

INTERNAL REVENUE SERVICE

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Employer =

Plan =

Trust =

Trustee =

Dear:

This is in reply to your letter dated September 2, 1998, and subsequent correspondence, on behalf of the above Employer requesting a ruling on the federal tax consequences of Employer's deferred compensation plan (the "Plan") and related Trust under section 457 of the Internal Revenue Code as amended by the Small Business Job Protection Act of 1996.

Employer is represented to be an eligible employer within the meaning of section 457(e)(1)(A) of the Code. The Plan, which is offered to a select group of management or highly compensated employees, is intended to be an eligible deferred compensation plan to which section 457(a) applies.

Under the Plan an employee ("Participant") may elect to defer compensation that would otherwise have been received for services to the Employer until retirement, death or separation from service with the Employer or until the occurrence of an unforeseeable emergency. In addition, the Employer may make matching contributions under the Plan. The election to defer compensation must be made prior to the month for which the compensation is earned. The Plan provides for a maximum amount that may be deferred by a Participant in any taxable year and also provides for a catch-up computation for amounts deferred for one or more of the Participant's last three taxable years ending before he attains normal retirement age under the Plan. The amounts that may be deferred under the annual maximum limitation and the catch-up provision are within the limitations set out in section 457 of the Code.

A Participant or his beneficiary may elect the manner in which his deferred amounts will be distributed. Subsequent to the Participant's separation from service and prior to the date benefits would commence under the Plan, the Participant may make one election, which shall be irrevocable, to determine when benefits will be distributed or to change a previous election made prior to separation from service.

The Plan provides for payment of benefits in a lump sum or over a period not to exceed ten years. The manner and time of benefit payout must meet the distribution requirements of sections 457(d) and 401(a)(9) of the code. If the Participant or his beneficiary fails to make a timely election concerning distribution of the deferred amounts, benefits shall be paid at the time and in the manner prescribed by the Plan.

The Plan provides that all amounts of compensation deferred under the Plan, all Employer contributions, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights will remain (until made available to the Participant or other beneficiary) solely the property and rights of the Employer, subject only to the claims of the Employer's general creditors. A Participant's rights to benefit payments under the Plan are not subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the Participant or the Participant's beneficiary.

The Employer established the Trust to set aside funds for the purpose of assisting it in providing benefits under the Plan. The Trust conforms to the model trust contained in Revenue Procedure 92-64, including the order in which sections of the model trust language appear. The Trust does not contain any language that is inconsistent with, or conflicts with, the language of the model trust agreement.

Under the Plan and the Trust, the interest of the participants and beneficiaries in the trust estate are no greater than the interest of any general unsecured creditor of Employer.

Section 83(a) of the Internal Revenue Code provides that the excess (if any) of the fair market value of property transferred in connection with the performance of services over the amount paid (if any) for the property is includible in the gross income of the person who performed the services for the first taxable year in which the property becomes transferable or is not subject to a substantial risk of forfeiture.

Section 1.83-3(e) of the Income Tax Regulations provides that for purposes of section 83 the term "property" includes real and personal property other than money or an unfunded and unsecured promise to pay money or property in the future. Property also includes a beneficial interest in assets (including money) transferred or set aside from claims of the transferor's creditors, for example, in a trust or escrow account.

Under the economic benefit doctrine, an employee has currently includible income from an economic or financial benefit received as compensation, though not in cash form. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for the employee's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, Situation 4. In Rev. Rul. 72-25, 1972-1 C.B. 127, and Rev. Rul. 68-99, 1968-1 C.B. 193, an employee does not receive income as a result of the employer's purchase of an insurance contract to provide a source of funds for deferred compensation because the insurance contract is the employer's asset, subject to claims of the employer's creditors.

Under the terms of the Trust, assets will be placed in trust to be used to provide deferred compensation benefits to the Participants. However, the trustee has the obligation to hold the trust assets and income for the benefit of Employer's general creditors in the event of Employer's insolvency. The Trust further provides that an employee receives no beneficial ownership in or preferred claim on the trust assets. Therefore, although the assets are held in trust, in the event of Employer's insolvency they are fully within reach of Employer's general creditors, as are any other assets of Employer.

Section 457 of the Code provides rules for the deferral of compensation by an individual participant in an eligible deferred compensation plan (as defined in section 457(b)).

Section 457(a) of the Code provides that in the case of a participant in an eligible deferred compensation plan, any amount of compensation deferred under the plan and any income attributable to the amounts so deferred shall be includible in gross income only for the taxable year in which such compensation or other income is paid or otherwise made available to the participant or beneficiary.

A basic requirement prescribed by section 457(b)(5) is that an eligible section 457 plan must meet the section 457(d) distribution requirements described above in order to retain its tax-deferred eligible status. A section 457 plan would violate these provisions of section 457(b)(5) and regulations thereunder if the participant or anyone else received a distribution earlier than the earliest date established in section 457(d)(1)(A).

Section 457(d)(1)(A) provides that for a section 457 plan to be an eligible plan, the plan must have distribution requirements providing that under the plan amounts will not be made available to participants or beneficiaries earlier than i) the calendar year in which the participant attains age 70 1/2, ii) when the participant is separated from service with the employer, or iii) when the participant is faced with an unforeseeable emergency as determined under Treasury regulations. However, section 401(a)(9)(C)(i) generally allows plans to postpone the required beginning date until April 1 of the calendar year following the later of the calendar year in which the employee retires or in which he attains age 70 1/2.

Section 1.457-2(h)(4) of the Income Tax Regulations defines an unforeseeable emergency as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant or of a dependent, loss of a participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.

Section 301.7701-4(a) of the Procedure and Administration Regulations provides that, generally, an arrangement will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Section 671 of the Code provides that where a grantor shall be treated as the owner of any portion of a trust under subpart E, part I, subchapter J, chapter 1 of the Code, there shall then be included in computing the taxable income and credits of the grantor those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against tax of an individual.

Section 677(a)(2) of the Code provides that the grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be held or accumulated for future distribution to the grantor.

Section 1.677(a)-1(d) of the regulations provides that under section 677 of the Code, a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor.

Provided, (i) that the creation of the Trust does not cause the Plan to be other than "unfunded" for purposes of Title I of the Employee Retirement Income Security Act of 1974, and (ii) that the provision in the Trust requiring use of the Trust assets to satisfy the claims of Employer's general creditors in the event of Employer's insolvency is enforceable by the general creditors of Employer under federal and state law, and based on the information submitted and representations made, we conclude as follows:

1. The Plan is an eligible deferred compensation plan as defined in section 457 of the Internal Revenue Code of 1986.
2. The Trust will be classified as a trust under section 301.7701-4(a) of the Procedure and Administration Regulations. Because the principal and income of the Trust may be applied in discharge of legal obligations of the grantor, Employer will be treated as the owner of the entire Trust under section 677(a) of the Code and section 1.677(a)-1(d) of the regulations. Under section 671, Employer must include all of the income, deductions, and credits against tax of the Trust in computing its own taxable income and credits.
3. Neither the creation nor maintenance of the Plan and the Trust, nor the contribution of assets to the Trust, will result in a transfer of property to any participant or beneficiary for purposes of section 83 of the Code or section 1.83-3(e) of the regulations.
4. Amounts of compensation deferred under the Plan, including any income attributable to the deferred compensation, will be includible in gross income in the taxable year or years in which such amounts are actually paid or otherwise made available to such participant or beneficiary within the meaning of Code section 457.

This ruling is contingent upon the adoption of the modifications to the Plan and Trust contained in your subsequent submission of February 13, 1999. No opinion is expressed concerning the timing of the inclusion in income of amounts deferred under any deferred compensation plan other than the Plan described above. In addition, this ruling applies only to deferrals made after the date this ruling is issued. If the Plan or Trust are significantly modified, this ruling will not necessarily remain applicable.

This ruling is directed only to the Employer and its employees. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion in the ruling. See section 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, 47. However, when the criteria in section 12.05 of Rev. Proc. 99-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

Sincerely yours,

ROBERT D. PATCHELL  
Assistant Chief, Branch 1  
Office of the Associate  
Chief Counsel  
(Employee Benefits and  
Exempt Organizations)

Enclosure:  
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