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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Uniform Issue List: 403.04-04

Contact Person:

Telephone Number:

In Reference to:

Date: JAN 12 2000

T:EP:RA:T2

Attn:

Legend

Employer M =
Plan X =
Custodian O
Company N =

Dear

This letter is in response to a request for a ruling request dated December 19, 1997, as supplemented by correspondence dated April 9, 1999, May 12, 1999, and June 29, 1999, which was submitted on your behalf by your authorized representative, concerning an arrangement described under section 403(b) of the Internal Revenue Code ("Code").

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

Employer M is a nonprofit organization exempt from federal income taxation under section 501(c)(3) of the Code. Effective January 1, 1982, Employer M adopted Plan X for the benefit of its employees. At that time, Plan X was funded through the use of tax-sheltered annuity contracts with Custodian N. However, in 1997 Employer M decided to change the fundholder to which future contributions would be deposited and entered into an agreement with Custodian O to provide funding through mutual funds held in a custodial account. Although employees may continue to keep their existing funds in accounts with Custodian N, new contributions will be placed in custodial accounts with Custodian O. You represent that both, annuity contracts under Code section 403(b)(1) and custodial accounts under section 403(b)(7) are authorized by Plan X.

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Under Plan X, eligible employees may elect to defer compensation into Plan X on pretax basis. In addition, Employer M may choose, on a discretionary basis, to make a contribution on behalf of the eligible employees in Plan X. Discretionary contributions are allocated to the accounts of eligible employees in proportion to compensation. Eligible employees may elect to make salary deferral contributions to Plan X anytime after their date of hire. They become eligible to receive employer contributions as of the first day of the month following their completion of three months of service with Employer M.

Before 1997, no formal, integrated plan document had been established for Plan X. Prior to that time, the Plan documentation consisted of an amalgamation of documents, including annuity contracts issued by Custodian N; descriptions of the programs provided to the employees; and other communication materials. To formalize and clarify Plan X's provisions, and to ensure that Plan X meets the requirements of Code section 403(b), a new document was prepared and adopted by Employer M. The new document, effective January 1, 1996, is the subject of this ruling request.

Article IV, section 4.2 of Plan X provides that a participant may enter into a valid salary reduction agreement that authorizes Employer M to withhold and deposit a portion of the participant's salary into a custodial account held by Plan X. The salary reduction agreement under Plan X:

(1) shall remain in effect until modified or revoked;

(2) prior to January 1, 1996, modifications shall only be made during an annual election period and shall take effect as of the day of the next plan year.

(3) after January 1, 1996, modifications shall be made at any time during the year and shall take effect as of the first day of the month following the date such election is provided to the Administrator, providing that it is administratively feasible, if not administratively feasible, shall be put into effect as of the first payroll period after such date. A Participant may prospectively revoke his election in its entirety during the plan year, in which case no further salary reduction contributions shall be permitted until a new election is made.

Article IV, section 4.2(d) of Plan X provides that for each plan year, a participant's compensation made under Plan X and all other plans, contracts or arrangements shall not exceed, during any taxable year of the participant, the limitation imposed by section 402(g) of the Code.

Article IV, section 4.4 of Plan X provides that to the extent that contributions to

Plan X on behalf of an Employee do not exceed the participant's "exclusion allowance" under section 403(b)(2) of the Code; the limitation on salary reduction contributions under section 4 of the Code; or the annual additions' limitation under section 415 of the Code, such contributions are excluded from the employee's taxable compensation for the year.

Article IV, section 4.7 of Plan X provides, in pertinent part, that no rollovers or transfers from other 403(b) programs or individual retirement plans shall be allowed. Notwithstanding the foregoing, Employer M may from time to time and at any time change the custodial agreement or contract under which new contributions will be deposited by Employer M. If such a change occurs, an Employee shall be allowed to transfer the funds from the previous custodial accounts or contracts to the new custodial accounts or contracts.

Article IV, section 4.2(c) of Plan X provides that, with respect to amounts held in a participant's elective account, distributions may not be distributable prior to the earlier of the proven financial hardship of a Participant, subject to the limitations of section 6.9; a Participant's disability within the meaning of Code section 72(m)(7); termination of employment; attainment of age 59 1/2; a Participant's death.

Article VI, section 6.3(c) of Plan X provides that a participant will be fully vested in his Participant's account immediately upon entry into the plan.

Article VI, section 6.4(e) of Plan X provides, in pertinent part, that notwithstanding any provisions in Plan X to the contrary, the distribution of a participant's benefits shall be made in accordance with the requirements under this section and shall comply with section 401(a)(9) of the Code and the regulations thereunder (including section 1.401(a)(9)-2) of the Income Tax Regulations. This section provides that a participant's benefits shall be distributed to him not later than April 1st of the calendar year following the later of the calendar year in which the Participant attains 70 ½ or the calendar year in which the Participant retires.

Article VI, section 6.11(b)(1) of Plan X, as amended, provides that an eligible rollover distribution is any distribution of all or any portion of the balance to the credit of the distributee, except that an eligible rollover distribution 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 the distributee's designated beneficiary, or for a specified period of ten years or more, any distribution to the extent such distribution is required under section 401(a)(9) of the Code; the portion of any distribution that is not includable in gross income (determined without regard to the

exclusion for net unrealized appreciation with respect to employer securities); and, effective January 1, 1999, (or if elected by the Plan Administrator pursuant to IRS Notice 99-5, January 1, 2000), any distribution that is a hardship distribution as described in Section 6.9.

Article IX, section 9.2 of Plan X provides, in part, that benefits may not be transferred, assigned or alienated, except in the case of a qualified domestic relations order within the meaning of Code section 414(p).

Article X, section 10.8 provides that the Administrator shall have authority to make any and all necessary rules or regulations, binding upon all Participating Employers and all Participants, to effectuate the purposes of this Article. Notwithstanding anything to the contrary, in the event of a conflict between Plan X and an annuity contract or a custodial account, the terms of Plan X shall prevail.

Article X, section 10.9 has been amended to provide that if the Participant is an employee of more than one Employer hereunder:

(a) The limits of section 402(g) of the code shall apply to all salary deferral contributions of the Participant during a calendar year, regardless of which Employer employed such Participant at the time of such deferrals.

(b) The limits under section 403(b)(2) shall be applied separately for each Employer.

Based on the foregoing facts and representations, you have requested a ruling that Plan X meet the requirements of section 403(b) of the Code.

Section 403(b)(1) of the Code provides, in part, that amounts contributed by an employer to purchase an annuity contract for an employee is excludable from the gross income of the employee in the year contributed to the extent of the applicable "exclusion allowance," provided (1) the employee performs services for an employer which is exempt from tax under section 501(a) 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)) which is a state, a political subdivision of a state, or an agency or instrumentality of one or more of the foregoing; (2) such annuity contract is not subject to section 403(a); (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 paragraph 12, 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. In addition, except as provided in section 403(b)(7)(B), a custodial account described in section 403(b)(7) is treated as an annuity contract for all purposes of the Code.

Section 403(b)(2) of the Code provides that the exclusion allowance equals 20% of the employee's includible compensation multiplied by the employee's years of service with the employer less amounts previously excludable.

Section 403(b)(3) of the Code defines includible compensation to mean the amount of compensation received from the employer in the employee's most recent one-year period of service which is includible in the employee's gross income.

Section 403(b)(10) of the Code requires that arrangements pursuant to section 403(b) must satisfy requirements similar to those of section 401(a)(9) and similar to the incidental death benefit requirements of section 401(a) 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) are met regarding direct rollovers.

Section 401(a)(9) of the Code, generally, provides 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, in the case of an employee, who is not a 5-percent owner, April 1 of the calendar year following the later of: (a) the calendar year in which the employee attains age 70 1/2, or (b) the calendar year in which the employee retires.

Section 403(b)(7) of the Code 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) of the Code states 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(n)), 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 401(g) of the Code requires that the contract be nontransferable.

Section 401(a)(31) of the Code requires a qualified plan to provide a distributee of an eligible rollover distribution with the option of having the distribution directly rollover to an eligible retirement plan.

Effective for tax years beginning after December 31, 1995, section 1450(a) of 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.

For taxable years beginning after December 31, 1995, section 1450(c) of the SBJPA of 1996 amended section 403(b)(1)(E) to provide that in the case of a contract under a salary reduction agreement, the contract meets the requirements of section 401(a)(30). Section 401(a)(30) requires a 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, of an employer maintaining such plans or arrangements, providing for elective deferrals, to the limitation in effect under section 402(g)(1) for taxable years beginning in such calendar year.

Sections 402(g)(1) and (g)(5) of the Code provide, 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, as adjusted for cost of living increases.

Section 402(g)(4) of the Code provides that the limitation under paragraph (1) shall be increased (but not to an amount in excess of $10,000) by the amount of any

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employer contributions for the taxable year used to purchase an annuity contract under section 403(b) 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) under a salary reduction agreement, the limitation of section 402(g)(1), as modified by section 402(g)(4), 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 educational 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), and a "qualified employee" means any employee who has completed 15 years of service with the qualified organization.

Section 415(a)(2) of the Code provides, in relevant part, that an annuity contract described in section 403(b) shall not be considered 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.

In this case, you represent that Employer M, an employer described in section 403(b) of the Code, has established Plan X as its section 403(b) program for its employees. A participant's salary reduction contributions and the earnings thereon are fully vested and nonforfeitable at all times. Plan X is not an annuity contract described in section 403(a) of the Code. The annuity contracts are nontransferable as required by section 401(g).

Plan X satisfies the requirement, under section 403(b)(7) of the Code, that amounts held in custodial accounts shall be distributable only upon a participant's attainment of age 59 1/2, separation from service, death, disability or (with respect to elective deferrals only) in the case of hardship. Plan X satisfies the distribution

requirements under section 403(b)(10) and limits contributions in accordance with sections 402(g), 403(b)(2) and 415 of the Code. Plan X also provides Participants with an election to make a direct rollover distribution. Finally, Plan X satisfies all the requirements of section 403(b)(7) of the Code.

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

This ruling is limited to the form of Plan X, excluding any form defects which may violate the nondiscrimination requirements of section 403(b)(12) of the Code. This ruling does not extend to any operational violations of section 403(b) of the Code by Plan X, now or in the future.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

In accordance with a power of attorney on file in this office, a copy of this ruling is being sent to your authorized representative.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans
Technical Group 2
Tax Exempt and Government Entities Division

Enclosures:
Deleted copy of this letter
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