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Department of the Treasury

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Person to Contact:

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Refer Reply To:  
CC:EBEO:1-PLR-105829-99  
Date:  
July 20, 1999.

Employer =

Plan =

Qualified Plan =

Employee =

This is in reply to your letter dated February 24, 1999, and subsequent correspondence dated May 13, 1999, on behalf of the Employer. The Employer has requested a ruling on the federal income tax consequences under sections 83, 451 and 457 of the Internal Revenue Code with respect to the Plan. The Employer is represented to be a nonprofit corporation that is exempt from federal income tax under section 501(c)(3) of the Code.

The Employer has represented that the Plan is unfunded and has been established primarily for the purposes of "providing deferred compensation for a select group of management or highly compensated employees" within the meaning of section 202(2) of the Employee Retirement Income Security Act of 1974 ("ERISA"). Participation in the Plan is limited to the Employee. The Employee is the chief executive officer and one of the founders of the Employer.

Under the Plan, a bookkeeping reserve account (the "Reserve Account") shall be established for the Employee. The Reserve Account shall be used solely as a device for the measurement and determination of the amount to be paid to the Employee in the future under the terms of the Plan. Neither the Reserve Account nor any other

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reserve established on the financial books of the Employer to reflect liabilities under the Plan shall constitute or be treated as a trust fund of any kind. The Employer is not required to set aside any assets with respect to the Plan. Any assets actually held by the Employer with reference to the Plan shall be and remain the sole property of the Employer and shall be subject to the claims of the creditors of the Employer.

An initial amount shall be credited to the Employee's Reserve Account. After the initial amount is credited, as of August 31, 1998 and each August 31 thereafter during the Employee's employment with the Employer, an amount shall be credited to the Reserve Account equal to the difference between:

- (1) the amount that would have been allocated to the Employee's account in the Qualified Plan if (A) such plan were not subject to the limitations of sections 401(a)(17) and 415 of the Code, and (B) the allocation formula under the Qualified Plan were 25% of pay instead of the allocation formula contained in the Qualified Plan, and
- (2) the actual employer contribution allocable to the Employee's account under the Qualified Plan for such year ending August 31.

Furthermore, as of August 31, 1998 and each August 31 thereafter, and prior to any distribution under the Plan, an additional amount shall be credited to the Reserve Account as an investment return equivalent. The investment rate, positive or negative, will be the rate of investment return on the Employee's account under the Qualified Plan for the same period of time. This rate will be applied to the balance of the Reserve Account at the beginning of the year reduced by any distributions during the year.

The amount in the Reserve Account shall be subject to total forfeiture in the event that the Employee's employment with the Employer is terminated prior to the September 1 immediately following the Employee's attainment of age fifty-five (55). Amounts in the Reserve Account as of the September 1 immediately following the Employee's attainment of age fifty-five and all contributions credited thereafter shall be fully vested. However, the forfeiture rule shall not apply and the Reserve Account shall be fully vested if the Employee's employment is terminated before such date as a result of the Employee's death, disability or termination by the Employer without cause. The terms "disability" and "cause" shall have the meaning set forth in the Employee's employment agreement.

Vested benefits shall be paid as follows: (1) The Employee shall receive a cash payment from the Employer on or about the September 1 immediately following his 55<sup>th</sup> birthday of an amount equal to the Employee's estimated tax liability as a result of vesting under the Plan; (2) the balance of the Reserve Account shall be paid to the Employee as soon as practicable after the August 31 coincidental with or immediately following the Employee's termination of employment with the Employer for any reason.

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If the Employee terminates employment prior to age 55 because of death, disability or termination of employment without cause, a lump sum cash payment shall be made to the Employee or his beneficiary as soon as practicable after the August 31 coincidental with or immediately following the Employee's termination of employment.

Benefits under the Plan shall not be subject in any manner to alienation, sale, transfer, assignment, pledge, attachment, garnishment or encumbrance of any kind, by will, or by inter vivos instrument. Any attempt to alienate, sell, transfer, assign, pledge or otherwise encumber any such benefit payment shall not be recognized by the Board. Any benefit payment due under the Plan shall not in any manner be liable for or subject to the debts or liabilities of the Employee or the Employee's beneficiary.

The Plan shall be administered by the Board of Directors of the Employer. The Employer, by action of the Board, reserves the right to amend, modify, terminate or discontinue the Plan at any time. If the Plan or contributions to the Plan are terminated, benefits under the Plan shall remain subject to the forfeiture rules set forth above.

Section 457 of the Code provides the rules governing the deferral of compensation by an individual participating in a deferred compensation plan of an eligible employer. Under section 457(e)(1)(B), a tax-exempt organization is an eligible employer covered by section 457. The Employer is a tax-exempt organization under section 501(c)(3) of the Code, and is therefore an eligible employer within the meaning of section 457(e)(1).

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 is includible in gross income only for the taxable year in which the compensation or other income is paid or otherwise made available to the participant or beneficiary.

Section 457(b) of the Code and § 1.457-2 of the Income Tax Regulations (the "Regulations") define the term "eligible deferred compensation plan." One requirement under section 457(b)(3) is that the maximum amount which may be deferred under an eligible deferred compensation plan for the taxable year shall not exceed the lesser of \$7,500 or 33 1/3 percent of the participant's includible income. The Plan is not an eligible deferred compensation plan within the meaning of these provisions because amounts deferred may exceed this limit.

Under section 457(f)(1)(A) of the Code, if an eligible employer's plan deferring compensation is not an eligible deferred compensation plan, the compensation is included in gross income for the first year in which the participant's right to the compensation is not subject to a substantial risk of forfeiture.

Section 457(f)(3)(B) provides that the rights of a person to compensation are

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subject to a substantial risk of forfeiture if the person's rights to the compensation are conditioned upon the future performance of substantial services by any individual.

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 in 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 Regulations provides that for purposes of section 83, the term "property" includes real and personal property other than either 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.

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 in the taxable year in which it is actually or constructively received by the 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, set apart or otherwise made available so that the taxpayer may draw on 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.

Various revenue rulings have considered the tax consequences of nonqualified deferred compensation arrangements. Rev. Rul. 60-31, Situations 1-3, 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.

Provided that the Plan is unfunded for purposes of Title 1 of ERISA and that the Plan and the proposed amendments are adopted without further changes, and based on the information submitted and representations made, we conclude that:

1. The Plan constitutes an ineligible deferred compensation plan within the meaning of section 457(f) of the Code.

2. Pursuant to section 457(f), the amount of deferred compensation credited to the Reserve Account under the Plan is includible in the Employee's gross income (or in the case of the Employee's death, the gross income of his beneficiary) for the first taxable year for which the Employee's rights to these amounts are not subject to a substantial risk of forfeiture. This will be the August 31 immediately following the Employee's 55<sup>th</sup> birthday, or his death, disability or termination of employment without

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cause, if earlier. The entire amount of the Reserve Account on that date is includible in gross income for that taxable year even if payment is made at a later date. Subsequent deferrals shall be includible in the Employee's gross income when they are credited to the Reserve Account.

3. Pursuant to section 457(f), amounts paid or made available under the Plan to the Employee or his beneficiary are includible in gross income in accordance with the rules of section 72 of the Code. Amounts are made available when the individual becomes entitled to receive them under the Plan.

4. None of the following events shall constitute a transfer of property for purposes of section 83 of the Code or § 1.83-3(e) of the Regulations: (a) the adoption of the Plan, (b) the crediting of contributions to the Reserve Account; or (c) the crediting of earnings to the Reserve Account.

5. Under the economic benefit and constructive receipt doctrines of sections 61 and 451 of the Code, neither the creation of the Plan, nor the crediting of contributions or earnings to the Reserve Account will create taxable income for the Employee or his beneficiary under the cash receipts and disbursements method of accounting.

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. This ruling applies only to the Plan as proposed to be amended and only 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.

Sincerely,

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

Enclosure:

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