OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

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MEMORANDUM FOR BROOKLYN DISTRICT COUNSEL'S OFFICE
ATTN: PETER GAVAGAN
CATHERINE CHASTANET

FROM: Chief, Branch 7
Office of Associate Chief Counsel (EBEO) (CC:EBEO:7)

SUBJECT:

This Field Service Advice responds to your request for assistance regarding certain issues arising on an examination of the above-referenced taxpayer. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND:</u>

<u>TP</u> 1=
<u>TP</u> 2 = .
<u>TP</u> 3 =
<u>TP</u> 4 =
<u>TP</u> 5 =
<u>TP</u> 6 = ______
<u>TP</u> 7 =
<u>TP</u> 8 =
<u>TP</u> 9 =
<u>TP</u> 10 = ______
<u>TP</u> 11 = .
<u>TP</u> 12 =
<u>TP</u> 13 =

TP 14 =
A plan =
B plan =
C plan =
D plan =
E plan =
F plan =
G plans =
H plans =
I plans =
J plans =
K plans =
L plans =
M plans =
N plans =
O plans =
P plan =
Q plans =
R plans =
S plans =
T plans =
A trust =

ISSUES

1. Whether the A trust is a grantor trust under IRC §671 and, if so, which entity (or entities) is entitled to any tax attributes resulting from that determination.

2. Whether TP1 must include in gross income the interest paid on the A trust's promissory note.

3. Whether TP1 may exclude from gross income under IRC §1032 the proceeds from the disposition of stock by the A trust.

4. Whether TP1 or one of its subsidiaries (TP2 through TP14) is entitled to deduct the fair market value of TP1 stock contributed by the A trust to various nonqualified incentive compensation plans maintained by TP1 or its subsidiaries.

5. Whether TP1 or one of its subsidiaries (TP2, TP5, TP6, TP9, TP10 or TP13) is entitled to deduct the fair market value of the stock

contributed by the A trust to various qualified plans maintained by TP1 or its subsidiaries (TP2, TP5, TP6, TP9, TP10 or TP13).

6. Whether the A trust can contribute TP1 stock to satisfy obligations of TP1 or its subsidiaries (TP2, TP5, TP6, TP9, TP10 or TP13) under their respective IRC § 401(k) plans.

7. Whether participants in the A-F plans who receive allocations of shares of TP1 stock from the A trust may diversify such holdings after the stock is allocated under such plans.

8. Whether the shares of TP1 stock held by the A trust are treated as treasury stock and included in the calculation of earnings per share.

CONCLUSIONS

1. Based on the facts presented, we believe that the A trust is a grantor trust. TP1 and TP2-TP14 will each be treated as a grantor and an owner with respect to the amount that is used to fund the A-T plans in satisfaction of their legal obligations. TP1 is deemed to make a capital contribution to TP2-TP14 with respect to those amounts. Further factual development is recommended before a final determination can be made.

2. Interest paid on the A trust's promissory note is not required to be reported as income to TP 1 with respect to the portion of the trust that it owns. However, assuming TP1 and TP2-TP14 are treated as owners of the A trust, interest that is paid to TP1, and which is attributable to portions of the A trust that TP2-TP14 own, is considered to be interest paid by a subsidiary to the parent corporation. As stated in issue 1 above, additional factual information is necessary before determining whether there are multiple grantors.

3. Assuming TP1 and TP2-TP14 are treated as owners, IRC §1032 would not apply to the A trust's disposition of TP1's stock that was treated as contributed to the A trust by a subsidiary of TP1. Each subsidiary would recognize gain (or loss) on the A trust's sale of TP1 stock. However, as stated in issue 1 above, additional factual information is necessary before determining whether there are multiple grantors.

4. TP1 and TP2-TP14 are entitled to deduct the fair market value of the stock contributions used by the A trust to provide benefits on behalf of

their respective employees under the G-T plans. However, confirmation is needed with respect to (1) which entity is taking deductions for contributions made on behalf of which employees, (2) whether the contributions are made in cash or stock, and (3) how and when A trust assets are used to fund nonqualified benefits. In addition, additional information regarding the time at which deductions are being claimed and copies of the G-T plans is needed before a proper analysis can be made regarding whether deductions are being taken in accordance with IRC §404(a)(5) for benefits provided under the G-T plans, and whether the plans effectively defer the receipt of compensation.

5. TP2, TP5, TP6, TP9, TP10 and TP13, not TP1, are entitled to deduct an amount equal to the fair market value of the stock contributed by the A trust to fund the A-F plans on behalf of the subsidiaries' employees. However, confirmation of the facts is needed with respect to (1) which entity is taking deductions with respect to contributions made on behalf of which employees, (2) whether the contributions are made in cash or stock, and (3) how and when the contributions are made to the A-F plans.

6. Although IRC §4975 prohibits the indirect sale or exchange of any property between a plan and a disqualified person, the Code exempts a plan's acquisition of qualifying employer securities from the prohibited transaction rules under certain conditions. In this case, assuming the valuation of TP1 stock is appropriate at the time it is contributed to the IRC §401(k) plans, TP1 stock may be used to satisfy obligations of TP1 and its subsidiaries (TP2, TP5, TP6, TP9, TP10 or TP13) under their respective IRC §401(k) plans.

7. Except in the case of an employee stock ownership plan ("ESOP")(as defined in IRC §4975(e)(7)), the Code does not limit a participant's ability to diversify plan assets under qualified plans. See Treasury Regulation §1.401-1(b)(5). Trustees of trusts which form a part of such plans are subject to substantial limitations under the Code and ERISA Title I in their management of plan assets.

8. The treatment for tax purposes of TP1 stock held by the A trust (as either treasury stock or issued stock) may have no effect on the earnings per share computation, which is a financial accounting concept with its own rules.

FACTS

We understand that TP1 established the A trust in for the purpose of holding TP1 stock.[1] The stock held by the A trust is subsequently allocated to the A-F plans, qualified plans under IRC §401(a), and the G-T plans, nonqualified incentive compensation plans, maintained by TP1 or its subsidiaries, TP2-TP14.[2] The A trust was established for a term of years.

Under the terms of the A trust, the A trust acquired approximately $ of newly issued common stock of TP1 from TP1. The A trust purchased the stock with cash it received from TP1 in an amount equal to the aggregate par value of the stock and a year promissory note to TP1 (the Note") in an amount equal to the difference between aggregate par and market values of the TP1 stock. Each year thereafter, the A trust either repays a portion of the note with a cash contribution from TP1 or, pursuant to section of the A trust, that year's portion of the debt is forgiven. The stock is then apportioned and released to the trusts of the qualified A-F plans and the committees administering the nonqualified G-T plans maintained by TP1 or its subsidiaries, TP2-14, in accordance with the terms of the A trust. A trust, §§ et seq.[3]

Under the terms of the A plan, B plan and F plan included in your submission, the term "employer"

See A plan §§ and , F plan

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[1]Our response assumes that only TP1 stock is held by the A trust, and that only TP1 is contributing such stock. However, we note that this fact is unclear under the terms of the A trust and the documents provided by TP1. The A trust refers to "Company Stock", the definition of which is unclear as to whether subsidiary stock is also involved. See A trust, § . However, references to the Company and the description of the arrangement in the recitals appear only to refer to TP1.

[2]Footnote 2 of your field service advice request, dated September 24, 1998, indicated that you have identified plans. However, we have only identified the addressed herein.

[3]Our response also assumes, based on the terms of the A trust described above, that

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§§ and , B plan §§ and [4] In addition, the A plan and the F plan provide that

. See A and F plans §§ . The B plan provides that

. B plan §§ and . Also, under the plans terms,

.

In addition, the A trust provides that "

" A trust, § . The A trust also provides that "'

." A trust, § . Accordingly, while it appears from the terms of the A trust that, in addition to TP1, TP2-TP14 participate in the A trust arrangement, it is unclear whether assets of the A trust are available to satisfy claims of general creditors of TP2-TP14 in the event of bankruptcy or insolvency.

TP1 intends the A trust to be a grantor trust under IRC §671. Documents provided by TP1 explaining the A trust also appear to indicate that

In addition, although the information provided does not identify which tax years are at issue, we understand that

We also understand that TP1 and its subsidiaries deduct on those returns contributions to the qualified A-F plans or nonqualified G-T plans, which are made for the benefit of their respective employees.

[4] For the purposes of our response, we assume that TP1 through TP14 constitute a controlled group of corporations under IRC §1563(a).

DISCUSSION

ISSUE 1

IRC §671 provides that where a grantor shall be treated as the owner of any portion of a trust under subpart E, part 1, subchapter J, chapter 1 of the Code, there shall 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).

IRC §677(a)(2) 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.

Treas. Reg. § 1.677(a)-1(d) provides that under IRC §677, 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.

As noted above, the A trust provides that

We believe that at the time TP1 funds the A trust, it is deemed to make a contribution to capital of TP2-TP14 because the trust assets will be used to satisfy the legal obligations of TP2-TP14 under their respective plans based on the allocation formula set forth in the A trust. Accordingly, TP1 and TP2-TP14 will each be treated as a grantor of the trust with respect to the amount that is to be used to satisfy each corporation's legal obligation. Pursuant to IRC § 677, TP2-TP14 and TP1 will be treated as the owners of the portion of the A trust that they are treated as the grantors of. Accordingly, under IRC § 671, there would be included in computing the taxable income and credits of each grantor those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust that each grantor is treated as owning. See also Treas. Reg. § 1.671-3.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

This determination assumes that the transfer of cash to the A trust will not be treated as a transfer of property under IRC §83 to the employees of TP1 and TP2-TP14. This determination also assumes that the claims of the creditors of each subsidiary and TP1 will be limited to the amount of stock allocated to it in Article of the A trust. For example, the A Plan and the G Plan are allocated [redacted] percent of the available stock. We believe that at the time of the funding of the A trust, TP1 has made a contribution to capital of TP2 because TP2's obligation to fund the retirement plans has been satisfied to the extent of [redacted] percent of the available stock. However, if TP1's creditors can reach the [redacted] percent specifically allocated for TP2, the argument that TP2's obligations have been satisfied would be more tenuous and further review would be required by National Office. In sum, the ability of a creditor to reach more than the percentage of the assets allocated for its debtor would undercut our belief and argument that there is a capital contribution at the time of the funding of the A trust and our conclusions thereto.

We recommend contacting TP1 regarding [redacted] However, if further factual development suggests that our assumptions, as described above, are incorrect, our office would want to reconsider the issue.

ISSUE 2

Rev. Rul. 85-13, 1985-1 C.B. 184, holds that where a grantor is treated as the owner of the entire trust, the grantor is treated as the owner of the trust's property for federal income tax purposes. Therefore, a sale between the grantor and the trust will not be recognized for federal income tax purposes.

To the extent that the A trust pays TP 1 interest that is attributable to the portion of the trust owned by TP 1, the transaction will be ignored for federal income tax purposes. To the extent that the A trust pays TP1 interest that is attributable to the portions of the trust owned by TP2-TP14, the interest will be considered as an amount paid by the subsidiary to the parent corporation. See Rev. Rul. 85-13.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As noted in issue 1 above, further factual development is needed before determining whether TP1-TP14, as multiple grantors, would be treated as owning the assets of the A trust that are available to satisfy claims of their general creditors and their liabilities under the plans.

We note, however, that the second sentence of the fourth full paragraph on page 4 of your memorandum states that “ ” (Emphasis added) In our view, if TP1 does not recognize income on the interest payments from the A trust, the A trust should not be permitted to deduct such payments.

ISSUE 3

IRC §1032(a) provides that a corporation does not recognize gain or loss on the receipt of money or other property in exchange for its stock (including treasury stock). For purposes of §1032(a), a corporation’s transfer of its own stock as compensation for services is considered to be a disposition by the corporation for money or other property. Treas. Reg. § 1.1032-1(a).

When a corporation is treated as the owner of a grantor trust, the corporation is required to include those items of income, deductions and credits attributable to the trust in computing its taxable income and credits, as if the trust does not exist. Moreover, the owner of a grantor trust is treated as the owner of all property held in the grantor trust. *See* Rev. Rul. 57-390, 1957-2 C.B. 326 (corporate grantor of trust includes in taxable income the gross income from trust properties, determined by grantor-corporation as if trust had not been created); Rev. Rul. 66-159, 1966-1 C.B. 162 (where individual grantor is treated as the owner of the entire trust, no gain is recognized pursuant to IRC §1032 on the trust’s sale of grantor’s principal residence and timely reinvestment of the proceeds in a new residence).

Accordingly, in this case, IRC §1032 applies only to the portion of the A trust’s stock that TP1 owns. TP1 would not recognize any gain or loss when the A trust transfers or sells any such stock.

We assume, based on the discussion in issue 1 above, that each subsidiary is treated as a grantor of the amount deemed contributed to its capital.

Accordingly, we believe that each subsidiary would recognize gain or loss on the A trust's sale of any TP1 stock that it is deemed to own.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The amount of gain or loss the subsidiaries recognize depends on whether the subsidiaries are deemed to receive a cost basis in the portion of TP1 stock that they are treated as owning. We understand that you have not asked us to address this question. However, we note that this issue would probably need to be considered further in order to obtain a definitive resolution.

These conclusions are based on the assumptions and necessary additional factual development addressed in issue 1 above. Should these assumptions change as a result of further factual development, our office would want to reconsider the issue.

ISSUE 4

A. Which Entity is Entitled to the Deduction.

Accordingly, and based on the following discussion, we have concluded that TP1-TP14, respectively, are the entities entitled to deduct contributions by the A trust to the G-T plans for the benefit of their employees. However, such deductions are only allowable as otherwise provided under IRC §404(a)(5) and IRC §83.

Under IRC §404(a)(5), employer contributions to plans other than tax qualified plans are deductible in the taxable year in which the amounts attributable to the contributions are includible in the gross income of the employees participating in the plan, provided separate accounts are maintained for each employee if the plan covers more than one participant. Under IRC §83(h), in the case of a transfer of property to which IRC §83(a) applies, there is allowed as a deduction under IRC §162, to the person for whom the services were performed, an amount equal to the amount included under IRC §83(a) in the gross income of the person who performed the services.

If the A trust is a grantor trust under IRC §671, the assets of the A trust are treated for tax purposes as though they are part of the general assets of the owner(s)–either TP1 or TP1 - TP14, as addressed in issue 1 above. Under Rev. Rul. 84-68, 1984-1 C.B. 3, when a parent corporation transfers cash to an employee of a subsidiary of the corporation, the parent's payment is treated as a contribution to the subsidiary's capital and a constructive payment by the subsidiary to its employees. The payment is deductible by the subsidiary as compensation, provided it is reasonable for the service's performed. See also Rev. Rul. 80-76, 1980-1 C.B. 15, amplified by Rev. Rul. 81-45, 1981-1 C.B. 483 (when a majority stockholder of a corporation transfers stock of the corporation to an employee of the subsidiary of the corporation, (1) the fair market value of the stock is includible in the employee's income under IRC §83(a) and (2) the subsidiary is allowed the IRC §83(h) deduction.)[5] Accordingly, if TP1 is the sole grantor, the A trust's contribution to the plans would be treated as a contribution to the subsidiary's capital and a constructive payment by the subsidiary to its plan which would be deductible by the subsidiary as compensation, provided it otherwise satisfied the requirements of IRC §404 and §83(h).

If TP1 and TP2 - TP14 are treated as the grantors and owners of the A trust assets, amounts paid by the A trust to the G-T plans,

would be considered to be amounts paid by TP1 and TP2-TP14, the respective grantors and owners of the A trust. Therefore, amounts paid by the A trust on behalf of TP1 and TP2-TP14's employees would be paid and deductible by TP1 and TP2-TP14, the employer/service recipients, in accordance with IRC §§404(a)(5) and 83(h).

B. Timing of Deduction.

We note that some of the incentive compensation plans submitted indicate that a portion of the annual bonus is deferred and paid out over a [redacted] year period. According to some of the submitted documents, the deferred bonus is deemed to have been earned out and vested on a pro rata basis at the end of each year during the [redacted] year period only to the extent the employee does not terminate employment during that year. Some of the other plans indicate that the bonus is earned at the end of the year, but paid during the next year. These facts suggest that there may be an issue regarding the timing of the compensation deductions.

[5] This is distinguishable from a situation in which the parent corporation makes a contribution on behalf of a subsidiary corporation and the parent takes the deduction. In general, a parent corporation may not deduct compensation it pays for the benefit of the employees of its wholly owned subsidiary, even though the indirect benefit of their services inures to the parent corporation. Columbian Rope Co. v. Comm., 42 T.C. 800 (1964), acq. on other issues, 1965-1 C.B. 4. Therefore, under IRC §§404(a)(5) and 83(h), contributions by the A trust to the G-S plans would not be deductible by TP1 where TP1 is neither the "employer" nor the recipient of the services provided by employees of TP2 - TP14.

IRC §404(a) provides, in part, that if contributions are paid by an employer on account of any employee under a plan deferring the receipt of compensation, such contributions or compensation are not deductible under Chapter 1 of subtitle A of the Code, but if they would otherwise be deductible, they are deductible under §404, subject to the limitations contained therein.

As noted above, pursuant to IRC §404(a)(5), contributions to a nonqualified deferred compensation plan are deductible in the taxable year in which the contribution is includible in the gross income of employees participating in the plan (or that would be includible but for an exclusion under Chapter 1 of the Code); but in the case of a plan in which more than one employee participates, only if separate accounts are maintained for each employee. See also Treas. Reg. § 1.404(a)(12)-1(b)(1).

The rules of IRC §404(a) apply to any method or arrangement that has the effect of a plan deferring the receipt of compensation or other benefits for employees. Under Treas. Reg. § 1.404(b)-1, where a corporation is under an obligation, whether funded or unfunded, to pay a pension or other deferred compensation to an employee or his beneficiaries, there is a method having the effect of a plan deferring the receipt of compensation for which deductions are governed by §404(a).

According to Treas. Reg. § 1.404(b)-1T, Q&A-1, IRC § 404(b) clarifies that any plan, or method or arrangement, deferring the receipt of compensation is to be treated as a plan deferring the receipt of compensation for purposes of IRC § 404(a). Thus, for example, under IRC §404(a)(5), a contribution paid or incurred to a nonqualified plan, or method or arrangement, providing for deferred benefits is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is includible in the gross income of the employee.

Treas. Reg. §1.404(b)-1T, Q&A-2(a), provides that a plan defers the receipt of compensation or benefits to the extent that it is one under which an employee receives compensation or benefits "more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed." Under Treas. Reg. §1.404(b)-1T, Q&A-2(b)(1), a plan is presumed to defer the receipt of compensation for "more than a brief period of time to the extent that an employee receives compensation after the fifteenth day of the third calendar month following the end of the employer's taxable year in which the related services were rendered." As an example, the regulation provides that salary under an employment contract or a bonus under a year-end bonus declaration is presumed to be paid under a plan, or method or arrangement, deferring the receipt of compensation to the extent that the salary or bonus is received beyond the applicable 2 ½ month-period. See also Treas. Reg. §1.404(b)-1T, Q&A-2(c).

As noted above, IRC §83(h) provides that in the case of a transfer of property to which IRC §83(a) applies, there is allowed as a deduction under IRC §162, to the person for whom the services were performed, an amount equal to the amount included under IRC §83(a) in the gross income of the person who performed the services. This deduction is generally allowed to the service recipient for the taxable year in which or with which ends the taxable year in which the amount is included as compensation by the person who performed the services. Under Treas. Reg. §1.83-6(a)(3), however, where property is substantially vested on transfer, the deduction is allowed to the service recipient in accordance with its method of accounting (in conformity with IRC §§446 and 461).

The Tax Court addressed the issue of deferred compensation in Schmidt Baking Co., Inc. v. Commissioner, 107 T.C. 271 (1996). In Schmidt Baking, the taxpayer was an accrual-basis taxpayer with a fiscal year that ended December 28, 1991. The taxpayer funded its accrued vacation and severance pay liabilities for 1991 by purchasing an irrevocable letter of credit on March 13, 1992. The parties stipulated that the letter of credit represented a transfer of a substantially vested interest in property to employees for purposes of IRC §83, and that the fair market value of such interest was includible in the employees' gross incomes for 1992 as a result of the transfer. The Tax Court held that the purchase of the letter of credit, and the resulting income inclusion, constituted payment of the vacation and severance pay within the 2 ½ month period described in the regulations. According to the Tax Court, because the vacation and severance pay was treated as received by the employees within the 2 ½ month period and were not treated as deferred compensation under IRC §404, it was deductible by the taxpayer for its 1991 fiscal year pursuant to its normal accrual method of accounting.

Section 7001 of the Internal Revenue Restructuring and Reform Act, Pub. L. 105-206, enacted on July 22, 1998, prospectively overrules the result in Schmidt Baking by enacting IRC §404(a)(11). Under that section, for purposes of determining whether an item of compensation is deferred compensation, the compensation is not considered to be paid or received until actually received by the employee. In addition, an item of deferred compensation is not considered paid to an employee until actually received by the employee. The Conference Report states that no inference is intended that the result in Schmidt Baking is prior law beyond its immediate facts or that the use of similar arrangements is permitted under present or prior law. See Conf. Rep. 299, 105th Cong., 2d Sess. 344.

The question of the timing of the deduction arises regardless of whether the A trust is a grantor trust under IRC §671 or a secular trust under IRC §402(b). If the A trust is a grantor trust, then the timing of the deduction is governed by IRC § 404(a)(5). If the A trust is a secular employee's trust, taxable under IRC §402(b), then the timing of the deduction includes an analysis of IRC § 404(a)(5) and may also include consideration of Schmidt Baking (if there is an income inclusion event prior to the expiration of the 2 ½ month period described in the Treas. Reg. § 1.404(b)-1T). However, we cannot conclude, based on the facts submitted, when TP1-TP14 are entitled to claim the deductions.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We recommend that you obtain more information regarding whether the contributions from the A trust to the nonqualified plans are made in cash, stock, or a combination of both. (We note above that However, confirmation on this fact is necessary.) If the contributions are made in stock, we recommend that you obtain more information about whether the stock contains any restrictions related to the performance of future services. [redacted]. Additionally, we recommend that you obtain more information regarding [redacted] (Again we note that . However, confirmation on this fact is necessary.) [redacted]

As stated above, some of the submitted documents suggest that This may be incorrect if the amounts are considered deferred compensation under IRC §404(a)(5). Additionally, if the G-T plans are considered "funded" and the A trust considered an IRC §402(b) trust, consideration of Schmidt Baking may be required to determine the timing of the deduction.[6] However, it is unclear whether we would consider Schmidt Baking to apply to the facts of this case.

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[6]Payment of funds before actual payment of benefits to employee participants suggests that these arrangements are "funded" deferred compensation arrangements. Further development of the facts in this regard is necessary.

ISSUE 5

Under IRC §404(a)(3), regarding deductions for employer contributions to a qualified profit sharing plan, contributions are deductible by an employer in the taxable year when paid, if the taxable year ends within or with a taxable year of the trust in a year in which the trust is exempt under IRC §501(a). The amount of deduction cannot exceed 15 percent of the participants' compensation otherwise paid or accrued during the taxable year. The A trust provides, in part, that upon the payment or forgiveness in any trust year of any principal on the Note, common stock held by the A trust is allocated and transferred to the trusts established under the qualified A-F plans. The amount of the annual allocation is prescribed by the A trust.

As stated above, we understand that TP2, TP5, TP6, TP9, TP10 and TP13 file consolidated tax returns with TP1, and that TP2, TP5, TP6, TP9, TP10 and TP13, respectively, not TP1, claimed deductions on the returns for contributions paid by the A trust to the qualified A-F plans. Accordingly, we believe that the contributions by TP2, TP5, TP6, TP9, TP10 and TP13, which the A trust pays to the qualified A-F plans, are deductible under IRC §404(a)(3).

First, as stated above, as a grantor trust under IRC §671, assets of the A trust are treated for tax purposes as though they are part of the general assets of the owner(s), who is either TP1 or TP1 and TP2, TP5, TP6, TP9, TP10 and TP13. However, as noted in issue 4 above, if TP1 is the sole grantor and owner, a payment by a parent corporation for the benefit of its subsidiary is recognized for federal income tax purposes as a contribution of capital to the subsidiary corporation and a constructive payment by the subsidiary. See Rev. Rul. 84-68, 1984-1 C.B. 31, citing Estate of A.P. Steckel v. Comm., 26 T.C. 600 (1956), aff'd per curiam, 253 F.2d 267 (6th Cir. 1958) and Anderson v. Comm. , 67 T.C. 522 (1976), aff'd per curiam, 583 F.2d 953 (7th Cir. 1978). Accordingly, contributions by the A trust to the A-F plans in satisfaction of TP2, TP5, TP6, TP9, TP10 and TP13's liabilities under the plans would be deemed to be paid by TP2, TP5, TP6, TP9, TP10 and TP13, respectively. Therefore, the contributions are deductible in the year paid, to the extent that they are otherwise deductible under IRC §404(a). The amount of the deduction equals the fair market value of the money or property contributed at the time it is paid over to the trusts. See United States v. General Shoe Corporation, 282 F.2d 9 (6th Cir. 1960), cert. denied, 363 U.S. 641 (1961); and International Freighting Corp., Inc. v. Commissioner, 45 B.T.A. 716 (1941), aff'd, 135 F.2d 310 (1943). [7]

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[7] As stated in footnote 5 above, this is distinguishable from a situation in which the parent corporation makes a contribution on behalf of a subsidiary corporation and

Second, if TP1 and TP2, TP5, TP6, TP9, TP10 and TP13 are treated as the grantors and owners of A trust assets, contributions by the A trust to the A-F plans, as prescribed by the terms of the A trust, would be considered to be contributions by TP1 and TP2, TP5, TP6, TP9, TP10 or TP13, the respective grantors and owners for purposes of IRC §671. Therefore, A trust contributions would be considered to be paid by TP1 and TP2, TP5, TP6, TP9, TP10 or TP13, the respective employer, and deductible in the tax year paid in an amount equal to the fair market value of the money or property contributed at the time it is paid over to the trusts, provided the contributions otherwise satisfy the requirements of IRC §404(a). However, the additional factual development discussed above is needed before determining which entity is the grantor and owner of A trust assets.

ISSUE 6

Under the terms of the A plan, B plan and F plan, the IRC §401(k) plans included in your submission, employer contributions appear to be required to fund profit sharing contributions, IRC §401(k) elective deferrals, employer matching contributions, and/or employer matching stock contributions. In general, although the Code does not require that employer contributions be made in cash, the prohibited transaction rules under IRC §4975 prohibit the direct or indirect sale or exchange of property between a plan and a disqualified person, unless an exemption applies. See IRC §§4975(c), 4975(d). Under the circumstances presented, the A trust, as well as TP1 through TP14, are disqualified persons under the Code. See IRC §4975(e).

Under IRC §4975(d)(13), the prohibitions described under IRC §4975(c) do not apply to transactions exempt under §406 of ERISA Title I.[8] Section 406 of ERISA Title I lists transactions that are prohibited under ERISA Title I, which

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the parent takes the deduction. In general, a parent corporation may not deduct compensation paid by it for the benefit of employees of its wholly owned subsidiary, even though the indirect benefit of their services inures to the parent corporation. Columbian Rope Co. v. Comm., 42 T.C. 800 (1964), acq. on other issues, 1965-1 C.B. 4. Therefore, under IRC §404(a)(3), contributions by the A trust to the A-F plans would not be deductible by TP1 since TP1 is not the “employer” maintaining the plan on behalf of its employees. IRC §404(a). (Under the facts as we understand them, TP1 has not adopted the A-F plans on behalf of its own employees. See IRC §414(b).)

[8] Our response does not address whether the A trust is a plan under the provisions of ERISA Title I. ERISA Title I imposes a number of requirements on employee benefit plans, such as reporting and disclosure requirements, funding standards, and duties owed by plan fiduciaries.

generally parallel the prohibited transactions under IRC §4975(c). Section 408 of ERISA Title I provides exemptions under Title I, which generally parallel the exemptions under IRC §4975(d). For instance, pursuant to §408(e) of Title I, the provisions governing prohibited transactions under Title I found in §406 do not apply to a plan's acquisition of "qualifying employer securities" under certain conditions. See ERISA Title I, §408(e).[9] Those conditions are as follows: 1) the acquisition must be for adequate consideration; 2) the acquisition must not give rise to a commission; and 3) the plan is an eligible individual account plan, e.g., a profit sharing or stock bonus plan. See ERISA Title I, §408(e)(1)-(3); §407(d)(3).

According to the material provided, the conditions under ERISA §§408(e)(1)-(3) appear to be satisfied, provided the valuation of the stock at the time it is contributed to the qualified plans constitutes adequate consideration. Thus, the plans' acquisition of TP1 stock appears to fall within the exemption provided by IRC §4975(d)(13). Consequently, IRC §4975(d)(13) provides an exemption to the prohibition on the sale or exchange of property between the plans and the A trust. It is unclear whether assets of the A trust are used to satisfy all or a portion of these employers' liabilities under the plans. However, in general, the Code does not require that employer contributions be funded in cash.

ISSUE 7

Except in the case of an employee stock ownership plan ("ESOP")(as defined in IRC §4975(e)(7)), the Code does not limit a participant's ability to diversify plan assets under qualified plans. Subject to some important exceptions, trustees of trust which is part of an IRC § 401(a) plan can, in general, use plan assets to purchase any investments permitted by the trust agreement to the extent allowed by local law. See e.g., Treasury Regulation §1.401-1(b)(5). Under that regulation, no specific limitations apply to investments by trustees of an IRC §401(a) plan's related trust; however, the trustees of such a trust are subject to substantial constraints under the Code and ERISA Title I. Under the exclusive benefit rule under IRC §401(a)(2), plan assets must be used for the exclusive benefit of participants and beneficiaries under the plan. In addition, IRC §404 of ERISA Title I sets forth the duties owed by a fiduciary of an ERISA plan, including the duty to discharge his duties for the exclusive purpose of providing benefits to participants and their beneficiaries, in a prudent manner. ERISA §404 also requires the

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[9] The term "qualifying employer securities" means generally the common stock of the employer, which is readily tradable on an established market. See IRC § 409(l)(1); see also IRC §409(l)(2)(special rule for stock not readily tradable). We understand that the TP1 stock is readily tradable on an established market.

trustees of an ERISA plan to diversify the plan investments, unless it is not prudent under the circumstances.

ISSUE 8

Assuming the subsidiaries are treated as grantors of the A trust and are therefore treated as owning a portion of TP1 stock held by the A trust, the portion of the stock that the subsidiaries are considered to own is generally treated as outstanding for tax purposes. The portion owned by TP1 would be treated as treasury stock. We note, however, that the treatment of TP1 stock as treasury stock for tax purposes may have no effect on the calculation of earnings per share, which is a financial accounting concept with its own rules. We are not aware of any rules in the Code or regulations for calculating earnings per share or of any relevance of the earnings per share calculation for tax purposes. The Securities Exchange Commission (SEC), the Financial Accounting Standards Board (FASB) and other rule making authorities for financial accounting are responsible for providing guidance on these matters. Consequently, the tax treatment of the stock held by the A trust may have little, if any, bearing on the calculation of earnings per share.

SUPPLEMENT AND CONCLUSION

In addition to the foregoing issues, we recommend further development of facts regarding whether contributions to the A trust by TP1 and the rights conferred on plan participants under the A trust constitute a transfer of property under IRC §83.

Section 83(a) of the 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 §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.

Under the economic benefit doctrine, a person 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 person'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.

Whether a plan is funded depends on the facts and circumstances of each case. The essential feature of a funded plan is that its assets are segregated from the general assets of the employer and are not available to general creditors if the employer becomes insolvent. Northwestern Mutual Life Insurance Company v. Resolution Trust Corporation, 848 F. Supp. 1515 (N.D. Ala. 1994). However, an arrangement will be considered to be unfunded if the benefits are to be paid from the employer's general assets and there is no "res" or property which has been set aside from the corporation's ordinary assets in order to fund the plan. Dependahl v. Falstaff Brewing Co., 653 F. 2d 1208, 1214 (8th Cir. 1981), cert. denied 454 U.S. 968 (1981).

Thus, whether there has been a transfer of property for the performance of service within the meaning of §83, or a person has incurred an economic benefit because the A trust will be considered to have funded the nonqualified deferred compensation benefits of participants, will depend on the particular facts and circumstances of the arrangement. It is unclear from the documents provided us whether assets of the A trust are available to subsidiaries' creditors in the event of bankruptcy or insolvency of a subsidiary. Before a determination on this issue can be made, [redacted]. In addition, under § of the A trust,

Further information is necessary regarding how this provision is administered : [redacted].

Finally, we want to emphasize that separate and distinct laws and analysis apply to qualified and nonqualified plans. Accordingly, it is critical that you bear this point in mind when developing the case and the additional facts addressed herein. If you have any further questions, please call the branch telephone number.

By: ____________________________

MICHAEL ROACH
Chief, Branch 7