Internal Revenue Service

Department of the Treasury

Index Nos. 83.13-00 451.14-00
402.02-00 671.03-00
404.10-00 677.00-00

Washington. DC 20224

199901006

Person to contact:

Telephone Number:

Refer Reply to:

CC:EBEO:1 - PLR-105254-98

Date: SEP 28 1998

Parent =

Subsidiary =

Acquiring Company =

Plan

Trust

Dear

This replies to your ruling request and subsequent correspondence submitted on behalf of the above named Parent Company ("Parent") and its wholly-owned Subsidiary ("Subsidiary") with respect to the federal income tax consequences, pursuant to sections 83, 451, 671, and 677 of the Internal Revenue Code of 1986, of certain transactions occurring under the above identified ("Plan") and related Trust ("Trust")

Parent's and Subsidiary's primary business is the

Parent currently has no employees, all individuals who work for the above businesses are employees of Subsidiary or other subsidiaries of Parent. The annual accounting period for both Parent and Subsidiary is the calendar year, and both are accrual basis taxpayers.

Parent has two classes of common stock, neither of which is traded on an exchange. The shares, are owned exclusively by

Until recently, The shares were held by

On , Acquiring Company purchased a stake in Parent.. To effect the acquisition, Parent offered its shareholders the ability to redeem their shares for cash, and then sold the redeemed shares to Acquiring Company. In addition, sold Acquiring Company the number of shares that, when added to the shares sold by Parent to Acquiring Company, caused Acquiring Company to own percent of all shares of Parent's outstanding stock.

In 1995, Plan was approved by the shareholders of the predecessor company to Parent. Plan allows Parent to grant both incentive stock options ("ISO's") and nonqualified stock options ("NQSO's") to employees of Parent, Subsidiary and Parent's other subsidiaries. The options entitle the employee-holders to purchase shares of stock. Pursuant to the terms of Plan, Parent granted ISO's and NQSO's in 1995 and 1996, and NQSO's in 1997. The exercise price for each option was determined as of the most recent appraisal prior to the date of the grant of the option. However, none of the options had a readily ascertainable fair market value, within the meaning of section 1.83-7 of the Income Tax Regulations, as of the date of the grant. All the options are subject to a specific deferred vesting schedule. That is, each option is subject to the condition that the employee remain employed with Subsidiary for a 3-5 year period before the option can be exercised.

The only exception to Plan's stock option deferred vesting schedules is for retirement, at which time all of an employee's nonvested outstanding options became 100 percent vested. "Retirement is defined in the agreements granting options under Plan as termination of employment on or after age 65; on or after the date the sum of one's age and number of years of service equals 75; or at a time specifically approved by the Board of Director's of Parent.

In , in order to permit those employees holding outstanding options under Plan to share in the enhancement in the value of Parent stock that occurred as a result of the acquisition of stock by Acquiring company, and to provide a means to retain these employees in the employ of Subsidiary, Subsidiary provided its employees the ability to elect under Plan to surrender his or her options by (before the closing), in exchange for an "initial deferral amount" equal to the difference between the price at which parent sold its shares to Acquiring Company and the price at which the employee would have been able to exercise such option, had she or he not surrendered it, multiplied by the number of shares of stock covered by such option.

The price at which Parent sold its shares to Acquiring 'Company exceeded Parent's stock price as of the most recent appraisal. If an employee elected to surrender his or her options in exchange for the deferral amount, the employee was required to make the election with respect to all of his or her options. If an employee did not make the election, the employee continues to hold his or her options under Plan.

A hypothetical account was established under the Plan as of , for each employee who elected to surrender options. Within each participating employee's hypothetical account, subaccounts were established, with each subaccount reflecting the portion of the employee's account attributable to the various classes of options, the 1995 and 1996 ISO's and NQSO's and the 1997 NQSO's. It has been represented by the Taxpayer that none of the participating employees is a controlling shareholder.

Distribution of the amount credited to any participating employee's hypothetical subaccount will occur within 30 days of the date on which the employee becomes vested in that subaccount. In general, a participating employee becomes vested in a subaccount at the same time that he or she would have become vested in the surrendered options giving rise to such subaccount, pursuant to the vesting schedule set forth in Plan, including a provision that an employee is 100 percent vested upon reaching "retirement" as defined under Plan. (However, with respect to the deferred amounts, the Board of Directors no longer has discretion to allow retirement at a different time than "retirement" is defined under Plan). Vesting under the schedule is subject to the condition that the participating employee remain in the employ of Subsidiary until the applicable vesting date. If a participating employee terminates employment prior to this date, he or she will forfeit the amounts in the hypothetical subaccount.

There are certain exceptions to the generally applicable vesting schedules with respect to those employees who elected to surrender their options. For example, there is an extended vesting schedule (by one year) for certain subaccounts of some key employees, which is intended as a retention device for these key employees. If the participating employee terminates employment prior to the extended date, he or she will forfeit any nonvested amounts in the relevant subaccounts. In addition, Plan provides for 100 percent vesting if the participating employee terminates employment with Subsidiary upon a change of control, as defined in Plan. Finally, Plan provides for 100 percent vesting in the case of the death of a participating employee.

Under Plan, participating employees who elected to defer amounts to a hypothetical account have the status of general unsecured creditors and employees' rights to benefit payments may not be anticipated, alienated, sold, transferred, assigned, pledged, encumbered, attached, or garnished by creditors of the participant or the participant's beneficiary.

In order to provide a source of funds to assist it in meeting its obligations under Plan, Subsidiary has adopted a related Trust. The Trust conforms to the model language contained in Section 5 of Rev. Proc. 92-64, 1992-2 C.B. 11, that serves as a safe harbor against the constructive receipt of income and the realization of economic benefit. The Trust contains no language that is inconsistent or conflicts with the model trust language. Under the Trust, all trust assets remain subject to the general creditors of Subsidiary in the event of Subsidiary's insolvency. Subsidiary represents that the Trust is valid under the appropriate state law and that all material terms and provisions of the Trust, including the creditors' rights clause, are enforceable under the appropriate state law. Subsidiary further represents that the Trustee of the Trust is an independent third party that may be granted corporate trustee powers under the appropriate state law. The Trust provides that Subsidiary may direct the investment of all or any of its portion of the Trust assets.

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 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 402(b) of the Code provides that contributions made by an employer to an employee's trust that is not exempt from tax under section 501(a) are included in the employee's gross income in accordance with section 83, except that the value of the employee's interest in the trust will be substituted for the fair market value of the property in applying section 83. Under section 1.402(b)-1(a)(1) of the regulations, an employer's contributions to a nonexempt employee's trust are included as compensation in the employee's gross income for the taxable year in which the contribution is made, but only to the extent that the employee's interest in such contribution is substantially vested, as defined in the regulations under section 83.

Section 404(a) (5) of the Code provides the general deduction timing rules applicable to any plan or arrangement for the deferral of compensation, regardless of the Code section under which the amounts might otherwise be deductible. Pursuant to section 404(a)(5) of the Code and section 1.404(a)-12(b) (2) of the regulations, amounts of contributions or compensation deferred under a nonqualified plan or arrangement are deductible in the taxable year in which they are paid or made available to the employee, whichever is earlier, provided that they otherwise meet the requirements for deductibility.

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, 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-l 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.

Under the economic benefit doctrine, an employee has currently includible income from an economic or financial benefit received as compensation, though not in cash form. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for the employee's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952), Rev. Rul. 60-31, Situation 4. In Rev. Rul. 72-25, 1972-I C.B. 127, and Rev. Rul. 68-99, 1968-I C.B. 193, an employee does not receive income as a result of the employer's purchase of an insurance contract to provide a source of funds for deferred compensation because the insurance contract is the employer's asset, subject to claims of the employer's creditors.

Section 301.7701-4(a) of the Procedure and Administration Regulations provides that, generally, an arrangement will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees the responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of a business for profit.

Section 671 of the Code provides that where a grantor shall be treated as the owner of any portion of a trust under Subpart E, part I, subchapter J, chapter 1 of the Code, there shall then be included in computing the taxable income and credits of the grantor those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust (to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against tax of an individual).

Section 677(a) (2) of the Code provides that the grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be held or accumulated for future distribution to the grantor.

Section 1.677(a)-l(d) of the regulations provides that under section 677 of the Code, a grantor is, in general, treated as the owner of a portion of a trust whose income is, or, in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor.

Under the terms of the Trust, assets may be placed in trust to provide benefits to participating employees and their beneficiaries. However, in the event Subsidiary becomes insolvent, the Trustee will have the obligation to hold the Trust assets and income for the benefit of Subsidiary's general creditors. The Trust agreement further provides that a participating employee receives no beneficial ownership in or preferred claim on any Trust assets. Therefore, contributed assets will be held in trust, and in the event of the insolvency of Subsidiary, those assets will be fully within reach of its creditors, as are its other assets.

Provided, (i) that the creation of the Trust does not cause Plan to be other than "unfunded" for purposes of Title I of ERISA, and (ii) that the provision in the Trust requiring use of the Trust assets to satisfy the claims of general creditors in the event of Subsidiary's insolvency is enforceable by the general creditors of such employer under federal as well as state law, and based on the information submitted and representations made, we conclude that:

1. The Trust will be classified as a trust within the meaning of Section 301.7701-4(a) of the Procedure and Administration Regulations. Because the principal and income of the Trust may be applied in discharge of legal obligations of Subsidiary, Subsidiary shall be treated as the owner of the Trust

under section 677 of the Code. Accordingly, there shall be included in computing the taxable income and credits of Subsidiary, all items of income, deductions, and credits against tax of the Trust. Section 671.

2. Neither the creation of the Trust nor the contribution of assets by Subsidiary to the Trust will result in a transfer of property for purposes of section 83 of the Code or section 1.83-3(e) of the regulations.

3. Neither the creation of the Trust nor the contribution of assets to the Trust by Subsidiary will constitute a contribution to a nonexempt employees' trust under section 402(b) of the Code.

4. Under the economic benefit and constructive receipt doctrines of sections 61 and 451 of the Code, neither the opportunity to surrender, nor the actual surrender of, ISO's and NQSO's under the transaction stated above, will create taxable income to participating employees or their beneficiaries under the cash receipts and disbursements method of accounting.

5. Benefits payable under Plan and from the Trust will be includible as compensation in the gross income of participating employees or their beneficiaries on the cash receipts and disbursements method of accounting in the taxable year or years in which such amounts are actually distributed or otherwise made available, whichever is earlier.

6. Subsidiary is entitled to a deduction pursuant to section 404(a) (5) of the Code for the amounts paid or made available under Plan in the taxable year in which such amounts are includible in the gross income of participating employees or their beneficiaries, provided such amounts otherwise meet the requirements for deductibility under section 162.

This ruling is contingent upon the adoption of the proposed amendments to the Plan and the Trust, submitted with your letters and/or facsimiles dated August 31, 1998. It is directed only to the taxpayers who requested it. Section 6110(j) (3) of the Code provides that this ruling may not be used or cited as precedent. No opinion is expressed as to the federal tax consequences of the Plan or the Trust except as specifically ruled above with respect to the versions of those documents addressed in this letter. In particular, this ruling expresses no opinion as to the consequences of the arrangements under Title 1 of the Employee Retirement Income Security Act of 1974 ("ERISA"). In addition, this ruling expresses no opinion as to whether the invitation to elect to surrender the incentive stock options in exchange for an initial deferral amount in a hypothetical account is a modification of the option under section 424(h) (3) of the Code.

If either the Plan or Trust is substantially amended, this ruling may not remain in effect.

Sincerely,

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

Enclosure:
Copy for section 6110 purposes