

INTERNAL REVENUE SERVICE
Index Nos. 83.12-00 403.02-00
451.14-04
Ruling: **199905003**
Release Date: 2/5/1999

CC:EBEO:1 - PLR-113381-98

October 27, 1998

Corporation C =

Plan =

Dear

This responds to a request for a supplemental ruling you submitted in a letter dated June 26, 1998 on behalf of Corporation C concerning the tax law impact of C's proposed election of the participation option relating to certain group annuity contracts. These contracts relate to a nonqualified deferred compensation plan and the associated grantor trust established by C some years ago to provide nonqualified supplemental retirement benefits to certain highly compensated and key management employees pursuant to the Plan. In February 1989, this office issued a ruling letter, LTR 8917069 (TR-31-3206-88), concluding that C's Plan and trust deferred the inclusion in a participant's income of certain compensation until received or made available; the Plan was later amended. Subsequently, C purchased these annuity contracts to provide security for amounts previously recorded in the bookkeeping accounts of its nonqualified deferred compensation plan (the "Plan") and set aside in the associated grantor trust providing nonqualified supplemental retirement benefits to certain highly compensated and key management employees pursuant to the Plan after receiving a private letter ruling issued by this office, LTR 9713006 (PLR-75389-96). In LTR 9713006, this office concluded that generally participants entitled to benefit under the purchased annuity contracts had to include in their income the purchase price for the Contract benefits plus the gross-up payment made by C in the year of the contracts' purchase and payment and that C was entitled to deduct the purchase price plus the gross-up payments in that year.

Your letter indicates that the annuity contracts C purchased were originally non-participating contracts which included an option for C to elect the participation option at a later time

and that the presence of the participation option did not affect the price at which C purchased such contracts. The letter explains that if C elects the participation option, C will receive rebates from the insurance company that issued the annuity contracts if the level of reserves backing such contracts exceeds the required level determined pursuant to these contracts due to favorable investment, mortality or retirement-date experience. Conversely, if, after C makes the participation election, the necessary reserves dip below the required minimum due to unfavorable experience, C would have to make a payment to the insurer in an amount needed to restore the reserves backing these contracts to the required minimum level. Your letter represents that C's participation election has absolutely no effect upon the amounts which the Plan's participants and their beneficiaries would be entitled to receive under the Plan and the annuity contracts.

The Plan, now secured by the contracts, provides for the payment of deferred benefits to a participant or his beneficiary in the time and the manner prescribed under such Plan upon the participant's death, retirement or other termination of employment. After receiving LTR 9713006, Company C purchased group annuity contracts securing the promised benefits accrued to date for the Plan's participants and their beneficiaries. Pursuant to the arrangement, participants whose benefits were secured by the annuity contracts received contract certificates representing their interests in such contracts. Every participant whose benefits were secured by these contracts received a tax gross-up payment from C for his or her approximate income tax liability due to his or her receipt of the contract certificate.

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 403(c) of the Code states that premiums paid by an employer for a nonqualified annuity contract shall be included in

the employee's gross income in accordance with section 83 except that the value of such contract shall be substituted for the fair market value of the property for purposes of applying section 83. Section 1.403(c)-1(a) of the regulations provides that if an employer pays premiums for a nonqualified annuity contract for the benefit of an employee, the amount of such premiums shall be included as compensation in the employee's gross income for the taxable year during which such premiums are paid, but only to the extent that the employee's rights in such premiums are substantially vested (as defined in section 1.83-3(b)) at the time such premiums are paid.

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.

Provided that C's election of the annuity contracts' participation option neither increases nor decreases the amounts payable under such contracts to the Plan's participants and their beneficiaries, and based upon the information and documents submitted, we conclude as follows:

Neither the exercise of the participation option under the annuity contracts nor participation payments from the insurer to Company C nor participation payments from C to the insurer will result in the current inclusion of any amount in income by the participants under the Plan and their beneficiaries.

This ruling is directed only to the taxpayer who requested it, and it applies only to the above-described Plan, annuity contracts, C's proposed participation election, and the participants and beneficiaries under the Plan. In addition, no opinion is expressed regarding the tax consequences of any significant revision to the Plan or annuity contracts other than C's election of the participation option described above. Your requested rulings concerning the application of sections 61 and 162 to the above-described transaction as impacting on Corporation C will be the subject of a separate letter.

Section 6110(k)(3) of the 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. Moreover, if either the Plan, or the annuity contract arrangement are further and significantly revised, this ruling may not necessarily remain in effect.

Sincerely yours,

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