significant Index # 403.04-00

199922065

**Internal Revenue Service**

Department of the Treasury

Washington, DC 20224

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Telephone Number:
OP:E:EP:T:2
Refer Reply to:

Attn: **********
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Date: MAR 8 1999

Legend:

State A = **********
Employer M = **********
Plan X = **********
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Plan Y = **********

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, which provides for employee and employer contributions under section 403(b) of the Code, was established effective January 1, 1989, by Employer M, an organization in State A which is exempt from tax under section 501(c)(3) of the Code. Plan X was amended and restated effective January 1, 1994.

Under sections 1.16 and 3.2 of Plan X, any staff nurse of Employer M whose employment is governed by a collective bargaining agreement with Organization P is eligible for participation in Plan X, except leased employees, and employees who are current participants in Plan Y either by election or pursuant to the 1978 collective bargaining agreement. An eligible employee becomes a participant under Plan X on the first day the employee completes 1,000 or more hours of service in a computation period, or, in the case of an employee who commenced employment prior to March 1, 1995 and was regularly scheduled to perform 40 hours of service per payroll period, participation begins upon completion of the first hour of service. Additionally, an employee may participate in the plan upon the completion of a six-month period as an eligible employee, provided that during such

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period the eligible employee is regularly scheduled to work at least 40 hours per payroll period.

Under Article IV of Plan X, the three types of contributions that may be made are basic, matching and elective. Under section 4.2 of Plan X, for each payroll period, Employer M will make basic contributions for a participant equal to six percent of the participant's salary for the payroll period plus any amounts paid in cash under Employer M's paid time off policy, but excluding bonuses, overtime pay, shift differential, and money earned while working on relief status. Salary is limited to the extent required by section 401(a)(17), as incorporated by section 403(b)(12) of the Code.

Under section 4.1 of Plan X, participants may make elective contributions, which are made pursuant to a salary reduction agreement. A participant may enter into or change a salary reduction agreement only once per calendar quarter, and the agreement shall 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 contributions, be binding upon the participant with respect to compensation payable while in effect, be terminable at any time, with respect to salary not yet payable, with any termination effected by filing written notice with the plan administrator, not require an amount of contribution which 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)) and apply only to compensation payable after the agreement is in effect.

Under section 4.3 of Plan X, on behalf of any employee who has made elective contributions in an amount equal to or greater than two percent of gross earnings for a pay period, Employer M will make contributions equal to one percent of the participant's salary for such pay period. Under sections 4.1 and 4.4 of Plan X, the participants' contributions for a calendar year may not exceed the participant's exclusion allowance for the year under section 403(b) or the Code section 402(g) limitation. Section 4.5 of Plan X provides that amounts credited to a participant's

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accounts (not including transfers or rollovers from other plans) for any year are not to exceed the limitations of section 415 of the Code. In determining the applicable limits under sections 402(g), 403(b) and 415 of the code, any contributions made under other arrangements described under section 403(b) maintained by Employer M are taken into account.

Under section 4.9 of Plan X, contributions are invested as the participant directs from among such annuity contracts or custodial accounts as Employer M makes available from time to time. Each annuity contract available under Plan X shall be nontransferable as provided in section 5.3(g) of Plan X. Under section 4.7 of Plan X, participants are at all times fully vested in the portion of his or her accumulations under his or her annuity contracts and custodial accounts.

Under article V of Plan X, amounts held in an annuity contract or custodial account may be withdrawn early only under a qualified domestic relations order, or upon a participant's separation from service, disability, death, or in the case of salary reduction contributions, attainment of age 59 1/2, or immediate and heavy financial hardship.

Under section 5.3(e) of Plan X, all amounts are payable in a manner consistent with section 401(a)(9) of the Code. In general, all amounts held in an annuity contract or custodial account 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 the calendar year in which he or she retires, whichever is later, as required by section 403(b)(10). Under section 5.7 of Plan X, early withdrawals to satisfy an immediate and heavy financial need are made only (1) to purchase (excluding mortgage payments) or prevent eviction from or foreclosure on a principal residence, (2) to pay medical expenses or tuition for the next semester or quarter of post-secondary education for the participant, his or her spouse or dependents, or (3) to pay funeral expenses resulting from an immediate family member's death. Finally, under section 5.10 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 required by section 403(b)(10) of the Code.

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;

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(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.

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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).

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

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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

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

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Plan X also properly provides rules, under section 5.10, for direct rollovers and transfers as required by section 401(a)(31) of the Code.

Plan X complies with all of the requirements of section 403(b)(7) of the Code.

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,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Chief, Employee
Plans Technical Branch 2

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