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June 5, 2006

VIA FACSIMILE AND HAND DELIVERY

Mr. Thomas Reeder
Acting Benefits Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue NW, 3050 MT
Washington, DC 20220

Re: Effective Date of Final 403(b) Regulations

Dear Mr. Reeder:

We are writing on behalf of the Committee of Annuity Insurers (the "Committee") to urge the Treasury Department and the Internal Revenue Service (the "Service") to provide an adequate and appropriate transition period before the pending final regulations under section 403(b) are effective.[1] The Committee is a coalition of 29 of the nation's largest and most prominent issuers of annuities that was formed in 1982 to participate in the development of federal tax and securities policies with respect to annuities. A list of the Committee's member companies is attached.

As described in more detail below, the Committee believes that the general effective date for the final regulations under section 403(b) (for both operational and form compliance) should be no earlier than January 1, 2008. The Committee also believes that the final regulations should exempt existing annuity contracts, including so-called "orphan contracts," from any new restrictions on participant contract rights, and that delayed effective dates should be provided for amendments to annuity contracts and governmental 403(b) arrangements. We have attached for your consideration a draft that highlights the changes to the effective date provisions that the Committee recommends.

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[1] Unless otherwise indicated, all references to sections are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

I. The final 403(b) regulations should be effective no earlier than January 1, 2008.

The Treasury Department and the Service indicated earlier this year that they "expect that the 2004 proposed section 403(b) regulations when finalized will be applicable for taxable years on or after January 1, 2007."[2] If this remains an accurate statement of the government's intent, it would leave fewer than seven months between the date the final regulations are published and the date they are effective, even if final regulations were published today. The Committee is concerned that such a compressed timeframe will not provide enough time for sponsors and providers of section 403(b) arrangements to digest the final rules and make the changes necessary to ensure compliance.

The final regulations are expected to make far-reaching and fundamental changes to the rules governing section 403(b) arrangements. For example, if the final regulations mirror the proposed regulations, they will impose on 403(b) arrangements a written plan document requirement for the first time. Many section 403(b) sponsors have never adopted or maintained a written plan document and will need time to consider the design and operation of their arrangements as well as the most effective means of memorializing the operative terms thereof. In addition, if the substance of the proposed regulations is reflected in the final regulations, transfers under Revenue Ruling 90-24 will no longer be permitted and transfers between 403(b) funding vehicles, in general, will be significantly restricted. In such case, employers will need to review and evaluate the annuity contracts and custodial accounts that will be available under their arrangements because participants will no longer have the important and valuable right to opt out of the employer's choices. Furthermore, if the final regulations incorporate these types of changes from current law, insurers that issue section 403(b) annuity contracts will need to make extensive modifications to their operational procedures.

For example, the Committee is concerned that the final 403(b) regulations could require issuers of annuity contracts to coordinate among themselves (*e.g.*, where multiple annuity contracts or custodial accounts are included in a single arrangement) and with employers to a much greater extent than has been required previously. This would mean that changes would have to be made to sponsors' administrative systems and to the computer systems used by life insurance companies to administer the section 403(b) contracts they issue. Both would require an enormous commitment of resources in order to identify and make the necessary changes – the type and scope of commitment that can reasonably be made only *after* final regulations are published. That changes can only be made after final regulations are published is highlighted by the fact that the proposed 403(b) regulations explicitly provide that they may not be relied upon by taxpayers.

The need for appropriate transition time is exacerbated by the fact that the new rules will directly affect nonprofit employers and state and local schools that sponsor 403(b)

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[2] Notice of Prop. Rulemaking, 71 Fed. Reg. 4320 (Jan. 26, 2006) (proposing regulations under section 402A regarding distributions from designated Roth accounts).

arrangements. These employers often have a very limited capacity to quickly conform their practices and documents to comply with extensive changes in the tax law. They will find it very difficult (if not impossible) to begin complying with the new regulations in operation as of January 1, 2007, and it is doubtful that they will be able to adopt plan documents by that date.

This issue is particularly acute for state and local schools that typically operate on a school year with only a very limited staff presence during the summer months. For many of these employers, even if the regulations are finalized promptly, they would not have the necessary staff on hand to begin the decisionmaking process until the Fall, which would leave as little as four months to come into compliance if the current proposed effective date is retained. Similarly, state and local governments often require statutory authorization in order to make changes affecting state retirement plans, including state and local 403(b) arrangements. For these employers, there may be only a very limited legislative window in which to obtain statutory authorization and, in some states, it is clear that there will not be an opportunity to pass the necessary legislation between the date of this letter and January 1, 2007.

We would also note that the Treasury Department and the Service have provided significantly longer lead time when comparable, or even less significant, changes have been made to other retirement plan regulations. In this regard, the recently restated section 401(k) regulations provided for a materially longer delay between issuance of final regulations and the effective date, and those regulations involved much more modest changes. There, final regulations were issued in December 2004 (with additions and amendments in January 2005) that were effective for plan years beginning on or after January 1, 2006. Based on the evidence to date, the final 403(b) regulations may well make much more fundamental changes, and, in general, these changes will affect employers that do not have as great a capacity for absorbing major change. Accordingly, the Committee believes that the general effective date of the final regulations, for both operational and form compliance, should be no earlier than January 1, 2008.

II. The final 403(b) regulations should grandfather existing 403(b) contracts from any new restrictions on participant contract rights.

It is critical that the transition to final regulations take into account the contract rights that inhere to owners of section 403(b) annuity contracts that are currently in force. Unlike the funding vehicles for other retirement plans, section 403(b) annuity contracts – because they are a contract between the employee and the insurer – typically directly provide participants with a variety of contractual rights. If the employer or the issuer wishes to modify those contractual rights, then generally there must be some basis in the contract itself for making the modifications. Under state insurance law, an employer or issuer cannot simply and unilaterally impose a restriction on a participant that is not grounded in the section 403(b) contract.

There are several changes in the proposed regulations that, if retained in final regulations, would eliminate rights that participants currently have under their annuity contracts. In particular, the proposed revocation of Revenue Ruling 90-24 and the proposed imposition of

withdrawal restrictions on amounts attributable to employer contributions will reduce participant rights. Although the operative terms of some contracts may provide a basis for taking away this right, there is little question that affected participants will have lost a significant and valuable right and there will inevitably be questions about whether such a change is permissible. Without appropriate transition, the new regulations could force issuers to choose between complying with federal requirements for tax-favored status and state law.

The imposition of new contract limitations in the past has been a source of enormous difficulty. When the Tax Reform Act of 1986 imposed in-service withdrawal restrictions on amounts attributable to salary reduction contributions to a section 403(b) contract, a number of states (and contract owners) questioned whether those restrictions could be imposed on existing contracts without contravening state insurance law. For example, when life insurance company issuers filed endorsements with the New York Insurance Department to amend existing 403(b) contracts to reflect the section 403(b)(11) withdrawal restrictions, the Department initially rejected such endorsements. Furthermore, it was the Department's position that any such restrictions could only be imposed on existing contracts with the consent of the participant. It was only after senior representatives from the then Employee Plans Division of EP/EO in the Service's National Office, as well as senior representatives from the then EP/EO Office of the Chief Counsel, directly intervened that the New York Insurance Department allowed existing 403(b) contracts to be amended to reflect the section 403(b)(11) withdrawal restrictions.

A carefully crafted grandfathering rule could avoid similar problems from arising in connection with the final regulations. In addition, such an approach would address compliance issues that otherwise would be raised by annuity contracts and custodial accounts that no longer have a nexus to an employer by reason of a prior transfer made pursuant to Revenue Ruling 90-24. In this regard, anecdotal experience suggests that there are a substantial number of such "orphan" contracts, and, without an appropriate grandfathering rule, it is far from clear how issuers or employers would go about bringing these contracts into compliance with the new rules. For example, to the extent the final regulations require greater coordination between issuers and employers, it will be very difficult, if not impossible, for the issuer of an orphan contract to establish a relationship with the employer.

Thus, the Committee believes that the most appropriate transition is to grandfather annuity contracts that are in force on the date the final regulations are published. As a threshold matter, this would preserve outstanding contractual rights, including outstanding transfer and withdrawal rights. It also would be preferable to a grandfathering rule that applies only to outstanding account balances, rather than existing annuity contracts. For example, a rule that grandfathered only existing account balances would require issuers and participants to separately track and account for any grandfathered and non-grandfathered amounts held under the same contract. The Committee believes that such tracking functions should be avoided because they would be difficult and expensive for annuity issuers to undertake and could be a source of administrative errors as well as considerable confusion for participants. These problems would be avoided by a grandfathering rule that applies at the contract level, without allowing the

commingling of grandfathered and non-grandfathered amounts under the same contract, because current law would continue to apply to all future contributions and earnings under a grandfathered contract.

We recognize that, unless properly structured, a grandfathering rule that applies to existing annuity contracts has the potential of providing an "end run" around the new regulations. To address this, the Committee believes that grandfathering treatment should only be provided to the extent that a contract has not been modified in any respect material to compliance with the final regulations. Under this principle, for example, the addition of a loan feature or the addition of a hardship feature generally would be considered material modifications because they affect the contract in a manner that is relevant to compliance with the regulations under section 403(b). In contrast, the addition of a new contract benefit, such as a new guaranteed withdrawal benefit or a new investment option, would not be a material modification because such benefits are not relevant to compliance with the requirements of section 403(b).[3] In addition, as indicated above, the continued receipt of contributions, including salary reduction, matching, employer nonelective, and rollover contributions, would not be considered a material modification (unless for some reason a contract provision relevant to compliance with section 403(b) was modified in connection with the receipt of those contributions, *e.g.*, to provide for the receipt of non-salary reduction contributions). Similarly, any changes at the employer level, *e.g.*, changes in contributions or eligibility, would not be considered material modifications since those changes do not affect the contract.

In addition to the foregoing, the treatment of transfers or exchanges merits special consideration because such transactions could, at first blush, be viewed as material modifications that would trigger a loss of grandfathering for an existing 403(b) annuity contract. However, as described above, one of the primary reasons for a grandfather rule is to address the possibility that the final regulations could effectively eliminate a valuable participant right, namely the right to transfer amounts among contracts pursuant to Revenue Ruling 90-24. Thus, the Committee believes that it is appropriate and fair to preserve such rights at least in the narrow case of transfers among grandfathered contracts. In other words, amounts could be transferred among two or more grandfathered contracts pursuant to Revenue Ruling 90-24 without causing a loss of their grandfathered status. However, under the Committee's suggested approach of grandfathering contracts (versus account balances), any contract under which amounts that had been held under a grandfathered contract were commingled with amounts that had been held under a non-grandfathered contract would not be grandfathered. Thus, for example, if the owner of a contract that was in-force on the date final regulations were published (the "old contract") made a 90-24 transfer of half of his account balance to a new 403(b) contract that was issued after that date (the "new contract"), no part of the new contract would be grandfathered, while all

[3] This approach to material modification would be generally consistent with the approach recently taken in proposed regulations that address grandfathering of nonqualified deferred compensation plans under Code section 409A. *See* Proposed Treas. Reg. section 1.409A-6(a)(4)(iv).

amounts remaining in the old contract would continue to be grandfathered. Likewise, if the owner made a transfer from the new contract to the old contract, no part of the old contract would continue to be grandfathered. Under this construct, the grandfather rule would effectively preserve only transfers or exchanges among grandfathered contracts; it would not allow companies to issue new grandfathered contracts. This is a very modest grandfather and we believe it is reasonable and appropriate.

III. Delayed effective dates should be provided for amendments to annuity contracts and governmental 403(b) arrangements.

Special consideration also is needed for life insurance companies with respect to annuity contract modifications because in many cases companies must seek approval of state insurance departments before altering their annuity contract forms or endorsements. The need to take the state approval process into account when annuity contracts have to be modified as a result of changes in the tax law has been recognized by the Treasury Department and the Internal Revenue Service previously. *See, e.g.,* Rev. Proc. 98-59, 1998-2 C.B. 729 (providing transition relief for Roth IRAs). The effective date of the final regulations should allow additional time for forms issued and used by insurers to be modified as necessary to comply with the new rules.

In particular, we recommend that the final regulations provide a special rule pursuant to which section 403(b) annuity contracts will be deemed to satisfy the new requirements of the final regulations if (1) the issuing life insurance company submits proposed contract amendments to the relevant state insurance departments within a sufficient period, *e.g.*, 180 days, after the general effective date of the final regulations and (2) the contracts are administered in accordance with applicable rules from the general effective date of final regulations. Of course, the need for relief on the submission of contract amendments is affected by the timing of the general effective date. If the general effective date is January 1, 2008, as we recommend, a shorter period may suffice, while an earlier general effective date would require the full 180 days.

In addition to the generally applicable effective date, a special effective date should be included in the final regulations for state-sponsored arrangements. The special circumstances of state and local government arrangements with respect to making changes to 403(b) arrangements, including in some cases the need for legislative action before such changes can be made, have been recognized in numerous final regulations. Given that the final section 403(b) regulations will almost certainly represent substantially new guidance on any number of issues, state and local governments will need additional time to come into compliance. For these reasons, we recommend that the regulations first become effective for governmental arrangements for taxable years next following one full calendar year from the date after the opening of the first legislative session of the governing body with authority to amend the plan, if that body does not meet continuously.

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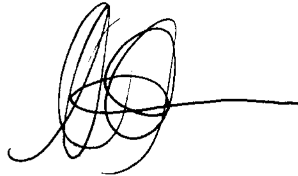
Attached for your consideration is possible draft of the effective date provisions that the Committee recommends. Thank you for your time and consideration of these matters. Please do not hesitate to contact either of the undersigned if you have any questions.

Sincerely,



Barbara N. Seymon-Hirsch

Jason K. Bortz

cc: Robert Architect (Internal Revenue Service)
William Bortz (Treasury Department)
R. Lisa Mojiri-Azad (Internal Revenue Service)
Cheryl E. Press (Internal Revenue Service)
John Tolleris (Internal Revenue Service)
Joseph F. McKeever, III (Davis & Harman LLP)

<u>DRAFT EFFECTIVE DATE PROVISION</u>

§ 1.403(b)-11 Effective dates.

(a) Except as otherwise provided in this section, §§ 1.403(b)-1 through 1.403(b)-10 apply for taxable years beginning after ~~December 31, 2005~~ **December 31, 2007**.

(b) In the case of a section 403(b) contract maintained pursuant to a collective bargaining agreement that is ratified and in effect on the date of publication of final regulations in the Federal Register, §§ 1.403(b)-1 through 1.403(b)-10 do not apply before the date on which the collective bargaining agreement terminates (determined without regard to any extension thereof after the date of publication of final regulations in the Federal Register).

(c) In the case of a section 403(b) contract maintained by a church-related organization for which the authority to amend the contract is held by a church convention (within the meaning of section 414(e)), §§ 1.403(b)-1 through 1.403(b)-10 do not apply before the earlier of –

(1) ~~January 1, 2007~~ **January 1, 2009**; or

(2) 60 days following the earliest church convention that occurs after the date of publication of final regulations in the Federal Register.

(d) Section 1.403(b)-8(c)(2) does not apply to a contract issued before ~~February 14, 2005~~ **January 1, 2008**.

(e) In the case of a section 403(b) arrangement maintained by a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing, §§ 1.403(b)-1 through 1.403(b)-10 do not apply before the date that is one full calendar year following the date after the opening of the first legislative session of the governing body with the authority to amend the plan, if that body does not meet continuously.

(f) Sections 1.403(b)-1 through 1.403(b)-10 do not apply to a section 403(b) contract issued before [insert the date of publication of final regulations in the Federal Register] (a "grandfathered contract"), unless such contract is modified in any respect that is material to compliance with the final regulations.

(1) *Example 1.* Participant A owns Contract W, which is a grandfathered contract because it was issued before [insert the date of publication of final regulations in the Federal Register]. After [insert the date of publication of final regulations in the Federal Register], A continues to make contributions to Contract W, including salary reduction contributions, employer matching contributions, nonelective employer contributions, and rollover contributions. Contract W continues to be a grandfathered contract after such contributions.

(2) *Example 2.* Participant A owns Contract W and Contract X, each of which is a grandfathered contract because it was issued before [insert the date of publication of final regulations in the Federal Register]. Pursuant to Revenue Ruling 90-24, A transfers half of his account balance under Contract W to Contract X. Both

Contract W and Contract X continue to be grandfathered contracts following the transfer.

(3) ***Example 3.*** **The facts are the same as in Example 2, except that Contract X is not a grandfathered contract because it was issued after [insert the date of publication of final regulations in the Federal Register]. Following the transfer of amounts from Contract W to Contract X, Contract W continues to be a grandfathered contract and Contract X (including the amounts transferred thereto from Contract W) continues to be a non-grandfathered contract.**

(4) ***Example 4.*** **The facts are the same as in Example 3, except that A transfers half of his account balance from Contract X to Contract W (rather than from Contract W to Contract X). Following the transfer, Contract W is no longer a grandfathered contract.**

(5) ***Example 5.*** **Participant B owns Contract Y, which is a grandfathered contract because it was issued prior to [insert the date of publication of final regulations in the Federal Register]. The issuer of Contract Y adds a new variable investment option under the contract, increases the guaranteed minimum interest rate under the contract's fixed investment option, and adds a new income distribution option to the contract. Contract Y continues to be a grandfathered contract after these changes because none of them is material to compliance with the final regulations.**

(6) ***Example 6.*** **The facts are the same as Example 5, except that the issuer of Contract Y also adds two new provisions that give B the right to take a loan from the contract and to request a hardship withdrawal. Neither of these rights was provided under Contract Y prior to the changes. Following the changes, Contract Y is no longer a grandfathered contract because the changes are material to compliance with the final regulations**

(7) ***Example 7.*** **Participant C owns Contract Z, which is a grandfathered contract because it was issued prior to [insert the date of publication of final regulations in the Federal Register]. The employer that sponsors the 403(b) plan in connection with which Contract Z was issued changes the contribution levels and eligibility requirements under the plan. Contract Z continues to be a grandfathered contract because no changes were made to the contract.**

(g) In the case of a section 403(b) contract that is required to be amended to comply with these regulations and cannot be modified without first seeking the approval of state insurance departments, the contract will be deemed amended if:

(1) the issuing life insurance company submits the relevant proposed contract amendments to the relevant state insurance departments within 180 days after January 1, 2008; and

(2) the contract is administered in accordance with §§ 1.403(b)-1 through 1.403(b)-10 after January 1, 2008.

The Committee of Annuity Insurers
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AXA Equitable Life Insurance Company, New York, NY
F & G Life Insurance, Baltimore, MD
Fidelity Investments Life Insurance Company, Boston, MA
Genworth Financial, Richmond, VA
Great American Life Insurance Co., Cincinnati, OH
Guardian Insurance & Annuity Co., Inc, New York, NY
The Hanover Insurance Group, Worcester, MA
Hartford Life Insurance Company, Hartford, CT
ING North America Insurance Corporation, Atlanta, GA
Jackson National Life Insurance Company, Lansing, MI
John Hancock Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Lincoln Financial Group, Fort Wayne, IN
Merrill Lynch Life Insurance Company, Princeton, NJ
Metropolitan Life Insurance Company, New York, NY
Nationwide Life Insurance Companies, Columbus, OH
New York Life Insurance Company, New York, NY
Northwestern Mutual Life Insurance Company, Milwaukee, WI
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
The Phoenix Life Insurance Company, Hartford, CT
Protective Life Insurance Company, Birmingham, AL
Prudential Insurance Company of America, Newark, NJ
Sun Life of Canada, Wellesley Hills, MA
USAA Life Insurance Company, San Antonio, TX

The Committee of Annuity Insurers was formed in 1982 to participate in the development of federal tax and securities law policies with respect to annuities. The member companies of the Committee represent over half of the annuity business in the United States.