



1401 H Street, NW, Washington, DC 20005-2148, USA  
202/326-5800 www.ici.org

May 22, 2009

Internal Revenue Service  
Attention: SE:T:EP:RA:VC  
1111 Constitution Avenue, NW  
Washington, DC 20224

Re: EPCRS Update for Final 403(b) Regulations

Dear Sir or Madam:

I am writing on behalf of the Investment Company Institute (the "Institute")<sup>1</sup> and its members to recommend improvements to the Employee Plans Compliance Resolution System ("EPCRS") in connection with 403(b) plans. There are a number of unique problems that arise in the context of 403(b) plans and it would be appropriate for the next iteration of EPCRS to include guidance on correction methods for these problems. We identify potential 403(b) errors below and suggest methods of correction for each.

#### Funding Agreement/Plan Coordination Failures

The final 403(b) regulations provide that 403(b) contracts must be "maintained pursuant to a plan." Contracts subject to the plan requirement include contracts that were issued prior to the final regulations' general effective date of January 1, 2009. The final regulations and Revenue Procedure 2007-71 grandfather certain categories of existing 403(b) contracts and provide good faith relief for others. However, in general, all contracts that receive contributions or contract exchanges on or after January 1, 2009, must satisfy the plan requirement.

In Notice 2009-3, the Internal Revenue Service indicated that it will not treat a 403(b) contract maintained by an employer that has not adopted a written plan by January 1, 2009, as failing to satisfy the requirements of section 403(b) during the 2009 calendar year, provided that certain requirements are satisfied. One requirement is that "on or before December 31, 2009, the sponsor of the plan has

---

<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$9.71 trillion and serve over 93 million shareholders.

adopted a written § 403(b) plan that is intended to satisfy the requirements of § 403(b) (including the final regulations) effective as of January 1, 2009.”

A number of the Institute’s members are concerned that some 403(b) plans will fail to satisfy the plan requirement because of the difference between the effective date of the plan requirement and the date by which a plan must be adopted. Consider a simple example. An employer makes contributions to a custodial account on or after January 1, 2009. As part of the adoption of a written plan document in 2009, the employer makes plan design decisions and decides that loans will be available under the plan. The custodian, however, does not offer loans, or does not provide certain services attributed to the custodian in the plan document (such as aggregation of loan information from other vendors). If the employer is not willing to limit loans to funding vehicles that offer loans and the custodian is not willing or able to offer loans or provide the administrative services desired by the employer, then there may be a fundamental inconsistency between the plan and the terms of the custodial account (and associated information sharing and recordkeeping agreements). This is one example of a possible inconsistency but there may be numerous circumstances in which the custodian and the employer may be unable to reach agreement on the services and plan features that will be provided by the custodian.

This issue is unique to section 403(b) plans for two reasons. First, the funding vehicles in a 403(b) plan are not mere investment vehicles. Instead, the terms of the “funding vehicles” – which may include (as separate documents or together) the vendor’s custodial account documentation (which could be an individual or group custodial account agreement), an information sharing agreement and recordkeeping agreements – also operate as a form of a service agreement, whereby the vendor agrees to offer or not offer certain provisions, including, for example, loans, hardship withdrawals, and Roth separate accounting and to take on certain responsibilities, such as processing loan requests. The addition of the plan document as an overlay to the terms of the funding vehicle raises the possibility that the plan document will require a renegotiation of the terms of the funding vehicle, which may be impossible due to the vendor’s business model (e.g., the services and features it offers to plans and participants). Second, the transition to the final 403(b) regulations has meant that employers and vendors have implicitly agreed that the custodial accounts and annuity contracts will be subject to the terms of the employer’s plan. That is, by making and accepting contributions for tax years beginning January 1, 2009, the employer and the vendor have effectively agreed to reach agreement on the terms of the employer’s plan, even though the plan terms may not be adopted until later in 2009. We are confident that employers and vendors will work to reach agreement on the services and design features that the vendors will provide, but there may be circumstances in which agreement is not and cannot be reached, notwithstanding good faith efforts. In such circumstances, there is a need for a correction method that will protect participants from adverse tax consequences.

In addition, contracts may be inadvertently misclassified as eligible for the reasonable good-faith transition relief under Revenue Procedure 2007-71 or the grandfather rule for 90-24 transfers

made prior to September 24, 2007, notwithstanding the best efforts of vendors to properly identify the contracts. These contracts may fail to be “maintained pursuant to a plan” because the employer or vendor relied on transition relief that was in fact not available.

We strongly recommend that EPCRS include an explicit method of correction for contracts that would fail to satisfy the section 403(b) requirements because they are not maintained pursuant to the employer’s plan. This method of correction should be available through the self correction program (“SCP”), since there does not appear to be any significant public policy benefit to mandating IRS involvement in the correction.

Correction raises two separate issues. First, the contracts will need to be treated as maintained pursuant to the employer’s plan in order to remain 403(b) contracts. As discussed above, it may, however, be difficult for the employer and the vendor to agree on the terms of the arrangement (in the example above, to agree on whether loans are available or the allocation of section 72(p) compliance responsibility between the plan sponsor and the vendor). As a result, a method of correction is needed and we believe the method should be based on the principles enumerated in Revenue Procedure 2007-71 for vendors that were discontinued as authorized vendors on or after January 1, 2005 and before January 1, 2009. Section 8.01 of the Revenue Procedure provides that a contract issued after December 31, 2004, and before January 1, 2009, by a provider that does not receive contributions under the plan on or after January 1, 2009, will not fail to satisfy section 403(b) merely because the contract is not part of the employer’s written plan if the employer “makes a reasonable, good faith effort to include the contract as part of the employer’s plan . . . .” Additional correction requirements could include the immediate cessation of all future contributions to the contracts and an effective information sharing agreement between the employer and vendor, two parties which have a vested interest in the contracts remaining qualified under section 403(b).

Second, there may be transactions occurring after the effective date of the final regulations and before the date good faith efforts are made to include the contracts in the plan that do not satisfy the section 403(b) requirements, for example, because of a lack of information sharing or a difference in plan and funding vehicle terms. We believe that a plan should be treated as having corrected an operational error in this context if best efforts are made to retroactively correct any operational failures in accordance with general principles of EPCRS and consistent with Notice 2009-3. If the Service were uncomfortable with this standard as a general rule, one approach might be to limit its application to errors that are identified as requiring correction by December 31, 2009 and actually corrected by December 31, 2010. This would encourage employers and vendors to identify and correct problems of this type, and would reflect that many of these issues will arise in connection with the transition to the final regulations.

The method of correction we recommend would be consistent with the correction principles that underlie EPCRS. It would be based closely on existing guidance, in particular, Revenue Procedure

2007-71, and, if transactional information sharing occurs, it would have the virtue of largely putting the plan in the position it would have been but for the error. Moreover, the approach we recommend would be consistent with Notice 2009-3, which requires that, before the end of 2009, best efforts are made to retroactively correct any operational failure during the 2009 calendar year.

### Loan Failures

EPCRS generally allows for correction of errors related to plan loans, including both self correction and correction with Service approval. However, unless the failure is described in, and correction is made in accordance with, one of three enumerated rules, correction does not obviate income tax reporting and withholding to the extent required by section 72(p). In this regard, EPCRS expressly states that income tax withholding is the employer's obligation. If correction is made in accordance with one of the three enumerated rules, relief is provided from income tax reporting and withholding only if correction is done with Service approval.

The Institute is concerned that the existing EPCRS rules will not be sufficient for 403(b) plans. Unlike other types of tax-preferred retirement plans, 403(b) plans often are funded through custodial accounts and annuity contracts issued by multiple vendors, each of which is responsible for recordkeeping with respect to the assets it holds. One of the stated goals of the final 403(b) regulations is to enhance compliance with section 72(p) by requiring that vendors and employers share information and communicate to ensure that plan limits and section 72(p) rules are satisfied. It seems likely, however, that loan errors will arise more frequently in the section 403(b) context given the prevalence of multiple vendor arrangements and the inevitable adjustment period as employers and vendors work through new structures for sharing information. In particular, we expect that the most common form of loan error will be a loan in excess of the 72(p) limits when loans from different contracts are aggregated. As with loan failures in general, we anticipate that these errors will be discovered after the fact, for example, when a custodian that made a loan discovers that a participant had other outstanding loans from another vendor that, when aggregated, would cause the participant to exceed the section 72(p) limits.

Section 403(b) plans also raise different loan correction issues than other types of tax-preferred arrangements because 403(b) plans are subject to different income tax withholding obligations. Section 3405 generally imposes an income tax withholding obligation on the payor of a taxable distribution, including a distribution of a loan that is in excess of the section 72(p) limit. Section 3405, however, recognizes that the plan administrator (usually the employer) is the party with the information and knowledge needed to determine the tax status of a distribution. As a result, section 3405(d)(2) allows the plan administrator to assume the income tax withholding responsibility for the vast majority of plan types, including 401(a) plans and governmental 457 plans. Section 3405 does not, however, extend these rules to section 403(b) plans and we are not aware of any rule that would allow section 403(b) plans to shift the income tax withholding responsibility to the plan administrator – the party with the

knowledge and oversight responsibility for loan compliance. As a result, it appears that the custodian or issuer of a section 403(b) contract is potentially liable for the income tax withholding liability but does not control the requisite information. Further, the general correction rule that requires withholding by the employer does not fit the section 403(b) plan context.

After careful consideration, the Institute recommends that EPCRS allow 403(b) vendors to correct a loan in excess of the section 72(p) limits by taking reasonable steps to have the excess loan amount, plus appropriate interest from the date of the excess payment to the date of the repayment, returned by the participant to the account at the vendor from which the loan was distributed. One condition of relief could be that the vendor must have loan request processing procedures that are designed to reasonably ensure compliance with section 72(p) and are consistent with the other responsibilities allocated to, and accepted by, the vendor under the terms of the "funding vehicle" documentation. In addition, the employer could be required to review all of the then outstanding loans to determine if other loan errors exist (so that they may be corrected) and ensure that vendors have appropriate procedures in place to prevent the reoccurrence of similar loan errors. The same allocation and correction principles for excess loans described in section 6.07(2)(b) of Revenue Procedure 2008-50 would apply. Under the approach we recommend, if a participant repays the required amount, no reporting or income tax withholding should be required. However, to the extent the participant fails to repay the excess amount, the vendor should have an income tax reporting obligation for the year of the failure but should not have an income tax withholding liability. Regardless of whether the participant repays the excess loan, the plan should be treated as having corrected the error, including any failure to operate the plan in accordance with its terms.

We further recommend that this method of correction be allowed under SCP without Service involvement. We realize that, in the past, the Service has been reluctant to allow SCP correction in contexts that involve changes in individual income tax inclusion, for example, allowing for no imputed income tax on a deemed distribution by virtue of correction. Because excess loan errors may be common, however, we are concerned by the vast number of possible submissions that would be required. Further, the Service now has significant experience in administering loan defects and the need for supervised correction would appear to have diminished. Accordingly, self-correction along the lines described above should be permitted.

#### Failed Plan Termination

Under the final 403(b) regulations, employers for the first time may terminate a 403(b) plan and distribute the accumulated benefits to participants and beneficiaries. The Institute has submitted two comment letters urging the Treasury Department and Service to issue guidance that addresses a number of plan termination issues unique to 403(b) plans that are funded through individual custodial accounts. We continue to believe that there is a pressing need for such guidance. It is also important that the Service issue correction guidance in connection with substantive guidance on plan termination.

There has been significant confusion over a wide range of issues related to plan termination and, under almost any form of guidance, it is likely that some employers will have authorized plan terminations that were ineffective, which generally would mean that impermissible in-service distributions occurred.

Due to the possibility of multiple vendors, unique issues may arise in the termination of a 403(b) plan. Specifically, if errors occur that result in the assets associated with a particular vendor not being timely distributed, accounts with other vendors under the terminating plan may be affected. Vendors that have met their obligations relating to the termination may not be aware of errors associated with another vendor's contracts. It is important to have guidance specifying how employers should correct errors relating to one vendor's contracts without adding new obligations for other vendors that have satisfied all outstanding responsibilities under the plan termination. In other words, compliant vendors should have no obligation to notify former participants and beneficiaries who received termination distributions that a failure occurred with respect to the termination or to undertake additional tax reporting on the distributions or, if applicable, attempt to reverse rollovers to IRAs or other plans. Instead, the employer should be permitted to correct the failed termination by completing the termination with respect to assets that were not timely distributed.

#### Failure to Timely Adopt Plan Document

As mentioned above, Notice 2009-3 provides that the Service will not treat a 403(b) contract maintained by an employer that has not adopted a written plan by January 1, 2009, as failing to satisfy the requirements of section 403(b) during the 2009 calendar year, provided that, among other requirements, the employer adopts a plan document on or before December 31, 2009. The draft revenue procedure that was published in Announcement 2009-34 would create a remedial amendment period that runs from January 1, 2010 until the date an employer timely adopts a prototype plan document that has been approved by the Service.

The Institute greatly appreciates the flexibility created by Notice 2009-3 as well as the creation of a remedial amendment period for 403(b) plans that adopt prototype plan documents. However, we are concerned that some employers will fail to adopt a 403(b) plan document by December 31, 2009 and that some employers will also fail to timely adopt a prototype plan document within the remedial amendment period contemplated by Announcement 2009-34. As a result, we believe a correction method should be available under EPCRS for an employer to correct either failure, because there are no other mechanisms to correct the failure under the Code or related regulations. This correction method should be modeled on the simplified correction procedures that apply to a 401(a) plan that is not timely amended for new legislation. It should have very low compliance fees and should be available through a streamlined process.

Internal Revenue Service

SE:T:EP:RA:VC

May 22, 2009

Page 7 of 7

We greatly appreciate your attention and look forward to discussing these issues further if it would be helpful.

Sincerely,

/s/ Elena Barone

Elena Barone

Associate Counsel – Pension Regulation

cc: J. Mark Iwry, Treasury Department  
Andrew Zuckerman, Internal Revenue Service  
Alan Tawshunsky, Internal Revenue Service