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Internal Revenue Service **Department of the Treasury**

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:
CC:EBEO:1 - PLR-110161-98

Date:
SEP 30 1998

X =

Plan =

Trust =

Dear

This is in response to your request for a ruling dated April 24, 1998, on behalf of X concerning the income tax consequences of the amended nonqualified deferred compensation agreement (the "Plan") and a trust agreement (the "Trust") established by X. A favorable ruling was issued to X on September 30, 1997, with regard to the Plan and Trust. The Plan was amended on April 14, 1998, and X now requests a letter ruling with respect to the amended Plan and the Trust.

The Plan was originally adopted effective as of October 18, 1988, and was amended and restated in its entirety, effective as of March 21, 1997. X established the Plan for the purpose of providing certain deferred compensation and retirement benefits to a select group of X's management, highly compensated employees and directors (the "Participants") upon termination of employment. The Plan also provides for distributions to alleviate an unforeseeable emergency of the Participant.

The Plan permits Participants to defer receipt of future compensation pursuant to a participation agreement entered into prior to the first day of the Plan Year to which the agreement relatesw. The Participant also makes deemed investment elections on the participation agreement. The Participant's account balance under the Plan is credited with the investment return as if the deferred compensation amounts had been invested pursuant to the participation agreement. X amended the Plan on April 14, 1998, to permit Participant's to change their deemed investment election with regard to past, as well as future, accruals under the Plan.

No benefit payable under the Plan shall be subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, garnishment or charge prior to actual receipt by the payee.

X established a trust to hold assets to provide X with a source of funds to assist it in paying its obligations to the Participants under the Plan. The Trust conforms to the model trust contained in Revenue Procedure 92-64, including the order in which the 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 a Participant (or beneficiary) in the trust estate shall be no greater than the interest of any general unsecured creditor of X.

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.

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 fair market value of the property in applying section 83. Section 1.402(b)-1(a)(1) of the regulations provides that employer contributions to a nonexempt employees' trust are included as compensation in an 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 the regulations under section 83.

Section 404(a)(5) 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 amount 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 contributions or compensation deferred under a non-qualified plan or arrangement are deductible in the taxable year in which they are paid or made available, whichever is earlier. Section 404(d) of the Code provides that amounts paid to independent contractors (e.g., corporate directors) under a plan deferring the receipt of compensation shall be deductible by the payor for the taxable year in which an amount attributable to the contribution or compensation is includible in the gross income of the persons participating in the plan.

Section 451(a) of the Code provides that the amount of any item of gross income shall be included in gross income for the taxable year in which the taxpayer receives it, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period. Section 1.451-1(a) of the regulations provides that under the cash receipts and disbursements method of accounting, amounts are included in gross income when actually or constructively received.

Section 1.451-2(a) of the regulations provides that income is constructively received in the taxable year during which it is credited to the taxpayer's account or set apart for him or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

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.

Various revenue rulings have considered the tax consequences of nonqualified deferred compensation arrangements. Rev. Rul.

60-31, Situation 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 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 X's general creditors in the event of X'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 X's insolvency they are fully within reach of X's general creditors, as are any other assets of X.

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 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 of the Trust requiring use of trust assets to satisfy claims of X's general creditors in the event of X's insolvency is enforceable by such creditors under federal and state law, we conclude that:

1. The amendment of the Plan by the April 14, 1998, amendment will not adversely affect any rulings contained in the prior letter ruling, dated September 30, 1997, received by the X with respect to the Plan and Trust.

2. The Trust will be 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 in discharge of legal obligations of the grantor, the grantor shall be treated as the owner of the entire trust under section 677 of the Code. Accordingly, there shall be included in computing the taxable income and credits of the X all items of income, deductions, and credits against tax of the Trust. Section 671.

3. Neither the adoption of the Plan by X, the creation of the Trust, the contribution of assets to the Trust, nor the crediting of earnings on the trust assets will constitute a contribution to a nonexempt employees' trust under section 402(b) of the Code.

4. Neither the creation of the Trust nor the contribution of assets by X to the Trust will result in a transfer of property for purposes of section 83 of the Code or section 1.83-3(e) of the regulations. Therefore, under section 83, neither the creation of the Trust nor the transfer of assets by X to the Trust will result in the inclusion of any amounts in the gross incomes of the Participants or beneficiaries under the cash receipts and disbursements method of accounting.

5. Benefits payable under the Plan and out of the Trust will be includible as compensation in the gross income of the Participants or their beneficiaries under the cash receipts and disbursements method of accounting only in the taxable year or years in which such amounts are actually distributed or otherwise made available, whichever is earlier. Neither (i) the creation of the Trust nor the contribution of assets to the Trust; (ii) the accumulation of earning on Trust assets; (iii) the deferral of compensation by Participants under the Plan, (iv) the availability of hardship distributions to the Participants under the Plan under the limited unforeseeable emergency withdrawal provisions in the Plan, nor (v) the Participants' rights to designate or modify investments in which their deferrals are

deemed to be invested under the Plan will cause Participants to recognize income prior to this time under either the doctrine of constructive receipt, within the meaning of section 451 of the Code, nor under the economic benefit doctrine.

6. X is entitled to a deduction pursuant to section 404(a)(5) of the code, relating to participating employees, and 404(d) of the Code, relating to participating diirectors, for the amounts paid or made available under the Plan in the taxable year in which such amounts are includible in the gross income of the Participants or their beneficiaries, provided such amounts otherwise meet the requirements for deductibility.

7. With respect to the balance of the Participants' accounts in the Plan attributable to deferred compensation earned by them prior to the effective date of the April 14, 1998, amendment, the amendment of the Plan to permit the Participants to modify prior investment designations pursuant to which their deferrals are deemed invested and any such modifications and investment designations by the Participants will neither, in and of themselves, cause any amount to be included in the gross incomes of cash basis recipients under the constructive receipt doctrine of section 451 of the Code or the economic benefit doctrine, nor constitute the transfer of property for purposes of section 83 of the Code.

Rulings 1, 3,4, and 5 that relate to the Trust are based on the assumption that prior deferrals under the Plan did not result in constructive receipts of income or economic benefit. No opinion is expressed as to whether such deferrals were actually or constructively received in the prior years.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it 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 the Plan or Trust is substantially amended, this ruling may not remain in effect.

Sincerely yours,

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

Enclosure:
Copy for section 6110 purposes