and on methods that could reduce those burdens.

The Takeaway

For terminating 403(b) plans, Rev. Rul. 2020-23 is welcome news. Aligning earlier guidance on annuity contracts with the current guidance on 403(b) custodial accounts creates a more uniform path for employers to wind down their plans. They now know that an in-kind distribution will satisfy the IRS's requirement that all plan assets must be paid out before a plan is considered terminated. So in-kind ICA distributions will make it easier for employers who receive no distribution directions from participants to properly terminate their plans. Visit ascensus.com for further developments on this and other guidance.