INVESTMENT COMPANY INSTITUTE

February 14, 2005

VIA ELECTRONIC MAIL

Internal Revenue Service
CC:PA:LPD:PR (REG-155608-02)
1111 Constitution Avenue, N.W.
Washington, DC

Re: Proposed Regulations Under Code Section 403(b)

Ladies and Gentlemen:

The Investment Company Institute,[1] on behalf of its investment company members, commends the Service on its comprehensive proposed regulations under section 403(b) of the Internal Revenue Code. This section provides a unique retirement savings vehicle for employees of public educational institutions and certain non-profit organizations.[2]

The mutual fund industry's interest in these proposed regulations is substantial, because Institute members offer eligible employees the ability to save for retirement in custodial accounts invested in mutual fund shares.[3] According to Institute estimates, $263 billion of 403(b) assets were invested in mutual funds as of December 31, 2003.[4]

The Institute for many years has advocated simplification and harmonization of the rules governing various types of retirement plans. Thus, we generally support the Service's efforts to make the rules governing 403(b) arrangements more consistent with those governing 401(k) plans. In developing these rules, however, the Service should keep in mind the distinctive characteristics of the employers that offer 403(b) arrangements.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,553 open-end investment companies ("mutual funds"), 633 closed-end investment companies, 141 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about $7.830 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 87.7 million as of mid 2004, representing 51.2 million households.

[2] The Institute's comments do not address church retirement income accounts under section 403(b)(9) of the Code.

[3] *See* § 403(b)(7) of the Code.

[4] *Mutual Funds and the U.S. Retirement Market in 2003*, Fundamentals, Vol. 13, No. 2, Investment Company Institute (June 2004).

As detailed below, we recommend that the Service take affirmative steps to assist employers in complying with the proposed plan document requirement. Specifically, we urge that the Service provide a delayed effective date, model forms, and detailed guidance (along with the Department of Labor) as to the effect of the new rules upon ERISA coverage. We also advocate that the Service retain, rather than curtail, the ability of 403(b) participants to transfer assets among 403(b) annuity contracts and custodial accounts. Finally, we support the proposal to allow employers to freeze or terminate their 403(b) plans, and request additional options.

The Unique Nature of the 403(b) Arrangement

The 403(b) arrangement is unique among retirement vehicles, and was developed to serve a particular segment of the workforce. The public school systems and non-profit organizations that sponsor 403(b) programs typically have limited administrative budgets. Most of these programs involve only salary reduction contributions by the employee, and each participant's contributions are directed to an annuity contract or custodial account in his or her name.[5] Section 403(b) of the Code requires that each underlying annuity contract and custodial account include particular provisions, including restrictions on contributions and limitations on distributions and withdrawals.

Because the individual's account is maintained in his or her name, the participant typically retains the account upon termination of employment. The portable nature of these accounts is especially important to providing retirement security to these employees. Indeed, in some cases, such a participant can make additional contributions to the contract or account at a new place of employment. In addition, under the terms of Revenue Ruling 90-24, participants have been able to change the investments under their 403(b) arrangement via a transfer to another 403(b) annuity contract or custodial account.

Important differences exist among 403(b) sponsors. Many such employers are governmental entities. As such, they are not subject to the provisions of ERISA under any circumstances.[6] Private 403(b) sponsors, on the other hand, may be considered to maintain plans subject to the requirements of ERISA as well as the Code, unless they limit their involvement to certain activities.[7] Any increased involvement in these plans could subject the plans to additional substantive and administrative rules, and subject the plan sponsor and other officials to ERISA fiduciary responsibility.

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[5] For purposes of the balance of this letter, the term "account" generally refers to both annuity contracts and custodial accounts, unless otherwise indicated.

[6] 29 U.S.C. § 1002(32).

[7] *See* 29 C.F.R. § 2510.3-2(f).

The unique nature of the 403(b) arrangement, and the mutual fund industry's experience with 403(b) sponsors and participants strongly suggest that the Service and the Department of Labor must balance regulatory requirements against the limited ability of such sponsors to devote financial resources to administering complex rules. Additional rules and requirements may cause 403(b) sponsors to discontinue their plans, and thus limit retirement savings opportunities for their employees. We recommend that the Service improve upon the proposed regulations by providing more support to these employers and encouraging them to continue to maintain 403(b) arrangements.

Plan Document Requirement

Section 1.403(b)-3(b)(3) of the proposed regulations would provide for the first time that a section 403(b) contract does not satisfy the Code requirements unless it is maintained pursuant to a plan. The proposed regulations further would define the term "plan" as a "written defined contribution plan, which, both in form and operation, satisfies the requirements" of the regulations. Specifically, the proposed regulations would require that the plan contain all the material terms and conditions for

- Eligibility;
- Benefits;
- Applicable limitations;
- The contracts available under the plan; and
- The time and form under which benefit distributions would be made.[8]

The plan document requirement will have a substantial impact upon employers offering 403(b) plans.

Given the significance of this change, the Institute urges the Service to delay the plan document requirement so that employers will be able to bring their plans into compliance. The Service also should provide assistance to employers in complying with this requirement.

Impact of Plan Document Requirement on Employers

The impact of the plan document requirement on a particular employer generally will depend upon the plan's status under Title I of ERISA. Generally, if a plan is already covered under ERISA, then, under the requirements of ERISA section 402(a)(1),[9] a

[8] The plan also could contain certain optional features such as hardship withdrawal distributions, loans, plan-to-plan or contract-to-contract transfers, and acceptance of rollovers to the plan.

[9] 29 U.S.C. § 1102(a)(1).

written plan document requirement currently applies. ERISA coverage only attaches, however, if the plan is sponsored by a nongovernmental entity that exerts sufficient control over the plan to trigger ERISA coverage.[10]

For other entities sponsoring 403(b) plans, the written plan requirement could cause a substantial increase in administrative responsibilities and costs. In light of the limited budgets of public school systems, governmental employers may opt not to offer such plans to their employees in the future. In addition, any uncertainty concerning their plans' coverage under ERISA (and their corresponding fiduciary and administrative responsibilities[11]) could discourage non-governmental 403(b) sponsors from continuing to maintain these plans.

We therefore recommend that the Service take affirmative steps to assist employers in complying with the new plan document requirement. First, we urge that the effective date of this aspect of the proposed regulations be delayed at least a year in order to allow employers sufficient time to put their plans in place. For most plans, the recommended effective date should be no earlier than January 1, 2007.

Second, we urge that the Service assist employers by developing a model form similar to Form 5305-SEP. Form 5305-SEP is used widely by employers that establish Simplified Employee Pension arrangements and includes only a limited number of provisions. The underlying IRA accounts contain the majority of the required provisions, and are maintained in the names of the individual employees.

A new model form for 403(b) plans could be similarly streamlined because, as noted above, the underlying annuity contracts and custodial agreements already include many of the requirements of section 403(b). Thus, the plan document could consist of the executed model form "wrapped around" the existing provisions of the individual annuity contracts and custodial agreements.

In particular, we recommend that the model form include the following provisions:

- Employee eligibility;
- Permitted contributions;

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[10] *See* 29 C.F.R. § 2510.3-2(f).

[11] Coverage under ERISA could have substantive effects upon the plans as well. For example, 403(b) arrangements are not generally subject to any Code requirement to provide benefits in the form of a joint and survivor annuity, but if the plan were covered by ERISA, the joint and survivor annuity requirement would attach pursuant to section 205 of ERISA. 29 U.S.C. § 1055.

- Approved annuity contract and custodial account vendors;[12]
- Whether loans will be permitted;
- Whether hardship withdrawals will be permitted;
- Contributions after termination of employment;
- Transfers to other investment options during and after employment;[13]
- Purchase of permissive service credits under a qualified defined benefit governmental plan;
- Plan termination; and
- Missing participants.[14]

We also recommend that the Service work with the Department of Labor, in developing the form, to provide concrete guidance as to the effect of the new plan document requirement upon a nongovernmental plan's coverage under ERISA.[15] According to the preamble to the proposed regulations, the Service has discussed this issue with the Department of Labor, but the DOL has not provided definitive guidance as to its impact upon the plan's status under ERISA.

We specifically recommend that the new model form follow the approach taken in the current Form 5305-SEP[16] by incorporating into the form guidance on the rules determining ERISA coverage. For example, these rules might address the significance of loan provisions and acceptable limits on the number of investment providers. Such guidance might reassure employers by providing certainty on this important issue.

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[12] We recommend that the employer be able to list the approved vendors on an attachment to the form, so that any future changes could be accomplished in the attachment without amending the form.

[13] We specifically recommend that the model form's provisions on transfers permit employers on a "blanket" basis to allow employees, former employees, and/or beneficiaries of former employees to transfer their assets to any annuity contract or custodial account that satisfies the requirements of section 403(b). *See* discussion of transfers, *infra*.

[14] In this regard, the form could include language similar to that contained in the model 457 plan amendments published in Notice 2004-57, 2004-35 I.R.B. 376.

[15] As noted above, ERISA coverage is a critical issue for nongovernmental employers that have not in the past been covered by ERISA because of their limited involvement with the plan. *See* 29 C.F.R. § 2510.3-2(f).

[16] Page 2 of the Form 5305-SEP describes the Form 5500 filing requirements applicable to employers sponsoring SEPs.

Through the extended effective date, the model form, and concrete guidance on ERISA coverage, the Service could accomplish its goals of consistency among retirement plans and, at the same time, encourage employers to maintain their 403(b) arrangements.[17] The Institute would be pleased to take a leading role in assisting the Service and the Department of Labor in developing the model form and related ERISA guidance.

Transfers Among Accounts

The preamble to the proposed regulations states that they would repeal Revenue Ruling 90-24, which currently allows 403(b) participants to transfer among accounts under certain circumstances. Although the proposed regulations would permit certain transfers, they should be revised so that participants retain their current rights to transfer among investments.

The Institute was instrumental in the development of Revenue Ruling 90-24 as a result of a Securities and Exchange Commission proceeding that allowed certain 403(b) participants to change their 403(b) investments for the first time. The proposed repeal of this revenue ruling, and its replacement with the transfer provisions of the proposed regulations, may unduly restrict investment choice for 403(b) participants. The consequences of this change would be especially severe for those who no longer worked for an employer that maintained (or could maintain) a section 403(b) plan.

We therefore request that the final regulations incorporate the transfer rules of Revenue Ruling 90-24. If the final rules retain restrictions on transfers, however, we urge the addition of a "grandfathering" rule that would allow transfers after the effective date for those currently holding section 403(b) accounts. We also request the elimination or clarification of the proposal's restrictions against reduction in the participant's benefit as a result of a transfer.

History of Revenue Ruling 90-24

Revenue Ruling 90-24 was requested by a diverse group of organizations and institutions that sought clarification of the circumstances under which 403(b) participants could transfer assets among 403(b) accounts. Prior to this 1990 guidance, existing general precedent under section 1035 of the Code suggested that participants could not accomplish tax-free partial exchanges. In addition, certain differences between 403(b) annuity contracts and custodial accounts raised issues concerning the

[17] From time to time, the Service has raised the possibility of establishing a determination letter-type program for review of section 403(b) plans. The Institute notes that the model plan approach recommended here could reduce substantially the number of employers that would use such a program. Nevertheless, we recommend that the Service explore the establishment of a determination letter (or similar) program to allow employers to receive assurance that their plans satisfy the requirements of section 403(b). The program might be especially helpful for those employers that maintain more complex plans than those that could be accommodated under the model form, such as those plans that include employer contributions.

treatment of exchanged amounts under the new vehicle. More details about the requested ruling and the considerations leading up to the request are included in the attachments to this letter.

Employers as well as participants viewed the expansion of participants' investment options positively. In light of this generally positive reaction and the absence of significant concerns, we strongly recommend that the Service allow transfers to continue under the final regulations.

Transfers Under the Same Plan[18]

Under the proposed regulations, a current employee can transfer to another 403(b) "under the same 403(b) plan" if the plan "provides for the exchange."[19] The final regulations should clarify that employers may allow for such transfers to any annuity contract or custodial account that qualifies under section 403(b). This is the typical arrangement for public school 403(b) plans in many states. Although such employers may limit, for administrative reasons, the number of investment vehicles to which they will send salary reduction contributions, they often do not limit the vehicles into which employees may transfer their existing balances. The final regulations should accommodate such provisions.[20] For example, the final regulations could state that any account to which transfers are permitted under the plan (including those permitted under a "blanket" authorization) would be considered "under the same 403(b) plan."

Transfers After Termination of Employment

A separate section of the proposed regulations provides for plan-to-plan transfers. Under this provision, 403(b) participants who changed employers could transfer their 403(b) assets to their new employer's 403(b) plan. The provision, however, is unduly restrictive in that it would only permit terminated participants to accomplish a transfer if (1) their current employer was eligible to sponsor a 403(b) plan; and (2) the new employer's plan provided for the receipt of transfers.

The proposed rules thus would not allow a former employee the same transfer rights currently permitted under Revenue Ruling 90-24. First, a former employee who was not reemployed by an entity eligible to sponsor a 403(b) plan would have no transfer rights under the proposed regulations. Similarly, an individual who was

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[18] The relevant provision of the proposed regulations refers to "exchanges" rather than transfers in this context. We recommend that the final version of this provision specifically include a reference to transfers.

[19] Prop. Reg. § 1.403(b)-10(b)(2).

[20] This type of option would be similar to "brokerage window" arrangements under many 401(k) plans. According to the Profit Sharing/401(k) Council of America's latest annual survey, 13.0% of the profit sharing and 401(k) plans surveyed include a brokerage window as an investment option. Profit Sharing/401(k) Council of America, 47th Annual Survey of Profit Sharing and 401(k) Plans (Reflecting 2003 Plan Year Experience).

reemployed by an eligible entity that opted not to allow transfers would lose his or her transfer rights.

The proposed requirement that a former employee must be employed by a 403(b) plan sponsor is not essential to the account's satisfaction of the requirements of section 403(b). An individual's 403(b) annuity contract or custodial agreement contains all the restrictions and limitations that are necessary for the contract or agreement to continue to qualify under section 403(b). These same provisions would be included in any new 403(b) contract or agreement. Other provisions relevant to a particular employer's plan, such as nondiscrimination provisions and contribution limits, are largely irrelevant to a transfer of existing 403(b) assets, especially if the individual is no longer employed by a 403(b) sponsor.

In order to avoid "locking" such individuals into investments, the final regulations should allow transfers by former employees.[21]

Alternative "Grandfathering" Protection for Current 403(b) Account Owners[22]

If the Service does not make sufficient changes to the transfer provisions in the final regulations to allow for 403(b) account transferability, then the Service should provide specific protection for current account holders. Participants who currently hold 403(b) accounts made their contributions and chose their investments with the understanding that they could later change investments through a transfer under Revenue Ruling 90-24. Such a rule change would be especially unfortunate in the context of a former employee of a public school or non-profit entity who has not been reemployed by a similar entity. As noted above, the former employee could not qualify to transfer to another 403(b) investment under the proposed regulations.

We recommend, therefore, that if the final regulations repeal Revenue Ruling 90-24, they should include a "grandfather" provision that would allow current 403(b) account holders to transfer their assets pursuant to Revenue Ruling 90-24 after the effective date of the final regulations. At a minimum, the rules should grandfather 403(b) accountholders no longer employed by 403(b) sponsors.

Limitation on Fees

The Service similarly should reconsider its proposed requirement that the participant's accumulated benefit after the exchange or transfer must equal the accumulated benefit before the transfer. In the custodial account context, certain mutual

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[21] It is unclear under the final regulations whether such an individual could change investments via a rollover to another 403(b) account, because the proposed regulations do not discuss whether such an account can exist outside of a 403(b) plan.

[22] In addition to current and former employees, beneficiaries of deceased employees and former employees, who are specifically mentioned in Revenue Ruling 90-24, would be impacted negatively by its repeal.

fund redemptions may involve contingent deferred sales charges or redemption fees. Such charges and fees are disclosed in the fund's prospectus, and generally may apply in a variety of contexts, including 401(k) plans, other defined contribution plans, and IRAs. Thus, the rule contained in sections 1.403(b)-10(b)(2)(ii) and 1.403(b)-10(b)(3)(iv) of the proposed regulations would be inconsistent with those applied in other retirement plan contexts, and should therefore not be included in the final regulations. In the alternative, the final regulations should clarify that they would not prohibit contingent deferred sales charges or redemption fees upon a transfer or exchange.

Plan Terminations

Section 1.403(b)-10(a) of the proposed regulations would allow 403(b) plans to provide for "freezing" of benefits and for plan termination.[23] This change would benefit those employers that wish to establish section 401(k) or other qualified plans for their employees and discontinue future contributions to their 403(b) plans.

The proposed guidance in its current form, however, would not accommodate an employer that wished to retain a frozen 403(b) plan's assets under a new 401(k) plan. Under the proposed regulations, the only reference to transfers from 403(b) plans to qualified plans occurs in the context of purchases of permissive service credit under certain defined benefit plans.[24]

For some employers, the ability to transfer the 403(b) assets to a 401(k) plan would eliminate the additional administrative expense involved in maintaining two plans simultaneously. The Institute therefore requests that the final regulations allow the assets of a frozen 403(b) plan to be directly transferred to the employer's 401(k) plan.

* * *

The Institute would welcome the opportunity to provide further assistance to the Service in finalizing the proposed regulations. Please feel free to contact the undersigned at (202) 371-5432, or Keith Lawson, Senior Counsel, at (202) 326-5832 with any comments or questions.

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[23] We note that the proposed regulations provide that a distribution upon plan termination "includes delivery of a fully paid individual insurance annuity contract," but does not describe a distribution in the context of a custodial account. We request that the Service either (1) explicitly discuss the treatment of custodial accounts, or (2) clarify that the annuity contract reference serves merely as an example of a permitted distribution.

A similar uncertainty concerning the application of the proposed rules to custodial accounts arises under section 1.403(b)-3(b)(2). This provision discusses the treatment of excess annual additions, and requires that annuity contracts create a separate 403(c) account for such excesses. The final regulations should explain how these rules apply to custodial accounts.

[24] Prop. Reg. § 1.403(b)-10(b)(1)(i).

Sincerely,

/s/ Kathy D. Ireland

Kathy D. Ireland
Senior Associate Counsel

Attachments

cc: Robert Architect
R. Lisa Mojiri-Azak
John Tolleris
William Sweetnam
William Bortz
W. Thomas Reeder
Ann Combs
Robert Doyle

July 17, 1989

Honorable Fred T. Goldberg, Jr.
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Honorable Kenneth W. Gideon
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Peter K. Scott, Esq.
Acting Chief Counsel
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Dear Messrs. Goldberg, Gideon and Scott:

We are writing to express serious concern about the pressing need for public guidance on the tax consequences of transfers among investment alternatives available to participants in retirement programs under section 403(b) of the Internal Revenue Code. This letter is submitted on behalf of a broad spectrum of higher education groups and institutions, joined by entities providing pension annuities or investment services for higher education retirement programs. All of the signatories to this letter represent active participants in an agreement reached regarding a Securities and Exchange Commission proceeding referred to below. We summarize below the nature of the tax problem facing participants in such retirement programs and the critical need for published guidance from the IRS.

A. The Undersigned Organizations

The American Council on Education represents over 1,400 educational institutions ranging from community colleges to research universities, as well as national professional associations of college and university administrators and faculty. The American Association of University Professors has 40,000 members who are faculty members and research scholars from all the academic disciplines. Of the 2 million members of the National Education Association, approximately 80,000 are faculty and staff at institutions of higher education. The United University Professions is the collective bargaining representative for 20,000 faculty and staff members in the State University of New York system and is a representative of the American Federation of Teachers/New York State United Teachers, whose membership includes over 100,000 faculty and staff in higher education. Stanford University, which offers a 403(b) retirement plan with over 100 investment fund options to approximately 4,000 members of its faculty and administration, has taken a special interest in investment flexibility under section 403(b) retirement programs of educational institutions.

Teachers Insurance and Annuity Association of America ("TIAA") and College Retirement Equities Fund ("CREF") are companion nonprofit organizations which provide annuity contracts for employees of 4,200 American colleges, universities, private secondary schools, and other nonprofit educational and scientific research organizations. Approximately 1.2 million individuals are participants in retirement programs funded through section 403(b) annuity contracts issued by TIAA-CREF. These individuals have more than $70 billion invested with TIAA-CREF.

The Investment Company Institute is the national association of American investment companies, which provide section 403(b)(7) custodial accounts offered under the retirement programs of tax-exempt organizations and public schools. Fidelity Investments Institutional Services Company, Inc., Scudder Fund Distributors, Inc., T. Rowe Price Associates, Inc., and the Vanguard Group, Inc. represent over 100 investment companies. Together they serve more than 75,000 college, university, and health care institution employees who have approximately $2 billion invested in 403(b) retirement programs.

Further details about these entities and their particular perspectives on the tax consequences of transfers among investment alternatives under section 403(b) programs appear in Attachment A. All share a common concern in the need for published guidance from the Internal Revenue Service on this subject.

B. The Matters at Issue

TIAA-CREF has for many years provided a nationwide pension system for qualified nonprofit educational institutions. As mentioned above, 1.2 million individuals have $70 billion invested with TIAA-CREF. With limited exceptions, once retirement monies have been invested with TIAA-CREF, they cannot be withdrawn except upon the death of the participant or in the form of a lifetime annuity after retirement. Retirement monies can be moved from CREF to TIAA, but presently cannot be moved from TIAA to CREF or from TIAA or CREF to any alternative funding vehicles.

A number of retirement programs in the educational community are now offering employees alternative investment vehicles for their retirement accumulations. In addition, an offer of settlement currently pending before the Securities and Exchange Commission regarding TIAA-CREF ("SEC Settlement") will provide investment flexibility for retirement accumulations that had previously been limited to TIAA-CREF investments. Employees will be able to move accumulations from CREF to alternative investment options as early as six months after final SEC approval if their employers' plans so provide. Under a separate agreement, TIAA accumulations will be transferable (over a period of ten years) as early as two years after final SEC approval if the applicable employer's plan so provides.

While the SEC order will permit more investment flexibility, the uncertainty of the tax consequences of certain transfers among the funding vehicles offered under these retirement programs, available during or upon termination of employment, will inhibit the exercise of that flexibility. Since 1973, the only IRS guidance has been in the form of private letter rulings, which may not be relied upon as precedent. Moreover, some of these private letter rulings appear inconsistent and are difficult to reconcile. It is necessary, therefore, in order to give meaning to the SEC Settlement and the separate agreement granting investment flexibility to participants with retirement accumulations in TIAA-CREF, to obtain published guidance on transfers among section 403(b) alternative funding vehicles.

The settlement agreement establishing the framework for transferability was submitted to the SEC on December 21, 1988, and the anticipated SEC approval could occur at any time. Since the new transfer options will be available six months thereafter, we fully expect that many of the 1.2 million participants in TIAA-CREF may consider transferring accumulations among investment vehicles offered under their employers' retirement programs. These participants therefore are in immediate need of published guidance as to the tax consequences of such transfers.

It is our understanding that published guidance has been requested over the past years by a number of parties, including the Investment Company Institute in a letter dated August 22, 1988 to William Posner, Assistant Director of the IRS Employee Plans and Actuarial Division. We are advised that the IRS currently is considering a revenue ruling that would address the transfer of an entire accumulation in one funding vehicle to an alternative funding vehicle under section 1035 of the Internal Revenue Code. We are pleased that such action is contemplated, and urge its prompt completion. However, the proposal, as we understand it, unfortunately would provide no guidance to participants who wish to transfer less than their entire accumulation to another vehicle under the employer's program. Nor would it be helpful to any TIAA contractholder, whose accumulations will be transferable only over a ten-year period. Unfortunately, IRS staff members indicate that no published guidance on partial transfers can be expected in the foreseeable future.

We therefore request that the IRS publish a revenue ruling or other guidance of general applicability that expressly would permit employees to transfer all or part of their section 403(b) retirement accumulations in one funding vehicle to another vehicle under an employer's program on a tax-free basis without imposing undue burdens on the participant. In addition, we urge that such guidance rely not on section 1035, but rather on a theory comparable to that permitting such transfers among funding vehicles within a qualified plan under section 401(a).

Favorable published guidance on these matters will not, we submit, give rise to the possibility of tax abuse, inasmuch as all that is at issue is the transfer of funds among investment alternatives under a section 403(b) retirement program. Faculty members and staff of educational and research organizations (and other nonprofit sponsors of section 403(b) programs) should enjoy the same degree of flexibility available to participants in other types of retirement programs. We note, finally, that the guidance that we seek would have no revenue impact.

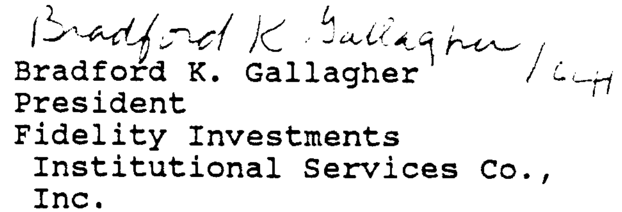
We would welcome the opportunity to designate a small group of representatives to meet with you concerning this significant concern to the American higher education community.

Sincerely,

Robert H. Atwell
President
American Council of Education

Matthew P. Fink
Senior Vice President
and General Counsel
Investment Company Institute

Ernst Benjamin
General Secretary
American Association of
University Professors



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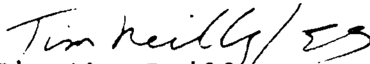

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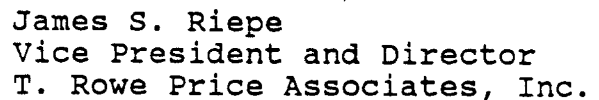

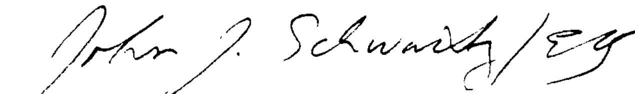

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ATTACHMENT A
DESCRIPTION OF CO-SIGNERS

The American Council on Education ("ACE") is the major coordinating agency and representative organization of the higher education community on issues affecting all aspects of higher education in the United States and abroad. The Council represents over 1,400 member educational institutions ranging from community colleges to research universities, including liberal arts colleges, professional schools, large and small universities, and state-sponsored and private institutions. ACE's membership also includes the national professional associations of college and university administrators and faculty. It has long been interested in a sound and fair retirement system for higher education.

The American Association of University Professors ("AAUP") enjoys the support of over 40,000 faculty members and research scholars in all the academic disciplines. Founded in 1915, AAUP is the country's largest organization dedicated exclusively to advancing the interests of higher education from the perspective of faculty concerns. AAUP was consulted by the Carnegie Foundation for the Advancement of Teaching in 1916 about the proposal to create a national pension plan for professors, and since that time AAUP has taken a special interest in the operation of that system, in which many of its members participate.

The National Education Association ("NEA") represents over 2 million employees in the American educational system. Of its 80,000 members in higher education, NEA estimates that approximately 30,000 are participants in TIAA-CREF. For the past ten years, NEA has been engaged in a major initiative to increase the investment alternatives in 403(b) retirement plan arrangements in colleges and universities.

The United University Professions ("UUP") is the collective bargaining representative for more than 20,000 faculty members and staff in the State University of New York system, and is a representative of the American Federation of Teachers/New York State United Teachers, whose membership includes over 100,000 faculty and staff in higher education. UUP has sought since 1983 to promote flexibility for its members' retirement options, through efforts including negotiations and lobbying.

Stanford University offers a 403(b) retirement plan with over 100 investment fund options to approximately 4,000 members of its faculty and administration. Stanford also offers voluntary 403(b) arrangements to thousands of other employees. Stanford's 403(b) program reflects the University's strong policy in favor of investment flexibility for retirement accumulations, and the ability of participants to transfer funds among investment funds and managers as their needs and circumstances change.

Teachers Insurance and Annuity Association of America ("TIAA") and College Retirement Equities Fund ("CREF") are companion nonprofit organizations created to serve as a nationwide pension system for qualified nonprofit educational institutions. TIAA supports nonprofit colleges, universities, and other institutions engaged primarily in education or research by providing retirement and related benefit programs suited to the needs of such institutions, and by counseling institutions and their employees concerning pension planning and other measures of employee security. TIAA provides a fixed benefit annuity, and CREF provides variable annuity contracts. Although some of the 4,200 participating institutions have TIAA-CREF pension plans that are qualified under section 401(a) of the Internal Revenue Code, most institutions employ TIAA-CREF annuity contracts under retirement plans conforming to the requirements of section 403(b). TIAA-CREF has taken a particular interest not only in clarification of the tax consequences of partial transfers of accumulations under 403(b) retirement arrangements, but also in transfers of accumulations from section 403(b)(7) mutual fund custodial accounts to the annuity contracts which it offers.

The Investment Company Institute is the national association of the American investment company industry. Its membership includes 2,894 open-end investment companies ("mutual funds"), 163 closed-end investment companies, and 14 sponsors of unit investment trusts. Its open-end investment company members have assets of about $859 billion, accounting for approximately 90% of total industry assets, and have over 30 million shareholders. As illustrated by its letter of August 22, 1988 to the IRS seeking published guidance on the tax consequences of transfers among 403(b) investment alternatives, the Institute has taken a special interest in this subject.

Fidelity Investments Institutional Services Company, Inc., Scudder Fund Distributors, Inc., T. Rowe Price Associates, Inc., and The Vanguard Group, Inc. have aggregate net assets of approximately $100 billion dollars in a total of over 100 investment companies. They serve as funding vehicles under retirement programs established by approximately 250 colleges, universities, and hospitals. Approximately 75,000 employees of these organizations have selected these investment companies as investment options for approximately $2 billion of their retirement monies.

All of the entities described above have been active participants in proceedings before the Securities and Exchange Commission involving TIAA-CREF.

September 12, 1989

Martin I. Slate
Director
Employee Plans Technical and
Actuarial Division
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 6526
Washington, D.C. 20224

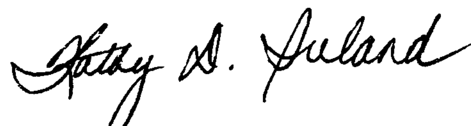
RE: Section 403(b) Transfers

Dear Mr. Slate:

Enclosed for your review are copies of a draft revenue ruling concerning the issue of transfers of accumulations among funding vehicles under Section 403(b) retirement programs, as well as an accompanying memorandum. Both documents reflect input from the organizations that joined in the July 17, 1989 letter to Commissioner Goldberg, Assistant Secretary Gideon and Acting Chief Counsel Scott concerning this issue.

Please feel free to contact the undersigned, or our counsel, Mark Iwry, if you have any questions.

Sincerely,



Kathy D. Ireland
Assistant General Counsel

Enclosures

cc: William B. Posner
Stuart A. Sirkin

M E M O R A N D U M

I. INTRODUCTION

In a letter dated July 17, 1989, representatives of the academic community and the investment management industry urged Treasury Department and Internal Revenue Service officials to publish a revenue ruling or other guidance of general applicability concerning transfers among funding vehicles under retirement programs authorized by section 403(b) of the Internal Revenue Code. Specifically, the signatories to this letter requested published guidance that expressly would permit employees to transfer all or part of their retirement accumulations in one section 403(b) funding vehicle to another such vehicle, consistent with the employer's program, on a tax-free basis without imposing undue burdens on the participant.

This coalition has prepared the attached draft revenue ruling in order to indicate the type of published guidance sought. As stated above, however, the coalition's ultimate goal is published guidance of general applicability, whether in the form of a revenue ruling or some other pronouncement. The

following memorandum is submitted in further support of this request.

II. SECTION 403(b) PROGRAMS

Section 403(b) of the Internal Revenue Code provides for retirement programs for employees of public educational organizations and certain other tax-exempt organizations. Employer contributions to such programs are not included in the employee's gross income until actually distributed to the employee, and earnings on such amounts accumulate tax-free until an actual distribution is made to the employee.

In order to qualify for this favorable tax treatment, the employer's program and the funding vehicles underlying the program must satisfy a number of requirements which are set forth in section 403(b). For example, the employees' rights under the program must be nonforfeitable and the program must satisfy nondiscrimination requirements similar to those applicable to qualified plans under section 401(a). Section 403(b)(1)(C) and (D), and section 403(b)(12). In addition, contributions under the program are limited. Sections 402(g)(4), 403(b)(2) and 415(c). The funding vehicles under such programs also must include restrictions upon distributions prior to the employee's attainment of age 59-1/2, separation from service, death, disability or financial hardship. Section 403(b)(7)(A)(ii) and section 403(b)(11).

Participants in section 403(b) programs are subject to many of the provisions applicable to participants in qualified plans under the Code. These provisions include the required minimum distribution rules of section 401(a)(9) and the rules permitting rollovers to individual retirement arrangements and other section 403(b) programs. Section 403(b)(8), (10).

Section 403(b) originally provided that these programs could be funded only through annuity contracts, but as part of the Employee Retirement Income Security Act of 1974 ("ERISA"), Congress added as permissible funding vehicles custodial accounts invested exclusively in stock issued by one or more regulated investment companies under section 403(b)(7). Typically, the employer's program will permit the employee to elect the funding vehicle(s) in which contributions on his or her behalf will be invested.

The legislative history of ERISA states that section 403(b)(7) custodial accounts were created to give employees of tax-exempt employers a greater variety of investment alternatives and greater investment flexibility. The House Ways and Means Committee explanation of ERISA section 1022, which added section 403(b)(7), notes that the committee believed "that it would be desirable to provide more flexibility in this area, and, accordingly, the committee bill provides that these contributions

may be placed in qualified custodial accounts if those funds are to be invested in mutual funds." H.R. Rep. 93-779, 93d Cong., 2d Sess. 160 (1974). Thus, the major policy concern reflected in the enactment of section 403(b)(7) was the desire to provide employees of tax-exempt employers with greater flexibility in the investment opportunities available to them for their retirement benefits.

III. TRANSFERS AMONG FUNDING VEHICLES

In enhancing investment flexibility under section 403(b) programs in 1974, Congress drew no distinction between the investment of existing accumulations and of new contributions. Presumably, then, Congress intended that the same flexibility should be available to employees who wish to move existing accumulations among funding vehicles permitted under the employer's program.

Despite the strong policy favoring flexibility, the exercise of such flexibility as a practical matter has been inhibited by uncertainty surrounding the individual income tax consequences of such transfers. Participants in other types of retirement arrangements, on the other hand, accomplish such transfers on a tax-free basis routinely. Adoption of the attached proposed revenue ruling would eliminate this uncertainty.

A. The Factual Situations

Each of the three taxpayers described in the proposed revenue ruling is a participant under the employer's program and has heretofore directed the investment of all contributions made on his behalf to only one of the three permissible investments under the program. Each participant has determined that he wishes to diversify the investment of his retirement monies and proposes to accomplish this by directing the transfer of part of his existing accumulation from one funding vehicle to another permitted under the program. Because the amounts will be transferred directly from one provider to another, the employee will at no time actually receive the amounts transferred.

B. Holding

The proposed revenue ruling reaches the following conclusions:

(1) No income will be realized by the taxpayers as a result of the transfer;

(2) The amounts transferred will not be considered "paid or made available" to the taxpayers in violation of section 403(b)(7)(A)(ii) or a "distribution" to the taxpayers in violation of section 403(b)(11);

(3) The amounts transferred will not be treated in the year of the transfer as contributions for purposes of the exclusion allowance under section 403(b)(2), as elective deferrals that must be taken into account for purposes of the limitation on the exclusion for elective deferrals under section 402(g)(4), or as contributions or additions for purposes of the limitation on contributions under section 415(c);

(4) The amounts transferred will not be treated as a designated distribution as defined in section 3405(d)(1) and will not be subject to withholding under section 3405 or information reporting under section 6047(d); and

(5) The tax basis and any other tax attribute applicable to the transferor section 403(b) funding vehicle immediately prior to the transfer will be allocated between the transferor funding

vehicle and the transferee funding vehicle in proportion to the remaining account balance of the transferor funding vehicle and the amount transferred to the transferee funding vehicle.

C. Analysis

1. Nonrealization. The only existing precedent specifically relating to the tax consequences of a change in investment under a section 403(b) retirement program is Revenue Ruling 73-124, 1973-1 C.B. 200. In this revenue ruling, the Service held that an employee could accomplish a tax-free exchange of section 403(b) annuity contracts by entering into a binding agreement with his employer to turn over the proceeds of his surrender of one annuity contract to his employer for reinvestment in a second annuity contract for the employee. A tax-free contract-for-contract exchange under Code section 1035 was accomplished, according to the revenue ruling, because the same person was the obligee under both contracts, and the proceeds received were applied immediately to the purchase of a second annuity contract.

Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for an annuity contract. The concept of nonrecognition normally applies only

where gain or loss is realized as a result of a transaction. Revenue Ruling 73-124 presumably relied upon section 1035 because the taxpayer at issue actually received the proceeds of the first contract, although such receipt was subject to the taxpayer's binding agreement with his employer to immediately turn over the proceeds.

This revenue ruling has been cited and followed in a series of private letter rulings[1/] permitting the tax-free transfer of the entire account balance from a section 403(b)(1) annuity contract to a section 403(b)(1) annuity contract, from a section 403(b)(1) annuity contract to a section 403(b)(7) custodial account, and from a section 403(b)(7) custodial account to a section 403(b)(7) custodial account.[2/] Although some of the administrative determinations explicitly rely on nonrecognition

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1/ We recognize that private letter rulings do not constitute precedential authority, but we refer to them as indicative of the prior views of the Internal Revenue Service, and for the relevant analysis and citations of authority contained therein.

2/ See, e.g., Private Letter Rulings 8607064 (1985); 8420080 (1984); 8536043 (1985).

The Service has consistently refused to rule upon whether a transfer may be accomplished from a section 403(b)(7) custodial account to a section 403(b)(1) annuity contract. As we understand the issue, the Service in the past has been concerned that a participant invested in a section 403(b)(7) custodial account could circumvent the distribution restrictions in section 403(b)(7)(A)(ii) by transferring the amounts in the custodial account to a section 403(b)(1) annuity contract, which is not required to impose identical restrictions, and taking an immediate distribution. As discussed in more detail, infra, such transfers should be permitted where the section 403(b)(1) annuity contract contains no less restrictive provisions on distributions than were applicable to the custodial account.

provisions of section 1035 relating to exchanges of insurance contracts, others do not cite section 1035, but appear to rely on the continued qualification of the replacement investment under section 403(b)(1) or 403(b)(7) and on the absence of any distribution of funds to the employee (except as a conduit), to conclude that no realization event has occurred from the standpoint of the employee.

We submit, for the reasons set forth below, that no realization event would occur for any of the three taxpayers described in the proposed revenue ruling and therefore the nonrecognition provisions of section 1035 should not enter into the analysis of such a transaction.

a. Repeal of the constructive receipt doctrine. As noted above, the taxpayers described in the proposed revenue ruling would at no time during the transfer process actually receive any amounts from either of the funding vehicles under their employer's program. In the absence of actual receipt, no realization event should occur unless a theory of constructive receipt were to be applied.

The constructive receipt doctrine as applicable with respect to section 403(b) programs was explicitly repealed pursuant to the Tax Reform Act of 1986. Effective after December 31, 1986, any amount held for an employee under a section 403(b)

annuity contract generally is excluded from the gross income of the employee (subject to sections 403(b)(2), 402(g)(4), and 415(c)) until the time when the amount is "actually distributed." As stated in the Committee reports, the intent of the 1986 amendment was to provide that "benefits under a tax-sheltered annuity are includible in income only when benefits are actually received." H.R. Rep. 99-841, 99th Cong., 2d Sess. II-459, II-462; H.R. Rep. 99-426, 99th Cong., 1st Sess. 732.

In the case of any transfer of a section 403(b) accumulation directly between section 403(b) funding vehicles, no actual distribution to the employee occurs, and no retirement benefit has commenced. The contract or account value and the amounts transferred should continue to be excluded, therefore, from the employee's gross income under the literal terms of section 403(b).

b. <u>Tax-free transfers within other retirement programs</u>. Section 403(b) retirement programs are similar to other types of retirement arrangements under the Code in that section 403(b) programs are subject to rules that include limitations upon contributions and distributions, and nondiscrimination requirements. Accordingly, employers offering section 403(b) programs should be able to offer the same degree of retirement investment flexibility to their employees as other employers can make available to their employees.

Direct transfers among funding vehicles offered by a qualified plan under section 401(a) of the Code are accomplished routinely, and the tax-free nature of such transfers has been recognized for many years. In Rev. Rul. 55-427, 1955-2 C.B. 27, a corporation maintained a non-trusteed retirement plan that was funded by individual annuity contracts. The company discontinued funding the plan by individual annuity contracts and instead established a section 401(a) trust for funding benefits under the plan. The funds accumulated under the non-trusteed plan were transferred from the insurer to the trust. The ruling held that participants under the non-trusteed plan were not in receipt of income as a result of the transfer of funds from the insurer to the trust. See Rev. Rul. 68-160, 1968-1 C.B. 167 (direct transfer of an annuity contract from a trust to a bank custodian did not constitute a premature distribution to an owner-employee); see also, Doing v. Commissioner, 58 T.C. 115 (1972).

Similarly, direct transfers between funding vehicles under individual retirement arrangements (IRAs) do not result in taxable income to the participant. In Rev. Rul. 78-406, 1978-2 C.B. 157, the funds in a participant's IRA at one bank were transferred by the trustee directly to a new trustee at a second bank. The Service held that such a transfer did not result in a payment or distribution includible in the gross income of the participant. Subsequent private letter rulings indicate that

this analysis applies equally to individual retirement annuities under section 408(b) of the Code. See, e.g., Private Letter Rulings 8332144 (1983) and 8309149 (1982).[3/]

We submit that these revenue rulings in analogous retirement arrangement situations provide direct support for the proposed revenue ruling concerning section 403(b) programs. The amounts transferred in all three situations remain within a tax-favored program, and are not actually distributed to the participant. Therefore, the section 403(b) participants, like participants in qualified retirement plans and individual retirement arrangements, should be able to accomplish direct transfers among section 403(b) funding vehicles without including the amounts transferred in gross income.

c. Transfers from section 403(b)(7) custodial accounts to section 403(b)(1) annuity contracts. The above

3/ Application of Rev. Rul. 78-406 to section 408(b) individual retirement annuities is significant to the instant analysis because, like section 403(b) annuity contracts, which are subject to the nontransferability requirement of section 401(g), such annuities must not be transferable by the owner. Section 408(b)(1). Indeed, the regulations under section 401(g) and section 408(b)(1) explaining the limitation on transferability are virtually identical. Each type of annuity contract is considered transferable "if the owner can sell, assign, discount, or pledge as collateral for a loan or as security for the performance of an obligation or for any other purpose his interest ... to any person other than the issuer thereof." Treas. Reg. sections 1.401-9(b)(3), 1.408-3(b)(1). In the case of a direct transfer, the participant retains his interest in the contract throughout and the nontransferability provisions of sections 401(g) and 408(b)(1) will not be violated.

analysis recognizes that the exclusion from an employee's gross income under section 403(b) can continue only so long as the restrictions on distributions required for qualification under section 403(b) continue to apply. Recent Code amendments have largely, but not entirely, eliminated the differences in restrictions required for qualification under section 403(b)(1) and the additional restrictions required for qualification under section 403(b)(7). Compare section 403(b)(7)(A)(ii) with section 403(b)(11). The proposed revenue ruling's fact pattern with respect to Taxpayer B includes the condition that the receiving annuity contract provide that amounts transferred from a custodial account may not be distributed before the occurrence of one of the events listed in section 403(b)(7)(A)(ii).

d. Applicability to partial transfers. A transfer of amounts representing less than the entire balance under a section 403(b) annuity contract or custodial account should qualify for nonrealization under the principles discussed above. We are aware of no tenet of tax or retirement policy that would permit tax-free transfers of entire accumulations but consider the transfer of only part of an accumulation a distribution to the participant. Such a result would be illogical and accomplish no valid purpose. Indeed, retirement policy as expressed in ERISA mandates diversification of retirement assets. See ERISA section 404(a)(1)(C). Such diversification with respect to existing accumulations can only be achieved if the participant

has the ability to elect to transfer less than his entire accumulation in one funding vehicle to another funding vehicle permitted under the program.

2. Tax basis. Because distributions from section 403(b) annuity contracts and custodial accounts do not qualify for the special capital gain or income averaging treatment available with respect to lump sum distributions of the entire balance to an employee's credit under tax-qualified plans, no revenue questions involving such special tax treatment arise with respect to the separation of a single section 403(b) annuity contract or custodial account into two or more contracts or accounts. Moreover, recent Code amendments relating to the recovery of tax basis under section 72 of the Code would seem, as a practical matter, to have eliminated any revenue concern with respect to any relationship between such separation and the employee's rate of recovery of any tax basis. We therefore suggest that an allocation of basis, as well as any other relevant tax attributes applicable to the transferor section 403(b) funding vehicle, between the transferor funding vehicle and the transferee funding vehicle in proportion to the remaining account balance of the transferor funding vehicle and the amount transferred to the transferee funding vehicle would result in the simplest administrative treatment of a partial transfer and would give rise to no adverse revenue consequences.

3. Related rulings. The remaining proposed rulings follow directly from the conclusion that direct full or partial transfers of amounts among section 403(b) funding vehicles do not constitute realization events for the participants in the section 403(b) program. First, the original annuity contract or custodial account would not fail to satisfy the requirements of section 403(b)(7)(A)(ii) or section 403(b)(11) if amounts were transferred directly to another section 403(b) funding vehicle. Second, because the amounts transferred had already been contributed under the section 403(b) program, they would not be treated as contributions or elective deferrals for purposes of sections 402(g), 403(b)(2),[4/] or 415(c). Third, in the absence of a distribution includible in gross income, the amounts transferred would not be subject to withholding under section 3405 or information reporting under section 6047(d). Section 3405(d)(1)(B)(ii); see Private Letter Ruling 8332144 (1983) (no reporting required of amounts directly transferred from one individual retirement annuity to another).

4/ Such amounts should be treated for these purposes as rollover amounts, which are not taken into account for purposes of the exclusion allowance under section 403(b)(2). Section 403(b)(1).

IV. CONCLUSION

For the reasons set forth above, we urge the prompt issuance of the proposed revenue ruling.

Attachment - Draft Revenue Ruling

DRAFT

Rev. Rul. 89-____

ISSUE

May a participant in an employer's section 403(b) program elect a direct transfer of all or less than all of his or her entire accumulation in one funding vehicle under the program to another funding vehicle permitted under the program on a tax-free basis?

FACTS

Employer S, a tax-exempt organization under section 501(c)(3) of the Code, offers a retirement program ("the Plan") to its employees pursuant to section 403(b). Employer S contributes five percent of each employee's compensation to the Plan, and the employee can elect to make before-tax contributions pursuant to a salary reduction agreement and/or after-tax contributions.

Under the Plan, participants can elect to invest both employer and employee contributions in any combination among the following three options: (1) a section 403(b)(1) annuity contract issued by Issuer X ("Annuity Contract X"); (2) a section 403(b)(7) custodial account offered by Custodian Y ("Custodial Account Y"); and (3) a section 403(b)(7) custodial account offered by Custodian Z ("Custodial Account Z"). All three of the

alternative funding vehicles satisfy the conditions of either section 403(b)(1) or section 403(b)(7). The Plan permits participants to allocate contributions on their behalf among these three vehicles and allows employees to elect transfers of existing accumulations among the three vehicles.

Taxpayer A is employed by Employer S and has not yet attained age 59-1/2. He has heretofore invested all $10x of the contributions on his behalf, including after-tax contributions, in Annuity Contract X. Taxpayer A has determined that he should diversify his investments by electing a direct transfer of $5x of his accumulation from Annuity Contract X to Custodial Account Y. Consistent with the Plan, Taxpayer A requests a direct transfer of $5x from Annuity Contract X to Custodial Account Y, and the transfer is made. Taxpayer A actually receives no amount from either Annuity Contract X or Custodial Account Y in connection with the transfer.

Taxpayer B is employed by Employer S and has not yet attained age 59-1/2. He has heretofore invested all $10x of the contributions on his behalf, including after-tax contributions, in Custodial Account Y. Taxpayer B has determined that he should diversify his investments by electing a direct transfer of $4x of his accumulation from Custodial Account Y to Annuity Contract X. Annuity Contract X provides that any amounts transferred to Annuity Contract X from a custodial account under section

403(b)(7) may not be distributed to the participant before the occurrence of one of the events listed in section 403(b)(7)(A)(ii). Consistent with the Plan, Taxpayer B requests a direct transfer of $4x from Custodial Account Y to Annuity Contract X, and the transfer is made. Taxpayer B actually receives no amount from either Custodial Account Y or Annuity Contract X in connection with the transfer.

Taxpayer C is employed by Employer S and has not yet attained age 59-1/2. He has heretofore invested all $10x of the contributions on his behalf, including after-tax contributions, in Custodial Account Y. Taxpayer C has determined that he should diversify his investments by electing a direct transfer of $7x of his accumulation from Custodial Account Y to Custodial Account Z. Consistent with the Plan, Taxpayer C requests a direct transfer of $7x from Custodial Account Y to Custodial Account Z, and the transfer is made. Taxpayer C actually receives no amount from either Custodial Account Y or Custodial Account Z in connection with the transfer.

LAW

Section 403(b)(1) of the Code provides, in part, that if an annuity contract is purchased (i) for an employee by an employer described in section 501(c)(3) which is exempt from tax under section 501(a), or (ii) for an employee (other than an employee

described in clause (i)), who performs services for an educational organization described in section 170(b)(1)(A)(ii), by an employer which is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing, and if certain other conditions are satisfied, then amounts contributed by such employer for such annuity contract on or after such rights become nonforfeitable shall be excluded from the gross income of the employee for the taxable year to the extent that the aggregate of such amounts does not exceed the employee's exclusion allowance for such taxable year under section 403(b)(2).

Section 403(b)(1) of the Code further provides that the amount actually distributed to any distributee under a section 403(b) annuity contract shall be taxable to the distributee (in the year in which so distributed) under section 72.

Section 403(b)(1) of the Code further provides that amounts transferred to a section 403(b) annuity contract by reason of a rollover contribution described in section 403(b)(8) or section 408(d)(3)(A)(iii) shall not be considered contributed by such employer.

Section 403(b)(7) of the Code provides that amounts paid by an employer described in section 403(b)(1)(A) to a custodial account which satisfies the requirements of section 401(f)(2)

shall be treated as amounts contributed by him for an annuity contract for his employee if (i) the amounts are to be invested in regulated investment company stock to be held in that custodial account, and (ii) under the custodial account no such amounts may be paid or made available to any distributee before the employee dies, attains age 59-1/2, separates from service, becomes disabled (within the meaning of section 72(m)(7)), or in the case of contributions made pursuant to a salary reduction agreement (within the meaning of section 3121(a)(1)(D)), encounters financial hardship.

Section 403(b)(11) of the Code provides that distributions from a section 403(b) annuity contract attributable to contributions made pursuant to a salary reduction agreement (within the meaning of section 402(g)(3)(C)) may be paid only (A) when the employee attains age 59-1/2, separates from service, dies, or becomes disabled (within the meaning of section 72(m)(7)), or (B) in the case of hardship.

Section 402(g) of the Code provides that the elective deferrals of any individual for any taxable year under a section 403(b) contract shall be included in such individual's gross income to the extent the amount of such deferrals for the taxable year exceeds $9,500 (or as much as $12,500, in certain cases).

Section 415(a)(2)(B) of the Code provides that contributions and other additions to an annuity contract described in section 403(b) may not exceed the limitation of section 415(c).

Section 415(c) of the Code provides that the limitation on contributions and other additions with respect to a participant, when expressed as an annual addition (the sum for any year of employer contributions, employee contributions, and forfeitures) to the participant is the lesser of (A) $30,000 (or, if greater, 1/4 of the dollar limitation in effect under section 415(b)(1)(A)), or (B) 25 percent of the participant's compensation.

Section 6047(d) of the Code provides that the Secretary of the Treasury shall by forms or regulations require that (A) the employer maintaining, or the plan administrator (within the meaning of section 414(g)) of, a plan from which designated distributions (as defined in section 3405(d)(1)) may be made, and (B) any person issuing a contract under which designated distributions (as so defined) may be made, make returns and reports regarding such plan (or contract) to the Secretary, to the participants and beneficiaries of such plan (or contract), and to such other persons as the Secretary may by regulations prescribe.

Section 3405(d)(1)(A) of the Code defines a designated distribution as any distribution or payment from or under (i) an employer deferred compensation plan, (ii) an individual retirement plan or (iii) a commercial annuity.

Section 3405(d)(1)(B)(ii) of the Code excludes from the definition of designated distribution the portion of a distribution or payment which it is reasonable to believe is not includible in gross income.

ANALYSIS

Amounts contributed on behalf of an employee by an employer described in section 403(b)(1)(A) to an annuity contract that satisfies the requirements of section 403(b)(1) or a custodial account that satisfies the requirements of section 403(b)(7) are excluded from the gross income of the employee for the taxable year to the extent that such amounts do not exceed the applicable limitations of sections 402(g), 403(b)(2) and 415(c), and are taxable only when amounts under the annuity contract or custodial account are actually distributed. The direct transfer of funds for each of Taxpayers A, B and C between section 403(b) funding vehicles does not result in a distribution under section

403(b)(1) and, therefore, the transferred amount is not includible in the gross income of Taxpayer A, B, or C under section 72.

Similarly, the amounts transferred are not "paid or made available" to the taxpayers in violation of section 403(b)(7)(A)(ii) or "distributions" to the taxpayers in violation of section 403(b)(11). The annuity contracts and custodial accounts therefore continue to satisfy 403(b)(1) and 403(b)(7).

Furthermore, the amounts transferred are analogous to amounts received by reason of a rollover contribution, which are not considered contributed by the employer under section 403(b)(1). The amounts transferred therefore are not treated in the year of the transfer as contributions for purposes of the exclusion allowance under section 403(b)(2) or as elective deferrals that must be taken into account for purposes of the limitation on the exclusion for elective deferrals under section 402(g). In addition, such amounts are not considered contributions or additions for purposes of the limitations on contributions under section 415(c).

The amounts transferred are not treated as designated distributions as defined in section 3405(d)(1) because the amounts are not includible in the taxpayers' gross income. Thus,

no withholding under section 3405 or information reporting under section 6047(d) is required concerning such amounts.

Because the original accumulations of all of the taxpayers include amounts contributed on an after-tax basis, the taxpayers have a tax basis in these accumulations. The tax basis applicable to the transferor section 403(b) funding vehicle immediately prior to the transfer is allocated between the transferor funding vehicle and the transferee funding vehicle in proportion to the remaining account balance of the transferor funding vehicle and the amount transferred to the transferee funding vehicle.

The above analysis would apply equally to transfers by Taxpayers A, B and C if they requested transfers of their entire accumulations.

HOLDING

A participant in an employer's section 403(b) program may elect a direct transfer of all or less than all of his or her entire accumulation in one section 403(b) funding vehicle to another section 403(b) funding vehicle on a tax-free basis. The amounts transferred will not be included in gross income under section 72, "paid or made available" in violation of section 403(b)(7)(A)(ii), a "distribution" in violation of section

403(b)(11), a contribution for purposes of the exclusion allowance under section 403(b)(2), an elective deferral subject to the limitations of section 402(g), or a contribution or addition for purposes of section 415(c). In addition, the amounts transferred will not be subject to withholding under section 3405 or information reporting under section 6047(d).

DRAFTING INFORMATION

The principal author of this revenue ruling is _____________________ of the ___________________ Division. For further information regarding this revenue ruling, please contact _____________________ of the ___________________ Division by calling (202) 566-_______ (not a toll-free call).