

## Internal Revenue Service

Department of the Treasury

Index Numbers: 83.01-00; 402.00-00; 419.00-00; 671.02-00; 677.04-00 Washington, DC 20224

Number: **199932031**  
Release Date: 8/13/1999

Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:3 PLR-111205-98

Date:

May 14, 1999

### LEGEND:

Corporation =

Company =

Plan =

Trust =

Trustee =

State =

Exempt Trusts =

Date 1 =

Date 2 =

Dear :

This letter responds to your letter dated May 4, 1998, and subsequent correspondence requesting rulings on the income tax consequences of a trust established to pay benefits under a Plan to participating employees.

### **FACTS**

Corporation, a holding company, is incorporated in State and is the parent corporation of Company. Company is the principal subsidiary of Corporation and is a regulated public utility principally engaged in the production, purchase, transmission, distribution, and sale of electricity to customers in northern State. It is represented that Corporation, along with Company and other wholly-owned subsidiaries of Corporation (Affiliated Companies) are corporations under common control within the meaning of § 414(b) of the Internal Revenue Code and file a consolidated federal income tax return.

Company has for many years maintained Plan to provide hospital and medical benefits to certain employees and retired employees of Company and other Affiliated Companies (collectively Employers) and their dependents that participate in Plan. The Plan provides benefits to the dependents of such employees and retired employees as well. In accordance with Plan, Company established Exempt Trusts to fund benefits under Plan. It is represented that the Service, under a separate letter, has determined that Exempt Trusts are voluntary employees' beneficiary associations that are exempt from federal income tax under § 501(c)(9). Pursuant to certain provisions in Plan, Employers do not make contributions to Exempt Trusts to fund retiree benefits under Plan for executives, former executives, or their dependents.

To provide a source of funds for retiree benefits for executives and former executives of the Employers (collectively Executives), Company established Trust on Date 1 between Company and Trustee. The Trust agreement was amended on Date 2. To the extent Affiliated Companies have employees who are on an executive payroll, contributions would be made to the Trust on behalf of such employees by their respective Employer. According to the language in the Trust agreement, Trust is intended to be an "unfunded arrangement and shall not affect the status of Plan as an unfunded plan for the purpose of providing certain benefits for a select group of management or highly compensated employees for purposes of Title 1 of the Employee Retirement Income Security Act (ERISA) of 1974."

The Trust agreement provides that the trustee shall establish a separate account (Employer Fund) under the Trust for each participating Employer whose employees are Plan participants. In addition, the Trust agreement provides that at all times during the duration of the Trust, the portion of principal and income of the Trust (Trust Assets) that is attributable to each Employer Fund shall, in the event of insolvency of the corresponding Employer, be subject to the claims of that Employer's general creditors. If an Employer becomes insolvent, Trustee shall immediately cease distributions from that Employer's Fund and shall hold such Employer's Fund for the benefit of that Employer's general creditors. Trustee shall, if ordered by a court of competent jurisdiction, distribute the assets of the Employer Fund as such court may direct to pay the claims of creditors without regard to the amount of other assets of such Employer

available to pay such claims.

The Trust agreement provides that an Employer is insolvent if it is unable to pay its debts as they become due or if it is subject to a pending proceeding as a debtor under the federal Bankruptcy Code. The Board of Directors and the Chief Executive Officer of each Employer has the duty to inform Trustee in writing if the Employer becomes insolvent. If a person claiming to be a creditor of an Employer alleges in writing to Trustee that the Employer has become insolvent, Trustee shall determine whether the Employer is insolvent, and pending the determination, shall discontinue payment of benefits to Plan participants and their beneficiaries. Unless Trustee has actual knowledge of an Employer's insolvency, or has received notice from an Employer or person claiming to be a creditor alleging that an Employer is insolvent, Trustee has no duty to inquire whether an Employer is insolvent. Trustee may rely on evidence concerning an Employer's solvency as may be furnished to Trustee and that provides Trustee with a reasonable basis for making a determination concerning the Employer's solvency.

The Trust agreement provides that if Trustee discontinues the payment of benefits from the Trust, and subsequently resumes such payments, the first payment following such discontinuance shall include the aggregate amount of all payments due to Plan participants or their beneficiaries under the terms of the Plan for the period of such discontinuance, less the aggregate amount of any payments made to Plan participants or their beneficiaries by the Employers in lieu of the payments provided for hereunder during any such period of discontinuance.

The Trust agreement provides that benefits payable to the Executives and their dependents may not be anticipated, assigned (either at law or in equity), alienated, pledged, encumbered or subjected to attachment, garnishment, levy, execution or other legal or equitable process. Also, the Executives (and their dependents) have no preferred claim on, or any beneficial ownership interest in, any Trust Assets, and all rights created under the Plan in the Trust shall be nothing more than unsecured contractual rights against the Employers.

Section 1(b) of the Trust agreement provides that the Trust is revocable, but shall become irrevocable following the issuance of favorable rulings from the Service. The following rulings have been requested:

- (1) Trust will be classified as a trust under § 301.7701-4(a) of the Procedure and Administration Regulations;
- (2) Trust is a grantor trust under § 677;
- (3) Trust is not a welfare benefit fund under § 419; and

(4) The deposit of assets in Trust is not a transfer of property to the Executives or their dependents for purposes of § 83 or a transfer to a nonexempt employees' trust under § 402(b).

### **LAW AND ANALYSIS**

#### **Ruling Requests 1 and 2**

Section 301.7701-4(a) 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 provides that if the grantor or another person is treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person 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 in computing the taxable income or credits against the tax of an individual.

Section 677(a) provides that the grantor is 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 distributed or accumulated for future distribution to the grantor.

Section 1.677(a)-1(d) of the Income Tax Regulations provides that under § 677 a grantor is 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.

The terms of the Trust provide that the assets will be transferred to a trustee who will have responsibility for the management, protection, conservation, and investment of the assets. Neither Executives nor their dependents share in this responsibility. Accordingly, the Trust will be classified as a trust for federal tax purposes under § 301.7701-4(a).

The purpose of the Trust is to provide benefits to Executives of Employers. However, if an Employer becomes insolvent, the Trustee has an obligation to cease payments from the Employer's Fund and hold the Employer's Fund for the benefit of the general creditors of the insolvent Employer. In the present case, Employers are grantors of the Trust because they contribute funds to the Trust. Because the principal and income of the Trust may be applied to discharge legal obligations of each Employer, each Employer will be treated as an owner of the Trust under §§ 677 and 1.677(a)-1(d). As owners of the Trust, each Employer must include its share of the items of income, deduction, and credit against the tax of the Trust in computing its taxable income and credits under § 671.

### **Ruling Request 3**

Section 419(a) provides that employer contributions to a welfare benefit fund are not deductible under Chapter 1 of the Code, but if they would otherwise be deductible then they are deductible, subject to the limitation of § 419(b), under § 419 for the taxable year in which paid.

Section 419(e)(1) defines "welfare benefit fund" to include any fund that is part of a plan of an employer and through which the employer provides welfare benefits to employees.

Section 419(e)(2) defines "welfare benefit" as any benefit other than a benefit with respect to which § 83(h) applies, § 404 applies (determined without regard to § 404(b)(2)), or § 404A applies.

In the present case, Trust will become irrevocable. However, the assets of Trust are subject to the claims of Employer's creditors if an Employer becomes insolvent. Thus, its assets are not irrevocably set aside, apart from the claims of the Employer's creditors, for the provision of welfare benefits under Plan. Accordingly, Trust is not a welfare benefit fund within the meaning of § 419(e)(1).

### **Ruling Request 4**

Section 83(a) provides that the excess, if any, of the fair market value of property transferred in connection with the performance of services over the amount, if any, paid 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(a)(1) states that a transfer of property occurs when a person acquires a beneficial interest in the property.

Section 1.83-8(a) provides generally that § 83 applies to a transfer to or from a

nonqualified trust for the benefit of employees, independent contractors, or their beneficiaries. To the extent such a transfer is subject to § 402(b), however, § 83 applies to the transfer only as provided for in § 402(b).

Section 402(b)(1) provides that contributions made by an employer to an employees' trust that is not exempt from tax under § 501(a) are included in the employee's gross income in accordance with § 83, except that the value of the employee's interest in the trust is substituted for the fair market value of the property in applying § 83.

In the present case, assets are placed in Trust to provide benefits under Plan to Executives and their families. Trustee has the obligation to hold Trust Assets for the benefit of Employer's general creditors in the event of insolvency. The Trust agreement provides that Executives have no beneficial interest in or preferred claim on Trust Assets. Thus, Trust Assets are not irrevocably set aside, apart from the claims of Employer's creditors, for the provision of welfare benefits under Plan, and the Executives do not acquire a beneficial interest in Trust. Accordingly, there is no transfer of property to the Executives for the purposes of § 83, and the deposit of assets in Trust is not a contribution to a nonexempt employees' trust under § 402(b).

### **CONCLUSIONS**

Accordingly, we rule as follows:

- (1) Trust will be classified as a trust under § 301.7701-4(a);
- (2) Each Employer will be treated as an owner of the Trust under §§ 677 and 1.677(a)-1(d). Under § 671, each Employer must include its share of the Trust's items of income, deduction, and credit against tax in computing its taxable income and credits;
- (3) Trust is not a welfare benefit fund under § 419(e)(1); and
- (4) The deposit of assets in Trust is not a transfer of property to the Executives or their dependents for purposes of § 83 or a transfer to a nonexempt employees' trust under § 402(b).

Our conclusions are conditioned on the propositions that (i) Plan is not funded, in whole or in part, through a cafeteria plan under § 125, and (ii) the assets of Trust are not "plan assets" with respect to Plan for purposes of Title 1 of ERISA.

Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the transaction described above under any provision of the Code. If Plan or Trust is amended, these rulings may not remain in effect.

These rulings are directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. Pursuant to § 3.01(30) of Rev. Proc. 98-3, 1998-1 I.R.B. 100, or its successor, these rulings are not applicable to any controlling shareholder of Corporation or Employer.

Sincerely yours,

Donna M. Young  
Senior Technician Reviewer,  
Branch 3  
Office of the Assistant Chief  
Counsel  
(Passthroughs and Special  
Industries)

Enclosures (2)  
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