

June 30, 2003

William Bortz
Associate Benefits Tax Counsel
Office of Benefits Tax Counsel
U.S. Treasury Department
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: 403(b) Reg Project

Dear Mr. Bortz:

On behalf of the National Council on Teacher Retirement ("NCTR"), we want to thank you and your colleagues at Treasury and IRS for meeting with us on April 22 to discuss issues of interest to public retirement systems that offer and/or administer retirement programs described in section 403(b) of the Internal Revenue Code of 1986 ("Code"). This letter confirms and expands upon issues that we would like the new proposed section 403(b) rules to address. We appreciate your considering these comments and would be pleased to elaborate on them or to respond to any additional questions you may have.

NCTR is made up of 77 state, territorial, local and university retirement systems that serve more than 16 million active and retired teachers, non-teaching personnel, and other public employees. The systems have combined assets of more than \$1.4 trillion in their trust funds.

1. Preservation of Grandfather for Self-Insured Programs

The vast majority of K-12 public school 403(b) programs are "salary reduction only." In many cases, a section 457(b) or grandfathered section 401(k) program is also

available. Some jurisdictions offer matching contributions and use the 403(b) program as a "FICA alternative" plan.

Section 403(b) programs for public school teachers take various structures. A number of jurisdictions allow selected or even large numbers of 403(b) providers (i.e., insurers and/or mutual funds) to offer their products for the teachers' selection. Others offer exclusively custodial accounts (e.g., California STRS) or commercial annuities from one insurer. Still others, such as Oklahoma and Wisconsin, offer a self-insured program as an alternative to insurance company or mutual fund plans offered by local school districts. Finally, the largest single public sector 403(b) program, i.e., New York City Teachers with over \$8 billion in assets and 70,000 participating members, is entirely self-insured.

As we discussed, a number of public retirement systems qualify for, and continue to rely on, the grandfather treatment for self-insured annuity programs under Rev. Rul. 82-102. These systems include the New York City Teachers' Retirement System, the Duluth Teachers' Retirement Fund Association, the Wisconsin Retirement System and the Oklahoma TRS. (There are probably others.) Each of these systems established its self-insured program based on a private letter ruling that, applying then outstanding published IRS rulings (Rev. Ruls. 67-361 and 67-387), expressly permitted such arrangements if certain requirements were met. In many cases, the self-insured 403(b) options are invested in the same portfolios (or at least by the same investment managers) as the "401(a)" portion of the retirement system, with separate accounting for contributions, distributions, income and expenses of each program.

We respectfully submit that the decision to rewrite the section 403(b) rules does not provide a basis for revoking the 20-year grandfather rule upon which these well-established state and local systems and their members have relied. These systems are offering their members lower costs and unique managed investment options not available in the public market. There typically is a higher level of compliance and administration assumed by the governing body than in individually marketed plans. Because the annuity obligation (and on occasion fixed-income investment options) is or may be backed by state or local governments, these programs also may offer a high

level of benefit security to their members. Many long-service employees have built their supplemental retirement plans around these investment programs. We see no reason why they should be forced to convert them to commercial annuity or mutual fund programs, with possibly significantly higher fees.

At the meeting, a Treasury representative expressed a concern that IRS auditors might not be able to identify grandfathered systems at some point in the future. We do not share this concern since generally the systems will have received IRS private letter rulings, and their existence prior to the publication of Rev. Rul. 82-102 should be easily verifiable in any event. If, however, this remains a concern, we see no reason why they could not be listed by name in the regulations. In this regard, the regulations should also clarify that such grandfathered systems may include any feature (e.g., loans) or other provision that is currently permitted (or is permitted in the future) under Code section 403(b).

2. Permissible Sources of Deferrals

The proposed regulations under section 457(b) make it clear that various sources of compensation other than regular compensation may be the source of employee deferrals as long as the election is made before the month when cash payment is available. Prop. Reg. § 1.457-4(b). It would be helpful for the 403(b) rules to contain similar provisions for deferrals from sick pay, vacation pay and back pay. Also, as commentators on the proposed 457 rules have requested, provision for elective deferrals from severance and other post-termination amounts should be added. In this regard, we recommend that the regulations clarify that the "5-year after employee termination" provision of Code section 403(b)(3) (added by EGTRRA) permits employee deferrals from severance pay or other amounts payable following termination of employment, as well as employer contributions based on such amounts.

3. Loans

The regulations should confirm that 403(b) programs may offer loans under the same rules as section 401(k) plans (and, of course, section 72(p)).

The regulations should also make it clear that loans are not required to be available, but are an optional feature.

4. Document/Operational Compliance

The proposed regulations for section 457(b) plans include requirements for complete plan documents as well as operational compliance with the applicable requirements. Prop. Reg. § 1.457-3(a). We think substantially less expansive approaches to these matters are appropriate for 403(b) plans and, consistent with current practice, should be reflected in the forthcoming regulations.

First, we note that, unlike section 457(b), section 403(b) is not structured to require various provisions to be set forth in a "plan." The 1999 IRS examination guidelines and EPCRS similarly make minimal references to a section 403(b) plan document. Indeed, EPCRS does not even reference "Document Failures" for 403(b) plans.

Second, we think the absence of documentation requirements is appropriate because (1) section 403(b) arrangements take a wide variety of forms -- from unstructured individually marketed programs to centrally funded and administered ones, and (2) where the program is operated as part of a governmental retirement plan, the "document" may be (i) nonexistent, as in the case of many "salary reduction only" school district plans, (ii) contained in state or local code provisions that are controlled by legislatures or other governing bodies, and that compete with a wide variety of matters for limited attention when such legislatures are in session (sometimes only for a few weeks a year and, in some cases, only every other year), or (iii) set forth in various policies, rules or regulations. Thus, to the extent that any specific provisions are required, we recommend that the governing retirement board or governmental employer be permitted to determine what constitutes the "plan document" intended to meet such requirements, and be afforded substantial flexibility.

Finally, we note that the noncompliance with most of the requirements for 403(b) plans and arrangements affects only the individual experiencing the failure, and not all other participants in the same program. Indeed, under

EPCRS, it appears that relatively few defects potentially affect the tax status of the entire program. We think that approach should be continued in the proposed rules.

5. Rev. Rul. 90-24/EGTRRA Transfers

Many teachers (and their beneficiaries) take advantage of the ability to make direct transfers of 403(b) amounts between different 403(b) programs under Rev. Rul. 90-24. We recommend that these principles be reflected in the forthcoming regulations. In addition, the regulations should reflect the EGTRRA provisions for 403(b) transfers to purchase service credit under governmental plans. IRC § 403(b)(13). We respectfully submit that the regulations in this area should make it clear that 403(b) programs may (but are not required to) provide for Rev. Rul. 90-24 and/or EGTRRA transfers. They also should make it clear that both types of transfers are permitted between (or, in the case of EGTRRA transfers to purchase service credit, from) 403(b) programs of tax-exempt or public school employers.¹

6. Plan Termination

We agree that it would be helpful for the regulations to permit termination of a 403(b) plan (and describe how it is done), filling in a significant gap in the Code as the proposed 457(b) rules do. See Prop. Reg. § 1.457-10(a). Although our members have no intention of terminating current plans, there is no compelling reason to "lock" an employer into maintaining a frozen 403(b) program for potentially several decades. This is particularly true now that the Code freely allows rollovers among different types of tax-favored programs.

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¹ We note in this regard that section 903 of H.R. 1776 would inappropriately limit EGTRRA transfers to those between governmental 403(b) and 401(a) plans.

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Once again, we appreciate your consideration of these comments and invite further questions or requests for information in this area of vital importance to the retirement of public school teachers and other employees. In this regard, please contact Cynthia L. Moore, Washington Counsel, National Council on Teacher Retirement, at (703) 243-1667 or cmoore@nctr.org.

Respectfully submitted,

David A. Stella
Legislative Committee Chair
NCTR

cc: Tom Reeder
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