DOCS AND DEFERRED COMPENSATION:
MORE SIGNS OF A KINDER AND GENTLER IRS

By A. Thomas Brisendine

Since Congress extended Section 457 of the Internal Revenue Code to apply to the deferred compensation plans of tax-exempt organizations in 1986, hospitals and other health care organizations have experienced significant difficulty in structuring plans that are competitive in attracting highly skilled physicians and executives. Simultaneously, the health care delivery system in this country has been going through a virtual revolution in how it provides services. In some cases, tax-exempt facilities are being acquired by taxable providers, and in other instances mergers and consolidations of facilities in and among taxable and nontaxable organizations are occurring in an effort to improve efficiencies.

Additionally, medical practices are being acquired, with the doctors becoming employees of the health care providers, or practices are being combined to provide greater leverage in contracting to furnish professional services. The future of the health care industry in America is unclear, but what is clear is that it will be vastly different from what it is today or has been in the past. Key people will continue to be critical, but attracting and retaining highly sought-after specialists is made doubly difficult when tax-exempts are barred by law from utilizing compensation techniques and arrangements that are widely used in the taxable sector to lure and keep contented the best talent.

Several private letter rulings (PLRs) recently issued by the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations) of the Internal Revenue Service indicate an increasing willingness on the part of the Service to provide greater flexibility in construing these statutory rules and thereby assisting tax-exempt health care organizations and other tax-exempt entities in their efforts to attract and retain outstanding people.

PLR 9810005

Private Letter Ruling 9810005, dated December 3, 1997, was made available to the public on March 6, 1998. It is apparent on the face of the ruling that it was under consideration at the Service for three to four years (from some time in 1994 until December 1997). Thus, in the interest of full disclosure, I should state that its life predates my retirement from the Office of the Chief Counsel.

In this “breakthrough” ruling, the Service approved a complex arrangement involving a Section 501(c)(3) tax-exempt charitable organization and a taxable corporation. For purposes of our discussion (since we are focusing on doctors and deferred compensation), let us assume that the parties involved in the ruling are a tax-exempt health care organization (which we will call Healthcare), a taxable corporation providing services to Healthcare (which we will call Doc Corp.), and the “top-hat” group of Doc Corp. Under the arrangement, a trust is created to hold assets beyond the

reach of creditors of Healthcare, Doc Corp., and the executives and highly compensated physicians of Doc Corp., who are participants in a supplemental retirement plan (SERP) maintained by Doc Corp. The ruling affords some of the benefits to the SERP normally associated with Section 401(a) qualified plans, although the plan is a nonqualified arrangement.

Ruling’s Facts

The facts of the published ruling are critical to its conclusions, so they will be restated here in detail. In the ruling, Doc Corp. provides services to Healthcare pursuant to an “exclusive requirements” contract under which, apparently, Doc Corp. promises to provide all medical services required by Healthcare, and Healthcare promises to look only to Doc Corp. for these services. The contract is renewed annually and, it would appear, has been in place for a number of years. The parties represented to the Service that they are independent entities and negotiate at arm’s length. The contract is a product of these negotiations, under which Doc Corp. is compensated for its services by means of some sort of fixed payment (probably a per capita payment) that changes annually. It is interesting to note that the negotiated payment to Doc Corp. appears to approximate Doc Corp.’s anticipated operating expenses for the forthcoming year.

Doc Corp. has a qualified retirement plan and a nonqualified, unfunded supplemental retirement plan (SERP) for its executives and highly compensated employees. The SERP provides retirement benefits to those individuals whose benefits under the qualified plan are limited by various provisions of the Internal Revenue Code. Traditionally, Doc Corp.’s current obligations under the SERP have been included as a part of its operating expenses when calculating the fixed payment under the requirements contract. In order to qualify for payments under the SERP, certain age and service requirements must be met, and participants in the plan who fail to meet these requirements forfeit their benefits.

The reason for the requested ruling was that Healthcare and Doc Corp. proposed to enter into an agreement under which Healthcare would be obligated to make payments to a trust to provide Doc Corp. with a source of funds to satisfy its obligations under the SERP. The proposed trust provides that amounts in the trust are not reachable by creditors of Healthcare, Doc Corp., or participants in the SERP. Amounts would become payable from the trust to Doc Corp. as Doc Corp.’s obligations to participants in the SERP mature and would, at that point, be general assets of Doc Corp. and reachable by its creditors. Participants in the SERP have no rights or beneficial interests in the trust and possess only the rights of unsecured, general creditors of Doc Corp.

Healthcare’s contributions to the trust will be determined on the basis of the total present value of the benefits Doc Corp. expects to pay to participants in the SERP. Assumptions used in making these calculations will not take into account employee turn-over or mortality. “This method of calculating the amount of [Healthcare’s] contributions ensures that [Doc Corp.] will be able to receive from the Trust all amounts [Doc Corp.] will need to meet its obligations to its [SERP participants] under the plan.” The initial contribution following execution of the trust will equal the total present value of all expected benefits that could be made during all future years to participants who will not satisfy the age and service requirements until at least two years after the date of the contribution. Subsequent annual contributions will be sufficient to assure full funding through the valuation date. In
no event, however, will contributions be made to the trust with respect to any participant who could satisfy the age and service requirements within two years of the contribution date.

All trust amounts will be allocated to individual memorandum accounts that are identified by reference to the participants in the SERP. The trust will make payments to Doc Corp. each quarter equal to the payments Doc Corp. must make to plan participants. Over-funding will revert to Healthcare at stated intervals, and the balances of accounts will be forfeited to Healthcare if a participant does not become entitled to a benefit under the SERP. Forfeitures to Healthcare will also occur if Doc Corp. voluntarily terminates its relationship with Healthcare, or if Healthcare terminates the relationship for cause. If Healthcare terminates the relationship without cause, the trustee will distribute all trust assets to Doc Corp. For financial accounting purposes, the parties indicate that Healthcare intends to expense all contributions to the trust, and Doc Corp. intends to show the trust assets on its books as an offset against its liabilities under the SERP.

**Ruling’s Conclusions**

In analyzing the proposed transaction, the ruling concludes that Healthcare will be making contributions to a trust in which Doc Corp. will hold a beneficial interest, and that these contributions represent transfers of property under Section 83 of the Code. Doc Corp.’s beneficial interest, the ruling indicates, is subject to a substantial risk of forfeiture until participants meet the age and service requirements in the SERP and apparently for that reason is not taxable property to Doc Corp. at the time of the contributions. The ruling holds that, prior to the lapse of the risk of forfeiture, Healthcare is treated as the grantor and owner of the trust. Once the risk of forfeiture lapses, the trust is treated as having made a deemed distribution to Doc Corp., which Doc Corp. then contributes to a deemed trust established by Doc Corp.

Doc Corp. will be treated as the owner of the deemed trust and the income relating to that portion of the trust. Presumably Doc Corp. is also taxed on the deemed distribution made to it under Section 83, although the ruling does not say so. Finally, the ruling holds that the arrangement will not give rise to any income to the participants and beneficiaries of the SERP prior to their actual receipt of amounts under the SERP.

**Ruling’s Apparent Rationale**

The ruling is relatively cryptic. Like a lot of private letter rulings, it is long on facts, statement of the law, and conclusions, and short on rationale. It would seem, however, that the apparent rationale rests almost entirely on Section 83.

Section 83, as we all know, taxes transfers of property in connection with the performance of services to the service provider at the time of transfer, unless the service provider’s interest in the property is both nontransferable and subject to a substantial risk of forfeiture. If the property is not taxable at transfer, it is taxable in the first taxable year in which the service provider’s interest is either transferable or no longer subject to a substantial risk of forfeiture. The service provider can be any person, which includes an individual, trust, estate, partnership, association, company, or corporation. Property is not defined in the statute, but it is defined broadly in Section 1.83-1(c) of the regulations.
and includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account. Thus, the ruling’s conclusions with regard to the applicability of Section 83 seem to be within the literal wording of the statute and regulations.

Having concluded that Section 83 is applicable, the ruling then moves on to the question of whether there is a substantial risk of forfeiture. (It does not address the issue of transferability, so we must assume Doc Corp.’s interest in the trust was nontransferable within the meaning of Section 83.) The ruling concludes that a substantial risk of forfeiture exists because Doc Corp.’s rights in the property that have been transferred are conditioned on the occurrence of a condition related to the purpose of the transfer. The purpose of Healthcare’s transfer of property to the trust, the ruling holds, is to provide Doc Corp. with a source of money to fund Doc Corp.’s obligations to the participants in the SERP. The condition related to the purpose of the transfer is each individual participant meeting the eligibility requirements to receive SERP benefits. Once those requirements are met (the participant attaining a specified age while still employed by Doc Corp. or completing five years of service, if later), the risk of forfeiture ceases.

Resort to the “condition related to the purpose of the transfer” language for the finding of a substantial risk of forfeiture apparently was necessary because it would be difficult to argue that Doc Corp.’s enjoyment of its beneficial interest in the trust was conditioned upon the future performance of substantial services by Doc Corp.

The ruling further concludes, without explanation, that the requirement that a participant live until a specified age is not a substantial risk of forfeiture under Section 83. Also the possibility of a reversion of trust amounts to Healthcare if Doc Corp. terminates the agreement voluntarily or if Healthcare terminates the agreement for cause does not result in a substantial risk of forfeiture under Section 83.

Treating Healthcare as the owner of the portion of the trust consisting of amounts that are subject to a substantial risk of forfeiture is consistent with Section 1.83-1(a)(1) of the regulations which states that until property becomes substantially vested, the transferor shall be regarded as the owner of the property.

OTHER AUTHORITIES

The ruling does not address (and need not under IRS ruling procedures) one line of authority which clearly should be considered if practitioners are to have any comfort that the ruling’s conclusions could apply to other taxpayers, and it pointedly expresses no opinion on the tax consequences of the arrangement in existence prior to the proposed trust. Additionally, it states that no opinion is expressed with respect to the possible applicability of two other sections of the Code, Sections 402(b) and 457(f), both of which deserve at least some brief discussion.

**Anticipatory Assignment of Income**

Practitioners should be aware of United States v. Basye, 410 U.S. 441 (1973), because of