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April 28, 1999

Company C =

Parent Company P =

Dear :

This responds to a request for a ruling you submitted in a letter dated October 19, 1998, and in subsequent correspondence on behalf of Company C, which is a wholly owned subsidiary of Parent Company P, a distributor of a particular brand of manufactured goods. This private ruling request concerns the federal income tax consequences of establishing a trust to assist C in providing nonqualified deferred compensation benefits to a select group of highly compensated key personnel, working for retail-level firms to which P supplies its goods, pursuant to its deferred compensation plan (the "Plan").

The Plan provides for the payment of deferred bonus compensation benefits to the participants or their beneficiaries in the time and manner determined under the Plan after a participant’s death or termination of employment. Participants must make elections regarding the manner and time of distribution of benefits subject to such election before earning such benefits. Pursuant to the Plan, C will create bookkeeping accounts on its books for each participant for the purpose of crediting deferred bonus award accruals and the deemed earnings thereon under the Plan. The Plan also permits the participants to designate, among several choices, the investment options in which the amounts in their bookkeeping accounts will be deemed to be invested.

By agreement with a third party ("Trustee"), C has established a trust to which C may, in its discretion, contribute cash and other property to assist C in providing for accrued deferred benefit payments under 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 either C or P, the Trustee shall hold the assets of the trust for the benefit of general creditors of the bankrupt entity, either C or P. The trust agreement also provides that the chief executive officer and board of directors of the appropriate entity (either C or P) have the duty to notify the Trustee if either C or P 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 C, have only the unsecured promise of C to pay benefits, and receive no rights or security interest in the assets of C or the trust. The Plan and the trust agreement also provide that the benefits payable pursuant to the plan are not subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the participant or the participant's beneficiary.

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 bonus compensation benefits to the participants or their beneficiaries. However, the Trustee has the obligation to hold the trust assets and income for the benefit of the general creditors of C or P in the event of either firm's 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 insolvency of C or P, they are fully within reach of the firms's general creditors, as are any other of their 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. Section 404(d) of the Code provides that amounts paid to independent contractors 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 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 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 C and its parent P 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 entity 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 in discharge of legal obligations of C, C shall be treated as the owner of the entire trust under section 677 of the Code. Accordingly, under section 671, there shall be included in computing the taxable income and credits of C, the grantor, all items of income, deductions, and credits against tax of the trust.

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

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

4. Neither the establishment of the Plan or trust, nor the contribution of assets or money to the trust, nor the accumulation of earnings by the trust, nor a participant's right to designate and change the investments in which his bookkeeping account is deemed to be invested 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 from the trust 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 such amounts are 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, Company C will be entitled to deduct the amounts paid or made available pursuant to the Plan under section 404(d) of the Code in the taxable year in which such amounts are includible in the gross income of the recipient, provided such amounts otherwise meet the requirements for deductibility under section 162.

This ruling is directed only to the taxpayer who requested it, and it applies only to the Plan and trust agreement submitted on October 19, 1998, with the Plan revised in accordance with the amendment submitted on February 17, 1999. This ruling applies only to the deferred compensation benefit 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(j)(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. In addition, the rulings herein apply for income tax purposes only. No opinion is expressed as to the Federal employment tax consequences of the transaction described above or whether the related employment tax liability rests with the taxpayer or with the retail-level firms.

Sincerely yours,

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

Enclosure:

Copy for section 6110 purposes