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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Significant Index No. 4980.00-00

MAY 29 2003

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Attn: ********
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T:EP:RA:T2

Legend:

Employer A = ********

Plan X = ********

Dear ********:

This is in response to your request for a private letter ruling dated March 26, 2001, as supplemented by a letter dated September 19, 2001, concerning whether a reversion of excess amounts in Plan X, a defined benefit plan, upon its termination would be subject to the excise tax described in section 4980 of the Internal Revenue Code.

The following facts and representations have been submitted:

Plan X is a defined benefit plan that was established January 1, 1971, to provide retirement income and other benefits for certain employees and their beneficiaries. The most recent amendments were made December 4, 1995 and December 9, 1999, effective retroactive to January 1, 1987. Plan X covers substantially all of the employees of Employer A who have attained age 20½ and have completed six months of continuous employment or one year of credited service, whichever is earlier. Section 1.3 of Plan X provides that it is the intent of Employer M that Plan X shall be established and maintained (1) as a retirement program which is in full compliance with the Employee Retirement Income and Security Act of 1974 (ERISA) and (2) as a qualified plan under the terms of section 401(a) of the Internal Revenue Code.

Section 15.4 of Plan X provides the Employer M reserves the right to terminate Plan X at any time. Section 15.4 further provides, in general, that after the assets of Pan X have been withdrawn and allocated, any amount remaining in Plan X will be returned to Employer M.

Employer A is an organization exempt from federal income tax under section 501(c)(7) of the Code. In your letter dated September 19, 2001, you represent that Employer M has been subject to unrelated business income tax on income from nonmember use of club facilities, as well as investment income. You further state that under other guidance, Employer M is not treated as having a profit motive. As such, Employer M is unable to use its loss from nonmember use of club facilities to offset its investment income. You further state that Employer M has paid unrelated business income tax on its investment income, but has never received a tax benefit from its pension contributions to Plan X.

Employer A intends to terminate Plan X. The estimated assets at the date of termination total $6.1 million with $4.3 million is estimated liabilities. This results in a reversion of approximately $1.8 million. Employer M has decided not to establish a replacement plan. Employer M intends to terminate Plan X and to receive an employer reversion as defined in section 4980(c)(2)(A) of the Code. Employer M asserts that no amount of the reversion should be included in unrelated business taxable income and that Employer M should not be subject to the excise tax under section 4980 of the Code because it has not received a tax benefit from the contributions it made to Plan X.

Based on these facts and representations, you request the following ruling:

Upon the termination of Plan X, the amount of the "reversion" will not be included in unrelated business income and Employer A will not be subject to the excise tax under section 4980 of the Code.

Section 4980(a) of the Code imposes an excise tax of twenty percent on the amount of any "employer reversion" from a qualified plan. In accordance with section 4980(b), the excise tax will be imposed on the employer maintaining the plan.

Section 4980(c)(1) of the Code provides, in pertinent part, that a "qualified plan" for purposes of section 4980 is a plan meeting the requirements of section 401(a) or 403(a), other than a plan maintained by an employer if such employer has, at all times, been exempt from tax under subtitle A.

Section 4980(c)(2)(A) of the Code provides 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 a qualified plan.

Section 4980 (d)(1) of the Code provides that "50 percent" shall be substituted for "20 percent" in section 4980(a) with respect to any employer reversion from a qualified plan unless the employer establishes or maintains a qualified replacement plan, or the plan provides benefit increases that meet the requirements of section 4980(d)(3).

Section 501(c)(7) of the Code provides for the exemption from Federal income tax of clubs organized for pleasure, recreation, and other nonprofitable purposes where

substantially all of the activities are for such purposes and no part of the net earnings inures to the benefit of any private shareholder.

Section 1.501(c)(7)-1(a) of the Income Tax Regulations ('regulations") states that the exemption provided to organizations described in section 501(c)(7) of the Code applies only to clubs which are organized exclusively for pleasure, recreation, and other nonprofitable purposes, but does not apply to any club it its net earnings inures to the benefit of any private shareholder. The regulation also states that, in general, this exemption extends to social and recreation clubs, which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

Section 511 of the Code imposes a tax on unrelated business taxable income of organizations described in section 401(a) and section 501(c), which are exempt from tax by reason of section 501(a). Section 512(a)(3) provides, in general, that in the case of an organization described in section 501(c)(7), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are not directly connected with the production of the gross income (excluding exempt function income), both computed with modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b).

Section 512(a)(3)(B) of the Code defines "exempt function income" as the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other that an amount equal to the gross income derived from an unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside (i) for a purpose specified in section 170(c)(4), or (ii) in the case of an organization described in paragraph (9), (17), or (20) of section 501(c), to provide for the payment of life, sick, accident, or other benefits. If during the taxable year, an amount which is used for a purpose other than that described in (i) or (ii), such amount shall be included in unrelated business taxable income for the taxable year.

Section 513(a) of the Code provides, in relevant part, that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by Section 511, any trade of business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derives) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(b) of the Income Tax Regulations ("regulations") provides that, for purposes of section 513 of Code, the term "trade or business" has the same

meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(c)(1) of the regulations provides that in determining whether a trade or business from which a particular amount of gross income derives is "regularly carried on", within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(d)(1) of the regulations provides that gross income derives from "unrelated trade or business", within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.

Section 1.513-1(b) of the regulations indicates that the primary objective of the adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. Where an activity does not possess the characteristics of a trade or business within the meaning of section 162 of the Code, the unrelated business income tax does not apply since the organization is not competition with taxable organizations.

The issue of whether the reversion, or any part thereof, is income to Employer M and taxed as unrelated business taxable income involves an analysis of whether the reversion, or any part thereof, is income as defined in section 61 of the Code, as modified by section 111.

Under section 61 of the Code, gross income generally includes income from whatever source derived. However, under section 111(a), gross income does not include income attributable to the recovery during the taxable year of an amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by Chapter 1. Section 111(a) represents the exclusionary arm of the tax benefit rule. Conversely, if the taxpayer recovers an amount previously deducted which did not reduce the amount of tax, the recovery is includible in income. This is the so-called inclusionary arm of the tax benefit rule.

"Recovery" is defined in section 1.11-1(a)(2) of the regulations as resulting from the receipt of amounts in respect of the previously deducted or credited Code section 111 item, such as bad debts or taxes. Thus, the application of the tax benefit rule requires a fundamentally inconsistent event. Under the regulations, a previously deducted item that is recovered would represent such an event, even if the item is not listed there. If the taxpayer derived no benefit from the inconsistent deduction the recovery would be excluded from gross income. This principle has been followed when the taxpayer did not receive a benefit from the deduction because the taxpayer was tax-exempt.

The potential reversion in this case may not just represent the return of contributions to Plan X, but may also represent previously untaxed income earned on the contributions while in Plan X. You represent that Employer M has never received a tax benefit from the contributions it made to Plan X. Therefore, with respect to the first part of your ruling request we conclude that Employer M does not have unrelated business taxable income from the recovery of the surplus of assets from Plan X following the termination of Plan X.

With respect to the second part of your ruling request, concerning the applicability of the Code section 4980 excise tax to Employer M, you represent that Employer M has paid unrelated business income tax on its investment income and income it receives from nonmember use of its club facilities. A tax-exempt employer is subject to tax under subtitle A of the Code if it has unrelated business taxable income. Because Employer M has been subject to tax under subtitle A of the Code, Plan X has not at all times been maintained by an employer that has at all times been exempt from tax under subtitle A. Therefore, with respect to the second part of your ruling request, we conclude that Employer M will be subject to the excise tax under section 4980(d)(1) of the Code.

This ruling is based on the assumption that Plan X is qualified under section 401(a) of the Code and its trust is tax exempt under section 501(a).

This letter ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may be used or cited by others as precedent.

A copy of this ruling has been sent to your authorized representative in accordance with a power of attorney on file in this office.

If you have any questions about this ruling, please contact ****** T:EP:RA:T2, at ********

Sincerely yours,

James E. Holland, Jr., Manager
Employee Plans Technical

Enclosures:
Deleted copy of ruling letter
Form 437