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INTERNAL REVENUE SERVICE

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OP:E:EP:T:2

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Attn: **********
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Legend:
State A = **********
Employer M = **********
Plan X = **********
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Dear M**********

This is in response to a ruling request dated November 7, 1997, 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.

Under section 3.1 of Plan X, all employees of Employer M are eligible to participate in Plan X. An eligible employee becomes a participant under Plan X by agreeing to make elective deferrals pursuant to a salary reduction agreement. Under section 4.1 of Plan X, such a salary reduction agreement shall be made or changed only once per calendar year, be in writing and signed by the participant prior to the first pay check for which such agreement is to be effective, provide for a reduction in the compensation paid to the participant by Employer M in exchange for the contribution of a like amount by Employer M to the applicable annuity contract or custodial account on behalf of said participant, specify the amount of elective deferral contributions, be binding upon the participant with respect to compensation payable while in effect, be terminable at any time, with respect to compensation not year payable, with any termination effected by filing written notice with Employer M, not require an amount of contribution which, when added to applicable contributions under any other section 403(b) arrangement would exceed the participant's maximum "exclusion allowance" under section 403(b) or the limitation on "annual additions" under section 415, not permit an aggregate amount of contributions which, when added to elective deferrals made on the participant's behalf under any other section 403(b) or 401(k) program sponsored by Employer M for a participant's taxable year, exceed $9,500 (or such higher limit as may be in effect for the year under

section 402(g)(1) of the Code and apply only to compensation payable after the agreement is in effect.
In the event that an amount is included in a participant's gross income as a result of an excess deferral under Code section 402(g) and the Plan X Administrator receives proper notification of this excess deferral, the excess deferral may be distributed to the participant, provided that if the distribution is made within the same taxable year as the contribution, then the distribution of the excess deferral must be made after the excess contribution is received by the plan and must be designated by the plan and the participant as an excess deferral distribution.

Under section 4.2 of Plan X, the total amount of 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 or the maximum permitted annual addition for the year under section 415. In determining the applicable limits under Plan X, any elective deferrals made by the participant to other plans maintained by Employer M are taken into account.

Under section 4.4 of Plan X, a participant is at all times fully vested in all contributions made under Plan X and income attributable to them.

Section 4.5 of Plan X provides that contributions are invested as the participant directs from 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 shall be nontransferable, as provided under section 2.3 of Plan X. Section 4.3 of Plan X provides that elective deferral contributions must be paid over to the annuity contract issuer or custodial account custodian no later that 90 days after the date on which the compensation to which the contributions relate is paid, and are therefore made no less frequently than once per year.

Articles 5 and 6 of Plan X provides that amounts held in an annuity contract or custodial account may be withdrawn no earlier than a participant's separation from service, attainment of age 59 1/2, disability, death, or immediate and heavy financial hardship.

Pursuant to section 5.3 of Plan X, a participant may withdraw amounts to satisfy an immediate and heavy financial need as a result of: uninsured medical expense costs; the purchase of a principal residence of the participant (but not mortgage payments); tuition payments, related educational fees, or room and board for the next 12 months or post-secondary education for the participant or his or her spouse, children or dependents, or payments to prevent eviction or foreclosure on the mortgage of the participant's principal residence. Payments may include the amount of federal, state or local income taxes, but shall not include any income after December 31, 1988 that is attributable to participant contributions or, in the case of a custodial account, any amount allocated after December 31, 1988 that is not a participant contribution.

Under section 5.4 of Plan X, a participant may borrow against his or her annuity contract or custodial account in an amount that does not exceed the lesser of (1) 50 percent of contributions plus allocable earnings, or (2) $50,000 (reduced by the highest aggregate outstanding loan balance under plans maintained by Employer M during the year preceding the loan). Loans are available to all participants on a reasonable equivalent basis; not made available to highly compensated employees in an amount greater than the amount made available to other employees; made under written procedures; adequately

secured; made at a reasonable rate of interest; amortized evenly and at least quarterly; and, repayable within 5 years (except amounts used to purchase a principal residence). For any participant who is married on the date of a hardship withdrawal or loan, spousal consent is required within 90 days prior to such withdrawal or loan.

Under section 6.3 of Plan X, all amounts are payable in a manner consistent with section 403(b)(10) of the Code. Generally, 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). Further, all amounts held in an annuity contract or custodial account, including the balance as of December 31, 1986, will be payable in accordance with the incidental benefit rules as determined under section 403(b)(10).

Pursuant to section 6.1 of Plan X, for participants who are married on the first date that a benefit is payable ("annuity starting date") and whose vested balances under Plan X exceed $3,500, benefits shall be paid as a qualified joint and survivor annuity, paying a lifetime periodic benefit to the participant, and on the participant's death, to the surviving spouse in an amount between 50 and 100 percent of the amount payable to the participant. A participant may waive the qualified joint and survivor annuity and select another form of benefit available under the annuity contract or custodial account, provided that written spousal consent is made within 90 days prior to the annuity starting date, and such consent specifies the form of benefit selected and any non-spousal beneficiaries, and acknowledges the effect of such consent.

Under section 6.2 of Plan X, death benefits for an unmarried participant who dies before his or her annuity starting date are paid to the beneficiary designated by the participant. Death benefits for married participants who die before their annuity starting date are paid to his or her spouse unless, before the participant's death, the surviving spouse had consented to the change in a manner consistent with Code section 401(a)(11) for distributions to which Code sections 401(a)(11) and 417 do not apply. For all other distributions, the surviving spouse will be entitled to receive between 50 and 100 percent of the present value of the participant's annuity contract or custodial account, with the remaining portion paid to the beneficiaries designated in the contract or account. A participant may waive the spouse's payment, provided such waiver is made in the time period between the participant reaching the age of 35 and the death of the participant, and such waiver includes spousal consent as described above.

Under section 6.3 of Plan X, a participant whose balance under the plan is greater than $3,500 may not have his or her balances immediately distributed without his or her consent. All amounts held in an annuity contract or custodial account shall become payable no later than the required beginning date in section 206(a) of the Employee Retirement Income Security Act of 1974 or Code sections 403(b)(10) and 401(a)(9) (i.e., the April 1 following the calendar year in which the participant attains age 70 1/2), whichever is earlier. Benefits are payable in lump sums, periodic payments over the life, joint lives, or life expectancy of the participant and his or her beneficiary as determined under Code sections 403(b)(10) and 401(a)(9). Benefits payable upon death before the participant's annuity starting date are distributed within 5 years, or in accordance with exemptions in Code section 401(a)(9)(B). Benefits payable upon death after the annuity starting date are paid at least as rapidly as under the method of distribution in effect at the time of death.

Under section 6.4 of Plan X, all annuity contracts and custodial accounts provide that a participant who is entitled to receive an eligible rollover distribution within the meaning of sections 403(b)(10) and 401(a)(31) of the Code may elect to have the distribution paid directly, in whole or in part, to an individual retirement account or annuity described in section 408 of the Code, or to a tax-sheltered annuity plan described in section 403(b) which is a defined contribution plan and which permits the acceptance of rollover distributions.

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 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 contract 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 employer 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).

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 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 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 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 a 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 contributions in accordance with sections 403(b)(2) and 415 of the Code.

Plan X also properly provides rules, under section 6.4, for direct rollovers and transfers as required by section 401(a)(31) of the Code.

Plan X complies, under section 4.5, 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 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,

Joyce E. Floyd
Chief, Employee
Plans Technical Branch 2

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