

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:EBEO:1-PLR-121695-98
Date:
April 12, 1999

A =

Company =

Trust =

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This is in reply to your letter of November 19, 1998, and the additional information dated February 16, 1999, submitted on behalf of the taxpayer, A, requesting rulings on the federal income and gift tax consequences of proposed payments to various employees of the Company. You also requested a ruling regarding certain estate tax consequences, however, we are declining to rule on those issues.

A was one of the founders of the Company. The Company has grown from a small business to a multi-million dollar enterprise. The Company currently employs approximately 100 employees on a full-time basis and an additional 400 employees during its busy season. Currently, A's sons are employed by the Company. A has, directly or indirectly, retained 100% ownership of the Company. As a result, the Company has never issued stock options, preferred stock or other stock-based compensation to its employees. The Company has never sponsored a qualified retirement plan for its employees.

The Company will be sold to an unrelated third party. In his capacity as the chief executive officer of the Company, A wants to reward the loyalty of his employees who worked for the Company without the benefit of any long-term incentive plans or basic qualified retirement benefits. These employees have contributed to the success and growth of the Company, which A anticipates will ultimately be reflected in the sales price. The Company also wants to provide the new owners with an experienced workforce during the change in ownership.

The Company has developed a plan (the "Plan") to meet these objectives. Under the Plan, the Company will pay Additional Bonuses to approximately 62 of the

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100 permanent employees and 11 retired employees on or about the time the sale of the Company closes. The 11 retired employees were employed by the Company when A started it and continued with the Company until their retirements. Inclusion of specific employees in the Plan, and the amount of the Additional Bonus for any given employee is within A's sole discretion, as chief executive officer of the Company, but will become irrevocable upon the earlier of the closing date or the date of A's death. You have represented that the number of employees covered by the Plan and the amount of the Additional Bonus for each employee, and the total dollar amount of the Additional Bonuses will not change significantly from the information you provided to us. You also represent that amounts paid to A's sons, if any, will not be the highest dollar amounts, and will not be disproportionate in comparison to the Additional Bonuses paid to the other employees who perform comparable work.

The Plan provides that eligible management and office employees will receive their Additional Bonuses upon attaining age 62. Eligible employees who work in the field will receive their Additional Bonus upon attaining age 55. The Company will pay of the Additional Bonuses in a lump sum in cash to those employees who have attained the required age upon closing of the sale of the Company. The Company will purchase insurance contracts at the time of the sale of the Company for all employees who are younger than the required age. The insurance contract will provide for a single payment equal to the employee's Additional Bonus payable when the employee attains the required age. In addition to the insurance contract that is distributed, employees under the required age will receive a cash bonus sufficient to pay federal income taxes on the fair market value of the insurance contract at the time of issuance. Retired employees will receive the Additional Bonuses in cash in a lump sum upon the closing of the sale of the Company.

Current employees are subject to two conditions. First, the employee must be employed by the Company as of the date of the sale of the Company or A's death, whichever occurs first. Second, the employee must sign an employment contract agreeing to continue to work for the Company or the successor purchaser for at least one year. Retired employees must sign consulting contracts agreeing to provide consulting services to the Company or the successor purchaser for at least one year. For both the employment contracts and the consulting contracts, the one-year period commences with the date of the sale of the Company or A's death. Payment of the Additional Bonuses, in cash or through the purchase and transfer of annuity contracts, shall be made on or about the sale of the Company. Current and retired employees will not be required to return all or part of the Additional Bonuses in the event that they violate the terms of the one-year employment or consulting contract.

Based on the foregoing facts and representations, you requested the following rulings:

- (1) Additional Bonuses paid under the Plan to employees of the Company are

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compensation to the employee, includible in gross income for the taxable year received; and

(2) Additional Bonuses are not subject to the gift tax under § 2511(a) of the Code.

Ruling Request One

Section 61(a)(1) of the Code states that except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 83(a) of the Internal Revenue Code ("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 83(c)(1) provides that the rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

Section 1.83-3(c) of the regulations explains that 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 (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purposes of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

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.

Compensation may be paid voluntarily, without legal obligation, and may be for past services. Beggy v. Commissioner, 23 T.C. 736, 226 F.2d 584 (1955). The purchase of annuity contracts for employees has been held to be compensation, and not a gift, where the purchase of the annuities was in recognition of the employees' long and faithful service to the employer. Charles C.D. Gott v. Commissioner, 12 TCM 435 (1953), aff'd, 212 F.2d 205 (1954). Annuity contracts purchased for retired and disabled employees, plus the payment of cash in an amount sufficient to pay the income taxes due on the annuity, constituted compensation to the employee and not a

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gift despite the fact that the employer had no legal obligation to provide retirement benefits to retired employees. Peters v. Commissioner, 123 F. Supp. 711 (1954), rev'd and rem'd, 221 F.2d 721 (1955).

In the proposed transaction, the Additional Bonuses are in recognition of the long-term employment and efforts of current and retired employees. For employees who have attained the required age at the time of the closing of the sale of the Company, the Additional Bonuses paid in cash constitute compensation under § 61(a)(1) of the Code.

Employees who have not attained the required age as of the closing will receive annuity contracts that will pay a lump sum to the employee when the employee attains the required age. The transfer of the annuity contract is a transfer of property in the connection with the performance of services under § 83(a) of the Code. Because the employees are not required to return any or all of the Additional Bonuses if they fail to fulfill the requirements of the one-year employment or consulting agreements, the transfer of the annuity contracts is not subject to a substantial risk of forfeiture. Therefore, the employees will receive taxable compensation at the time the contracts are transferred to the employee under § 83(a). Those employees will also receive taxable compensation § 61(a)(1) of the Code equal to the amount of cash paid by the Company to cover income taxes on the annuity contracts.

Ruling Request Two

Section 2501(a)(1) of the Code imposes a gift tax on the transfer of property by gift. Section 2511(a) provides that the gift tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 25.2511-1(g)(1) of the Gift Tax Regulations provides that donative intent on the part of a transferor is not an essential element in the application of the gift tax to a transfer. Whether the gift tax is applicable is based upon the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. The tax, however, is not applicable to transfers for full and adequate consideration in money or money's worth or to ordinary business transactions described in § 25.2512-8.

Section 25-2511-1(h)(1) provides that a transfer of property made in the ordinary course of business (a transaction that is bona fide, at arm's length, and free of donative intent) will be considered as made for adequate and full consideration.

In Rev. Rul. 80-196, 1980-2 C.B. 32, two shareholders transferred stock to three employees as a bonus in consideration of past services to the corporation. The employees had provided exceptional duties to the corporation for more than 5 years,

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and were considered valuable to the continued success of the corporation. The two shareholders were not related to the three employees, nor did any special personal relationship exist with the three employees. The ruling holds, in part, that the stock received was includible in the employee's income under §§ 61 and 83. The ruling also holds, for gift tax purposes, the transfers to the three employees were in the ordinary course of business under § 25.2512-8, because the transfers were motivated by a valid business reason, that is, retaining valuable personnel in the employment of the corporation. Therefore, the transfers were not subject to gift tax.

As noted above, the payment of the Additional Bonuses by the Company is for prior and future services by the employees. The payment of the Additional Bonuses by the Company is in the ordinary course of business under § 25.2512-8 because the transfers were motivated by a valid business reason. Therefore, the Additional Bonuses will not constitute gifts by the Company or by A for federal gift tax purposes to the recipients.

Except as specifically ruled on above, no opinion is expressed as to the federal tax consequences of the above transaction under any other provision of the Code.

This ruling is directed only to the taxpayer who requested it and applies only to the Plan as proposed to be amended as of the date of this ruling. Section 6110(j)(3) of the Code provides that this ruling may not be used or cited as precedent.

In accordance with a power of attorney on file with this office, a copy of this ruling is being sent to your authorized representative.

Sincerely,

Charles T. Deliee
Chief, Branch 1
Office of the Associate Chief Counsel
(Employee Benefits and Exempt
Organizations)

Attachment:

Deleted copy of ruling letter