INTERNAL REVENUE SERVICE

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> CC:TEGE:EB:EC/PLR-130968-00 April 20, 2001

LEGEND:

Employer =

Employee =

Agreement =

This is in reply to your letter of December 7, 2000, in which certain rulings are requested regarding the federal income tax consequences of the Agreement, which was established solely to calculate annual bonuses and retirement benefits to be paid by Employer to Employee and his spouse.

The facts submitted are that Employer, an S corporation, uses an accrual method of accounting and has a taxable year ending on August 31. In order to comply with the requirements of Revenue Procedure 92-65,1992-1 C.B. 428, the Agreement provides that it is intended to be an unfunded deferred compensation plan for federal income tax and employment tax purposes and for purposes of Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"); that, with respect to all benefits payable under the Agreement, Employee (and his spouse) have the status of general unsecured creditors of Company; that the Agreement constitutes a mere promise by Company to make payments to Employee in the future; and that Employee's right to payments under the Agreement is not subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment or garnishment.

The Agreement provides that Employer is not obligated to make any investment for the purpose of meeting its obligations to make payments thereunder, and it is represented that no contributions will be made to any fund and that no assets will be segregated for the purpose of meeting those obligations. It is also represented that the Agreement will be administered by either Employer's board of directors or a committee appointed by that board, which will not include Employee. Employer does not expect to enter into an agreement similar to the Agreement with any of its other employees.

Starting with Employer's taxable year beginning on September 1, 1997,

Employee earned four Incentive Shares per year, and he will continue to do so until the earlier of 10 years from that date or the date that he ceases to "faithfully discharge his duties to Employer." Thus, the maximum number of Incentive Shares that Employee may earn is 40.

Under the Agreement, Employer promises to pay Employee an annual bonus before his retirement, and an annual retirement benefit thereafter, based upon the ratio ("Payment Ratio") of the number of his Incentive Shares to the number obtained by adding the number of those shares to the number of Employer's Class A and Class B common shares then-issued and outstanding. Incentive Shares do not represent any ownership interest in Employer, will not be issued in certificate form, will not have any voting rights, and will not be transferrable in any manner. Rather, *solely* for the purpose of calculating Employee's deferred compensation, Incentive Shares will be *treated* as participating in profits proportionately with actual shares.

In accordance with Revenue Procedure 92-65, the Agreement defines the time and method of payment of benefits for each event that entitles Employee (or his spouse) to receive benefits. Specifically, Employer promises that, on or before the 15th day of the third month following the end of its taxable year, it will pay to Employee an amount equal to the amount obtained by multiplying Employer's "Net Income" for that year (as defined in section 7519(d)(2)(B) of the Internal Revenue Code, so long as Employer maintains its S election) by the applicable Payment Ratio.

If, after September 1, 2003 and before reaching age 65, Employee becomes disabled for any reason (except alcoholism) and is resultantly unable to perform his duties, he will be entitled to disability retirement benefits as calculated above. Employer's liability for such payments will be limited by the number of Incentive Shares earned before the date of disability. If Employee retires before reaching age 65 and is not disabled, then no retirement benefits will be payable to him.

In order for Employee to receive the full benefit contemplated under the Agreement, he must continue working for Employer until he reaches age 65. At that time, Employer will be obligated to pay him an annual retirement benefit (as calculated above) until his death and, thereafter, to his spouse until her death. However, if Employee dies after retiring for disability, his surviving spouse's annual lifetime benefit will be one-half of the benefit that would otherwise have been payable to Employee. If, after his retirement, Employee engages in a business that is competitive with Employer's business, Employer's obligation to make payments under the Agreement will cease. If Employer continues to employ Employee after his 65th birthday, Employer promises to make all payments due under the Agreement in addition to any other compensation that Employee is paid for such services.

If Employee's employment is involuntarily terminated by Employer, the Agreement will have no further effect, except that Employee will be paid a lump sum payment of \$200,000 (adjusted for inflation) in extinguishment of Employer's obligation to make any future payments under the Agreement.

Similarly, if Employer's business is sold either before all of its obligations under the Agreement are discharged or within 12 months of Employee's involuntary termination of employment, Employer will pay employee a lump-sum amount to terminate its obligations under the Agreement. In either of those cases, the lump sum will be determined by dividing the total value of the Employer (as determined by the selling price of its stock or the sales price of its assets, plus or minus retained assets and liabilities) by the sum of its common shares issued and outstanding plus the number of Incentive Shares credited to Employee. The lump sum payment will equal the greater of the per share value so calculated multiplied by the number of Employee's Incentive Shares or \$300,000 (adjusted for inflation).

All obligations of Employer to make payments under the Agreement end upon the later of the deaths of Employee and his spouse. However, amounts accrued but unpaid at death will be paid to the appropriate estate within 30 days of the date of death.

Under section 83(a) of the Internal Revenue Code, if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property (disregarding any lapse restriction), determined on the first day that the transferee's rights in the property are transferable or not subject to a substantial risk of forfeiture, over the amount paid for the property is included in the service provider's gross income for the taxable year which includes that day.

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 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 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 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. Revenue Ruling 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 Revenue Ruling 69-650, 1969-2 C.B. 106, and Revenue Ruling 69-649, 1969-2 C.B. 106.

Under the economic benefit doctrine, an employee has currently includible compensation income when assets are unconditionally and irrevocably paid into a fund or trust to be used for the employee's sole benefit. See <u>Sproull v. Comm'r.</u>, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F. 2d 541 (6th Cir. 1952), and Revenue Ruling 60-31, Situation 4. Revenue Ruling 72-25, 1972-1 C.B. 127, and Revenue Ruling 68-99, 1968-1 C.B. 193, hold that an employee does not receive income as a result of his employee's purchase of an insurance contract to provide a source of funds for the employee's deferred compensation if the insurance contract is owned by the employer and subject to the claims of the employer's creditors.

Under section 404(a) of the Code, compensation paid or accrued by an employer on account of any employee under a plan deferring the receipt of such compensation is not deductible under Chapter 1 of the Code, but, if it is otherwise deductible, is deductible under the limitations of section 404.

Q&A-2 of section 1.404(b)-1T of the regulations addresses the question of when a plan or method or arrangement will be considered to defer the receipt of compensation or benefits for purposes of section 404(a) of the Code. Specifically, a plan or method or arrangement defers the receipt of compensation or benefits to the extent that it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. This determination is made separately with respect to each employee and each amount of compensation or benefit. See Q&A-2(a) of section 1.404(b)-1T.

Under Q&A-2(b)(1) of section 1.404(b)-1T of the regulations, a plan or method or arrangement is presumed to be one deferring the receipt of compensation for more than a brief period of time after the end of the employer's taxable year to the extent that an employee receives compensation after the fifteenth day of the third calendar month following the end of the employer's taxable year in which the related services were rendered ("the 2 ½ -month period"). Thus, for example, a year-end bonus received beyond the 2 ½ month-period by one employee is presumed to constitute payment under a plan or method or arrangement deferring the receipt of compensation for that employee, even though bonus payments to all other employees are not similarly treated because they are received within the 2 ½-month period. Benefits are "deferred benefits" if, assuming that the benefits were cash compensation, such benefits would be considered deferred compensation. Thus, a plan or method or arrangement is presumed to be one providing deferred benefits to the extent that an employee receives

benefits for services after the 2 ½-month period following the end of the employer's taxable year in which such services were rendered. As explained in Q&A-2(b)(2), the foregoing presumptions may be rebutted under circumstances not present here.

Section 404(a)(11) of the Code provides that, for purposes of determining under section 404 whether compensation of an employee is deferred compensation and when deferred compensation is paid, no amount will be treated as received by the employee, or paid, until it is actually received by the employee.

Section 404(a)(5) of the Code provides that an employer's payments to employees under a nonqualified deferred compensation plan are deductible by the employer in the taxable year in which they are includible in the employees' gross incomes. However, in the case of a plan in which more than one employee participates, deductions are allowed under section 404 only if separate accounts are maintained for each employee.

Section 1.404(a)-12(b) of the regulations provides, in effect, that, under section 404(a)(5) of the Code, a payment of "deferred compensation" is deductible only for the service recipient's taxable year in which or with which ends the service provider's taxable year in which the payment is included in gross income.

Section 1361(a)(1) of the Code provides that, for federal income tax purposes, the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not --

- (A) have more than 75 shareholders,
- (B) have as a shareholder a person (other than an estate, a trust described in section 1362(c)(2), or an organization described in section 1362(c)(6)) who is not an individual,
- (C)
- (D) have a nonresident alien as a shareholder, and
- (E) have more than 1 class of stock.

Section 1.1361-1(b)(4) of the regulations ("*Treatment of deferred compensation plans*") provides that, for purposes of subchapter S, an instrument, obligation, or arrangement is not outstanding stock if it --

(i) Does not convey the right to vote;

- (ii) Is an unfunded and unsecured promise to pay money or property in the future;
- (iii) Is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and
- (iv) Is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income.

That regulation also provides that a deferred compensation plan that has a current payment feature (*e.g.*, payment of dividend equivalent amounts that are taxed currently as compensation) is not for *that* reason considered outstanding stock.

Accordingly, provided that Employer's obligations to pay benefits under the Agreement are "unfunded" for purposes of Title I of the Employee Retirement Income Security Act of 1974, and that the compensation paid to Employee under the Agreement is not excessive by reference to the services performed by him, and based on the information submitted and the representations made, we conclude as follows:

(1) The issuance of Incentive Shares to Employee will not constitute a transfer of "property" for purposes of section 83 of the Code;

(2) Provided that the Incentive Shares are issued pursuant to a plan with respect to which Employee is not currently taxed on income, Incentive Shares issued pursuant to the Agreement will not cause Employer to have more than "one class of stock," within the meaning of section 1361(b)(1)(D) of the Code;

(3) For federal income tax purposes, Incentive Shares should not be allocated a pro rata shares of the income, gains, credits, losses, deductions, and expenses of Employer. Rather, those items should be allocated among the outstanding shares of Employer's common stock;

(4) All payments paid to Employee under the Agreement will constitute current compensation if received before his retirement and within the applicable 2 ¹/₂-month period but will constitute ordinary income from nonqualified deferred compensation if received after his retirement;

(5) To the extent that the requirements of section 162 of the Code are satisfied for payments made under the Agreement, Employer may deduct the payments constituting current compensation under its normal method of accounting, and may

deduct the payments constituting deferred compensation for its taxable year in which ends Employee's taxable year in which the payment is actually paid or made available to Employee; and

(6) Because Employee's Incentive Shares will not be considered Employer stock, Employee will not be considered a shareholder of Employer.

Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the transaction described above under any provision of the Internal Revenue Code. In this regard, no opinion is expressed regarding the validity of Employer's election under section 1362(a) of the Code.

This ruling is directed only to the taxpayer who requested it, and it does not apply to any payments made under the Agreement that were accrued prior to the date of this ruling. If the Plan is amended, this ruling may not necessarily remain in effect. Section 6110(j)(3) of the Code provides that this ruling may not be used or cited as precedent.

A copy of this letter should be attached to Company's federal income tax return for its first taxable year in which it is entitled to deduct payments covered by this ruling. A copy is enclosed for that purpose.

> Sincerely yours, CHARLES T. DELIEE Chief, Executive Compensation Branch Office of the Division Counsel / Associate Chief Counsel (Tax Exempt and Government Entities)

Enclosures Copy of this letter Copy for 6110 purposes