

Part I

Section 402.—Taxability of Beneficiary of Employees' Trust

26 CFR 1.402(b)-1: Treatment of beneficiary of trust not exempt under section 501(a)
(Also: §§ 83, 404, 409A, 661, 663, 671, 3101, 3111, 3121, 3301, 3306, 3401, 3402, 1.83-3, 1.83-8, 1.404(a)-12, 1.409A-1, 1.661(a)-2, 31.3102(a)-1, 31.3121(a)-1, 31.3306(b)-1, 31.3401(a)-1, 31.3402(a)-1, 31.3401(d)-1, 301.7701-4)

Rev. Rul. 2007-48

ISSUE

When an employer contributes to a nonexempt employees' trust on behalf of highly compensated employees, what are the Federal tax consequences to the employees, the employer, and the trust of contributions to the trust, vesting of an employee's interest in the trust, and distributions from the trust?

FACTS

X corporation has created a deferred compensation plan (Plan) for 50 key executives (participants), all of whom are highly compensated employees within the meaning of § 414(q) of the Internal Revenue Code. Pursuant to the Plan, X contributes each year on behalf of each participant to a trust, I. No contributions by participants to

I are required or permitted. The Plan fails to satisfy the provisions of § 410(b) as well as other qualification requirements of § 401(a). Therefore, I is not and never has been a qualified trust under § 401(a) and is not exempt from taxation under § 501(a).

I was established under state law as a trust for the benefit of all of the Plan participants. I's assets can revert to X only after all liabilities to participants and beneficiaries under the Plan have been satisfied. I's assets are not subject to the claims of X's creditors. Separate accounts that reflect the participant's share of the net trust assets and income are maintained for each participant. I is not a foreign trust within the meaning of § 7701(a)(31).

A participant's entire interest in I becomes vested upon completion of two years of service with X beginning on the date the individual first becomes a participant in the Plan. Participants or their beneficiaries are entitled to receive their vested interest in the net assets of I, net of applicable withholding and other taxes, on death, disability, or termination of employment. In addition, I is required to distribute to each participant each year an amount that the trustee reasonably estimates will be equal to the amount of Federal, state, and local income and employment taxes payable by the participant with respect to the increase in the participant's vested accrued benefit in I during such year. I is permitted to make the distribution in part as a distribution of cash to the participant, and in part in the form of applicable employment tax withholding under Federal, state, or local law. X and I file income tax returns on a calendar year basis.

On each of January 1, 2007, 2008, 2009, and 2010, X contributes \$100,000 to I on behalf of participant A under the Plan. As of the close of business on December 31,

2008, the fair market value of A's interest in T is \$214,000, which includes income and realized and unrealized gains and losses on T's assets. A's interest in T first becomes vested on January 1, 2009. As of the close of business on January 1, 2009, the fair market value of A's interest in T is \$314,000 (including a contribution of \$100,000 from X on that date). A files income tax returns on a calendar year basis.

In 2009, the trustee distributes \$132,000 to A. Part of the distribution is in the form of withholding of applicable Federal, state, and local income and employment taxes and the remainder is cash. T's distributable net income allocable to A's account for 2009 is \$15,000. The fair market value of A's interest in T at the end of 2009 (after the distribution) is \$198,000.

In 2010, the trustee distributes \$48,000 to A. Again, part of the distribution is in the form of withholding of applicable Federal, state, and local income and employment taxes and the remainder is cash. T's distributable net income allocable to A's account for 2010 is \$16,000. The fair market value of A's interest in T at the end of 2010 (after the distribution) is \$270,000.

LAW AND ANALYSIS

Income Tax Treatment

For Participant

Section 83(a) 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 1.83-8(a) of the Income Tax Regulations provides generally that § 83 applies to a transfer to or from a trust for the benefit of employees, independent contractors, or their beneficiaries if the trust is not described in § 401(a). To the extent such a transfer is subject to § 402(b), however, § 83 applies to the transfer only as provided for in § 402(b).

Section 402(b)(1) provides that employer contributions to an employees' trust not exempt from tax under § 501(a) (a nonexempt employees' trust) are included in the employee's gross income in accordance with § 83, except that the value of the employee's interest in the trust is substituted for the property's fair market value in applying § 83. Section 1.402(b)-1(a)(1) provides that employer contributions to a nonexempt employees' 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 the contribution is substantially vested. Because I is a nonexempt employees' trust whose assets are derived solely from employer contributions, the entire trust is treated as a nonexempt employees' trust subject to the provisions of § 402(b).

Section 402(b)(2) provides that the amount actually distributed or made available to an employee by a nonexempt employees' trust shall be taxable in the taxable year in which distributed or made available to the employee under § 72 (relating to annuities), except that distributions of income of the trust before the annuity starting date (as

defined in § 72(c)(4)) shall be included in the employee's gross income without regard to § 72(e)(5) (relating to amounts not received as annuities).

Section 402(b)(4)(A) provides that if one of the reasons a trust is not exempt from tax under § 501(a) is the failure of the plan of which it is a part to meet the requirements of § 401(a)(26) or § 410(b), then a highly compensated employee (as defined in § 414(q)) shall, in lieu of the amount determined under § 402(b)(1) or (2), include in gross income for the taxable year with or within which the taxable year of the trust ends an amount equal to the vested accrued benefit of the employee (other than the employee's investment in the contract) as of the close of the taxable year of the trust.

Section 409A generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with a nonqualified deferred compensation plan, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor. Under § 1.409A-1(b)(6)(i), a right to compensation income that will be required to be included in income under § 402(b)(4) is not a deferral of compensation for purposes of § 409A. Although the regulations under § 409A generally apply for taxable years beginning on or after January 1, 2008, taxpayers may rely on such regulations for taxable years beginning before January 1, 2008.

Because the Plan does not meet the requirements of § 410(b) and A is a highly compensated employee (as defined in § 414(q)), § 402(b)(4)(A) determines the tax consequences to A of A's interest in T. Because A has no vested accrued benefit in T in 2007 or 2008, A has no gross income on account of A's interest in T for those years. See § 1.83-3(c)(4), Example (1).

For 2009, pursuant to § 402(b)(4)(A), A must include in gross income as compensation \$330,000, which is A's vested accrued benefit (the \$198,000 fair market value of A's account in T as of the end of 2009, plus the \$132,000 distributed to A in 2009 to satisfy applicable withholding requirements and A's anticipated tax liability for 2009, less A's investment in the contract as of the end of 2008, which was zero). For 2010, A must include in gross income as compensation \$120,000, which is A's vested accrued benefit under § 402(b)(4)(A) (the \$48,000 distributed to A in 2010 to satisfy applicable withholding requirements and A's anticipated tax liability for 2010, plus the \$270,000 fair market value of A's interest in T at the end of the taxable year of T, less A's investment in the contract as of the end of 2009, which was \$198,000).

For Employer

Section 404(a) 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 § 404(a)(5), contributions paid by an employer to or under a deferred compensation plan or arrangement that is not included in § 404(a)(1), (2), or (3) (a nonqualified plan) are deductible in the taxable year in which amounts attributable to the contributions are

includible in the gross income of the employees participating in the plan or arrangement, provided that the contributions otherwise meet the requirements for deductibility. In the case of a nonqualified plan in which more than one employee participates, contributions are deductible only if separate accounts are maintained for each employee.

Section 1.404(a)-12(b)(3) provides that in the case of a funded nonqualified plan under which more than one employee participates, no deduction is allowable under § 404(a)(5) for any contribution unless separate accounts are maintained for each employee. The requirement of separate accounts does not require that a separate trust be maintained for each employee. However, a separate account must be maintained for each employee to which employer contributions under the plan are allocated, along with any income earned thereon. In addition, the accounts must be sufficiently separate and independent to qualify as separate shares under § 663(c).

The separate account requirement does not bar X from deducting contributions to I because I satisfies the separate account requirement. However, because A does not include in income any amount attributable to X's contributions to I on behalf of A until 2009, none of those contributions is deductible by X before 2009. For 2009, because A includes in that year all amounts attributable to the \$100,000 contributions made by X in each of 2007, 2008, and 2009, X may deduct \$300,000 for contributions to I made on behalf of A, assuming such contributions are otherwise deductible. For 2010, because A includes in that year all amounts attributable to the \$100,000 contribution made in the year, X may deduct \$100,000 for contributions to I made on behalf of A, assuming such contributions are otherwise deductible.

For Trust

Section 671 provides that where a grantor is treated as the owner of any portion of a trust under subpart E of part I of subchapter J of chapter 1 (subpart E), there are included in computing the grantor's taxable income and credits those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust (to the extent that those items could be taken into account in computing the taxable income or credits against the tax of an individual). Sections 673 through 678 specify the circumstances that cause a taxpayer to be regarded as the owner of a portion of a trust. However, the rules of §§ 402(b) and 404(a)(5) preclude a § 402(b) employees' trust from being treated as owned by the employer under subpart E.

Section 641(a) provides that the tax imposed by § 1(e) applies to the taxable income of any kind of property held in trust.

Section 661(a) provides that in computing the taxable income of an estate or trust a deduction is allowed for distributions to beneficiaries equal to the sum of the amount of income for the taxable year that is required to be distributed currently and any other amounts properly paid or credited or required to be distributed for the taxable year. However, the total amount deductible under § 661(a) cannot exceed the distributable net income as computed under the provisions of § 643(a).

Section 663(c) provides that for the sole purpose of determining the amount of distributable net income in the application of § 661, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust are treated as separate trusts.

Rev. Rul. 74-299, 1974-1 C.B. 154, holds that a nonexempt employees' trust is allowed a deduction under § 661(a) for distributions to a retired employee under a deferred compensation plan. Where the separate share rule of § 663 applies to the trust, the trust's deduction under § 661(a) is limited to the distributee's separate share of the trust's distributable net income. The taxation of the distributions is not governed by the provisions of § 662.

In the present case, T is taxed as a trust under § 641. T's deduction under § 661(a) is limited to \$15,000 for 2009 and \$16,000 for 2010 because in each of those years the distributed amount (including the amount used to satisfy withholding requirements and distributed to A to satisfy A's anticipated tax liability) exceeds T's distributable net income allocable to A's separate share in T for those years.

Employment Tax Treatment

Sections 3101 and 3111 impose Federal Insurance Contributions Act (FICA) taxes on "wages," as that term is defined in § 3121(a). FICA taxes consist of the Old-Age, Survivors and Disability Insurance tax (social security tax) and the Hospital Insurance tax (Medicare tax). These taxes are imposed both on the employer under § 3111(a) and (b) and on the employee under § 3101(a) and (b). Section 3102(a) provides that the employee portion of FICA tax must be collected by the employer of the taxpayer by deducting the amount of the tax from the wages as and when paid. Section 31.3102-1(a) of the Employment Tax Regulations provides that the employer is required to collect the tax, notwithstanding that wages are paid in something other than money. Section 3121(a) defines "wages" for FICA purposes as all remuneration for employment

including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions. Section 31.3121(a)-(2)(a) provides that “[w]ages are paid by an employer at the time they are actually or constructively paid” unless certain exceptions not relevant here apply. Section 3121(b) defines "employment" for FICA purposes as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

Rules similar to the FICA rules apply with respect to Federal Unemployment Tax Act (FUTA) tax under §§ 3301, 3306(b), and 3306(c).

Section 3402(a), relating to Federal income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon these wages a tax determined in accordance with prescribed tables or computational procedures. Section 31.3402(a)-1(b) provides that the employer is required to collect Federal income tax withholding by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. Under § 31.3402(a)-1(c), an employer is required to deduct and withhold income tax notwithstanding that the wages are paid in something other than money (for example, wages paid in stock or bonds) and to pay over the tax in money. Section 3401(a) provides that "wages" for Federal income tax withholding purposes means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions.

Section 31(a)(2) provides that an amount of Federal income tax withheld during a calendar year from wages is allowed as a credit against income tax for the taxable year of the employee beginning in such calendar year.

Under section 6672(a), any person required to collect, truthfully account for, and pay over any internal revenue tax who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat such tax or the payment thereof, shall, in addition to other penalties, be liable for a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. A trustee can be liable for unpaid employment and withholding taxes. See Rev. Rul. 84-83, 1984-1 C.B. 264.

Rev. Rul. 67-351, 1967-2 C.B. 86, concludes that certain contributions to an employees' trust are subject to employment taxes at the time of contribution. In Rev. Rul. 67-351, pursuant to a collective bargaining agreement between a union and a group of employers, a vacation plan and trust are established for the benefit of the employees. The agreement provides that the employers will pay into the trust a specified amount for each hour worked by qualified employees. An individual account is established for each qualified employee by the trustees of the trust. The individual employee's interest in the amount in his vacation account is fully vested and nonforfeitable from the time the money is paid by his employer. The ruling concludes that the contributions to the trust are includible in gross income at the time they are contributed to the trust. Furthermore, the ruling holds that the contributions to the trust

are payments of wages for purposes of the FICA, the FUTA, and Federal income tax withholding at the time they are contributed to the trust.

In Rev. Rul. 79-305, 1979-2 C.B. 350, a corporation transfers to an employee common stock subject to a substantial risk of forfeiture. The ruling holds that, under § 83, the fair market value of the stock at the time the substantial risk of forfeiture lapses is includible in the employee's gross income for the year in which the substantial risk of forfeiture lapses. The ruling also holds that the employee has received a payment of wages for purposes of the FICA, the FUTA, and Federal income tax withholding at the time the substantial risk of forfeiture lapses equal to the fair market value of the stock.

Section 3401(d)(1) provides that if the person for whom the individual performs services does not have control of the payment of the wages for such services, the term “employer” means the person having control of the payment of such wages. Section 3401(d)(1) applies as well to the employer and employee portions of FICA tax, and to FUTA tax. See Otte v. United States, 419 U.S. 43 (1974); In re Armadillo Corp., 561 F.2d 1382 (10th Cir. 1977); and Lane Processing Trust v. United States, 25 F.3d 662 (8th Cir. 1994). Section 31.3401(d)-1(f) clarifies that § 3401(d)(1) applies if the person for whom the individual performs the services does not have legal control of the payment of wages. The regulation provides as an example the payment of pensions or retired pay by a trust.

For FICA and FUTA purposes, contributions to a nonexempt employees' trust are taken into account as wages for FICA and FUTA purposes only once, either at the time of contribution or the time of vesting. Treas. Reg. §§ 31.3121(a)-2(a) & 31.3102-1(a).

Employer contributions to such a trust are wages at the time of contribution to the extent that the employee's interest in the amount contributed is vested at the time of contribution. To the extent the employee's interest is not vested at the time of contribution, the contributions are not wages at the time contributed. Rather, for FICA and FUTA tax purposes, the employee receives a payment of wages on the date of vesting in an amount equal to the fair market value of the employee's interest in the trust attributable to the amount contributed (i.e., the amount contributed plus any increase in the value of the trust with respect to the contributions or less any decrease in the value of the trust with respect to the contributions up to the date of vesting).

Because neither X's contributions nor A's interest in T are vested during 2007 or 2008, A has no vested accrued benefit for 2007 or 2008. Therefore, A does not receive a payment of wages for FICA and FUTA tax purposes for these years. Because X's contributions of \$100,000 on each of January 1, 2009, and January 1, 2010, are vested at the time they were made, those contributions are treated as payments of wages subject to FICA and FUTA taxes at the time of contribution. X is the employer responsible for FICA and FUTA taxes on the 2009 and 2010 contributions.

Furthermore, when A's interest in T vests on January 1, 2009, A receives a payment of wages on that date for FICA and FUTA tax purposes in the amount of A's vested accrued interest on that date, i.e., the fair market value of A's interest in T that is attributable to the contributions made in 2007 and 2008 (not including the amount contributed by X on January 1, 2009, on which FICA and FUTA taxes are owed by X). T is the employer under § 3401(d)(1) for FICA and FUTA tax purposes with respect to

the amount attributable to the contributions made in 2007 and 2008. In applying the annual social security tax and FUTA wage bases under §§ 3121(a)(1) and 3306(b)(1), all of the wages paid during 2009 in connection with A's interest in T are taken into account, including the wages attributable to contributions made in 2007 and 2008.

The rule for determining the amount and the timing of the payment of wages subject to Federal income tax withholding follows the rule in § 402(b)(4)(A) for determining the amount and timing of gross income received by A, rather than the rule for determining the amount and the timing of the payment of wages for FICA and FUTA purposes. The legislative history of §§ 3401 through 3404 indicates that an objective of Federal income tax withholding is to enable individuals to pay the correct amount of income tax. H.R. Conf. Rep. No. 78-510 at 1 (1943). Congress has also stated that because the social security system has objectives that are significantly different from the objectives underlying the Federal income tax withholding rules, an amount may be treated differently for FICA purposes than it is for Federal income tax withholding purposes. See the legislative history to the Social Security Amendments of 1983 at S. Rep. No. 98-23, 42 (1983). Aligning the rule for Federal income tax withholding with the rule for determining the amount and timing of compensation included in the employee's gross income will result in the amount of Federal income tax withheld more precisely approximating the employee's income tax liability. A rule that determined wages for income tax withholding purposes at the time of vesting rather than at the end of the trust's taxable year could result in either overwithholding or underwithholding. Thus, in order to apply §§ 3401(a) and 3402(a) consistent with their purpose, the wages of a

highly compensated employee (within the meaning of § 414(q)) with a vested accrued benefit in a nonexempt employees' trust are treated as paid for Federal income tax withholding purposes on the last day of the taxable year of the trust. The employer does not make a payment of wages for income tax withholding purposes at the time it makes contributions to such a trust even if the contributions are vested at the time of contribution. The nonexempt employees' trust is the employer within the meaning of § 3401(d)(1) for Federal income tax withholding purposes and is responsible for all Federal income tax withholding obligations with respect to wages that are also gross income determined under § 402(b)(4)(A).

In accordance with the foregoing, A's wages for FICA and FUTA purposes attributable to contributions made in 2007 and 2008 are treated as paid on January 1, 2009, the date on which A's interest vests, in an amount equal to \$214,000, which is the fair market value of A's interest in T on January 1, 2009, disregarding the \$100,000 contribution from X on that date. A's wages for FICA and FUTA purposes for 2009 and 2010 are treated as paid on January 1, 2009 and January 1, 2010, and for each year are in an amount equal to X's vested contribution of \$100,000 on each such date. A's wages for Federal income tax withholding purposes attributable to contributions made in 2007, 2008, and 2009 are treated as paid on December 31, 2009, in an amount equal to \$330,000, which is the excess on that date of A's vested accrued benefit in T over A's investment in the contract. A's wages for Federal income tax withholding purposes for 2010 are treated as paid on December 31, 2010, in an amount equal to \$120,000,

which is the excess on that date of A's vested accrued benefit in T over A's investment in the contract.

X is the employer for FICA and FUTA purposes with respect to A's wages resulting from X's vested contributions to T in 2009 and 2010. T is the employer within the meaning of § 3401(d)(1) for FICA and FUTA purposes with respect to A's wages attributable to the contributions made in 2007 and 2008.

T is the employer within the meaning of § 3401(d)(1) for Federal income tax withholding purposes for all years with respect to A's wages resulting from A's interest in T. Thus, T is liable for Federal income tax withholding on \$330,000 in wages paid to A for 2009, and T is liable for Federal income tax withholding on \$120,000 in wages paid to A for 2010. X is not liable for any Federal income tax withholding in connection with the contributions to T.

HOLDING

Income and Deductions. When an employer contributes to a nonexempt employees' trust on behalf of highly compensated employee participants, a participant includes in gross income as compensation under § 402(b)(4)(A) the participant's vested accrued benefit (other than the participant's investment in the contract) as of the end of the taxable year of the trust ending with or within the taxable year of the participant. Provided that the separate account rule of § 404(a)(5) is satisfied, the employer is entitled to deduct a contribution made to the trust on behalf of a participant in the taxable year in which amounts attributable to the contribution are includible in the participant's income, to the extent the contribution otherwise meets the requirements for

deductibility. The trust is taxed as a trust under § 641. Because the separate share rule of § 663(c) applies to the trust, the trust is entitled to deduct distributions made to a participant to the extent the distributions do not exceed the distributable net income allocable to the participant's separate share of the trust.

FICA and FUTA. When an employer contributes to a nonexempt employees' trust on behalf of a highly compensated employee, the FICA and FUTA taxation of such contributions depends on whether the employee's interest in the contribution is vested at the time of contribution. If the contribution is vested at the time of contribution, then the amount of the contribution is subject to FICA and FUTA taxes at the time of contribution. The employer is liable for the payment of FICA and FUTA taxes on such amounts. If the contribution is not vested at the time of contribution, then the amount of the contribution and the earnings thereon are subject to FICA and FUTA taxation at the time of vesting. With respect to contributions and earnings thereon that become vested after the date of contribution, the nonexempt employees' trust is considered the employer under § 3401(d)(1) with respect to such amounts as they become vested.

Income Tax Withholding. With respect to an employee described in § 402(b)(4)(C), whose gross income is determined under § 402(b)(4)(A), wages for Federal income tax withholding purposes are determined in the same way gross income is determined under § 402(b)(4)(A). Such wages are in the amount of the employee's vested accrued benefit on the last day of the taxable year of the nonexempt employees' trust and are treated as paid for Federal income tax withholding purposes on that same date. The nonexempt employees' trust is the employer within the meaning of

§ 3401(d)(1) with respect to the highly compensated employee whose gross income is determined under § 402(b)(4)(A), regardless of whether contributions made for the benefit of the employee are vested at the time of contribution. Thus, the employees' trust is responsible for all Federal income tax withholding with respect to such wages paid to the employee. Distributions of benefits from the nonexempt employees' trust to the employee or for the employee's benefit are included in determining the vested accrued benefit of the employee at the end of the trust's taxable year, which is subject to Federal income tax withholding at the end of the trust's taxable year.

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 74-299 is amplified.

DRAFTING INFORMATION

The principal authors of this revenue ruling are William C. Schmidt and Alfred G. Kelley of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Mr. Schmidt at (202) 622-6030 (not a toll-free call), Mr. Kelley at (202) 622-6040 (not a toll-free call), or Bradford R. Poston of the Office of Associate Chief Counsel (Passthroughs and Special Industries) at (202) 622-3060 (not a toll-free call).