

INTERNAL REVENUE SERVICE

Index Nos. 83.13-00 671.02-00  
451.14-04 404.11-00

Number: **199910002**

Release Date: 3/12/1999

November 18, 1998

Dear

This responds to a request for a ruling you submitted in a letter dated April 10, 1998, and in subsequent correspondence on behalf of Corporation C and its designated subsidiaries and related entities, including Entity E, an unincorporated entity. This private ruling request concerns the federal income tax consequences of establishing a trust to assist in providing nonqualified deferred compensation benefits to a select group of key or highly compensated employees pursuant to the supplemental executive retirement plan (the "Plan").

The Plan provides for the payment of nonqualified retirement benefits to the participants or their beneficiaries at the time and in the amount and manner determined under the Plan after a participant's death, retirement, or other termination of employment. Pursuant to the Plan, bookkeeping accounts will be created for each participant for the purpose of crediting the deemed deferred compensation contributions determined under the Plan for each participant and the deemed earnings thereon under the Plan.

By agreement with a third party ("Trustee"), C has established a trust to which it may, in its discretion, contribute cash and other property to assist in providing for accrued deferred benefit payments under the Plan. Within this trust, the assets will be allocated to each corporation or entity that employs one or more Plan participants in proportion to each employer's obligation to its employees who participate in the Plan. The Trustee will have the duty to invest the trust assets and funds in accordance with the terms of the trust agreement. The trust agreement provides that in the event of the insolvency (as defined therein) of C or a designated subsidiary or related entity, the Trustee shall hold the employer's share of the segregable assets of the trust for the

benefit of general creditors of the insolvent entity. The trust agreement also provides that the chief executive officer and board of directors of C or (their equivalent) of the insolvent entity have the duty to notify the Trustee if C or the entity becomes insolvent.

Pursuant to the provisions of the Plan and the trust agreement, the participants and their beneficiaries have the status of unsecured general creditors of their employer, have only their employer's unsecured promise to pay benefits, and receive no rights or security interest in their employer's allocable assets in the trust or their employer's other assets. The Plan and the trust agreement also provide that the benefits payable pursuant to such plan may not be assigned, pledged, transferred or encumbered.

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" does not include an unfunded and unsecured promise to pay money or property in the future. However, the term "property" does include 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.

Section 451(a) of the Code and section 1.451-1(a) of the regulations provide that an item of gross income is includible in gross income for the taxable year in which actually or constructively received by a taxpayer using the cash receipts and disbursements method of accounting.

Under section 1.451-2(a) of the regulations, income is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart, or otherwise made available so that the taxpayer may draw on it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Various revenue rulings have considered the tax consequences of nonqualified deferred compensation arrangements. Rev. Rul. 60-31, Situations 1-3, 1960-1 C.B. 174, holds that a mere promise to pay, not represented by notes or secured in any way, does not constitute receipt of income within the meaning of the cash receipts and disbursements method of accounting. See also, Rev. Rul. 69-650, 1969-2 C.B. 106, and Rev. Rul. 69-649, 1969-2 C.B. 106.

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 agreement, assets may be placed in trust to provide nonqualified deferred compensation benefits to the participants or their beneficiaries. However, the Trustee has the obligation to hold the segregated portion of the trust assets and income for the benefit of the employer's general creditors in the event of its insolvency. The trust agreement 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 the employer's insolvency, the segregable assets allocable to the insolvent employer are fully within reach of its general creditors, as are any other of its assets.

Section 402(b) of the Code provides that contributions made by an employer to an employees' trust that is not exempt from tax under section 501(a) are included in the employee's gross income in accordance with section 83, except that the value of the employee's interest in the trust will be substituted for the property's fair market value in applying section 83. Section 1.402(b)-1(a)(1) of the regulations provides that employer contributions to a nonexempt employees' trust shall be included as compensation in the employee's gross income for the taxable year in which the contribution is made, but only to the extent that the employee's interest in such contribution is substantially vested as defined in section 1.83-3(b).

Section 404(a) of the Code provides the general deduction timing rules applicable to any plan or arrangement for the deferral of compensation, regardless of the Code section under which the amounts might otherwise be deductible. Pursuant to section 404(a)(5) of the Code and section 1.404(a)-12(b)(2) of the regulations, and provided that they otherwise meet the requirements for deductibility, amounts of compensation deferred under a nonqualified plan or arrangement are deductible by the employer in the taxable year in which they are paid or made available, whichever is earlier.

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.

The terms of the trust agreement provide that the assets will be transferred to a trustee who will have responsibility for the management protection, conservation, and investment of the assets. According the trust will be classified as a trust for federal tax purposes under section 301.7701-4(a).

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 1.671-2(e) of the regulations states that the term "grantor" as used in the regulations under subpart E includes a corporation.

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 states 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 creation of the trust does not cause the arrangement established by 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 provisions of the trust agreement requiring use of trust assets to satisfy claims of the general creditors of the employer in the event of its insolvency are enforceable by such creditors under federal and state law, and based on the information submitted and representations made, we conclude that:

1. The trust created by Company C is classified as a trust within the meaning of section 301.7701-4(a) of the Procedure and Administration Regulations.

Because the principal and income of the trust may be applied to discharge legal obligations of the participant's employer, C and the designated subsidiaries and related entities shall each be treated as the owner of their respective shares of the trust assets under section 677 of the Code. Accordingly, under section 671, there shall be included in computing the taxable income and credits of C, and of each designated subsidiary and related entity, the grantors, all items of income, deductions, and credits against tax of each's respective share of the trust.

2. Neither the creation of the trust, the contribution of assets or money to the trust, the receipt of earnings by the trust, nor the adoption of the Plan will constitute transfers of property for purposes of section 83 of the Code or section 1.83-3(e) of the regulations.

3. Neither the creation of the trust, the contribution of assets or money to the trust, nor the adoption of the Plan will constitute a contribution to a nonexempt employees' trust under section 402(b) of the Code.

4. Neither the establishment of the trust, the transfer of assets or money to the trust, the receipt of earnings upon such assets, the crediting of deferred compensation contribution to the bookkeeping account of a participant, nor the adoption of the Plan will cause current recognition of income by the Plan's participants or their beneficiaries, who are on the cash receipts and disbursements method of accounting, under either the doctrine of constructive receipt, section 451 of the Code, or the economic benefit doctrine.

5. Amounts distributed under the Plan and the trust agreement will be included in the gross income of a participant or his beneficiary, under the cash receipts and disbursements method of accounting, in the taxable year or years in which actually paid or otherwise made available to the recipient, whichever is earlier.

6. Upon paying or making available to the participant or his beneficiary the amounts credited to his account, the employer that employed the participant, either C or the appropriate subsidiary or related entity, will be entitled to a deduction under section 404(a)(5) of the Code for the amount includible in income by the recipient, provided such amount otherwise meets the requirements for deductibility under section 162.

This ruling is directed only to the taxpayer who requested it, and it applies only to the trust agreement submitted on April 10, 1998, revised in accordance with the amendment submitted on November 12, 1998, and to the revised Plan submitted on June 12, 1998. This ruling applies only to the deferred compensation benefit credited

and deemed earnings thereon accrued after the date of its issuance. Moreover, if either the Plan or the trust agreement is significantly amended, this ruling may not necessarily remain in effect.

Section 6110(k)(3) of the Internal Revenue Code provides that this ruling may not be used or cited as precedent. Except as specifically ruled on above, no opinion is expressed as to the federal tax consequences of the transaction described above under any other provision of the Code.

Sincerely yours,

CHARLES T. DELIEE  
Chief, Branch 1  
Office of the Associate  
Chief Counsel  
(Employee Benefits and  
Exempt Organizations)