STRATEGIC PLAN TERMINATION: LEGAL VIEWPOINT

Kravitz asked our ERISA counsel for their opinion regarding strategic plan termination. The following is their response:

Treasury Regulation 1.401-1(b)(2) provides that a tax qualified "plan" under the Internal Revenue Code ("Code") must be a permanent, as distinguished from a temporary, program. It also provides that the abandonment of a plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide permanent program for the exclusive benefit of employees. The regulation further provides that the permanency of a plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan. Although the Code and regulations do not define "a few years", the IRS has ruled in Revenue Ruling 72-239 that a plan that has been in existence for over 10 years can be terminated without a business necessity.

The IRS has provided some guidance on what constitutes "business necessity" for plans terminated within a few years. Specifically, Revenue Ruling 69-25 provides that if a plan is terminated within a few years of its inception and there have been no unforeseeable developments in the business which make it impossible to continue the plan, this must be taken as evidence that the employer did not intend the plan as a permanent program from the time of its inception. The employer can rebut this presumption by showing that the abandonment of the plan was due to business necessity that could not reasonably have been foreseen when the plan was adopted. This Revenue Ruling also explains that the term "business necessity" has reference to adverse business conditions, not within the control of the employer, under which it is not possible to continue the plan. The Revenue Ruling specifically mentioned bankruptcy or insolvency and discontinuance of the business as "business necessities", along with merger or acquisition of the plan sponsor, as long as the merger or acquisition was not foreseeable at the time the plan was created.

IRS Manual 7.12.1 also gives guidance on how the IRS processes plan terminations. The IRS Manual provides that if a plan has been in existence for more than ten years, termination without a business reason will not affect its qualification. Additionally, the IRS Manual states the presumption that if a plan has been terminated within a few years, it is presumed to not have been a permanent program. The IRS Manual, as well as Form 5310, expands the types of business necessity that can be relied on to terminate a plan. For example, they add "adoption of a new superseding plan" or "change in law" as business necessities.

As you can see from the above, whether a particular employer can terminate a plan within a few years due to business necessity is based on each employer's facts and circumstances. Terminating a plan to obtain excess assets would not in and of itself be a valid business reason. If that is the sole reason, there is risk in terminating the plan if it has only been in existence for 3 to 5 years. With that said, if the employer's financial situation is such that it needs the assets to avoid bankruptcy or to otherwise stay in business then those additional facts may support the termination.

Adoption of a new superseding cash balance plan also in and of itself may not be viewed by the IRS as a valid business reason if the plan is essentially identical to the old plan with the exception of changes in contributions or interest crediting rates. The IRS could take the position that the current plan can just be amended to change contributions and interest crediting rate prospectively. Once again, additional facts regarding the employer's financial status could support termination of the plan and adoption of a new plan.

Ultimately, the employer should make the decision regarding whether it is comfortable with the potential risk. This is only a potential issue if the IRS agent reviewing the Form 5310 questions the business reason for terminating the plan or if the plan is separately audited by the IRS. In these cases, the employer would need to be able to prove that its financial status was the reason for the termination and that the new superseding plan supported its business need. Therefore, we cannot recommend the strategy in general but we note that it is possible that an employer may have facts to support the termination.