

**PILLSBURY WINTHROP_{LLP}****Impending May 16, 2001 Deadline for
Amendments of Certain Rabbi Trusts****Susan P. Serota • Peter J. Hunt • John J. Battaglia**

Rabbi trusts are grantor trusts commonly used to fund employers' deferred compensation obligations and to provide a source of shares for stock compensation plans. If the assets of a rabbi trust are subject to the claims of the employer's creditors in the event of bankruptcy or insolvency and the trust meets certain other requirements, the trust beneficiary will not be taxed on his or her interest in the trust until the beneficiary receives a distribution.

Where a subsidiary is the grantor of a rabbi trust created for the benefit of the subsidiary's employees and the trust holds stock of the subsidiary's parent, distribution of the parent stock to the subsidiary's employees may result in the recognition of gain by the subsidiary under final regulations promulgated under section 1032 of the Internal Revenue. Gain recognition can be avoided, however, if the rabbi trust is amended to make parent-contributed trust assets (including parent stock) available to satisfy the claims of the parent's creditors (as well as the subsidiary's creditors) in the event of bankruptcy or insolvency, and to give the parent certain reversion rights upon termination of the trust. This amendment will not be treated as a constructive dividend to the parent if it is adopted on or before May 16, 2001.

Final Regulations under Code Section 1032 Adopt Cash Purchase Model

Generally, under Internal Revenue Code section 1032, a corporation does not recognize gain or loss on a disposition of its own stock. On May 16, 2000, the Internal Revenue Service issued final regulations relating to the tax treatment under section 1032 of a subsidiary's disposition of its parent's stock (T.D. 8883). Income Tax Regulations section 1.1032-3 provides generally that, if certain conditions are met, a subsidiary will not recognize gain or loss on a disposition of its parent's stock to an employee of the subsidiary under a compensatory plan or arrangement. The regulation arrives at this result by

applying a "cash purchase" model. Under the cash purchase model, the transaction is treated as if, immediately before the subsidiary disposed of the parent stock, the subsidiary purchased the parent stock from the parent for fair market value with cash contributed to the subsidiary by the parent. The deemed cash purchase prevents the subsidiary from having a zero tax basis in the parent stock, which could trigger gain recognition on a subsequent disposition. The relief provided by the regulation is available, however, only if the subsidiary disposes of the parent stock immediately after acquiring it from the parent.

Cash Purchase Model Is Not Available to Certain Rabbi Trusts

Rabbi trusts that distribute parent stock to subsidiary employees are commonly structured with the subsidiary as grantor of the trust. Parent stock that is contributed to a subsidiary's rabbi trust is usually held by the trust until it vests or becomes distributable under the terms of the subsidiary's compensatory plan that is funded by the rabbi trust. Where the subsidiary is the grantor, the "immediate transfer" requirement of Income Tax Regulations section 1.1032-3 ordinarily will not be satisfied because the parent stock held by the rabbi trust pending distribution is treated for federal income tax purposes as owned by the subsidiary. Thus, unless the rabbi trust distributes the parent stock to employees immediately after it is contributed, the "no gain" treatment under the cash purchase model will not be available.

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Subsidiary Can Avoid Gain If Rabbi Trust Is Amended

On October 6, 2000, the Internal Revenue Service released [Notice 2000-56](#) confirming that violations of the “immediate transfer” requirement can be avoided if the parent and its creditors are given certain rights to the assets of the rabbi trust. In that case, parent stock contributed to the rabbi trust would not be considered transferred to the subsidiary until such time as the stock is distributed to employees of the subsidiary (or when a claim is made against the trust by a creditor of the subsidiary, in the case of the subsidiary’s insolvency). This relief is available only if the parent stock held by the trust is made subject to the claims of the parent’s creditors (as well as the subsidiary’s creditors) in the event of bankruptcy or insolvency, and if any parent stock not transferred to the subsidiary’s employees will revert to the parent upon termination of the trust.

Employers Should Act Now to Amend Trusts

For rabbi trusts that were in existence on June 15, 2000, the Internal Revenue Service has stated that it 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 or other assets that the parent contributed on or before May 16, 2001. In order for parent stock contributed after May 16, 2001 to be eligible for “no

gain” treatment, however, the terms of the rabbi trust must be amended to provide that the assets (including parent stock) contributed to the trust by the parent are subject to the claims of the parent’s creditors (in addition to being subject to the claims of the subsidiary’s creditors) in the event of bankruptcy or insolvency, and that any such parent stock and assets not transferred to the subsidiary’s employees or service providers will revert to the parent corporation upon termination of the rabbi trust. Provided the amendment is adopted no later than May 16, 2001, the Internal Revenue Service has stated that it will not treat the amendment as a constructive dividend to the parent corporation.

Materials Available On-Line

Readers who are using Acrobat Reader 3.0 or later (or an Acrobat 3.0 or later-enabled web browser) to review this bulletin can obtain the referenced administrative materials either through the links in text or in the ensuing list. Alternatively, the html version of this bulletin at www.pmstax.com/gen/bull0105.shtml contains links to the material.

- [T.D. 8883](#) (final regulations under Internal Revenue Code section 1032) [148K]
- [Internal Revenue Service Notice 2000-56](#) [38K]

