Private Letter Ruling
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This is in reply to your request for a ruling on behalf of A and X concerning the federal income tax consequences of a trust established by A to hold annual bonus payments made by X to A.

A is an employee of X who is no longer eligible to participate in X's qualified profit sharing plan because of amendments made to the plan due to the Tax Reform Act of 1986. In order to replace benefits that A would have been entitled to receive under X's profit-sharing plan, X proposes to provide A with an annual bonus equal to the amount it would have contributed to its profit-sharing plan on A's behalf had X remained eligible for participation, plus an amount to defray the taxes attributable to the bonuses.

In order to set the bonuses aside for retirement, A has established an irrevocable trust into which A intends to have X deposit the bonuses. A anticipates that the trust will invest in and hold various types of investments, including a variable annuity contract.

Under the terms of the trust, A has the unilateral right to determine whether a bonus is to be contributed to the trust or paid directly to A. A also maintains the right to make additional contributions to the trust and to direct the trustee as to trust investments. X must approve any withdrawals from the trust prior to A's termination of employment, except that A has the unilateral right to withdraw the trust's current year income and any bonuses within 30 days of being contributed. Neither X nor any of its creditors have any interest in the trust.

A and X will jointly administer certain provisions of the trust. For example, they will have the joint power to remove the trustee, appoint a successor trustee and amend the trust agreement. The trust agreement sets forth the particular time and manner for payment of A's Death Benefit, Retirement Benefit and Severance Benefit.

Section 451 of the Code states that the amount of any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-2(a) of the Income Tax Regulations states that income, although not actually reduced to a taxpayer's possession, 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 upon it at any time, or so that the taxpayer could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Regardless of whether A elects to receive the bonus payment directly and not have it contributed to the trust by X, or elects to have the amount contributed to the trust, A receives the right to the tax gross-up payment. Therefore, A does not forego a valuable right by electing the direct payment of the bonus, and the amounts X pays to the trust on behalf of A are considered to have been made available to A prior to their transfer to the trust by X. Thus, A's control of the receipt of the direct payment is not subject to substantial limitations or restrictions. Accordingly, A is constructive receipt of any contributions made by X to the trust.

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 (if any) paid 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 regulations provides that, for purposes of section 83 of the Code, the term "property" includes real or 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. However, to the extent a transfer to a trust is subject to section 402(b) of the Code, section 83 applies to such a transfer only as provided for in section 402 (b). See section 1.83-8(a) of the regulations.

Section 402(b)(1) of the Code provides, in general, that contributions to a nonexempt employees' trust made by an employer are includible in the gross income of the employee in accordance with section 83, with the value of the employee's interest in the trust substituted for the fair market value of the property for purposes of applying section 83. However, section 402(b)(1) does not apply to the present case because the Trusts are not employees' trusts within the meaning of section 402(b)(1).

Section 162(a)(1) of the Code provides that a deduction shall be allowed for the ordinary and necessary expenses paid or incurred in carrying on a trade or business, including a reasonable allowance for compensation paid for services rendered.

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 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 business for profit.

Section 671 of the Code provides the general rule that when the grantor or another person is regarded as the owner of any portion of a trust, there shall be included in computing his taxable income and credits, those items of income, deduction, and credits against tax of the trust which are attributable to that portion of the trust (to the extent that such items could be taken into account in computing the taxable income or credits against the tax of an individual).

Sections 673 through 677 of the Code specify the circumstances that cause a taxpayer to be regarded as the owner of a portion of a trust. Section 677(a) provides, in relevant part, that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, 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 (1) distributed to the grantor or the grantor's spouse, or (2) held or accumulated for future distribution to the grantor or the grantor's spouse.

In the present case, A will be considered the owner of the portion of the trust attributable to X's payments to the trust because A will receive the economic benefit of the amounts that X pays to the employee's trust. See Rev. Rul. 83-25, 1983-1 C.B. 116. A is treated as the owner under section 677 of the Code because the entire income of the trust will be distributed to or held or accumulated for future distribution to A, the grantor, without the approval or consent of any other party.

Section 72(u)(1) of the Code provides that if an annuity contract is held by a person who is not a natural person, then such contract shall not be treated as an annuity contract for purposes of subtitle A (other than subchapter L) and the income on the contract (as defined in section 72(u)(2)) for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year. Section 72(u)(1) further provides that the general provision in section 72(u)(1) is not applicable to annuity contracts held by a trust or other entity as an agent for a natural person.

The legislative history to section 72(u)(1) of the Code contains the following explanation:

Under the bill, if any annuity contract is held by a person who is not a natural person (such as a corporation), then the contract is not treated as an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year. In the case of a contract the nominal owner of which is a person who is not a natural person (e.g., a corporation or a trust), but the beneficial owner of which is a natural person, the contract is treated as held by a natural person. Thus if a group annuity contract is held by a corporation as an agent for natural persons who are the beneficial owners of the contracts, the contract is treated as an annuity contract for Federal income tax purposes. However, the committee intends that, if an employer is the nominal owner of an annuity contract, the beneficial owners of which are employees, the contract will be treated as held by the employer. The committee intends this rule because it is concerned that the Internal Revenue Service would have difficulty monitoring compliance with the general rule that a deferred annuity is not available on a tax-favored basis, to fund nonqualified deferred compensation.

H.R. Rep. No. 426, 99th Cong., 1st Sess. 703, 704 (1985); 1986-3 (Vol. 3) C.B. 703, 704.

The legislative history to section 72(u)(1) of the Code also contains the following reasons for the changes made to section 72(u)(1):

The committee believes that the present-law rules relating to deferred annuity contracts present an opportunity for employers to fund, on a tax-favored basis, significant amounts of deferred compensation for employees. This favorable tax treatment may create a disincentive for employers to provide benefits to employees under qualified pension plans, which are subject to significantly greater restrictions. In addition, because deferred annuity contracts can be provided to a limited class of employees, rather than to employees generally (as is required in the case of a qualified pension plan), the committee is concerned that the present-law treatment of deferred annuity contracts dilutes the effect of the nondiscrimination rules applicable to qualified pension plans.

Id . at 703.

Accordingly, we rule as follows:

(1) payments by X under the terms of the trust established by A are includible in A's gross income in the year paid to the trust by X, pursuant to section 451(a) of the Code.

(2) Payments by X under the terms of the trust established by A are deductible by X in the year paid, to the extent the payments are ordinary and necessary expenses within the meaning of section 162 of the Code.

(3) The trust will be classified as a trust for federal income tax purposes within the meaning of section 301.7701-4(a) of the regulations. A will be treated as the grantor of the trust. Because all income will be distributed to the grantor or accumulated for future distribution to the grantor, A, as the grantor, shall be treated as the owner of the entire trust under section 677 of the Code. Therefore, pursuant to section 571, A shall include all income, deductions, and credits of the trust in computing his taxable income.

(4) Because A is the grantor of the trust, an annuity contract held by the trust shall be deemed to be held by a natural person. Therefore, section 72(u)(1) of the Code does not apply.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Except as specifically ruled on above, no opinion is expressed as the federal tax consequences of the transaction described above under any other provision of the Code. Moreover, if the trust agreement is substantially amended, this ruling may not remain in effect.

Sincerely yours, A. Thomas Brisendine Chief, Branch 1 Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations)

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