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January 25, 1999

Employer =

Plan =

Trust X =

Trust Y =

Dear

This responds to your letter of July 29, 1998 and subsequent correspondence, on behalf of Employer, requesting a ruling concerning the proposed deferred compensation plan ("Plan") under which Employer intends to provide benefits under section 457(b) and section 457(f) of the Internal Revenue Code of 1986, and the related trusts thereunder. Employer is represented to be a governmental entity hospital described in section 457(e)(1)(A).

In response to the need for primary and specialty care physicians in Employer's service area, Employer created Plan in order to attract and maintain physicians to their area. Plan currently covers 5 physicians ("participants".) Each Participant has entered into an identical employment agreement with Employer, except that certain agreements cover a 4-year period of employment, while other of the contracts require a 5-year commitment. The participants have agreed to be covered by Plan rather than to participate in the State retirement system where Employer is located. Under the section 457(b) portion of Plan, participants are eligible to defer up to the legal limit established by section 457 for eligible plans. In addition, under the section 457(f) portion of Plan, Employer will contribute an amount totaling 6.7% of each participant's salary, which is subject to a substantial risk of forfeiture as discussed more fully below.

Under that portion of Plan providing eligible deferred compensation benefits under section 457(b), the amounts which may be deferred by participants are within the limits set out in section 457(b), adjusted for the calendar year to reflect increases in cost of living under sections 457(e)(15) and 415(d) of the Code, including the section 457(c) coordination of deferral provisions. The participant's election to defer compensation under the Plan must be filed prior to the beginning of the month in which his or her salary reduction agreement becomes effective.

Distribution of deferred benefits will commence 60 days after a participant ceases to be an employee of Employer, unless a participant irrevocably elects to defer the commencement of benefits to a later date. Participants may choose among distribution options including lump sum cash payment, periodic payments over a specified period of time made not less frequently than annually, or periodic payments over the life of the participant or beneficiary, or the joint lives of the participant and his or her or beneficiary. The time and manner of benefit payout must meet the distribution requirements of sections 457(d) and 401(a)(9) of the Code. If the participant fails to make a timely election, distribution will commence at the time and in the manner set forth in the Plan.

Plan further provides that the trustee of its assets must hold all of the section 457(b) plan's assets for the exclusive benefit of the participants and their beneficiaries, and that all amounts deferred under the Plan must be transferred to a trust meeting the requirements of section 457(g) of the Code within an administratively reasonable time period (i.e., within 15 business days after the end of the month in which such amounts were deferred). The rights of any participant or beneficiary to payments pursuant to Plan with respect to the benefits provided under section 457(b) are generally nonassignable and not subject to attachment, garnishment, pledge or garnishment.

Employer has created Trust X by an agreement in writing to hold the section 457(b) plan assets. Under the terms of Trust X , all assets and income of the trust will be held for the exclusive benefit of participants and their beneficiaries, and no assets will be subject to the claims of Employer's general creditors. The terms of Trust X make it impossible prior to the satisfaction of all liabilities with respect to plan participants and their beneficiaries for any part of the assets and income of Trust X to be used for, or diverted to, purposes other than the exclusive benefit of plan participants and their beneficiaries. The trust is represented to be a valid trust under state law.

Plan also provides benefits to the participants under section 457(f) of the Code. Under the section 457(f) portion of Plan, a participant receives from Employer an annual benefit totaling 6.7% of a participant's total salary (excluding bonuses or other compensation) only if the participant's employment ends due to full completion of the employment contract with Employer, death, total disability, retirement at age 70 ½ or termination of employment by the Employer other than for cause. It has been represented by Employer that none of the participants in Plan are members of the Board of Directors of Employer. The Board of Directors of Employer has also been represented to be independent from Employer and provided with the sole legal authority of the affairs of Employer pursuant to County and State law.

To assist it in providing assets from which to pay the section 457(f) benefit obligations to the participants, Employer has established Trust Y, drafted to conform to the requirements of Rev. Proc. 92-64, 1992-2 C.B. 422, with an independent third party ("Trustee"), a trust to which Employer intends to contribute funds or other property from which the retirement benefits may be paid. The Trustee has the duty to invest the trust assets in accordance with the terms of the trust agreement. At all times, the trust assets under the section 457(f) provisions of Plan will be subject to the claims of Employer's general creditors if Employer becomes insolvent, as defined in the trust agreement. Employer's Chief Executive Officer and its Board of Trustees have the duty to inform the Trustee of Employer's insolvency. Upon receipt of such notice or other written allegations of Employer's insolvency, the Trustee will suspend the payment of these benefits with respect to participants in Employer's Plan. If the Trustee determines in good faith that Employer is not insolvent or is no longer insolvent, the Trustee will resume the payment of benefits. If Employer is insolvent, the Trustee shall hold the trust corpus for the benefit of Employer's general creditors.

Both Plan and the trust agreement under Trust Y provide that all amounts deferred under the Plan pursuant to the section 457(f) portion of Plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights will remain (until made available to the participant or beneficiary) solely the property and rights of the employer, subject only to the claims of Employer's general creditors. Participants have only the status of general unsecured creditors of their employer. The rights of any participant or beneficiary to payments pursuant to the Plan and trust agreement are nonassignable, and their interests in benefits under the Plan and the trust agreement are not subject to attachment, garnishment, pledge, encumbrance or other legal process.

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 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.

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, 1972-1 C.B. 127, and Rev. Rul. 68-99, 1968-1 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 457 of the Code provides rules for the deferral of compensation by an individual participant in an eligible deferred compensation plan (as defined in section 457(b)).

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

Section 457(b)(5) prescribes that an eligible deferred compensation plan must meet the distribution requirements of section 457(d).

Section 457(d)(1)(A) provides that for a section 457 plan to be an eligible plan, the plan must have distribution requirements providing that under the plan amounts will not be made available to participants or beneficiaries earlier than i) the calendar year in which the participant attains age 70 ½, ii) when the participant is separated from service with the employer, or iii) when the participant is faced with an unforeseeable emergency as determined under Treasury regulations. However, section 401(a)(9)(C)(i) generally allows plans to postpone the required beginning date until April 1 of the calendar year following the later of the calendar year in which the employee retires or in which he attains age 70 ½.

Section 457(f) provides that if a section 457 plan is or becomes an ineligible plan then the deferred compensation shall be included in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation, and the tax treatment of any amount made available under such plan to a participant or beneficiary shall be determined under section 72 relating to annuities.

Section 457(f)(1) of the Code governs the tax treatment of a participant in a plan of an eligible employer, if the plan provides for a deferral of compensation, but is not an eligible deferred compensation plan. Section 457(f)(2) states that section 457(f)(1) does not apply to a plan described in section 401(a) which includes a trust exempt from tax under section 501(a), to an annuity plan or contract described in section 403, to that portion of any plan which consists of a transfer of property described in section 83, or to that portion of any plan which consists of a trust to which section 402(b) applies.

In general, section 457(f)(1)(A) of the Code provides that the amount of compensation which is deferred under a plan subject to section 457(f)(1) is included in the participant's or beneficiary's gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation. Section 457(f)(3)(B) provides that, for purposes of section 457(f), the rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

Section 1.83-3(c) of the Income Tax Regulations provides that for purposes of section 83 and the regulations thereunder, whether a risk of forfeiture is substantial depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. The regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial. See section 1.83-3(c)(2).

Section 1.83-3(c)(4), Example (1) of the regulations provides, by way of example, that where a corporation transfers to an employee 100 shares of stock in the corporation, at $90 per share, and the employee is obligated to sell the stock to the Corporation at $90 per share if he terminates his employment with the Corporation for any reason prior to the expiration of a two year period of employment, the employee's rights to the stock are subject to a substantial risk of forfeiture during such two year period. If the conditions on transfer are not satisfied, it is assumed that the forfeiture provision will be enforced.

Section 457(g)(1) provides that a plan maintained by an eligible governmental employer shall not be treated as an eligible deferred compensation plan unless all assets and rights purchased with such deferred compensation amounts and all income attributable to such amounts, property, or rights of the plan are held in trust for the exclusive benefit of participants and their beneficiaries.

Section 457(g)(2)(A) provides that a trust described in 457(g)(1) shall be treated as an organization exempt from tax under section 501(a). Section 457(g)(2)(B) provides that amounts in the trust are ttreated as includible in the gross income of participants and beneficiaries only to the extent, and at the time, provided in section 457.

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 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)-1(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 Plan and the trust agreement for Trust X , the trustee must hold all of the section 457(b) plan's assets for the exclusive benefit of the participants and their beneficiaries, and all amounts deferred under the Plan must be transferred to a trust meeting the requirements of section 457(g) of the Code within an administratively reasonable time period. In addition, the trust is represented to be a valid trust under state law.

Under the terms of Plan, a participant will be entitled to receive benefits under the section 457(f) provisions of Plan only if their employment ends due to full completion of the employment contract with Employer or death, total disability, retirement at age 70 ½ or termination of employment by the Employer other than for cause. Based on these facts, a participant's benefits under the Plan are subject to a substantial risk of forfeiture until they vest. Accordingly, under section 457(f) of the

Internal Revenue Code, no contributions or benefits are taxable to a participant or his beneficiary until the benefits vest under the terms of the Plan.

Under the terms of the trust agreement for Trust Y, assets may be placed in trust to be used to provide deferred compensation benefits to the Participants. However, the trustee has the obligation to hold the trust assets and income for the benefit of Employer's general creditors in the event of Employer's insolvency. The trust agreement for Trust Y further provides that an employee receives no beneficial ownership in or preferred claim on the trust assets. Therefore, although the assets are held in trust, in the event of Employer's insolvency they are fully within reach of r's general creditors, as are any other assets of Employer.

Provided, (i) that the creation of Trust Y does not cause the section 457(f) portion of Plan to be other than "unfunded" for purposes of Title I of the Employee Retirement Income Security Act of 1974, and (ii) that the provision in Trust Y requiring use of the trust assets to satisfy the claims of Employer's general creditors in the event of Employer's insolvency is enforceable by the general creditors of Employer under federal and state law, and based on the information submitted and representations made, we conclude as follows:

1. The portion of Plan providing deferred compensation under section 457(b) is an eligible deferred compensation plan as defined in section 457(b) of the Internal Revenue Code of 1986. All assets and income of Plan described in section 457(b)(6) will be held in trust for the exclusive benefit of participants and their beneficiaries.

2. Amounts of compensation deferred in accordance with Plan under section 457(b), including any income attributable to the deferred compensation, will be includible in the recipient's gross income for the taxable year or years in which amounts are paid or otherwise made available to a participant or beneficiary in accordance with the terms of Plan.

3. Trust X, established with respect to Employer's section 457(b) plan assets, is treated under section 457(g) as an organization exempt from taxation under section 501(a).

4. Trust Y, established with respect to the portion of Plan providing for deferred compensation under section 457(f), will be classified as a trust under section 301.7701-4(a) of the Procedure and Administration Regulations. Because the principal and income of Trust Y may be applied in discharge of legal obligations of the grantor, Employer will be treated as the owner of Trust Y under section 677 of the Code. Accordingly, there shall be included in computing the taxable income and credits of Employers all items of income, deductions, and credits against tax of Trust Y. Section 671.

5. Neither the creation nor maintenance of the portion of Plan providing deferred compensation under section 457(f) and Trust Y, nor the contribution of assets to Trust Y, will result in a transfer of property to any participant or beneficiary nor create taxable income to any participant or beneficiary under sections 83 of the Code or section 1.83-3(e) of the regulations.

6.. Benefits under the portion of Plan providing deferred compensation under section 457(f) are subject to a substantial risk of forfeiture until the participant ends their employment with Employer under the terms of the employment contract with Employer or death, total disability, retirement at age 70 ½ or termination of employment by Employer other than for cause. Accordingly, under section 457(f)(1)(A), amounts credited by Employer under Plan are included in the gross income of the participant or his beneficiary in the first taxable year in which participant ends employment with Employer under the terms of the employment contract with Employer, or because of death, total disability, retirement at age 70 ½ or termination of employment of the participant by Employer other than for cause.

No opinion is expressed concerning the timing of the inclusion in income of amounts deferred under any deferred compensation plan other than Employer's Plan described above. In addition, this ruling applies only to deferrals made after the date this ruling was issued. If Plan is significantly modified, this ruling will not necessarily remain applicable. This ruling is directed only to Employer and the participants of Plan and applies only to the Plan and Trusts submitted on July 29, 1998 and revised in accordance with the amendments submitted on November 4, 1998, January 7, 1999 and January 18, 1999. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

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. 98-1, 1998-1 I.R.B. 7, 47. However, when the criteria in section 12.05 of Rev. Proc. 98-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

Sincerely yours,

ROBERT D. PATCHELL
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Chief Counsel
(Employee Benefits and
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Enclosure:
Copy for section 6110 purpose