

Part I

Section 402. -- Taxability of Beneficiary of Employees' Trust (Also: §§ 165 and 1341.)

Rev. Rul. 2002-84

ISSUES

(1) Under the facts described below, what amount is required to be treated as a distribution in a year in which payments made to an individual by a qualified retirement plan described in § 401(a) of the Internal Revenue Code are reduced because, in a prior year, the individual received payments in excess of the amounts due to the individual?

(2) Under the facts described below, is an individual entitled to a deduction to reflect a payment to a qualified retirement plan described in § 401(a) to repay the plan for payments made by the plan to the individual in a prior year in excess of the amounts due to the individual in that prior year?

FACTS

Situation (1). Employer X maintains Plan A, a qualified defined benefit plan described in § 401(a). Plan A does not provide for employee contributions. At the beginning of 2001, Employee D retired and started to receive a straight life annual annuity of \$36,000 from Plan A. Employee D included \$36,000 in gross income in 2001. In June 2002, it was determined that Employee D's annuity benefit had been miscalculated and the annuity payment for 2001 should have been \$35,000. Under the administrative procedures of Plan A, which are in accordance with the relevant correction procedures of the Employee Plans Compliance Resolution System ("EPCRS"), Rev. Proc. 2002-47, 2002-29 I.R.B. 133, erroneous payments from the plan can be corrected by recouping the entire excess payment made in 2001 from Employee D's remaining

benefit payments for 2002. Thus, Employee D's annual straight life annuity benefit for 2002 of \$35,000 is reduced to \$33,940 to reflect the excess benefit amounts (increased by interest) that were paid from Plan A to Employee D during 2001.

Situation (2): Employer Y maintains Plan B, a qualified defined benefit plan described in § 401(a). Plan B does not provide for employee contributions. Employee E, who is a participant in Plan B, retired in 1992 and started to receive an annual straight life annuity of \$14,000 from Plan B. In November 2002, it was determined that Employee E's annuity benefit had been miscalculated and that the annual payment for 1992 through 2001 should have been \$13,000. Thus, Plan B overpaid Employee E by \$1,000 per year for 10 years and Employee E included these amounts in gross income in the years received. Under the administrative procedures of Plan B, erroneous payments from the plan can be recouped by reducing future payments so that the actuarial present value of the reduction is equal to the erroneous overpayments plus interest attributable to the overpayment based on Plan B's interest rate factors. Plan B's correction method is consistent with the procedures of EPCRS. The administrator of Plan B determines that to recoup the overpayment, future payments should be reduced \$900 annually for life commencing in 2002. Plan B adjusts Employee E's annuity accordingly so that Employee E's annual straight life annuity benefit of \$13,000 is reduced for 2002 and subsequent years to \$12,100 to reflect the excess benefit amounts (increased by interest) that were paid from Plan B to Employee E.

Situation (3) The facts are the same as in Situation (1), except that the benefit was paid to Employee F in a single-sum distribution in 2001. The amount of the single-sum distribution exceeded the amount that was due Employee F by \$2,000. Employee F included the entire amount of the single-sum distribution in gross income in 2001. In 2002, Plan A's administrator discovered the overpayment to Employee F. Pursuant to the plan's procedures, the administrator of Plan A notified Employee F of the overpayment and demanded repayment with

appropriate interest. In 2002, Employee F repaid \$2,120 (the \$2,000 overpayment plus \$120 interest) to Plan A.

LAW AND ANALYSIS

Section 61(a) provides that, except as otherwise provided, gross income means all income from whatever source derived.

Section 402(a) provides that any amount actually distributed to any distributee from a qualified plan described in § 401(a) will be taxable to the distributee in the taxable year of distribution under § 72 (relating to annuities).

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year that is not compensated by insurance or otherwise. Section 165(c) limits the deduction under §165(a) for individuals to losses incurred in a trade or business, losses incurred in transactions entered into for profit, and casualty losses. The performance of services as an employee is the carrying on of a trade or business. (See Rev. Rul. 79-322, 1979-2 C.B. 76, and Rev. Rul. 82-178, 1982-2 C.B. 59.)

Section 67(a) provides that in the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2-percent of adjusted gross income.

Section 451(a) provides that the amount of any item of gross income shall be included in the taxable year in which received by the taxpayer unless the amount is to be properly accounted for in a different period.

Section 1.451-1(a) of the Income Tax Regulations provides that under the cash receipts and disbursements method of accounting, an item of income is included in gross income for the taxable year in which such item is actually or constructively received.

Section 1341(a) provides rules for the computation of tax where a taxpayer is entitled to a deduction in excess of \$3,000 as a result of restoring an amount included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to such amount. The amount of the tax imposed on the taxpayer under § 1341 is the lesser of the tax

for the taxable year computed with the deduction or an amount equal to the tax for the taxable year computed without the deduction but minus the decrease in tax for the prior tax year or years after excluding the income. Under § 67(b)(9), a deduction under § 1341 is not a miscellaneous itemized deduction subject to the 2-percent adjusted gross income floor of § 67(a).

Rev. Rul. 67-350, 1967-2 C.B. 58, which addresses the income tax treatment of a reduction in military retirement pay to offset a previously received lump-sum readjustment payment, holds that only the remainder of the retired reservist's military retirement pay is includible in the retiree's gross income. Thus, the retiree included in gross income only amounts that he actually or constructively received based on the principles of §§ 61 and 451.

Rev. Rul. 80-9, 1980-1 C.B. 11, holds that a taxpayer who had amounts withheld from his disability pay to repay a lump-sum readjustment payment is considered as never having received the amounts withheld. The ruling concluded that there was no constructive receipt of the withheld disability pay.

Rev. Rul. 82-178 holds that repayment of amounts by a rehired employee in order that certain employee benefits would be restored to the level that they were at the time the rehired employee was laid off is a loss incurred under § 165(c)(1).

Rev. Rul. 79-322 holds that a repayment of amounts received by an employee for sick leave that was includible in the employee's gross income in a prior taxable year is deductible as a business loss under § 165.

Sections 402(a) and 403(a) specifically address the tax treatment of distributions from qualified retirement plans. Under these provisions, amounts payable under a qualified retirement plan are included in gross income of the participant in the taxable year of distribution. The amounts are taxable to a distributee at the time of receipt, even though the distributee may be later obligated to repay amounts attributable to a plan overpayment in subsequent taxable years, either by direct payment or by payment reduction. Consequently, in Situations (1), (2), and (3), the amounts attributable to a plan overpayment are distributions taxable under § 402(a)

in the year of receipt.

In years after the year of the plan overpayment, under the facts presented in Situations (1) and (2), only the amounts received by the distributee after the plan's required reduction to recoup an earlier plan overpayment are included in the distributee's gross income in the taxable year of distribution. This ruling is consistent with Rev. Ruls. 67-350 and 80-9, which held that there was no constructive receipt of withheld military retirement pay that was used to offset amounts previously received as a lump-sum readjustment pay for reserve officers.

Consequently, the qualified retirement plan participants in Situations (1) and (2) who received distributions that included overpayments, and included the full amount of these distributions in gross income in the year of distribution, are in subsequent years only required to treat as distributions taxable under § 402(a) amounts distributed by the plan after offset or adjustment to correct for the prior overpayments. Because the participants in Situations (1) and (2) are not treated as receiving the amounts attributable to the offset or adjustment, these participants cannot take a loss deduction under § 165(a) as a result of such offset or adjustment. See Rev. Rul. 80-9. The tax result for Situations (1) and (2) is limited to situations in which the amount of the plan overpayment was included in the gross income of the participant for the year the overpayment was distributed to the participant and the qualified retirement plan has demanded the adjustment or offset to recoup the plan overpayment.

In contrast to Situations (1) and (2), in Situation (3), the overpayment is not recouped by a reduction in the amount of benefits paid to a participant but instead is repaid by the taxpayer directly in a single-sum payment. For overpayments repaid to a qualified retirement plan in the same taxable year as the overpayment, the amount repaid reduces the taxable amount received as a distribution by the participant from the plan in the taxable year. For overpayments repaid to a qualified retirement plan in a taxable year or years subsequent to the year of the overpayment, a participant would be entitled to a deduction under § 165(a) because the amount

of the plan overpayment is attributable to compensation for services rendered to the employer. The deduction is allowable in the year that the single-sum repayment is paid by the taxpayer, but only if the taxpayer itemizes his deductions. A deduction under § 165(a) for an individual with losses that are incurred in a trade or business is considered a miscellaneous itemized deduction and, thus, is subject to the 2-percent floor established under § 67(a) for miscellaneous itemized deductions.

If the amount of the distribution in Situation (3) had instead exceeded the amount that was due Employee F by more than \$3,000, the rules of § 1341 would apply in determining the taxpayer's income tax liability for 2002. In applying the rules of § 1341, the deduction is determined without regard to the 2-percent floor as provided under § 67(b)(9).

HOLDINGS

Issue 1:

Under Situations (1) and (2), in which an individual's payments from a qualified retirement plan are reduced in one or more taxable years to recoup overpayments made in prior taxable years and properly included in gross income in such prior years, only the amounts received by the individual after the plan's required reduction to recoup an earlier plan overpayment are includible in the individual's gross income in the taxable year of distribution. The individuals under Situations (1) and (2), with respect to the offset or adjustment, are not eligible for a deduction under § 165(a) for a loss incurred in a trade or business. Accordingly, in Situation (1), Employee D includes \$33,940 as a distribution from Plan A under § 402(a) for 2002. Similarly, in Situation (2), Employee E includes \$12,100 as a distribution from Plan B under § 402(a) for 2002 and for each subsequent year in which a distribution is received.

Issue 2:

Under Situation (3), when an individual repays in the current year an overpayment made by a qualified retirement plan in a previous year, the amount actually paid in the previous year

was properly included in gross income. The amount of the repayment is deductible under § 165(a). Accordingly, the \$2,120 repaid to Plan A is deductible for 2002, subject to the rules of § 67(a).

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Rubin of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Rubin may be reached at 1-202-283-9888 (not a toll-free number).