As Clear as Mud? The 403(b) Plan Termination Rules

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Unlike qualified plans, where the plan termination regimen is well established via an IRS determination letter process and thousands upon thousands of terminations have occurred without incident over the years; only within the last few years, via the final 403(b) regulations and Revenue Ruling 2011-7, was it clearly established that 403(b) plans could be terminated at all. And, though it was welcome news that a 403(b) plan could indeed be terminated, the guidance created more questions than answers as to the actual termination process. In this article, we will attempt to get to the bottom of the issues that can make plan terminations, as a practical matter, difficult or even impossible to complete.

403(b) PLAN TERMINATION BASICS

At first glance, the termination process listed on the IRS’ 403(b) Plan Termination web page does not appear daunting. All a plan sponsor needs to do to complete the process is:
- Establish a plan termination date
- Cease contributions
- Fully vest any non-vested employer contributions (elective deferrals are always 100% vested)
- Authorize the distribution of benefits as soon as administratively practical

Sound simple? While the first three steps are straightforward, it is in last step that the process begins to break down.

Before we address that issue, however, the web page goes on to state that a plan sponsor, or any related entity, must cease contributions to any other 403(b) plan for 12 months. Thus, the scope of the guidance is greatly narrowed, as a 403(b) plan cannot be terminated and replaced by another 403(b) plan (unless the employees wish to take a contribution holiday for 12 months!).

There is a limited exception if fewer than two percent of the employees who were eligible to participate in the terminating plan are eligible to participate in any new 403(b) plan; however, this is a rare scenario.

So in what situations would it make sense for a 403(b) plan to be terminated? Well, the primary scenario is if the plan sponsor wishes to replace the 403(b) plan with a 401(k) plan, the primary type of qualified plan available to most sponsors that would permit pre-tax elective deferrals. However, a 401(k) plan may not be practical for many tax-exempt entities to implement. For example, school districts may only implement a 401(k) if they are located in a state that maintains a grandfathered state-sponsored 401(k) option. And non-governmental 401(k) plans require nondiscrimination testing of elective deferrals, otherwise known as Average Deferral Percentage (ADP) testing. Many tax-exempts do not have sufficient voluntary participation percentages to pass such testing, and the failure of such testing generally results in refunds of contributions to senior executives (not a pleasant scenario).

Thus, for most plan sponsors, terminating a 403(b) plan and replacing it with a 401(k) plan is not a feasible option. Of course, there are exceptions where the establishment of a 401(k) may make sense, such as at a small non-profit where there are no highly compensated employees and where discrimination testing is not necessary, or plans where voluntary participation is extremely high or that utilize auto enrollment. But such plans are not commonplace.

Are there other scenarios where terminating a 403(b) makes sense? Certainly, but again these are not common scenarios. One example would be when a plan sponsor has ceased operations and no longer exists, however, finding the proper entity to serve as the “plan sponsor” for termination purposes could prove difficult. Another potential scenario would be when a tax-exempt is taken over by a for-profit that cannot sponsor a 403(b) plan.
And finally, an entity could simply decide to exit the business of providing any sort of retirement benefit for its employees. But again, these are the relatively rare exceptions to the general rule that 403(b) plan terminations will have no applicability to the vast majority of plan sponsors.

THE DISTRIBUTION DILEMMA

Now that we established that a relatively small number of 403(b) plan sponsors are good candidates to terminate their 403(b) plans, we can examine the issue of the practicality of terminating such plans for this limited group of employers.

The other significant requirement to terminate a plan, listed on the IRS 403(b) Plan Termination web page, is the distribution of plan assets within 12 months of the plan’s termination date. If this were a qualified plan, distribution of all plan assets would be straightforward, since all plan assets generally reside in a trust controlled by the employer. However, it is a rare event that a 403(b) plan utilizes a trust. Instead, a 403(b) plan utilizes annuity contracts and/or custodial accounts, which can be controlled by the employer (group contracts), the participant (individual contracts) or both (group contracts with individual certificates/rights). Thus, plan termination distributions in a 403(b) plan can be much more problematic, since the employer may not be in ultimate control of the amounts distributed.

The IRS did provide some relief in this regard in the aforementioned Revenue Ruling 2011-7, greatly simplifying termination distributions for annuity contracts. The Revenue Ruling considered delivery of a full-paid individual annuity contract to be a full distribution for plan termination purposes, eliminating the requirement for such contracts to be distributed in cash. Thus, plan termination distributions could be made for many participants to whom such distributions would not normally have been practical if the contracts did not permit cash distributions upon contract termination. However, issues regarding contracts already received by a participant, such as individual annuity contracts or certificates in a group annuity contact - a common occurrence in 403(b) plans, were unresolved.

And, unfortunately, the guidance did not extend to custodial accounts (i.e., mutual funds), where the requirement to distribute all assets in cash remains. This means that termination distributions for plans where individual custodial accounts exist are, as a practical matter, impossible to execute.

Finally, for plans subject to ERISA, there is the question of whether a plan that is considered terminated for IRS purposes would also be terminated from a Department of Labor perspective. The reason for this possible divergence lies in the fact that the DOL might require that all plan assets be distributed in cash, rather than the IRS’ interpretation that delivery of a full-paid individual annuity contract constitutes a distribution. The consequence of conflicting determinations would be an administrative nightmare, as the plan sponsor would need to continue to satisfy the requirements of ERISA (including 5500 annual report filings, providing Summary Plan Descriptions, etc.) for a “terminated” plan!

CONCLUSION

There is a good reason why there has not been an abundance of 403(b) plan terminations in the three years since Revenue Ruling 2011-7 was issued. Aside from the fact that there are not a large number of candidates for plan termination, the guidance certainly does not pave the way for smooth terminations in the relatively few cases where it makes sense. It remains to be seen whether any future guidance will improve the termination landscape.