

Rabbi Trusts

Notice 2000-56

1. PURPOSE

This notice provides guidance on which entity is treated as the grantor and owner of a grantor trust when a parent corporation contributes its stock to a rabbi trust for the benefit of the employees of a subsidiary.

2. BACKGROUND

(1) Rabbi Trust Model

Rev. Proc. 92-64, 1992-2 C.B. 422, contains a model grantor trust for use in nonqualified executive compensation arrangements that are popularly referred to as rabbi trust arrangements. Under that revenue procedure, the Service will not rule on unfunded deferred compensation arrangements that use a trust other than the model trust, except in rare and unusual circumstances. Section 1(d) of the model trust document states that Any assets held by the Trust will be subject to the claims of the Company's general creditors under federal and state law in the event of Insolvency, as defined in Section 3(a) herein. In the case of a trust that provides benefits to employees of a subsidiary, it is the Service's position that Section 1(d) will not be satisfied unless the assets held by the trust are subject to the claims of the subsidiary's creditors (whether or not those assets are also subject to the claims of the parent's creditors). In this case, it has been the Service's position that the subsidiary is treated as the grantor and owner of the rabbi trust.

(2) Final Regulations under Section 1032 of the Internal Revenue Code

Section 1032 states that no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock of the corporation. Regulations were recently issued under section 1032 of the Internal Revenue Code (see 65 FR 31073 (May 16, 2000)). Section 1.1032-3(b)(1) of these regulations provides that no gain or loss is recognized on the disposition of the issuing corporation's stock by an acquiring entity if the requirements set forth in Reg. 1.1032-3(c) are met. Section 1.1032-3(c)(2) requires, among other things, that the acquiring entity transfer the stock of the issuing corporation to another person immediately after acquiring the stock from the issuing corporation (the immediacy requirement). Under the regulations, if the requirements of Reg.

1.1032-3(c), including the immediacy requirement, are met, the transaction is treated as if, immediately before the acquiring entity transfers the stock of the issuing corporation, the acquiring entity purchased the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation (or, if necessary, through intermediate corporations or partnerships). This series of transactions is commonly referred to as the cash

purchase model.

Rabbi trust arrangements typically do not involve an immediate transfer of stock to employees. In the case of a rabbi trust arrangement in which Parent Stock is treated for federal tax purposes as owned by a subsidiary for a period of time before the Parent Stock is transferred to the employees of the subsidiary, the immediacy requirement of Reg. 1.1032-3(c)(2) will not be satisfied when the Parent Stock is transferred from the rabbi trust to employees of the subsidiary. Because the cash purchase model of those Regulations will as a result not apply, the nonrecognition treatment of section 1032 will be inapplicable in such a case, and, thus, the subsidiary typically will recognize gain on the transfer of the Parent Stock from the rabbi trust to employees of the subsidiary.

3. TREATMENT OF PARENT CORPORATION AS GRANTOR OF A RABBI TRUST

The Service and Treasury have determined that when a parent corporation contributes Parent Stock to a rabbi trust to assist a subsidiary in meeting the subsidiary's deferred compensation obligations to its employees or service providers, and the Parent Stock is both subject to the claims of the creditors of the parent corporation and subject to the requirement that any Parent Stock not transferred to the subsidiary's employees will revert to the parent on termination of the trust, then the parent corporation will be considered the grantor and the owner of the Parent Stock held in the trust, even though the Parent Stock is also subject to the claims of the creditors of the subsidiary. If these conditions are satisfied, the Parent Stock (or other assets) will not be considered transferred to the subsidiary until such time as they are used to satisfy the subsidiary's deferred compensation obligation to its employees or service providers, or when a claim is made against the trust by a creditor of the subsidiary in the case of the subsidiary's insolvency. Thus, the immediacy requirement of Reg. 1.1032-3(c)(2) would be satisfied with respect to the Parent Stock.

This concept is illustrated in Example 10 of Reg. 1.1032-3(e). In the example, in Year 1, the issuing corporation, X, forms a trust which it will use to satisfy deferred compensation obligations owed by Y, X's wholly owned subsidiary, to Y's employees. X funds the trust with X stock which would revert to X upon termination of the trust, subject to the employees' rights to be paid the deferred compensation. The creditors of X can reach all trust assets upon the insolvency of X. Similarly, the creditors of Y can reach all trust assets upon the insolvency of Y. In Year 5, the trust transfers X stock to the employees of Y in satisfaction of the deferred compensation obligation. The example states that X is considered to be the grantor of the trust, and, under section 677 of the Code, X is also the owner of the trust. Y is not considered a grantor or owner of the trust corpus at the time X transfers X stock to the trust. Any income earned by the trust would be reflected on X's income tax return. In Year 5, when employees of Y receive X stock in satisfaction of the deferred compensation obligation, no gain or loss is recognized by X or Y on the deemed disposition of the X stock by Y. Immediately before Y's deemed disposition of the X stock, Y is treated as purchasing the X stock from X for fair market value using cash contributed to Y by X. Under section 358, X's basis in its Y stock increases by the amount of cash deemed

contributed. Accordingly, when employees or service providers of Y receive X stock in satisfaction of the deferred compensation obligation, the requirements of 1.1032-3(c) are satisfied, and no gain or loss is recognized by X or Y on the deemed disposition of the X stock by Y.

Similarly, the parent corporation will be treated as the grantor and owner of assets other than Parent Stock that are contributed by the parent corporation to a rabbi trust if the assets are both subject to the claims of the creditors of the parent corporation and subject to the requirement that any such assets not transferred to the subsidiary's employees or service providers will revert to the parent on termination of the trust, even though such assets are also subject to the claims of the creditors of the subsidiary. The cash purchase model applies only to transfers of stock by the parent corporation to the trust. Therefore, when assets other than Parent Stock are transferred from the trust to the employees of the subsidiary, the subsidiary is treated as receiving the other assets from the parent corporation with the parent's carryover basis and the subsidiary will recognize gain or loss (if any) on the transfer of the assets to the subsidiary's employees or service providers.

4. MODIFICATION TO MODEL TRUST UNDER REV. PROC. 92-64

The Service will rule on a request submitted under Rev. Proc. 92-64 where the model language has been modified to provide that Parent Stock (or other assets) contributed by a parent corporation to a rabbi trust for the benefit of employees or service providers of a subsidiary is subject to the claims of the creditors of both the parent corporation and the subsidiary, and the remaining Parent Stock (or other assets) contributed by the parent corporation reverts to the parent corporation upon termination of the trust.

5. TRANSITION PROVISIONS FOR EXISTING TRUSTS

The Service will not challenge a taxpayer's position that no gain or loss is recognized by a subsidiary upon the rabbi trust's disposition of Parent Stock contributed to the rabbi trust by the parent corporation on or before May 16, 2001, with respect to trusts in existence on or before June 15, 2000.

If the terms of the rabbi trust are amended to provide that assets (including Parent Stock) contributed by the parent corporation to the rabbi trust are subject to claims of the parent corporation's creditors (in addition to being subject to the claims of the subsidiary's creditors) and those assets not transferred to the subsidiary's employees or service providers will revert to the parent corporation upon termination of the rabbi trust, the Service will not treat such amendment as a constructive dividend to the parent corporation, provided the amendment is adopted by May 16, 2001.

6. EFFECT ON OTHER GUIDANCE

Rev. Proc. 92-64 will not fail to be satisfied if Parent Stock (or other assets) contributed by a parent corporation to a rabbi trust for the benefit of employees or service providers of a subsidiary is subject to the claims of the creditors of the parent corporation and the subsidiary, and the remaining Parent Stock (or other assets) contributed by the parent corporation reverts to the parent corporation upon termination of the trust.

DRAFTING INFORMATION

The principal author of this notice is Susan Lennon of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Service and the Treasury Department participated in its development. For further information regarding this notice, contact Ms. Lennon at (202) 622-6030 (not a toll-free telephone number).