PLAN DISTRIBUTIONS

IRS Rules That a Direct Transfer from a Terminated DB Plan to a Replacement DC Plan Is Subject to Preferential Tax Treatment, but Reversion Is Taxed

The new position taken by the IRS in Revenue Ruling 2003-85, unlike its holdings in the previous private letter rulings, is rational and is supported by the plain meaning of the definition of the "employer reversion" that is subject to the excise tax under Code Section 4980.

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On July 1, 2003, the IRS issued Revenue Ruling 2003-85 (published in Internal Revenue Bulletin 2003-32 on August 11, 2003), which held that a company that terminated its defined benefit plan, established a replacement defined contribution plan, and directly transferred to the new plan an amount in excess of 25 percent of the maximum amount otherwise available for reversion, would receive preferential tax treatment on the direct transfer. The IRS further ruled that the reversion that the company received would be subject to the 20 percent excise tax under Section 4980(a) of the Internal Revenue Code (the Code) and would be includible in the company's federal gross income.

Issue Presented

The specific issue upon which the IRS ruled in Revenue Ruling 2003-85 was: If a defined benefit plan is terminated, and an amount in excess of 25 percent of the maximum amount otherwise available for reversion is transferred from the terminating defined benefit plan to a defined contribution plan, what is the tax treatment of the amount transferred to the defined contribution plan and of any reversion to the employer from the terminating defined benefit plan?

Facts

The facts that the IRS considered in Revenue Ruling 2003-85 were as follows. Company M maintained Plan A, a defined benefit plan qualified under Code Section 401(a). On March 1, 2002, the Board of Directors of Company M adopted resolutions to terminate Plan A, effective July 1, 2002, and to adopt Plan B, a defined contribution plan. Company M did not amend Plan A in connection with the termination of the plan to provide for any increases in the accrued benefits of the participants.

All employees of Company M were eligible to participate in Plan B upon attainment of age 21 and completion of 1 year of service. Of the 1,000 participants with accrued benefits under Plan A that remained as employees of Company M as of July 1, 2002 (the termination date of Plan A), 95 percent were participants in Plan B on that date.

After satisfaction of all liabilities of Plan A, Company M could have received a reversion of \$60X of surplus assets, determined without regard to Code Section 4980(d). After satisfaction of all the plan liabilities and before taking a reversion of the surplus assets under Plan A, Company M transferred \$20X to Plan B. Plan B provided for the receipt and immediate allocation of excess assets in the form of a direct transfer from the terminating Plan A. The allocation of the excess assets satisfied the requirements of Code Sections 401(a)(4) and 415.

Legal Analysis

The IRS set forth the following legal analysis in Revenue Ruling 2003-85. Code Section 61 defines gross income as all income from whatever source derived (subject to certain exceptions). Code Section 111(a) provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of the tax imposed by Code Sections 1 through 1400L.

Code Section 4980(a) provides for a 20 percent excise tax on the amount of any reversion from a qualified plan. Code Section 4980(d)(1) provides, in pertinent part, that the excise tax under Code Section 4980(a) is increased to 50 percent with respect to any employer reversion from a qualified plan unless the employer establishes or maintains a qualified replacement plan or the plan provides *pro rata* benefit increases described in Code Section 4980(d)(3).

Code Section 4980(c)(2) generally defines "employer reversion" as the amount of cash and the fair market value of other property received (directly or indirectly) by an employer from the qualified plan.

Under Code Section 4980(d)(2), a plan is a "qualified replacement plan" if it is established or maintained by the employer in connection with a qualified plan termination and certain additional requirements are met. Under Code Section 4980(d)(2)(A), in order for the replacement plan to be a qualified replacement plan, at least 95 percent of the active participants in the terminated plan who remain as employees of the employer after the termination must be active participants in the replacement plan. Code Section 4980(d)(2)(C) provides rules for the allocation of the amount transferred.

Under Code Section 4980(d)(2)(B), in order for the replacement plan to be a qualified replacement plan, a direct transfer must be made from the terminated plan to the replacement plan before any employer reversion, and the transfer must be an amount equal to the excess (if any) of (I) 25 percent of the maximum amount the employer could receive as an employer reversion (determined without regard to Code Section 4980(d)) over (II) the present value of the aggregate increases in the accrued benefits under the terminated plan of any participants or beneficiaries under a plan amendment which is adopted within 60 days before the plan termination and which takes effect immediately upon plan termination.

Code Section 4980(d)(2)(B)(iii) provides that, in the case of any amount transferred under Code Section 4980(d)(2)(B)(i) from a terminated plan to a qualified replacement plan, such amount (I) shall not be includible in the gross income of the employer, (II) no deduction shall be allowable with respect to such transfer, and (III) such transfer shall not be treated as an employer reversion for purposes of Code Section 4980.

Holdings

The IRS held that:

1. Plan B was a qualified replacement plan for purposes of Code Section 4980(d).
2. In accordance with Code Section 4980(d)(2)(B)(iii), the direct transfer from Plan A to Plan B of $20X, an amount that was at least 25 percent of the maximum amount which the employer could have received as an employer reversion, would be treated as follows:
   a. The amount transferred would not be includible in the gross income of the employer;
   b. No deduction would be allowable with respect to the amount transferred; and
   c. The amount transferred would not be treated as an employer reversion for purposes of Code Section 4980.
3. The $40X that the employer received would be subject to the 20 percent excise tax under Code Section 4980(a) and would be includible in income under Code Section 61.

Conclusions

The IRS holding in Revenue Ruling 2003-85 is directly contrary to a series of recent private letter rulings in which the IRS held that when more than 25 percent of the excess assets of a terminated defined benefit pension plan are directly transferred to a qualified replacement plan, any excess over that 25 percent cushion would be subject to the 20 percent excise tax under Code Section 4980(a) as well as to federal income tax. [*See*, PLRs 200212035, 200227040, 199911058, and 9823051] The new position taken by the IRS in Revenue Ruling 2003-85, unlike its holdings in the previous private letter rulings, is rational and is supported by the plain meaning of the definition of the "employer reversion" that is subject to the excise tax under Code Section 4980. Amounts in excess of the 25 percent cushion that are directly transferred from a terminated plan to a qualified replacement plan do not constitute an "employer reversion" as defined under Code Section 4980(c)(2)(A) and should not, as Revenue Ruling 2003-85 concludes, be subject either to excise or income taxation.