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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Significant Index No. 415.00-00

T:EP:RA:T3

LEGEND:

Hospital A:

Company M:

Plan X:

Contract C:

Association Y:

Bank O:

Account W:

State S:

Court N:

This is in response to a letter dated October 27, 2002, as supplemented by correspondence dated February 27, 2003, May 23, 2003, and June 5, 2003, in which your authorized representative requests on your behalf a series of letter rulings under sections 401(a), 415, 402(a), 511 and 512 of the Internal Revenue Code. The following facts and representations support your ruling request.

Hospital A maintains Plan X, which is a money purchase pension plan intended to meet the requirements of section 401(a) of the Code. From the inception of Plan X until April 18, 1995, Plan X's assets were held in their entirety in Contract C, a group annuity contract issued by Company M. The form of Contract C, as well as the original plan documentation, was negotiated by Association Y and Company M. Although Hospital A is a member of Association Y, it did not participate in the negotiation or drafting of Contract C. Member Hospitals of Association Y could elect to participate in Contract C and Hospital A elected to do so.

Neither Contract C, as originally effective, nor its first amendment provided for any reduction in the value of plan assets in the form of surrender fees, investment liquidation fees, or any other deferred expense charge. Amendment 3 to Contract C was adopted on October 15, 1993, but, by its terms was made retroactively effective to January 1, 1991. For the first time since the inception of Plan X, amendment 3 imposed a reduction on the value of Plan X assets by applying surrender and investment liquidation fees (Surrender Fee) on all funds withdrawn from Contract C by Hospital A. Hospital A did not agree to the adoption of amendment 3, nor did it participate in any negotiations leading to the alleged adoption of that amendment. Amendment 3 was executed only by Association Y and Company M.

Subsequent to adoption of amendment 3, Hospital A elected to transfer all assets held under Contract C to another investment medium. To that end, Hospital A demanded that Company M transfer all Plan X assets to the new investment medium, with no reduction for the Surrender Fee. Hospital A contended that Company M had no contractual or other legal authority to impose the Surrender Fee because neither Hospital A nor Plan X's participants or beneficiaries had agreed to any such changes.

Company M refused to transfer any of Plan X's assets absent imposition of the Surrender Fee. Hospital A determined, in the exercise of its fiduciary discretion, that it was in the best interest of Plan X to nonetheless transfer Plan assets to another investment medium. The transfer occurred on April 18, 1995. Consistent with its interpretation of amendment 3, Company M reduced the value of Plan X assets transferred by approximately 4.6 percent, which it claimed as the Surrender Fee.

Hospital A subsequently instituted a law suit, on behalf of Plan X, against Company M in Court N, a court of competent jurisdiction. The case was tried and the court determined that Company M's imposition of the Surrender Fee violated Contract C. The court awarded to Hospital A the full Surrender Fee withheld by Company M along with compensation for economic losses and attorney's fees. The award included interest which is required to be determined under specific provisions of the law of State S. The case was appealed to the highest appellate court in State S and was upheld. All appeals have now been exhausted and the time for appealing any additional issues in the case has expired.

Hospital A intends to make a replacement payment to Plan X consisting of the proceeds of its Court N suit against Company M plus interest to be allocated on a pro rata basis to the accounts of participants and former participants who were adversely affected by the wrongfully imposed Surrender Fee. The accounts of participants and former participants will be restored as of the date the Surrender Fee was imposed plus an interest adjustment from that date forward. The interest adjustment to Plan X accounts has two components. Interest for the period from the date the Surrender Fee was wrongfully imposed until the court ordered payment was actually made to Hospital A will be determined in accordance with the provisions of the law of State S applicable to the payment made to Hospital A. Interest for the period from the date payment was made to Hospital A, December 31, 1999, until the replacement payment is made to Plan X is being determined as follows: On the day Hospital A received the payment, composed of the Surrender Fee and the interest adjustment, it deposited the payment in Account W at Bank O. Interest is accruing on the deposit in accordance with the terms of Account W until the deposit and the interest accrued to date are paid to Plan X.

Based on the above, you, through your authorized representative, request the following letter rulings:

1. That the replacement payment will not be considered a contribution or other payment that may adversely affect the qualified status of Plan X under Code section 401(a)(4);

2. That the replacement payment will not be considered a contribution for purposes of Code section 415;

3. That the allocation of the replacement payment to participants' accounts will not cause participants, their beneficiaries or their estates to currently recognize gross income in the tax year of the replacement, pursuant to Code section 402(a).

With respect to your ruling requests, Code § 401(a)(4) generally provides that the contributions or benefits provided under a qualified retirement plan may not discriminate in favor of highly compensated employees.

Code section 415(a) provides, in part, that a trust which is part of a pension, profit-sharing, or stock bonus plan shall not constitute a qualified trust under section 401(a) if: A) in the case of a defined benefit plan, the plan provides for the payment of benefits with respect to a participant which exceeds the limitations of subsection (b); or, B) in the case of defined contribution plan, contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitations of subsection (c).

Section 1.415-6(b)(2) of the Income Tax Regulations provides that the term "annual additions" includes employer contributions which are made under the plan. Section 1.415-6(b)(2) further provides that the Commissioner may, in an appropriate case, considering all of the facts and circumstances, treat transactions between the plan and the employer or certain allocations to participants' accounts as giving rise to annual additions.

Code § 402(a) generally provides that amounts held in a trust that is exempt from tax under Code § 501(a) and that is part of a plan that meets the qualification requirements of Code § 401(a) will not be taxable until such time as such amounts are actually distributed to distributees under such plan.

The Service has analyzed the facts in this case and has arrived at the following conclusions. The replacement payment has several components. Initially, it is a substitute for contributions that were wrongfully deducted from Plan X participant accounts when the Surrender Fee was imposed. Insofar as the contributions were previously subject to the requirements of Code sections 401(a)(4) and 415, the replacement payment, as a substitution therefore, will not be subject thereto.

Secondly, the replacement payment is a substitute for earnings on contributions made to Plan X. The earnings portion of the replacement payment has several components. Included is an earnings component that refers to earnings from the date the Surrender Fee was imposed on Plan X until the date Hospital A received the court ordered Payment from Company M. A second earnings component refers to earnings computed

from the date Hospital A received the court ordered payment from Company M until the date the replacement payment will actually be paid to Plan X.

All of the earnings components of the replacement payment are substitutes for earnings that plan accounts would have accrued during the relevant periods had the Surrender Fee not been imposed. In this regard, section 415 would not be applicable to the portion of the payment representing such earnings and the fact that the payment is being allocated on a pro rata basis would obviate concerns about section 401(a)(4).

With respect to section 402 of the Code, the allocation of the replacement payment to the accounts of participants and former participants is not taxable to participants and former participants until such allocation is distributed.

Therefore, with respect to your ruling requests, the Service concludes as follows:

1. That the replacement payment will not be considered a contribution or other payment that may adversely affect the qualified status of Plan X under Code section 401(a)(4);

2. That the replacement payment will not be considered a contribution for purposes of Code section 415;

3. That the allocation of the replacement payment to participants' accounts will not cause participants, their beneficiaries or their estates to currently recognize gross income in the tax year of the replacement, pursuant to Code section 402(a).

This ruling is based on the facts and representations contained therein.

No opinion is expressed as to the Federal income tax consequences with respect to the transactions described above under any other provisions of the Code.

Additionally, the representation made herein, that the accounts of participants and former participants will be restored, is like all factual representations made to the Internal Revenue Service in applications for rulings and is subject to verification on audit by Service field personnel.

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

If you have any questions, please call at .

Sincerely yours,

/S/

Frances V. Sloan
Manager, Technical Group 3
Tax Exempt and Government
Entities Division

Enclosures:
Deleted copy of letter
Notice of Intention to Disclose