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Department of the Treasury

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C:TEGE:EB:QP:2/PLR-118309-02
Date:
February 11, 2003

Legend

Employer =
EIN:
Plan =
Participant =
State M =

Dear :

This responds to your letter of January 25, 2002, and subsequent correspondence on behalf of Employer, requesting a ruling concerning the proposed deferred compensation plan under which Employer intends to provide benefits under sections 457(b) and 457(f) of the Internal Revenue Code of 1986 and a related trust.

Employer is exempt from federal income tax under section 501(c)(3) and is a supporting organization within the meaning of section 509(a). Employer has recently established a retirement plan comprised of two deferred compensation agreements that Employer has entered into with Participant, a key employee of Employer. The first of the agreements (Plan A) is designed to be an eligible deferred compensation plan within the meaning of section 457(b). The second of these agreements (Plan B) is designed to be an ineligible deferred compensation plan within the meaning of section 457(f). Both Plan A and Plan B are designed solely to benefit Participant.

Under Plan A, Participant may elect to defer compensation he would have received for services rendered to Employer until attainment of age 70 ½, disability, death, separation from service with Employer or until the occurrence of an unforeseeable emergency. Participant may participate in Plan A only by signing a participation agreement.

Participant's election to defer compensation under Plan A must be filed prior to the beginning of the month in which his salary reduction agreement becomes effective. Plan A provides for a maximum amount that may be deferred by Participant in any taxable year and also provides for a catch up contribution for amounts deferred for one or more of Participant's last three taxable years ending before he attains normal retirement age under Plan A.

With certain limitations, participant may elect the manner in which the deferred amounts will be distributed. Subsequent to the Participant's severance from employment, and prior to the date benefits would commence under Plan A, the Participant may make one election, which shall be irrevocable, to determine when benefits will be distributed or to change a previous election made prior to separation from service. If participant fails to make a timely election, distribution will commence at the time and in the manner set forth in the Plan. The manner and time of benefit payout must meet the distribution requirements of sections 401(a)(9) and 457(d)(2).

Under Plan B, Employer will credit certain amounts to Participant's account in the Plan. Plan B does not include provisions limiting the amount deferred to the lesser of $12,000 or 100 percent of Participant's includible compensation.

Participant will receive all amounts credited to the section 457(f) account (including all earnings and gains and losses allocable thereto) only if the Participant's employment ends due to (a) full completion of the employment term under Plan B on or after reaching Retirement Date (the first day of the month that occurs after Participant attains age 58), (b) death, (c) disability, or (d) termination of employment by Employer other than for cause.

If the participant voluntarily terminates employment with Employer, or if he is terminated by Employer for good cause, prior to his retirement date, all amounts credited to the section 457(f) account shall be irrevocably forfeited and no further amounts shall be paid to him. Any such forfeited amounts shall be paid by the Trustee to Employer pursuant to the terms of the Trust.

Upon the termination of the Participant's employment with the Employer prior to his retirement date by reason of disability, all amounts credited to the section 457(f) account shall be paid to him in a lump sum sixty days after such termination.

Upon the death of the participant prior to his retirement date, all amounts credited to the section 457(f) account shall be paid to a beneficiary designated by the Participant in a lump sum sixty days after the Participant's death, provided that if the Participant fails to designate a beneficiary, or if such designation is for any reason illegal or ineffective, or if no designated beneficiary survives the Participant, the amounts credited to the section 457 (f) account shall be paid to the duly appointed legal representative of his estate.

To assist it in providing assets from which to pay the benefit obligations to the participant under Plan A and Plan B, Employer has adopted a trust (the Trust) with an unrelated third party as trustee (Trustee). The Trust, as amended, conforms to the model language contained in section 5 of Rev. Proc. 92-64, 1992-2 C.B. 422, that serves as a safe harbor against the constructive receipt of income and the realization of economic benefit. The Trust is a valid trust under state M's law. Under the plans and the Trust, the interests of participant and his beneficiaries in the trust are no greater than those of any other general unsecured creditor of the Employer.

Under the plans, Participant has the right to request that employer designate deferred amounts credited to his plan accounts as invested among the available investment options established by Employer. Employer may choose whether it invests according to such requests in its sole discretion. By contrast, the Trustee has complete discretion regarding his investment of amounts contributed to the Trust.

The Trustee has the duty to invest the trust assets in accordance with the tems of the trust agreement. At all times, the trust assets will be subject to the claims of Employer's general creditors if Employer becomes insolvent, as defined in the trust agreement. Employer's Chief Executive Officer and its Board of Directors have the duty to inform the Trustee of Employer's insolvency. Upon receipt of such notice or other written allegations of Employer's insolvency, the Trustee will suspend the payment of benefits with respect to Participant and any beneficiaries in the Plan. If the Trustee determines in good faith that Employer is not insolvent or is no longer insolvent, the Trustee will resume the payment of benefits. If Employer is insolvent, the Trustee shall hold the trust corpus for the benefit of Employer's general creditors.

The plans and Trust provide that all amounts deferred under the plans, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights will remain (until made available to the participant or other beneficiary) solely the property and rights of Employer, subject only to the claims of Employer's general creditors. Participant has only Employer's unsecured promise to pay deferred compensation pursuant to the plans. The rights of the participant or his beneficiaries to payments pursuant to the plans and trust agreement are nonassignable, and the interests in benefits under the plans and the trust agreement are not subject to attachment, pledge, garnishment, encumbrance or other legal process.

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 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 creditor, 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 a taxpayer's account or set apart or otherwise made available so that the taxpayer may draw upon 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.

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 (6^{th} 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.

Section 457 of the Code provides rules for the deferral of compensation by an individual participant in an eligible deferred compensation plan (as defined in section 457(b)).

Section 457(a) of the Code provides that in the case of a participant in an eligible deferred compensation plan, any amount of compensation deferred under the plan and any income attributable to the amounts so deferred shall be includible in gross income only for the taxable year in which such compensation or other income is paid or otherwise made available to the participant or beneficiary.

Section 457(b)(5) prescribes that an eligible deferred compensation plan must meet the distribution requirements of section 457(d).

Section 457(d)(1)(A) provides that for a section 457 plan to be a eligible plan, the plan must have distribution requirements providing that under the plan amounts will not be made available to participants or beneficiaries earlier than (i) the calendar year in which the participant attains age 70 ½, (ii) when the participant is separated from service with the employer, or (iii) when the participant is faced with an unforeseeable emergency as determined under Treasury regulations. However, section 401(a)(9)(C)(i) generally allows plans to postpone the required beginning date until April 1 of the calendar year following the later of the calendar year in which the employee retires or in which he attains 70 1/2.

Section 457(f) provides that if a section 457 plan is or becomes an ineligible plan, then the deferred compensation shall be included in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation, and the tax treatment of any amount made available under such plan to a participant or beneficiary shall be determined under section 72 relating to annuities.

Section 457(f)(1) of the Code governs the tax treatment of a participant in a plan of an eligible employer, if the plan provides for a deferral of compensation, but is not an eligible deferred compensation plan. Section 457(f)(2) states that section 457(f)(1) does not apply to a plan described in section 401(a) which includes a trust exempt from tax under section 501(a), to an annuity plan or contract described in section 403, to that portion of any plan which consists of a transfer of property described in section 83, or to that portion of any plan which consists of a trust to which section 402(b) applies.

In general, section 457 (f)(1)(A) of the Code provides that the amount of compensation which is deferred under a plan subject to section 457(f)(1) is included in the participant's or beneficiary's gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation. Section 457(f)(3)(B) provides that, for purposes of section 457(f), the rights of a person to compensation are subject to a substantial risk of forfeiture if such person 's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

Section 1.83-3(c) of the Income Tax Regulations provides that for purposes of section 83 and the regulations thereunder, whether a risk of forfeiture is substantial depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned , directly or indirectly, upon the future performance of substantial services by a person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. The regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial. See section1-83-3(c)(2).

Section 1.83-3(c)(4), Example (1) of the regulations provides, by way of example, that where a corporation transfers to an employee 100 shares of stock in the corporation, at $90 per share, and the employee is obligated to sell the stock to the corporation at $90 per share if he terminates his employment with the corporation for any reason prior to the expiration of a two year period of employment, the employee's rights to the stock are subject to a substantial risk of forfeiture during such two year period. If the conditions on transfer are not satisfied, it is assumed that the forfeiture provision will be enforced.

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 is 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.

Under the terms of the Trust, assets may be placed in trust to be used to provide deferred compensation benefits to Participant. However, the trustee has the obligation to hold the Trust assets and income for the benefit of Employer's general creditors in the event of 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 Employer's insolvency they are fully within reach of Employer's general creditors, as are any other general assets of Employer.

Provided, (i) that the creation of the Trust does not cause either Plan A or Plan B 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 the trust assets to satisfy the claims of Employer's general creditors in the event of Employer's insolvency is enforceable by the general creditors of Employer under federal and state law, and based on the information submitted and representations made, we conclude as follows:

1. Plan A established by Employer constitutes an eligible deferred compensation plan as defined in section 457(b).

2. Plan B established by Employer constitutes an ineligible deferred compensation plan as defined in section 457(f).

3. Amounts of compensation deferred in accordance with Plan A, including any income attributable to the deferred compensation, will be includible in gross income for the taxable year or years in which amounts are paid or otherwise made available to Participant or a beneficiary in accordance with the terms of Plan A.

4. Benefits under Plan B are subject to a substantial risk of forfeiture until the earliest of the date Participant dies, terminates service due to disability, or attains age 58. Accordingly, under section 457(f)(1)(A), amounts credited by Employer under Plan B are included in the gross income of Participant or his beneficiaries when they vest in the earliest of the taxable year in which Participant dies, terminates service due to disability, or attains age 58, if Participant is in Employer's employ on attaining age 58.

5.The Trust will be classified as a trust within the meaning of Treasury Regulations section 301.7701-4(a). Because the principal and income of the Trust may be applied in discharge of legal obligations of Employer, under section 677, Employer shall be treated as the owner of the Trust. Accordingly, under section 677, there shall be included in computing Employer's taxable income and credits, those items of income, deductions, and credits against tax of Trust, subject to the provisions of the Code applicable to section 501(c)(3) organizations.

6. Neither the adoption of Plan A or Plan B, nor the creation of the Trust, nor Employer's contributions of assets to the Trust will result in a transfer of property to Participant or beneficiary for purposes of section 83 or Treasury Regulation section 1.83-3(e).

7. Neither the adoption of Plan B, nor the creation of the Trust, nor Employer's contributions of assets to the Trust will cause any amount to be included in the gross income of Participant or his beneficiaries under the cash receipts and disbursements method of accounting, pursuant to either the constructive receipt doctrine of section 451, the economic benefit doctrine, or section 457(f).

No opinion is expressed concerning the timing of the inclusion in income of amounts deferred or payable under any plan other than Employer's Plans described above. If the Plans are significantly modified, this ruling will not necessarily remain applicable. This ruling is directed only to Employer and applies only to the Plans submitted on January 25, 2002, as modified by the revisions submitted on November 19, 2002. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion in the ruling. See section 12.04 of Rev. Proc. 2003-1, 2003-1 I.R.B. 1. However, when the criteria in section 12.05 of Rev. Proc. 2003-1 are satisfied , a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

Sincerely,

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