Significant Index Nos. 414.06-00
414.12-00

200442037

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JUL 22 2004

SE:T:EP:RA:T:AI

In re:

Taxpayer =

Dear

This letter is in response to your request for rulings on the proper treatment under section 414(l) of the Internal Revenue Code ("Code"), of a spin-off of the defined contribution portion of a Code section 414(k) plan into a separate plan.

The Taxpayer sponsors the Plan, a defined benefit plan which provides that a portion of a participant's benefit is derived from a separate account in accordance with section 414(k) of the Code. The Plan has been frozen since Decembe The Plan is intended to be qualified under section 401(a) of the Code and its related trust is intended to be tax-exempt under section 501(a) of the Code.

The Taxpayer proposes to spin-off the defined contribution portion of the Plan into a separate defined contribution plan. The proposed defined contribution is intended to be qualified under section 401(a) of the Code and its related trust is intended to be tax-exempt under section 501(a) of the Code.

Requested Rulings:

(1) That the requirements of Code section 414(l) will be satisfied if the defined contribution portion of the Plan is spun-off into a separate plan.

(2) That Code section 414(l) will be satisfied if the defined contribution portion of the Plan is spun-off without an allocation of any of the Plan's surplus funding that might exist relating to the defined benefit portion of the Plan.

(3) That the proposed transaction will not create a taxable event for the affected participants.

(4) That the proposed transaction will not be deemed a reversion of funds to the Plan sponsor followed by a contribution to the new defined contribution pension plan.

Law

Section 61 of the Code provides that "gross income" is defined to include all income from whatever source derived (except as otherwise provided in Subtitle A of the Code). This definition has been clarified in Rev. Rul. 68-104 (1968-1 C.B., 361) which provides that "where amounts previously deducted from gross income (which thereby effected a tax benefit) are recovered in subsequent years, such recoveries are includible in gross income for the year of recovery. This so called "tax benefit rule" was originally fashioned by the judiciary in order to approximate the results produced by a tax system based on transactional, rather than annual accounting. The rule was applied by the United States Supreme Court in Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983). The tax benefit rule, as formulated in that decision, provides that a taxpayer includes income when an event occurs that is "fundamentally inconsistent" with a deduction taken in a prior year, unless a nonrecognition provision of the Code prevents inclusion. Thus, under Hillsboro, an actual recovery of the amount in question is not necessary. The determination that must be made under the Hillsboro test is whether the subsequent event would have foreclosed the earlier deduction if the subsequent event and the event giving rise to the deduction had occurred in the same year. If the subsequent event would have foreclosed the deduction, the event is fundamentally inconsistent and the taxpayer must include the amount as income in the year of the subsequent event.

Section 72 of the Code provides rules for the taxation of a distribution from a qualified plan which is received as an annuity and also provides rules for the taxation of a distribution which is not received as an annuity.

Section 402(a) of the Code provides that, except as otherwise provided in that section, any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72 (relating to annuities).

Section 414(k) of the Code provides that a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of a separate account of a participant shall ____

(1) for purposes of section 410 (relating to minimum participation standards) be treated as a defined contribution plan,

(2) for purposes of section 72(d) (relating to treatment of employee contributions as separate contract), 411(a)(7)(A) (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 401(m) (relating to nondiscrimination tests for matching requirements and employee contributions) be treated as consisting of a defined contribution plan to the extent that benefits are based on a separate account of a participant and as a defined benefit plan with respect to the remaining portion of benefits under the plan, and

(3) for purposes of section 4971 (relating to tax on prohibited transactions) be treated as a defined benefit plan.

Section 414(l)(1) of the Code provides, in general, that a trust which forms a part of a plan shall not constitute a qualified trust under Code section 401 unless in the case of any merger or consolidation of the plan with, or in the case of any transfer of assets or liabilities of such plan to, any other trust plan after September 2, 1974, each participant in the plan would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated).

Section 414(l)(2)(A) of the Code provides, in general, that, in the case of a plan spin-off of a defined benefit plan, a trust which forms part of -----

(i) the original plan, or

(ii) any plan spun-off from such plan, shall not constitute a qualified trust under that section unless the applicable percentage of excess assets are allocated to each of the plans.

Section 414(l)(2)(B) of the Code provides that for purposes of subparagraph (A), the term "applicable percentage" means, with respect to each of the plans described in clauses (i) and (ii) of subparagraph (A), the percentage determined by dividing ------

(i) the excess (if any) of (I) the amount determined under section 412(c)(7)(A)(i) with respect to the plan over (II) the amount of the assets required to be allocated after the spin-off (without regard to that paragraph), by

(ii) the sum of the excess amounts determined separately under clause (i) for all such plans.

Section 414(l)(2)(C) of the Code provides that for purposes of subparagraph (A), the term "excess assets" means an amount equal to the excess (if any) of --------

(i) the fair market value of the assets of the original plan immediately before the spin-off, over

(ii) the amount of assets required to be allocated after the spin-off to all plans (determined without regard to that paragraph)

Section 1.414(l)-1(b)(4) of the regulations provides that the term "spinoff" means the splitting of a single plan into two or more plans.

Section 1.414(l)-1(m) of the regulations provides that in the case of a spinoff of a defined contribution plan, the requirements of section 414(l) will be satisfied if -------

(1) the sum of the account balances for each of the participants in the resulting plans equals the account balance of the participant in the plan before the spinoff, and

(2) the assets in each of the plans immediately after the spinoff equals the sum of the account balances for all participants in that plan.

Section 1.414(l)-1(n)(1) of the regulations provides that in the case of a spinoff of a defined benefit plan, the requirements under section 414(l) will be satisfied if --------

(i) all of the accrued benefits of each participant are allocated to only one of the spun-off plans, and

(ii) the value of the assets allocated to each of the spun off plans is not less than the sum of the present value of the benefits on a termination basis in the plan before the spin off for all participants in that spun off plan.

Section 1.414(l)-1(o) of the regulations provides that any transfer of assets or liabilities will for the purposes of section 414(l) be considered as a combination of separate mergers and spinoffs using the rules of paragraphs (d), (e) through (j), (l), (m), or (n) of that section, whichever is appropriate.

Analysis

In the instant case, the Taxpayer proposes to split the Plan into a defined contribution plan and a defined benefit plan that is not a plan described under section 414(k) of the Code. Because it is proposed that the Plan is to be split into a defined contribution plan and a defined benefit plan, it is necessary that the requirements of section 1.414(l)-1((m) of the regulations be satisfied with respect to the defined contribution plan and section 1.414(l)-1(n) of the regulations be satisfied with respect to the defined benefit plan.

Currently, the benefits of each participant in the Plan are based partly on the separate account of the participant and partly on defined benefit formulas. Subsequent to the proposed transaction, the benefits that each participant would receive from the Plan that are based on the separate account of the participant would be received under the defined contribution plan. Similarly, the defined benefits that each participant would receive under the Plan would be received under the defined benefit plan.

Because the sum of the account balances for each of the participants in the defined contribution plan would equal the account balance of the participant in the Plan before the spinoff and because the assets of the defined contribution plan would equal the sum of the account balances for all participants in the Plan, the requirements of section 1.414(l)-1(m) would be satisfied under the proposed transaction.

Because the defined benefits of each participant under the Plan would be allocated only to the defined benefit plan and the value of the assets of the defined benefit plan is not less than the sum of the present value of the defined benefits on a termination basis in the Plan before the spin off for all participants, the requirements of section 1.414(l)-1(m) would be satisfied under the proposed transaction.

Moreover, because the excess of (I) the amount determined under section 412(c)(7)(A)(i) with respect to the defined contribution plan over (II) the amount of the assets required to be allocated after the spin-off to the defined contribution plan is not greater than zero, the applicable percentage under section 414(l)(2)(B) with regard to the defined contribution plan is zero, and thus, no allocation of the Plan's surplus assets to the defined contribution plan is necessary to satisfy section 414(l)(2)(A).

Accordingly, the requirements of section 414(l) will be satisfied if the defined contribution portion of the Plan is spun-off into a separate plan without an allocation of the Plan's surplus funding (if any) that might exist relating to the defined benefit portion of the Plan.

Section 402(a) of the Code provides that the amount actually distributed to any distributee by an employee's trust described in section 401(a) which is exempt under section 501(a) shall be taxable to the distributee under section 72 (relating to annuities). In the instant case, however, the Taxpayer merely proposed to split the Plan into defined contribution and defined benefit plans. That is, under the proposed transaction, no amounts are intended to be distributed to participants. Accordingly, the proposed transaction will not create a taxable event for the affected participants

Section 61 of the Code provides that gross income includes income from whatever source derived. Under the Hillsboro test, a taxpayer includes amounts in income whenever an event occurs which is fundamentally inconsistent with a deduction in a prior year. In the instant case, the Taxpayer would derive no economic benefit if the Plan was split into defined contribution and defined benefit plans because such a split would have no effect on the need for the Taxpayer to make future contributions into either the defined contribution plan or the defined benefit plan.

Moreover, because the aggregate benefits of the participants under the Plan would remain unchanged if the Plan were to be split into defined contribution and defined benefit plans, and the surplus (if any) of the Plan would become the surplus of the defined benefit plan, there is no diversion of assets from the benefit of one group to the benefit of another group. Accordingly, the proposed transaction does not constitute a reversion of plan assets to the taxpayer followed by a contribution to the defined contribution plan.

Conclusions

(1) The requirements of section 414(l) of the Code will be satisfied if the defined contribution portion of the Plan is spun-off into a separate plan.

(2) Code section 414(l) will be satisfied if the defined contribution portion of the Plan is spun-off without an allocation of any of the Plan's surplus funding that might exist relating to the defined benefit portion of the Plan.

(3) The proposed transaction will not create a taxable event to the affected participants.

(4) The proposed transaction will not be deemed a reversion of funds to the Plan sponsor followed by a contribution to the new defined contribution plan.

These rulings are based on the assumption that the Plan, and the two plans established after the spinoff (i.e. the defined contribution plan and the defined benefit plan that is not a section 414(k) plan) are qualified under section 401(a) of the Code and that their related trusts are tax-exempt under section 501(a) of the Code, at the time of the proposed transaction

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited by others as precedent.

A copy of this letter is being furnished to your authorized representative pursuant to a power of attorney (Form 2848) on file. A copy of this letter is also being sent to the Manager, Employee Plans Classification in

If you have any questions on this ruling letter, please contact

Sincerely,

James E. Holland, Jr.

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