DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Deputy Area Counsel (TEGE), Northeast/Mid-Atlantic Area

FROM: Michael Roach, Chief, CC:TEGE:EB:QP1

SUBJECT: Section 4980 Excise Tax on Reversions

This Chief Counsel Advice responds to your memorandum transmitted to this office on January 31, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Employer A -
Plan X -
Plan Y -
date M -
date N -
date O -
date P -
date Q -
date R -
date S -
date T -
date U -
date V -
date W -
date X -
F$ -
G$ -
H$ -
J participants -
K participants -
L participants -

ISSUES

1. Whether Plan X is required to file a separate Form 5330 for the reversion of pension assets received on or about date T.

2. Whether Plan X may amend the 1999 Form 5330 to include the reversion of pension assets received on or about date T, after the reconciliation of all accounts and the completion of administrative matters.

3. If Plan X may amend its 1999 Form 5330, is the IRS foreclosed from collecting any additional tax due based on the closing agreement determining X's 1999 Form 5330 liability under Internal Revenue Code (Code) § 4980?

4. May the closing agreement be construed as requiring the Internal Revenue Service to settle the § 4980 tax due for the year 2000 on a basis consistent with the settlement of the tax due on the 1999 Form 5330?

5. On what basis should the second reversion from Plan X be settled?

6. Is the 20 percent (20%) rate set forth in § 4980 automatically available for a reversion of pension assets received after the filing of the liquidating Chapter 11 petition?

7. Does Plan Y have to increase the benefits of active and inactive plan participants by at least twenty percent (20%) of the amount of the reversion, prior to receiving a reversion of the Plan Y assets in order to qualify for the 20% tax rate under § 4980? If Employer A has no obligation to participants, active or inactive, must Employer A pay tax on fifty percent (50%) of the reversion pursuant to § 4980(d)?

8. On what basis should the third reversion be settled?

CONCLUSIONS

1. Employer A is required to file a separate Form 5330 for each reversion. For a reversion received on date T, a Form 5330 should be filed no later than date U.

2. A Form 5330 filed with respect to a reversion received in 1999 should not be amended to report a reversion received in 2000.

3. This issue is rendered moot by the response to Issue 2, preceding.

4. No, the 1999 closing agreement may not be construed as requiring the Internal Revenue Service to settle the IRC § 4980 tax for a later taxable period with potentially different facts on the same basis.

5. The second reversion from Plan X in the year 2000 should be settled on the same terms as the first reversion covered by the 1999 closing agreement if the same material facts and circumstances exist.

6. No, the 20% rate of IRC § 4980(a) is not automatically available to a reversion received after the filing of a liquidating chapter 11 petition.

7. If Employer A cannot satisfy the conditions of § 4980(d)(1)(A) or (B), Employer A will be liable for the increased excise tax pursuant to § 4980(d)(1).

8. The Service can and should consider a compromise of a tax liability while a bankruptcy proceeding is pending, unless the compromise is based entirely on doubt as to collectibility.

FACTS

Employer X sponsored Plan A. Employer X terminated Plan A with a termination date of N. On or about date M, Employer X filed a Form 5310, Application for Determination for Terminating Plan, with the Internal Revenue Service. On or about date O, the Internal Revenue District Director, Ohio Key District Office, issued a favorable determination letter which stated that the termination of Plan A did not adversely affect Plan A's qualification. On date P, Employer X caused the transfer of funds from Plan X to Plan Y, prior to Employer X's receipt of any reversion amount in order to satisfy the replacement plan requirements of IRC § 4980(d)(2)(B). On date Q, Employer X received a reversion of F$ from terminated Plan A. All vested employee liabilities of Plan A were satisfied prior to the reversion. On or about date R, Employer X filed a Form 5330, Return of Excise Taxes Related to Employee Benefit Plans, with the Internal Revenue Service reporting an employer reversion of F$ from Plan A and a reversion tax of G$. The return asserted that the excise tax was calculated at the 20% rate of IRC § 4980(a) because the Employer A established a qualified replacement plan, Plan Y, in accordance with the requirements of IRC § 4980(d)(1)(A).

On date S Employer A and the Commissioner of Internal Revenue entered into a closing agreement under Code § 7121. In the closing agreement Employer A made the following representation:

> Whereas Employer A has represented that it satisfied all vested employee liabilities under the Plan and that it has established a qualified replacement Plan, the "Employer A Retirement Plan," prior to the receipt of the reversion. Employer A has established that it transferred funds to the Employer A Retirement Plan on date P, prior to its receipt of the reversion amount. The IRS has agreed, based on these representations that twenty percent (20%) is the appropriate rate for the excise tax due under I.R.C. Section 4980.

Paragraph 7(a) of the Determined and Agreed portion of the closing agreement states:

> This Closing Agreement is final and conclusive between the parties except: (a) the matters which it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of material facts.

On date T, Employer A received an additional H$ as a reversion in connection with the 1999 termination of Plan X. On or about date U, Employer A filed a bankruptcy petition under chapter 11 of title 11 of the United States Code in the United States District Court for the District of Delaware. In its plan of reorganization, Employer A proposed to liquidate its business and cease all business activity (a "liquidating chapter 11").

Plan Y is now to be terminated. On date V, the Benefits Plans Committee of Employer A resolved in part that "no further accruals will be made under " Plan Y. We are assuming for purposes of our analysis that the date of Plan Y's termination was date W. We are assuming that on that date that Plan Y had a total of J participants, of whom K participants were active, and L participants were inactive.

LAW AND ANALYSIS

Introduction

Code § 4980(a) provides for the imposition of an excise tax equal to 20% of the amount of any employer reversion from a qualified plan. Code § 4980(c)(2)(A) provides the general rule that the term “employer reversion” means the amount of cash and the fair market value of other property received (directly or indirectly) by an employer from the qualified plan. Code § 4980(d) increases the percentage of excise tax from 20% to 50% unless the employer establishes or maintains a qualified replacement plan or the plan provides benefit increases that satisfy the requirements of § 4980(d)(3).

Issues: 1, 2, and 3

Code § 6011(a) provides the general rule that when required by regulations, any person liable for any tax shall make a return according to the forms and regulations prescribed. Regulation § 54.6011-1T provides that every employer liable for the tax imposed under § 4980(a) with respect to an employer reversion as defined in §4980(c)(2) shall file a return on Form 5330 “and shall include therein the information required by such form and the instructions issued with respect thereto.”

Form 5330, Return of Excise Taxes Related to Employee Benefit Plans, is the designated return for reporting Code § 4980 excise taxes. The Instructions for Form 5330, provide that for tax due under § 4980, the Form 5330 is due not later than the last day of the month following the month in which the reversion occurred. The taxable event that requires the reporting of the excise tax is the receipt of a reversion by the employer. To this end the Instructions for Form 5330 provide that a taxpayer is to use one Form 5330 to report excise taxes with the same filing due date. For example, if a qualified plan terminated in 1999, and the employer maintaining the plan received a reversion on October 31, 1999, and an additional reversion on May 31, 2000, the Instructions for Form 5330 indicate that two Form 5330s would be required. The Form 5330 for the reversion received on October 31, 1999, would be due not later than November 30, 1999. The Form 5330 for the reversion received on May 31, 2000, would be due not later than June 30, 2000. A Form 5330 should be filed for each taxable event in accordance with the Instructions.

Code § 401(a)(2) requires as a condition of qualification that the trust forming part of the plan must provide that “under the trust instrument it is impossible, at any time prior to the satisfaction all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be ... used for, or diverted to, purposes other than for the exclusive benefit of [the employer’s] employees or their beneficiaries ....” This section also provides for certain limited exceptions not relevant to this case. Regulation § 1.401-2(b)(1) states that the intent and purpose in § 401(a)(2) of the phrase “prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust” is to permit the employer to reserve the right to recover at termination of the trust, and only at such termination, any balance remaining in the trust which is due to erroneous actuarial computations during the previous life of the trust. This section of the regulations gives an example of a situation in which a trust has accumulated assets of $1,000,000 at the time of liquidation, and it is found that $950,000 will satisfy all liabilities under the plan. Under these circumstances, the trust has a surplus of $50,000 due to erroneous actuarial computations after the satisfaction of all liabilities within the meaning of Code § 401(a)(2). The regulations conclude: “This $50,000, therefore, is the amount which may be returned to the employer as the result of an erroneous actuarial computation.” The use of the words “recover” and “returned” as used in these regulations suggests that a reversion occurs when the trust transfers such “balance remaining in the trust due to erroneous actuarial computation” to the employer, and not before.

Code § 4980 was added by section 1132 of the Tax Reform Act of 1986, P.L. 99-514. The legislative history of § 4980 supports the conclusion that no reversion occurs until the employer is in receipt of such excess amounts. H.R. Rep. No. 99-426 at 756 (1985) (1986-3 C.B. Vol. 2 at 756) states in this regard:

> However if assets remain in a defined benefit plan upon plan termination as a result of actuarial error, then after the plan has satisfied all liabilities those assets may be <u>paid</u>, as a reversion, to the employer.

(Emphasis added.) S. Rep. No. 99-313 at 635 (1985) (1986-3 C.B. Vol. 3 at 635) contains the identical provision. H.R. Rep. No. 99-426 at 757 also states Code § 4980 is effective for “... a reversion <u>received</u> pursuant to a plan termination occurring after December 31, 1985.” (Emphasis added.) S. Rep. No. 99-313 at 638 provides a similar formulation:

> The excise tax applies to a reversion <u>received</u> after December 31, 1985 ....

(Emphasis added.) H.R. Conf. Rep. No. 99-481, Vol II at 482 (1986) (1986-3 C.B. Vol. 4 at 482) is more expansive but essentially identical:

> However, if assets remain in a defined benefit pension plan upon plan termination as a result of actuarial error, then those assets may be <u>paid</u>, as a reversion, to the employer after the plan has satisfied all liabilities, if the plan provides for such payment.

(Emphasis added.) With regard to the effective date of this provision the Conference Report provides: "This provision generally applies to reversions received after December 31, 1985. H.R. Conf. Rep No. 99-841, Vol. II at 484. (Emphasis added.) The clear and cumulative intent of these provisions is that a reversion does not occur until the employer is "paid" or has "received" a reversion. Thus, the word "reversion" contemplates payment or receipt. Until paid to or received by an employer the funds remain assets of the trust.

The Instructions for Form 5330 do not provide for the amendment of a Form 5330 filed for a reversion in the circumstance where a later reversion creates a separate taxable event. Under such circumstance, the Instructions indicate that a separate Form 5330 is to be filed.

Issue 4

Code § 7121(a) authorizes the Secretary of the Treasury to enter into an agreement in writing with any person relating to the liability of such person in respect of an internal revenue tax for any taxable period. Code § 7121(b) provides that if such agreement is approved by the Secretary the agreement will be final and conclusive and will not be reopened as to the matters agreed upon except upon a showing of fraud, malfeasance, or misrepresentation of material fact.

The terms of the closing agreement do not reflect any agreement with respect to any reversion received in the year 2000. In this regard we note that the closing agreement was executed by the Commissioner of Internal Revenue on date S, prior to the receipt of any additional reversion. Thus, the closing agreement settling the 1999 § 4980 excise tax liability may not be construed to require the Internal Revenue Service to settle the 2000 § 4980 excise tax liability which arises out of a different taxable event. However, if the facts as developed with respect to the 2000 liability are consistent with the facts represented in the 1999 closing agreement, the 1999 closing agreement may provide a basis for a similar settlement.

Issues 5 and 8

The leading case on whether a liability under the Internal Revenue Code is a tax or a penalty for purposes of the Bankruptcy Code priority provisions is the Supreme Court's decision in United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996). CF&I involved whether the Code § 4971 accumulated funding deficiency excise tax was a tax or a penalty for purposes of determining priority status under the Bankruptcy Code. Relying on earlier decided cases, such as City of New York v. Feiring, 313 U.S. 283, and United States v. New

York, 315 U.S. 510 (1942), the Court reasoned that the function of the provision using the term in question, not the label placed on the exaction, is dispositive of the exaction's characterization under the Bankruptcy Code. Under New York, "a tax is a pecuniary burden laid upon individuals or property for the purpose of supporting the Government." New York, at 515. Under Feiring, a tax is a "pecuniary burden laid upon individuals or their property ... for the purpose of defraying the expenses of government or of undertakings authorized by it." Feiring, at 285. Under United States v. La Franca, 282 U.S. 568 (1931), a penalty is "an exaction imposed by statute as punishment for an unlawful act." La Franca, at 572. Based on these standards, the Court concluded that the exaction imposed under Code§ 4971 was a penalty.

In concluding that the Code § 4971 exaction was penal in character, the Supreme Court also emphasized that the excise tax structure (i.e., a flat percentage tax, followed by a substantially greater flat percentage flat percentage if certain action did not occur) and legislative history. H.R. Rep. No. 93-807 (1974) provides "For this reason, the bill places the obligation for funding and the penalty for underfunding on the person on whom it belongs - namely, the employer." (Page 28).

Before the Supreme Court decided CF&I, the Fourth Circuit decided a similar issue: whether the Code § 4980 imposed a tax or a penalty for purposes of the Bankruptcy Code. In re C-T of Virginia, Inc., 977 F.2d 137 (4th Cir. 1992). Because the legislative history provided little guidance on this issue, the Fourth Circuit applied a standard similar to the "functional analysis" standard subsequently applied by the Supreme Court in CF&I. In holding the exaction imposed under IRC § 4980 is a tax for purposes of bankruptcy, the Fourth Circuit noted the deterrent effect of the § 4980 exaction, but concluded that that attribute alone did not prevent the exaction from being considered an excise tax entitled to priority treatment in bankruptcy. In re C-T of Virginia, Inc. involved a tax year in which IRC § 4980 was imposed at a 10 percent rate.

After the Supreme Court decided CF&I, the Eighth Circuit decided In re Juvenile Shoe Corporation of America, 99 F.3d 898 (8th Cir. 1996), which involved whether a 15 percent exaction under IRC 4980 was a tax or a penalty for purposes of the Bankruptcy Code. The Eighth Circuit applied the "functional analysis" standard set forth in CF&I, and recognized the provision's revenue recapture attributes:

> Congress granted a corporate tax exemption to employers for placing money in an employee pension fund. As the pension fund grows, it includes earnings on the money that would have been taken as tax revenue at the corporate tax rate had it not been placed in the

> pension fund. Although the employer must pay the corporate tax rate on funds reverted from the pension plan, the employer earns interest while the funds are in the pension plan, and the government is denied the use of the tax revenue during the same period forcing the government to borrow from other source to fund its operations. Capturing the tax benefit the employer received at the expense of the government has the same purpose and similar effect as assessing the tax prior to the employer's placement of the funds in the pension plan.

In re Juvenile Shoe Corporation of America, 99 F.3d at 901 (citations omitted).

The court acknowledged that the use of a flat rate may not accurately reflect the government's revenue loss, but noted that Congress imposed a flat rate for the sake of simplicity. Moreover, a General Accounting Office report reviewed by Congress in 1990 in considering whether to increase the rate concluded that in many cases a 15 percent rate is not sufficient to recapture the tax benefits received by an employer. In re Juvenile Shoe Corporation of America, 99 F.3d at 902.

With respect to CF&I, the court stated:

> The Reorganized CF&I definition of a penalty requires that the exaction be imposed "as punishment for an unlawful act." Although Congress disfavors the reversion of pension plan funds to employer, it has not made such reversions unlawful, instead giving employers that inadvertently over fund their employee pension plans the right to revert the overfunding.

In re Juvenile Shoe Corporation of America, 99 F.3d at 902.

The court noted that IRC § 4971, unlike IRC § 4980, was not enacted to generate or recapture revenue since it "imposes a tax on conduct that does not deny the government any tax revenue. In re Juvenile Shoe Corporation of America, 99 F.3d at 903. It also noted that, unlike IRC § 4980, the conduct taxed by IRC § 4971 is prohibited under federal law, citing to the minimum funding requirements applicable to pension plans. See 29 U.S.C. §1001 (1988). Accordingly, the court concluded that the primary operation of IRC § 4980 is to support the government rather than to penalize an unlawful act and, thus, the assessment constitutes an excise tax entitled to priority in bankruptcy. In re Juvenile Shoe Corporation of America, 99 F.3d at 903.

Issue 6

Code § 4980(a) provides the general rule that the reversion tax is equal to 20% of the employer reversion. Code § 4980(d)(1) provides that the percentage of the reversion tax is increased from 20% to 50% unless the employer establishes or maintains a qualified replacement plan as defined in § 4980(d)(2), or in the alternative a plan provides for benefit increases in accordance with § 4980(d)(3). Code § 4980(d)(6) provides that subsection 4980(d) does not apply to an employer who as of the plan termination date "is in bankruptcy liquidation under chapter 7 of title 11 of the United States Code or in similar proceedings under State law". The facts of this case indicate that on or about date V, Employer A filed a liquidating chapter 11 proceeding in the United States District Court for the District of Delaware. Code § 4980(d)(6) does not except liquidating chapter 11 plans from the requirements of Code § 4980(d). If the requirements of Code § 4980(d)(1) are not satisfied, the 20% tax of § 4980(a) is increased to 50% pursuant to § 4980(d)(1).

Issue 7

Since Employer A's bankruptcy case involves a liquidating chapter 11, we are assuming that the alternative of providing a qualified replacement plan as provided by Code § 4980(d)(1)(A) will not be available to Employer A. Instead, if Employer A is to get a 20% reversion tax rate, Employer A must satisfy the criteria of Code § 4980(d)(3) which require, in part, pro rata increases in the accrued benefits of all qualified participants These increases must take effect immediately on the plan termination date; they must have an aggregate present value of not less than 20% of the maximum amount that could be received as a reversion by Employer A; and the aggregate increases in the benefits of qualified participants who are not active participants may not exceed 40 percent of 20 percent (i.e., 8 percent) of the aggregate present value equal to the maximum amount which could be received by Employer A as a reversion. IRC §4980(d)(3)(A) and (B). For these purposes "qualified participants" include (1) active participants, (2) participants or beneficiaries in pay status, (3) participants with nonforfeitable rights to accrued benefits under the terminated plan as of the termination date whose creditable service creditable under the terminated plan terminated during the period beginning 3 years before the termination date and ending on the date on which the final distribution of trust assets occurs, or (4) beneficiaries of participants in group (3). IRC § 4980(d)(5)(A). Since K, the number of active participants in Employer A's plan is less than one half of one percent of J, the total number of plan participants, it would be impossible to provide these K participants with 60 percent of the required minimum benefit increase without violating the benefit limits of section 415 and disqualifying Employer A's plan.

H.R. Rep. No. Report 101-881 at 334 (1990) states that for the purposes of § 4980(d)(3) a nonactive participant is (1) a participant in pay status as of the termination date, (2) beneficiary who has a vested benefit under the terminated plan as of the termination date, or (3) a participant who has a vested right to a benefit under the plan as of the termination date and who separated from service before the period beginning 3 years before the termination date and ending on the date of final distribution of plan assets.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call Don Parkinson of my staff if you have any further questions. Don can be reached at (202) 622-6090.