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November 17, 1999.

Plan =

Entity X =

Employee A =

Date D =

This responds to your request for a ruling submitted in a letter dated June 4, 1999, and subsequent correspondence on behalf of Entity X concerning X's proposed nonqualified deferred compensation plan (the "Plan") and a related trust (the "Trust"). You represent that X is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code ("Code") and that it is a public charity within the meaning of section 509(a) of the Code. The Plan is designed to be an ineligible deferred compensation plan within the meaning of section 457(f) of the Code and to benefit solely X's president, Employee A. You represent that A is a member of a "select group of management or highly compensated employees."

Under the Plan, X promises to pay benefits described in the Plan to A or his beneficiary only if he continues performing substantial services (as defined under the Plan) for X until Date D (which is significantly more than two years into the future), unless A's employment is terminated due to death or disability as defined under the Plan. The Plan permits the Board of Directors to increase the benefits provided to A under the Plan, but the Plan bars the Board of Directors from decreasing the amount of the deferred benefits without A's written consent. The Plan does not include provisions limiting the amount deferred to the lesser of $7,500 or 33-1/3 percent of the participant's includible compensation.

The Plan provides that Employee A, or his beneficiaries, will be paid the benefits described either in 25 annual payments or in a present-value lump sum with such payments made or commencing within 30 days of A's death, disability, as defined in the Plan, or retirement. If A's employment with X is terminated, for reasons other than death or disability, prior to Date D set in the Plan, all his rights and benefits thereunder will be forfeited, and X generally will have no further obligation to pay any benefit under

the Plan. However, the Plan includes a limited benefit reinstatement provision if A resumes his employment with X within a relatively short period after having terminated it prior to Date D.

To assist it in providing assets from which to pay the benefit obligations to the participant, Entity X has adopted a Trust with an independent third party as trustee ("Trustee"). The Trust 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. Additionally, the Trust contains no inconsistent language that conflicts with the model trust language. You represent that the Trust is a valid trust under the appropriate state law and that all material terms and provisions of the Trust, including the creditors' rights clause, are enforceable under the appropriate state law.

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

The Plan and trust agreement both provide that all amounts deferred under the Plan, 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 beneficiary) solely the property and rights of the employer, subject only to the claims of X's general creditors. The participant has only X's unsecured promise to pay deferred compensation pursuant to the Plan. The rights of any participant or beneficiary to payments pursuant to the Plan and trust agreement are nonassignable, and their interests in benefits under the Plan and the trust agreement are not subject to attachment, pledge, garnishment, encumbrance or other legal process.

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.

Section 1.451-2(a) of the Income Tax Regulations ("regulations") explains that income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, 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.

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) of the Code and section 1.457-2 of the regulations define the term "eligible deferred compensation plan." Those provisions contain the various requirements for an eligible plan, including rules for participation, deferral of compensation, and payment of benefits. Pursuant to section 457(b)(2), an eligible plan must provide that the maximum amount that may be deferred under an eligible plan shall not exceed the lesser of $7,500 as adjusted pursuant to section 457(e)(15) or 33⅓ percent of the participant's includible compensation.

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. The term "eligible employer" is defined in section 457(e)(1), and includes a state or any political subdivision or any agency or instrumentality of a state, and any other tax-exempt organization. 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. This language is substantially similar to language contained in section 83 of the Code.

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 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 1.83-3(c) of the regulations provides that whether a risk of forfeiture is substantial depends upon the facts and circumstances. For purposes of section 83 and the regulations thereunder, 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 any person, or the occurrence of a condition related to a purpose of the transfer, and the a 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 section 1.83-3(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 the transfer are not satisfied, it is assumed that the forfeiture provision will be enforced.

Employee A will be entitled to receive benefits under the Plan only if he continues to provide substantial future services to X until the earliest of the date he dies, terminates from service due to disability, or Date D. Based on these facts, a participant's benefits under the Plan are subject to a substantial risk of forfeiture until they vest, at the latest, by Date D. Accordingly, under section 457(f) of the Code, no contributions or benefits are taxable to the participant or his beneficiaries until the benefits vest under the terms of the Plan.

Section 402(b) of the Code provides that contributions made by an employer to an employee's 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. Under section 1.402(b)-1(a)(1) of the regulations, an employer's contributions to a nonexempt employee's trust are 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 the regulations under section 83.

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.

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 the 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 a 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.

Under the terms of the Trust, assets may be placed in trust to provide deferred compensation benefits to the Plan participant and beneficiaries. However, in the event X becomes insolvent, the Trustee will have the obligation to hold the Trust assets for the benefit of the X's general creditors. The Trust agreement further provides that Employee A receives no beneficial ownership in or preferred claim on any Trust assets. Therefore, contributed assets will be held in trust, and in the event of the insolvency of the employer, those assets will be fully within reach of its creditors, as are its other assets.

Provided, (i) that the creation of the Trust does not cause the Plan to be other than "unfunded" for purposes of Title I of ERISA, and (ii) that the provision in the Trust requiring use of the Trust assets to satisfy the claims of general creditors in the event of insolvency is enforceable by the general creditors of the employer under federal as well as state law, and based on the information submitted and representations made, we conclude that:

1. Neither the adoption of the Plan, nor the creation of the Trust, nor X's contributions of assets to the Trust will cause any amount to be included in the gross income of Employee A 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).

2. The Plan will be an ineligible deferred compensation plan within the meaning of section 457(f).

3. Benefits under the Plan are subject to a substantial risk of forfeiture until the earliest of the date Employee A dies, terminates service due to disability, or Date D. Accordingly, under section 457(f)(1)(A), amounts credited by X under the Plan are included in gross income of Employee A or his beneficiaries in the earliest of the taxable year in which Employee A dies, terminates service due to disability, or in which Date D occurs, if Employee A remains employed by X until Date D or such earlier year.

4. 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 Entity X, under section 677 of the Code, X shall be treated

as the owner of the trust. Accordingly, under section 671, there shall be included in computing X's taxable income and credits, those items of income, deductions, and credits against tax of the trust, subject to the provisions of the Internal Revenue Code applicable to section 501(c)(3) organizations.

5. Neither the adoption of the Plan, nor the creation of the Trust, nor the contributions of assets to the Trust, nor the crediting of earnings on those assets will constitute a transfer of property to Employee A for purposes of section 83 of the Code or section 1.83-3(e) of the regulations or an employer's contribution to an employees' trust under section 402(b) of the Code.

This ruling applies only to the revised Plan and Trust, approved by X's board in September 1999, and submitted with the letter dated September 16, 1999. It is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent. This ruling expresses no opinion as to the consequences of the arrangements under Title I of the Employee Retirement Income Security Act of 1974 ("ERISA").

If either the Plan or Trust is substantially amended, this ruling may not necessarily remain in effect.

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

Enclosure:

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