Internal Revenue Service Department of the Treasury

Washington, DC 20224

Significant Index No: 403.04-00

Person to Contact:

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Refer Reply to:

OP:E:EP:T:2

Date: MAR 8 1999

Attn: **********

Legend:

State A = **********

Employer M = **********

Plan X = **********

Plan Y = **********

Plan Z = **********

Dear M**********

This is in response to a ruling request dated November 7, 1997, as supplemented by correspondence dated December 22, 1998, submitted on your behalf by your authorized representative, with respect to an arrangement described under section 403(b) of the Internal Revenue Code (Code).

The following facts and representations have been submitted on your behalf:

Plan X, a plan intended to allow elective deferrals of salary under section 403(b) of the Code, was established effective March 1, 1981, by Employer M, an organization in State A which is exempt from tax under section 501(c)(3) of the Code, and was restated effective January 1, 1987.

Under sections 2.1 and 1.15 of Plan X, all regular exempt (class 3) employees of Employer M are eligible to participate in Plan X, except employees who are covered by a collective bargaining agreement, employees who are nonresident aliens with no U.S. source income, leased employees, and employees who are current participants in either Plan Y or Plan Z, other arrangements described under section 403(b) of the Code and maintained by Employer M. Eligible employees commence participation in Plan X on the first day of the payroll period following the completion of a year of service (an anniversary year in which he or she has at least 1000 hours of service).

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Under article III of Plan X, three types of contributions may be made: employer contributions, salary reduction contributions, and after tax contributions. Sections 3.2 and 3.2 of Plan X provide that participants may make salary reduction contributions or after tax contributions. Salary reduction contributions are made pursuant to a salary reduction agreement, which may be made or changed only once per calendar quarter.

Under section 3.1 of Plan X, for each payroll period for which an eligible employee makes salary reduction contributions or after-tax contributions equal to 5 percent of basic compensation, Employer M will make employer contributions for the employee equal to 10 percent of the employee's basic compensation for the payroll period. "Basic compensation" is defined in section 1.5 of Plan X to include regular salary and any pay for paid time off which is paid in cash (including amounts deferred pursuant to Code sections 125, 401(k), 402(e)(3), 402(h) or 403(b)). Compensation is also limited to the extent required by section 401(a)(17), as incorporated by section 403(b)(12). Under section 4.3 of Plan X, employer contributions and after tax contributions for highly compensated participants, taken together, may not exceed the limits of section 401(m) of the Code. Employer and after tax contributions are also subject to the other Code limitations discussed below.

Under section 4.2 of Plan X, the total amount of employer and salary reduction contributions to be made with respect to a participant for a calendar year may not exceed the participant's exclusion allowance for the year under section 403(b) of the Code, and the total amount of employer, salary reduction and after tax contributions made with respect to a participant for a calendar year may not exceed the maximum permitted annual addition for the year under section 415. In determining the applicable limits under sections 402(g), 403(b)(2), and 415, any elective deferrals made under Plans Y and Z for the participant are taken into account.

Under section 10.3 of Plan X, contributions are invested as the participant directs among such annuity contracts issued by insurance companies, or custodial accounts investing in the shares of one or more regulated investment companies, as Employer M makes available from time to time. Each annuity contract available under Plan X shall be nontransferable as provided in section 1.3. Under section 3.4 of Plan X, employer, salary reduction, and after tax contributions are paid over to the annuity contract issuer or custodial account custodian as soon after each payroll period as the amounts can be reasonably segregated.

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Under article VI of Plan X, participants are at all times fully vested in all contributions (and attributable income) made under Plan X. Under articles VII and IX of Plan X, except as may otherwise be provided in a qualified domestic relations order, amounts held in an annuity contract or custodial account may be withdrawn no earlier than a participant's death or other separation from service.

Under section 7.1 of Plan X, all amounts are payable in a manner consistent with section 403(b)(10) of the Code. In general, all amounts held in an annuity contract or custodial account, other than those held as of December 31, 1986, are payable to a participant beginning no later than the April 1 following the calendar year in which he or she attains age 70 1/2 or retires, whichever is later, as required by section 403(b)(10). Plan X does not provide for any loans, hardship withdrawals, or any other withdrawals while the participant is an employee. Finally, under section 8.2(c) of Plan X, all annuity contracts and custodial accounts will also comply with direct rollover rules similar to those required by section 401(a)(31), as require by section 403(b)(10) of the Code.

Under the "Establishment and Purpose" section of Plan X, to the extent any Plan X provision is inconsistent with any annuity contract or custodial account agreement provision, the Plan X provision will control.

Based on the foregoing facts and representations, your authorized representative has requested rulings that:

(1) Plan X satisfies the requirements of section 403(b) of the Code;

(2) contributions, including elective deferrals under Plan X are not includible in the income of the participants so long as the amounts do not exceed the limitations of section 403(b) of the Code; and,

(3) all distributions from Plan X will be taxed under sections 72 and 403(b)(1) of the Code.

Section 403(b)(1) of the Code provides that amounts contributed by an employer to purchase an annuity contract for an employee are excludable from the gross income of the employee in the year contributed to the extent of the applicable "exclusion allowance" as defined in section 403(b)(2) of the Code, provided (1) the employee performs services for an employer which is exempt from tax under section 501(a) of the Code as an organization described in section 501(c)(3), or the employee performs services for an educational institution (as defined in section

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170(b)(1)(A)(ii) of the Code) which is a state, a political subdivision of a state, or an agency or instrumentality of any one or more of the foregoing; (2) the annuity contract is not subject to section 403(a) of the Code; (3) the employee's rights under the contract are nonforfeitable except for failure to pay future premiums; (4) such contract is purchased under a plan which meets the nondiscrimination requirements of section 403(b)(12) of the Code, except in the case of a contract purchased by a church; and, (5) in the case of a contract purchased under a plan which provides a salary reduction agreement, the plan meets the requirements of section 401(a)(30). Section 403(b)(1) of the Code provides further that the employee shall include in his gross income the amounts actually distributed under such contract in the year distributed as provided in section 72 of the Code.

Section 403(b)(1)(E) of the Code provides that in the case of a contract purchased under a plan which provides a salary reduction agreement, the contract must meet the requirements of section 401(a)(30) of the Code. Section 401(a)(30) of the Code requires a Code section 403(b) arrangement which provides for elective deferrals to limit such deferrals under the arrangement, in combination with any other qualified plans or arrangements providing for elective deferrals of an employer maintaining such plan, to the limitation in effect under section 402(g)(1) of the Code for taxable years beginning in such calendar year.

Except as provided in section 403(b)(7) of the Code, a custodial account described in section 403(b)(7) is treated as an annuity contract for all purposes of the Code.

Section 403(b)(7) provides that the amounts paid by a qualifying employer to a custodial account which satisfies the requirements of section 401(f)(2) shall be treated as amounts contributed by the employer for an annuity contract for his employee if the amounts are to be invested in regulated investment company stock to be held in that custodial account, and 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, encounters financial hardship.

Section 403(b)(7)(B) provides that a custodial account which satisfies the requirements of section 401(f)(2) shall be treated as an organization described in section 401(a) solely for purposes of subchapter F and subtitle F with respect to amounts received by it (and income from investment thereof).

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Section 401(f)(2) of the Code provides that a custodial account shall be treated as a qualified trust under section 401 if the assets thereof are held by a bank (as defined in section 408(m)), or another person who demonstrates to the satisfaction of the Secretary that the manner in which he will hold the assets will be consistent with the requirements of section 401.

Section 402(g)(1) of the Code provides, generally, that the elective deferrals of any individual for any taxable year shall be included in such individual's gross income to the extent the amount of such deferrals exceeds $7,000.

Section 402(g)(4) of the Code provides that the limitation under paragraph (1) shall be increased (but not to any amount in excess of $9,500) by the amount of any employer contributions for the taxable year used to purchase an annuity contract under section 403(b) of the Code under a salary reduction agreement.

Section 402(g)(8) of the Code provides that in the case of a qualified employee of a qualified organization, with respect to employer contributions to purchase an annuity contract under section 403(b) of the Code under a salary reduction agreement, the limitation of section 402(g)(1) of the Code, as modified by section 402(g)(4) of the Code, for any taxable year shall be increased by whichever of the following is the least: (i) $3,000; (ii) $15,000, reduced by amounts not included in gross income for prior taxable years by reason of this paragraph, or (iii) the excess of $5,000 multiplied by the number of years of service of the employee with the qualified organization over the employer contributions described in paragraph (3) made by the organization on behalf of such employee for prior taxable years (determined in the manner prescribed by the Secretary). A "qualified organization" for these purposes means any education organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches and includes any organization described in section 414(e)(3)(B)(ii) of the Code, and a "qualified employee" means any employee who has completed 15 years of service with the qualified organization.

Section 1.403(b)-1(b)(3) of the Income Tax Regulations provides, in pertinent part, that the exclusion allowance is applicable to amounts contributed by the employer for an annuity contract as a result of an agreement with an employee to take a reduction in salary, or to forego an increase in salary, but only to the extent such amounts are earned by the employee after the agreement becomes

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effective. The agreement must be legally binding and irrevocable with respect to amounts earned while the agreement is in effect and the employee is not permitted to make more than one such agreement with his employer during any taxable year. The exclusion shall not apply to any amounts which are contributed under any further agreement made by such employee during the same taxable year beginning after such date. The employee may be permitted, however, to terminate the entire agreement with respect to amounts not yet earned.

Effective for tax years beginning after December 31, 1995, section 1450(a) of the Small Business Job Protection Act of 1996 ("SBJPA") provides that the frequency that an employee is permitted to enter into a salary reduction agreement, the salary to which such an agreement may apply, and the ability to revoke such an agreement shall be determined under the rules applicable to cash or deferred elections under section 401(k) of the Code.

Section 415(a)(2) of the Code provides, in relevant part, that an annuity contract described in section 403(b) shall not be considered as an annuity contract described in section 403(b) unless it satisfies the section 415 limitations. In the case of an annuity contract described in section 403(b), the preceding sentence applies only to the portion of the annuity contract exceeding the section 415 limitations and the amount of the contribution for such portion shall reduce the exclusion allowance as provided for by section 403(b)(2).

Under section 415(c)(1) of the Code, contributions to a section 403(b) plan for a limitation year are generally limited to the lesser of: (A) $30,000 or (B) 25% of compensation.

Section 403(b)(10) of the Code requires that arrangements pursuant to section 403(b) of the Code must satisfy requirements similar to the requirements of section 401(a)(9) of the Code with respect to benefits accruing after December 31, 1986, in taxable years ending after such date. In addition, this section requires that, for distributions made after December 31, 1992, the requirements of section 401(a)(31) of the Code are met. Section 401(a)(31) of the Code contains provisions for direct rollovers of distributions made after December 31, 1992.

Section 401(a)(9) of the Code provides, generally, for a mandatory benefit commencement date at age 70 1/2 and specifies required minimum distribution rules for the payment of benefits from qualified plans. For taxable years beginning after December 31, 1996, section 1404(a) of the

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SBJPA amended section 401(a)(9) to provide that the term, "required beginning date", means April 1 of the calendar year following the later of the calendar year in which the employee attains age 70 1/2, or the calendar year in which the employee retires.

Section 403(b)(11) of the Code provides, generally, that section 403(b) annuity contract distributions attributable to contributions made pursuant to a salary reduction agreement (within the meaning of section 402(g)(3)(C) of the Code) may be paid only when the employee attains age 59 1/2, separates from service, dies, becomes disabled (within the meaning of section 72(m)(7) of the Code), or in the case of hardship. Such contract may not provide for the distribution of any income attributable to such contributions in the case of hardship.

With respect to your ruling requests, you represent that Employer M, an employer described in section 403(b) of the Code, has established Plan X as its section 403(b)(1) or 403(b)(7) program for certain of its employees. A participant's salary reduction contributions are fully vested and nonforfeitable at all times. Plan X is not subject to section 403(a). The restrictions on transferability are present in Plan X as required by section 401(g).

Plan X correctly limits, under section 403(b)(12) of the Code, the distributions made pursuant to the salary reduction agreement to attainment of age 59 1/2, separation from service or hardship. In addition, Plan X satisfies the section 403(b)(10) and 402(g)(2) requirements and limits on contributions in accordance with sections 403(b)(2) and 415 of the Code.

Plan X also properly provides rules, under section 8.2(c), for direct rollovers and transfers as required by section 401(a)(31) of the Code.

Plan X complies, under sections 3.4 and 10.3, with all of the requirements of section 403(b)(7) of the Code, including the requirement that contributions are invested in custodial accounts investing in the shares of one or more regulated investment companies.

Accordingly, based on the foregoing law and facts, we conclude with respect to ruling request number one that Plan X satisfies the requirements of section 403(b) of the Code.

With respect to ruling requests number two and three, since we concluded above that Plan X satisfies the requirements of section 403(b) of the Code, we conclude that

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contributions, including elective deferrals under Plan X, are not includible in the income of the participants so long as the amounts do not exceed the limitations of section 403(b) of the Code, and that all distributions from Plan X will be taxed under sections 72 and 403(b)(1) of the Code.

This ruling does not extend to any operational violations of section 403(b) by Plan X, now or in the future. This ruling has not addressed whether Plan X meets the nondiscrimination requirements of section 403(b)(12) of the Code, where applicable, in either form or operation.

A copy of this letter has been sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Chief, Employee
Plans Technical Branch 2

Enclosures:
Deleted Copy of this Letter
Notice of Intention to Disclose