Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:ITA:5 – PLR-129996-01
Date: June 14, 2002

In Re:

LEGEND:

P=

S=

A=
Costs=

Dear

This is in response to your May 29, 2001 request for rulings on behalf of P. Additional information was received in a letter dated December 7, 2001.

P and S are accrual method, calendar year taxpayers. P owns 100 percent of the stock of S. P and S were organized to supply services to A. Such services are supplied pursuant to a Agreement between P and A. As part of the charge for provided, A is required to reimburse P and S for their share of the Costs.

A has given P notice of cancellation of the Agreement. Pursuant to Agreement, A must make funds available for Costs by the effective date of the termination of the Agreement, together with the funds for insurance policies, or other assurances, to cover any shortfall, but P must refund any excess amounts advanced by A once all of P's costs are paid. In order to satisfy its obligation to P, regarding Costs in connection with the termination of the Agreement, A intends to set aside sufficient funds to pay all estimated future Costs. P represents that under the terms of the trust agreement, all Costs, including the funds that must be available upon termination effective date (which date has not arrived), shall be payable to T.

A proposes that it deposit amounts equal to the present value of the total amount of its share of Costs, including any funds due upon cancellation, into a trust ("T"), which will be created by A and administered by an independent trustee (the "Trustee"). Under the trust agreement, all investments made by T will be in obligations of the United States government, or obligations guaranteed by the full faith and credit of the United States government, or in other investments, in each case as directed by A. The proposed trust agreement also provides that during the term of T, all income received by the trust, net of expenses, shall be accumulated and reinvested until disbursed pursuant to the terms of the trust agreement.

The trust will be used to pay Costs to P, as P incurs them and presents bills for Costs to A. Under the proposed trust agreement, P must file a claim for incurred, qualified expenses for Costs to receive payment. P represents that it will have no right to any of the funds held by the Trustee and no right to file a claim for reimbursement from the Trustee until a qualifying expense actually has been incurred. The proposed trust agreement also provides that P's employees and their beneficiaries shall have no preferred claim on, or any beneficial ownership interest in, any assets of T. Any amounts remaining in T after the payment of all Costs, shall be returned to A. If actual Costs exceed the estimate, A will pay the increased amounts.

Section 301.7701-4(a) of the Procedure and Administration Regulations defines an ordinary trust as an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

Rev. Rul. 76-265, 1976-2 C.B. 448, addresses the treatment of a program established by an agency of the United States for the purposes of financing the construction of buildings on land owned by the United States. In the ruling, the agency appointed a bank to sell participation certificates in a trust created by the agency. The bank used the proceeds of the sales for payment of the agency's obligations related to the construction of the buildings and took title to the land and buildings as security for the agency's obligation to repay the certificates. The United States was obligated to pay annually amounts sufficient to establish and maintain a sinking fund sufficient to retire the participation certificates on a timely basis. The trustee was authorized to invest the funds in United States Government bonds as directed by the agency. Other than amounts required to be paid to the certificate holders in satisfaction of the United States' obligation, all property and money received, held or paid by the trustee was received, held or paid for the benefit of the United States. The ruling holds that the trustee did not take title to the land or buildings for the purpose of protecting or conserving them for the beneficiaries, but as agent for the United States. Accordingly, the arrangement was not classified as a trust for federal income tax purposes, but as a security arrangement with the bank trustee acting as an agent on behalf of the United States.

T will serve merely as a method of segregating funds representing A's future payment obligations similar to the arrangement in Rev. Rul. 76-265. See also Rev. Rul. 73-100, 1973-1 C.B. 613. This arrangement was proposed to accommodate A's budgetary preferences to set aside funds for accounting purposes. T will hold funds received from A and A will direct the investment of these funds. The investments will be used to pay A's obligations as they arise. T will disburse funds to P only as P incurs its reimbursable expenses for Costs and as A authorizes the disbursement of the funds. Thus, T will not take title to the assets conveyed by A to conserve them for the benefit of P (or its employees); rather T will hold and invest the assets as an agent of A. Consequently, the arrangement is not a trust for federal income tax purposes, but an arrangement with the Trustee acting as an agent on behalf of A. Accordingly, for federal income tax purposes, T will not be treated as a separate taxable entity.

Because T will be treated not as a trust for federal income tax purposes but as an arrangement with the Trustee acting as an agent on behalf of A, income from investments made by T will be income of A as the tax owner of the assets of T. See Rev. Rul. 76-265.

Section 61 of the Internal Revenue Code provides "gross income means all income from whatever source derived." Section 451(a) provides "the amount of any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." Section 1.451-1(a) of the Income Tax Regulations provides under the accrual method of accounting, "income is includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. See Schlude v. Commissioner, 372 U.S. 128 (1963). See also Rev. Rul. 80-308, 1980-2 C.B. 162.

The proposed trust agreement states repeatedly that "P employees and their beneficiaries shall have no preferred claim on, nor any beneficial ownership interest in, any assets of T." It also states "P shall have no right or power to direct Trustee to pay to P or to divert to others any of the Trust assets except as provided herein." The trust agreement places investment authority in A and states investment authority "shall in no event be exercisable by P or any of its employees past or present." It also states, "upon termination of the trust agreement any assets remaining in T shall be returned to A."

Because P has no ownership in, nor power to direct the disposition of, nor investment authority over, nor right to the residual assets of T upon termination, all events have not occurred to fix P's right to receive income from the trust upon the funding of the trust. Therefore, A's deposits to T are not taxable income to P at the time of the deposits.

Based on the foregoing, we rule that (i) for federal tax purposes, T will not be treated as a separate taxable entity; (ii) income from investments made by T will be income of A as the owner of the assets; and (iii) A's deposit of amounts with T, including any funds due on the termination effective date, will not be taxable income to P at the time of such deposits, but will be income to P as P incurs qualified expenditures.

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110 of the Internal Revenue Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
George Baker
Assistant to Chief, Branch 5
Office of Associate Chief Counsel
(Income Tax & Accounting)

Cc: