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Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EB:QP2-PLR-161992-01

Date:

September 30, 2002

Legend:

Entity E =

Plan P =

Dear _____ :

This responds to the submission of November 5, 2001 and subsequent correspondence, on behalf of Entity E and its Plan, requesting a ruling concerning the possible application of section 457 of the Internal Revenue Code of 1986 to a number of different nonqualified deferred compensation (NQDC) plans maintained by Entity E. Although E is currently a taxable entity, E represents that it expects soon to receive a favorable determination letter from the Internal Revenue Service concerning its tax-exempt status under section 501(c)(3) of the Code.

E, as a taxable entity, has in recent years established for its directors and a select group of highly compensated or key employees a number of different NQDC plans such as 1) a supplemental executive pension plan, 2) an excess benefit plan similar to a number of corporate NQDC arrangements providing deferred compensation benefits in excess of the section 401(a)(17) and section 415 limitations respectively upon qualified plan benefits, 3) an incentive compensation plan similar to other corporate deferred bonus plans, 4) a trustees' deferred compensation plan resembling other corporate directors' NQDC arrangements, and 5) Plan P, a stock appreciation right/restricted equity plan discussed below. All these NQDC plans specify that the amounts in the participants' accounts are nonassignable and nontransferable. In addition, the supplemental executive pension plan, excess benefit plans, incentive

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compensation plan and trustees' deferred compensation plan all provide that the amounts in their participants' bookkeeping accounts are unfunded and unsecured promises to pay in the future the NQDC provided pursuant to the plans. These NQDC plans were all established after July 14, 1988.

Entity E has requested this ruling to resolve whether section 457 (which imposes a number of additional requirements upon NQDC arrangements of tax-exempt entities and state and local governmental entities) would, upon E's becoming a tax-exempt entity, apply to E's NQDC plans which hitherto have been subject to the more liberal NQDC provisions of section 451 and the regulations thereunder. E represents that its board intends to adopt a corporate resolution that freezes and bars future deferrals to its five existing NQDC plans described above upon E's receiving a favorable determination letter establishing its status as a tax-exempt organization described in section 501(c)(3). The amounts in the frozen plans (and the deemed earning thereon) would be held and distributed in accordance with these plans' provisions.

Under Plan P, E can grant key employees either restricted stock or stock appreciation rights (SAR) in spun-off or outside corporate entities relating to E's operations.

Section 83(a) of the Internal Revenue 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 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 the 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, 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.

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Section 457 of the Internal Revenue Code of 1986 governs the taxation of eligible deferred compensation plans of eligible employers. The term “eligible employer” is defined in section 457(e)(1) as a state, political subdivision of a state, and any agency or instrumentality of a state or political subdivision of a state, and any other organization (other than a governmental unit) exempt from tax under subtitle A of the Code. An “eligible deferred compensation plan” as defined in section 457(b) must, among other things, provide that the maximum amount which may be deferred under the plan for a taxable year shall not exceed the lesser of the applicable dollar amount (as determined under sections 457(b)(2) and (e)(15), \$11,000 in 2002) or 100 percent of the participant’s includible compensation. None of E’s NQDC plans currently conforms to this or other limitations of section 457.

Section 457(f)(1)(A) provides that if a plan of an eligible employer providing for a deferral of compensation is not an eligible deferred compensation plan, compensation deferred under such plan shall be included in the participant’s gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation. Section 457(f)(3)(B) states that a person’s rights to compensation are subject to a substantial risk of forfeiture if such person’s rights are conditioned upon the future performance of substantial services by any individual.

The legislative history of section 457 must be examined to determine the appropriate tax impact upon E’s NQDC plans, originally established during E’s period as a taxable entity, of E’s becoming a tax-exempt organization. The House Ways and Means Committee Report concerning the 1978 enactment of section 457 states, “The committee believes that limitations should be imposed on the amounts of compensation that can be deferred under these arrangements and allowed to accumulate on a tax-deferred basis. The committee realizes that the denial of a compensation deduction to a nontaxable entity until an amount is includible in the income of the person providing services does not act as a restraint on the amounts that nontaxable entities are willing to let employees defer as it does when a taxable entity is involved. Accordingly, the committee believes that a percentage-of-compensation limit on amounts that can be deferred, as well as an absolute dollar limitation to prevent excessive deferrals by highly-compensated employees, is necessary. . . [T]he denial of a compensation deduction until there is a corresponding income inclusion by a [corporate] plan participant places some natural restraints on the amounts of compensation that can be deferred under private plans.” (H.R. Report No. 95-1445 at 53 and 59, 1978-3 CB 227 and 233).

This indicates that a significant Congressional concern when it enacted section 457 was limiting the revenue loss that occurs when an employee defers compensation that his tax-exempt employer is unable to deduct since it pays no income tax, whereas in a corporate NQDC arrangement, the revenue loss attributable to executive NQDC deferrals is offset to a significant degree by the corporate employer’s inability to currently deduct such amounts against its taxable corporate income.

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In E's case, when unrestricted amounts were deferred into its NQDC arrangements due to its taxable status, E was subject to corporate income taxation upon the amounts deferred. However allowing E to continue unlimited deferrals in these plans under section 451 after its conversion into a tax-exempt entity would produce the type of revenue loss that Congress intended to limit when it enacted section 457 in 1978. Thus, to comply with this Congressional intent that E's plan not produce revenue losses in excess of those permitted under section 457, E would have to freeze deferrals under its existing NQDC plans upon its becoming a tax-exempt organization.

To comply with the above-discussed Congressional intent, E, after it becomes a tax-exempt organization, would be able to allow its employees to make income tax deferrals under a NQDC arrangement only in a plan that meets the requirements of section 457(b). E's board of directors will adopt a resolution freezing these five plans as of the date when E receives a favorable determination letter from the IRS approving its status as an exempt organization described in section 501(c)(3). Amounts credited to the NQDC plan accounts of its employees (and the earnings thereon) due to deferrals made after E becomes a tax exempt organization would be subject to section 457 and would have to comply with the requirements of section 457(b) and the regulations thereunder for such amounts to remain tax-deferred under section 457(a) until they are paid or made available.

In light of the documents presented and the representations made, we conclude as follows:

Provided that E adopts and implements its corporate resolution freezing and barring any additional deferrals to its five NQDC plans described in this letter after E receives a favorable determination letter establishing its status as a tax-exempt organization, its five above-described NQDC plans will remain subject to the nonqualified deferred compensation rules under section 451 and the regulations thereunder, and these five NQDC plans will not be subject to section 457.

No opinion is expressed concerning the timing of the inclusion in income of amounts deferred under any deferred compensation plan other than the five NQDC plans discussed above and mentioned in the corporate resolution submitted on July 25. If the plans are significantly modified other than as provided in the July 25 corporate resolution, this ruling will not necessarily remain applicable. In addition, no opinion is expressed concerning whether any of E's five pre-existing NQDC plans constitutes a non-qualified deferred compensation plan that complies with the NQDC provisions under section 451 and the regulations thereunder. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion in the ruling. See section 12.04 of Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 50. However, when the criteria in section 12.05 of Rev. Proc. 2002-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

Sincerely,

Robert D. Patchell
Branch Chief, Qualified Plans 2
Office of Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure (1)

cc: