Significant Index No: 403.04-00

199921058

Internal Revenue Service Department of the Treasury

Washington, DC 20224

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Attn: ********** Date:
********** MAR 4 1999

Legend:

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

This is in response to a ruling request dated November 14, 1996, as supplemented by correspondence dated May 20 and July 17, 1998, and January 5 and February 9, 1999, submitted on your behalf by your authorized representative, with respect to an arrangement described under sections 403(b)(1) and (b)(7) of the Internal Revenue Code (Code).

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

Employer M, a State A school corporation, effective January 1, 1996 reduced the terms of its section 403(b) plan to writing in one document, Plan X, for the purpose of continuing to provide certain benefits to eligible employees on and after January 1, 1996. Employer M is an educational organization described in section 170(b)(1)(A)(ii) of the Code and an instrumentality of State A.

Pursuant to sections 3.02 and 3.04 of Plan X, rollover contributions and salary reduction contributions only are permitted. There are no nonelective employer contributions nor employer matching contributions. Contributions under Plan X are applied to individual annuities issued to each participant, who may purchase such annuities from any of fourteen different section 403(b) vendors. Section 2.02(d) of Plan X defines "annuity contract" as (1) an individual or group annuity contract, fixed or variable, issued by a life insurance company authorized to do business in State A, which provides for periodic payments at regular intervals whether for a period certain or for one or more lives, or (2) a custodial account as defined in section 403(b)(7) of the Code held by a bank or an approved non-bank trustee or

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custodian under section 401(f), the assets of which are invested exclusively in regulated investment company stock.

Section 3.02 of Plan X provides that a participant who is an eligible employee may enter into a written salary reduction agreement with Employer M, whereby a participant agrees to contribute each pay period pre-tax contributions to Plan X of a specified dollar amount from his/her compensation. The salary reduction agreement is legally binding and is irrevocable with respect to amounts earned while the agreement is in effect. The salary reduction agreement applies only to amounts earned after such agreement is effective. The salary reduction agreement also provides that an employee will not be permitted to make more than one such agreement during the calendar year but may make, change or discontinue the agreement nonretroactively.

Under section 4.02(a) of Plan X, elective deferrals made on behalf of any employee may not exceed the limitation in effect under section 402(g)(1) of the Code during the employee's taxable year, as increased by Code sections 402(g)(4) and (8) applicable to such year. elective deferrals which exceed the limit during the year are distributed to the participant according to the procedure set forth within section 4.02(b) of Plan X.

Pursuant to section 4.04 of Plan X, the maximum addition to a participant's account during any calendar year shall not exceed the lesser of $30,000 (or, if greater, or fourth of the dollar limitation in effect under section 415(b)(1)(A) of the Code), or 25 percent of the participant's annual compensation as defined in section 415(c)(3) of the Code. However, a participant may elect one of the alternative limits set forth in section 415(c)(4) of the Code if the participant is eligible for such election.

Section 4.03 of Plan X provides generally that the total contributions to Plan X may not exceed the participant's maximum exclusion allowance. Under this section, the participant's exclusion allowance equals the product of (1) twenty percent; (2) the participant's years of service; and the participant's includible compensation, reduced by amounts previously excludable (i.e., (i) amounts contributed by Employer M to a 403(b) plan in prior plan years, (ii) amounts contributed by Employer M or any other employer in prior plan years to a qualified cash or deferred arrangement under section 402(g)((3) of the Code or a simplified employee pension under section 408(k)(6) of the Code, or to an eligible state deferred compensation plan under section 457(a) which were excludable from the participant's gross income for such years, and (iii) amounts accrued by the participant in prior plan years under a plan

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qualified under section 401(a) of the Code or amounts contributed toward the purchase of an annuity contract under a plan which meets the requirements of section 404(a)(2) of the Code).

Pursuant to section 2.02(d) of Plan X, each annuity contract purchased under the plan must provide that each participant's rights thereunder are nonforfeitable at all times. Section 11.02 of Plan X provides that no benefit under the plan shall be subject to transfer, assignment or alienation.

Article VI of Plan X provides that distributions must satisfy the requirements of section 401(a)(9) of the Code and/or the incidental death benefit requirement. Plan X is not subject to section 403(a) of the Code.

Section 6.01(b) of Plan X provides, generally, that amounts in a participant's account held under a Code section 403(b)(7) custodial account may not be distributed prior to the date such participant (1) attains age 59 1/2, (2) separates from service, (3) dies, (4) becomes disabled, or (5) incurs a financial hardship.

Under section 6.03 of Plan X, generally, distribution of a participant's interest must begin not later than April 1 of the calendar year following the year in which such participant attains age 70 1/2, except for those portions of the account balance which accrued prior to January 1, 1987. Such required distribution may be made over the life of the participant and a designated beneficiary (or over a period not extending beyond the life expectancy of the participant or the life expectancies of the participant and a designated beneficiary).

The pre-1987 account balances of a participant must be distributed to such participant no later than April 1 of the calendar year following the year in which the participant attains age 75. Such required distribution must be made in accordance with the minimum incidental benefit distribution rules over the life of the participant or over the lives of the participant and a designated beneficiary.

Under section 6.01 of Plan X, if distribution of a participant's interest has begun and the participant dies before the entire interest in his or her account is distributed, the remaining portion of such interest must be distributed at least as rapidly as under the method of distribution used at the date of death. If the participant had not begun distributions before his or her death, the participant's entire interest must be distributed to the designated beneficiaries within five years after the death

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of such participant. If such designated beneficiary is the surviving spouse of the participant, the date on which distributions are required to begin shall not be earlier than the date on which the participant would have attained age 70 1/2.

Article VII of Plan X provides that a distributee may elect to have any portion of an eligible rollover distribution paid directly to an eligible retirement plan specified by a distributee in a direct rollover. A "direct rollover" is defined as a payment by Plan X to an eligible retirement plan specified by a distributee. An "eligible rollover distribution" is defined as any distribution of all or any portion of the balance to the credit of the distributee, except that it does not include any distribution that is one of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the distributee or the joint lives (or joint life expectancies) of the distributee and his designated beneficiary, or for a specified period of ten years or more. The term also does not include required minimum distributions under section 401(a)(9) of the Code, any distribution which is not subject to federal income tax withholding or any other distribution which is not considered an eligible rollover distribution under section 402 of the Code and the regulations thereunder. Article VII also defines "eligible retirement plan" as generally meaning an individual retirement account as described in section 408(a) and (b) of the Code, or an annuity under section 403(b) of the Code that accepts the distributee's eligible rollover distribution. However, in the case of distribution to a surviving spouse, an eligible retirement plan means an individual retirement arrangement or an individual retirement annuity.

Based on the foregoing facts and representations, your authorized representative has requested a ruling that Plan X satisfies the requirements of the Code as applicable to a program described under section 403(b) and amounts contributed on behalf of employees by Employer M (pursuant to salary reduction agreements) shall be excluded from the employees' gross income in the year of the contribution to the extent such amounts do not exceed the applicable limits described in 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

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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 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 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)

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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

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employee to take a reduction in salary, or to forego an increase in salary.

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 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

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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 request, you represent that Employer M, is an employer which is an instrumentality of State A and that employees for whom annuity contracts are purchased perform services for an education organization described in section 170(b)(1)(A)(ii) of the Code. 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 provides an appropriate manner for participants to defer a portion of their compensation through legally binding salary reduction agreements. Plan X properly limits the amounts that may be contributed during a year to the limitations imposed by sections 402(g), 401(a)(30) and 403(b)(1)(B) of the Code. A participant's salary reduction contributions are fully vested and nonforfeitable at all times.

Plan X correctly limits, under section 403(b)(11) of the Code, the distributions made pursuant to the salary reduction agreement to attainment of age 59 1/2, separation from service, death, disability 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.

Additionally, Plan X requires that minimum distributions be made to individuals in a manner consistent with the requirements imposed under section 401(a)(9) of the Code.

Plan X also properly provides rules, under Article VI, 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, 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 your ruling request that Plan X satisfies the requirements of section 403(b) of the Code and

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amounts contributed on behalf of employees by Employer M (pursuant to salary reduction agreements) shall be excluded from the employees' gross income in the year of the contribution to the extent such amounts do not exceed the applicable limits described in the Code. .

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. This ruling does not extend to any operational violations of section 403(b) by Plan X, now or in the future.

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