Department of the Treasury | Internal Revenue Service | Office of Chief Counsel

Notice

[CC-2004-038]

October 1, 2004

Subject: Deduction claimed under §404(k) for redemption of stock held by ESOP

Cancel Date: Effective Until Further Notice

PURPOSE

The purpose of this Notice is to provide guidance to Chief Counsel attorneys challenging deductions claimed by corporate taxpayers under §404(k) for redemptions of stock held by an employee stock ownership plan (ESOP). Some of the arguments for challenging these deductions are discussed in Rev. Rul. 2001-6, 2001-1 C.B. 491; additional arguments are set forth herein. Chief Counsel attorneys are encouraged to coordinate with the National Office on these issues.

SUMMARY

Section 404(a) permits a corporation to deduct contributions of its stock to an ESOP, provided various conditions are met. Section 404(k) also permits a corporation to deduct dividends paid on stock held by the ESOP, as long as the dividends are properly paid out to participants or their beneficiaries (or, in certain circumstances, to a creditor of the ESOP). Some corporations have claimed deductions under §404(k) for payments in redemption of stock held by an ESOP that are used to make distributions to terminating participants, arguing that the payments in redemption qualify as dividends under §§301 and 316 and therefore are deductible under §404(k). Under §§162(k), 302, and 404(k), such deductions are properly disallowed. Some of the arguments for disallowing these deductions are discussed in Rev. Rul. 2001-6. This document addresses in greater detail the primary arguments for disallowing deductions for payments in redemption of stock held by an ESOP. This document also addresses Boise Cascade Corporation v. United States, 329 F. 3d 751 (9th Cir. 2003), in which the Court of Appeals, on facts substantially identical to those of Rev. Rul. 2001-6, held that the taxpayer was entitled under §404(k) to deduct payments in redemption of its stock. As discussed below, the Service believes the decision in Boise Cascade is incorrect, and that deductions under §404(k) for redemptions should continue to be denied in jurisdictions outside the Ninth Circuit.

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The arguments below may be summarized briefly as follows: (1) The payments in redemption of stock are not dividends, and therefore §404(k) does not apply; (2) even if the payments are dividends, §162(k) disallows the deduction; and (3) treating such payments as deductible dividends under §404(k) is inappropriate because such treatment would vitiate important protections for ESOP participants and would duplicate an earlier deduction by the corporation for the same economic expense (e.g., a deduction permitted under §404(a) for a prior contribution of stock that is being redeemed).

BACKGROUND

Law

Section 316(a) defines “dividend” as any distribution of property made by a corporation to its shareholders out of accumulated or current earnings and profits.

Section 301(a) and (c) provides that the portion of any distribution that is a dividend is included in gross income.

Section 302(a) provides that if a corporation redeems its stock, and §302(b)(1), (2), (3), or (4) applies, the redemption is treated as a distribution in part of full payment in exchange for the stock. Section 302(b)(1) provides that §302(a) applies if the distribution is “not essentially equivalent to a dividend.”

United States v. Davis, 397 U.S. 301, 313 (1970) provides that a redemption is not essentially equivalent to a dividend if it “result[s] in a meaningful reduction of the shareholder’s proportionate interest in the corporation.”

In Rev. Rul. 76-385, 1976-2 C.B. 92, a shareholder’s interest in a corporation was reduced from .0001118 percent to .0001081 percent. In Rev. Rul. 76-364, 1976-2 CB 91, a shareholder’s interest in a corporation was reduced from 27 percent to 22.27 percent. Each ruling holds that the redemption was not essentially equivalent to a dividend.

Section 162(k)(1) provides, with exceptions not relevant here, that no deduction otherwise allowable under Chapter 1 is allowed for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person (as defined in §465(b)(3)(C)).

Previously, §162(k) referred to “redemption” rather than “reacquisition” of stock. In 1996 Congress amended §162(k) to clarify that it applied to any reacquisition of stock regardless of whether, e.g., it is treated as a redemption for purposes of Subchapter C of the Code. For any transaction that is both a redemption for purposes of Subchapter C and also a reacquisition, the analysis below applies equally to §162(k) as currently in effect.

Section 404(k)(1) provides that, in the case of a C corporation, there is allowed as a deduction for a taxable year the amount of any applicable dividend paid in cash by such corporation during the taxable year with respect to applicable employer securities. This deduction is in addition to the deductions allowed in §404(a).

Section 404(k)(2)(A) provides, in relevant part, that the term "applicable dividend" means any dividend which, in accordance with plan provisions, is paid to the plan and is distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year in which paid.

Under §404(k)(4), the deduction is allowable in the taxable year of the corporation in which the dividend is paid or distributed to a participant or beneficiary.

Prior to 2002, §404(k)(5)(A) provided that the Secretary may disallow the deduction under paragraph (1) for any dividend if the Secretary determines that such dividend constitutes, in substance, an evasion of taxation. Section 662(b) of the Economic Growth and Tax Relief Reconciliation Act of 2001 amended §404(k)(5)(A) to provide that the Secretary may disallow a deduction under §404(k)(1) for any dividend the Secretary determines constitutes, in substance, an "avoidance or evasion of taxation." The amendment is effective for tax years after December 31, 2001.

<u>Rev. Rul. 2001-6</u>

The facts of Rev Rul. 2001-6 are as follows (in slightly abridged form):

> Corporation A maintains an ESOP, which holds stock of Corporation A. The terms of the ESOP provide that when Corporation A pays dividends on its stock, the ESOP trustee may 1) allocate the dividends on the employer securities in a participant's account to the participant; 2) allocate the dividends on the employer securities in a participant's account to the plan and distribute it in cash to the participant not later than 90 days after the close of the plan year in which paid; or 3) use the dividends on employer securities allocated to a participant's account to repay a loan to the ESOP the proceeds of which were used to acquire the employer securities, provided that employer securities with a fair market value at least equal to the value of those dividends are allocated to the participant's account.
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> Under the plan, participants may elect to take a distribution in cash or stock at retirement or termination of employment. In the current year, participants with account balances totaling $5 million separate from service, become eligible for distributions from the ESOP, and elect cash distributions. As allowed under the plan, Corporation A redeems the shares in the terminating participants' accounts for $5 million immediately prior to the distributions. Corporation A claims that the redemptions are treated as dividends under the applicable rules of §§301, 302, and 316.

> The ESOP pays the $5 million redemption proceeds to the terminating participants within 90 days after the close of the plan year in which the plan received the proceeds.

Rev. Rul. 2001-6 concludes that the distributions of redemption proceeds to participants are made in connection with the reacquisition of the employer's stock and that §162(k)(1) therefore bars the deduction under these circumstances regardless of whether the distributions to participants would otherwise be deductible under §404(k). The revenue ruling also concludes that the treatment of redemption proceeds as "applicable dividends" under §404(k) would produce such anomalous results that the section cannot reasonably be construed as encompassing such payments. The revenue ruling states that the application of §404(k) to redemption amounts not only would allow employers to claim deductions for payments that do not represent true economic costs, but also would vitiate important rights and protections for recipients of ESOP distributions, including the right to reduce taxes by utilizing the return of basis provisions under §72, the right to make rollovers of ESOP distributions received upon separation from service, and the protection against involuntary cash-outs. Finally, the ruling states that a deduction would be disallowed under §404(k)(5)(A) because a deduction under these circumstances would constitute, in substance, an evasion of taxation.

ARGUMENTS FOR DISALLOWING DEDUCTIONS CLAIMED UNDER §404(K)

1. Redemption is not a dividend because it is a meaningful reduction in ESOP's stock interest.

To qualify as an "applicable dividend" under §404(k), the redemption payment would have to first qualify as a "dividend." The term "dividend" is defined in §316(a) as any distribution of property out of earnings and profits made by a corporation "to its shareholders." As set forth in Rev. Rul. 2001-6, it is the Service's position that the ESOP, rather than the participants, is the owner of the corporation's stock at the time of the redemption, and is therefore the shareholder for purposes of §316. (It should be noted that in Boise Cascade, the government argued that the ESOP's participants were shareholders of the corporation for §316 purposes.)

If the corporation has sufficient earnings and profits, a redemption of stock will be treated as a distribution under §301(c) if none of the provisions of §302(b)(1) through (4) applies. In many cases involving §404(k), the relevant provision is §302(b)(1), which provides that a redemption will not be subject to §301(c) if the redemption is "not essentially equivalent to a dividend." A redemption is not essentially equivalent to a dividend if it "result[s] in a meaningful reduction of the shareholder's proportionate interest in the corporation." United States v. Davis, 397 U.S. 301 (1970). In many cases a redemption of the shares in terminating participants' accounts will result in a meaningful reduction of the ESOP's proportionate interest in the corporation.

This follows from two points: First, in cases where a corporation redeems stock from a shareholder that does not have actual or effective control over the corporation after the redemption, a reduction in the shareholder's interest generally has been treated as meaningful. See Rev. Rul. 76-385, 1976-2 C.B. 92 (reduction from .0001118 percent to .0001081 percent held meaningful); Rev. Rul. 76-364, 1976-2 CB 91 (reduction from 27 percent to 22.27 percent held meaningful). Second, in many cases an ESOP will not have actual or effective control over the corporation to bail out corporate earnings. For example, the ESOP may not own a sufficient amount of stock in the corporation. Even in cases where the ESOP owns a significant amount of the corporation's stock, the voting rights available to participants under §409(e) may prevent it from exercising effective control over the corporation. Thus, in many cases a redemption by a corporation of an ESOP's stock will not be treated as a dividend under §§301 and 316.[1] Because of its factual nature, Chief Counsel attorneys should coordinate this issue with the National Office.

2. Section 162(k) disallows any deduction for payments in connection with reacquisition of stock, and therefore disallows deduction claimed under §404(k).

Section 162(k) bars the claimed deduction for redemption payments to the ESOP because the amounts in question were paid by a corporation in connection with the redemption or reacquisition of its stock. Section 162(k) applies to any deduction otherwise allowable under Chapter 1 of the Code, which includes §404(k). Section 162(k) denies a deduction for any payment "in connection with" a corporation's reacquisition of its stock. The phrase "in connection with" is "intended to be construed broadly." H.R. Conf. Rep. No. 99-841, at 168-169 (1986). Congress intended this phrase to include both amounts paid by a corporation directly to shareholders in consideration for the redeemed stock and certain other amounts paid by a corporation associated with the redemption.[2] Although the phrase does not encompass a payment made at the same time (and to the same shareholder) as a redemption payment when the former payment represents an economic expense that is separate and apart from the redemption payment and is otherwise deductible under the Code,[3] "in connection with" necessarily includes the cost of the redemption itself.

In these transactions the amount claimed as a deduction is the amount the corporation paid to a shareholder, the ESOP, to redeem its stock; there is no payment by the

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1 We note that this position was not addressed in Rev. Rul. 2001-6, which stated the Service's arguments and position assuming the redemption was treated as a dividend. We note further that in Boise Cascade the parties stipulated that if the ESOP was held to be the shareholder, the redemption was not a meaningful reduction and therefore was entitled to dividend treatment.
2 As examples of the latter, both the House and Senate reports refer to "legal, accounting, brokerage, transfer agent, appraisal, and similar fees incurred in connection with the repurchase." H.R. Rep. No. 99-426, at 249 (1985); S. Rep. No. 99-313, at 223 (1986).
3 "For example, if a corporation redeems a departing employee's stock and makes a payment to the employee in discharge of the corporation's obligations under an employment contract, the payment in discharge of the contractual obligation is not subject to disallowance under this provision." H.R. Conf. Rep. No. 99-841, at 168-169 (1986).

corporation of an economic expense separate and apart from the redemption payments that could be viewed as not "in connection with the reacquisition of its stock."[4] The only other payment involved is the payment by the ESOP to its participants, which is a payment by the ESOP of the ESOP's economic expense. Thus, the claimed deduction is barred by §162(k).

The Court of Appeals for the Ninth Circuit reached the opposite result in Boise Cascade. The facts in that case were as follows: In 1989, Boise Cascade established an ESOP, which borrowed approximately $300 million and purchased convertible preferred stock from Boise Cascade specifically created for the ESOP. Under the terms of the ESOP, when a participant terminated employment, the convertible preferred stock in the participant's account was redeemed. At Boise Cascade's discretion, the redemption could be made either in cash or Boise Cascade common stock. In 1989 all of the redemption payments were made in cash. In addition, when a participant terminated employment, the participant became entitled to a distribution of his or her total vested account balance (ESOP and non-ESOP portions). For participants with vested account balances of $3500 or less, the entire amount of the vested account balance was distributed upon termination of employment. For participants with vested account balances in excess of $3500, they could elect: (1) to receive a distribution of the entire amount of the vested account balances, including ESOP amounts; (2) to defer distribution of the entire amount, including ESOP amounts; or (3) to receive a distribution of the ESOP amounts and defer distribution of the remaining account balance. A participant could elect to receive the distribution in the form of cash or Boise Cascade common stock. When a cash distribution was elected the ESOP trustee distributed the cash in accordance with the participant's election.

Boise Cascade claimed a deduction, arguing that the amounts paid to redeem the stock were deductible as applicable dividends under §404(k). The parties stipulated that if the ESOP, rather than the participants, owned the stock that was redeemed, the redemptions did not result in meaningful reductions of the ESOP's proportionate interest and §301(b) would not apply. The Court of Appeals concluded that the redemption payments in question were "dividends" for purposes of §404(k), and therefore deductible under that section, in part because the ESOP, not the participants, owned the stock. The Court further concluded that §162(k) did not bar the deduction because the distributions from the ESOP to the participants were not amounts paid "in connection with" the redemption.

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4 In addressing the same example set out in the legislative history, a footnote in the General Explanation of the Tax Reform Act of 1986 (J. Comm. Print 1987) states that §162(k) "was not intended to deny an employer a deduction for compensation where a deduction has been deferred under other provisions of the Code, and the deduction becomes allowable when the employer reacquires the employee's stock. See, e.g., sections 83 and 421(b)." The deductions at issue in both Rev. Rul. 2001-6 and Boise Cascade, however, were not deferred for amounts contributed to the ESOP. Under §404(a), amounts are deductible when contributed by the corporation to the qualified trust described in §401(a). Under §§83 and 421(b), the corporation's deduction is delayed until income is included by the employee.

Section 404(k) permits a deduction if (as relevant here) two conditions are met: (1) the corporation pays a dividend to the plan and (2) the plan distributes the dividend to its participants within a specified time period. Thus, the amount the corporation is entitled to deduct under §404(k) is the amount of dividend it pays to the ESOP that the ESOP then pays to its participants. The Court apparently believed the two requirements of §404(k) were segregable, and, furthermore, appeared to treat the deduction as arising entirely from the distributions to the participants, and not at all from the payment to the ESOP in consideration for the stock. But the distributions by the ESOP to the participants did not represent a separate expense of Boise Cascade, and cannot independently support a deduction under §404(k) where the amounts Boise Cascade actually paid out as a dividend—the predicate to a §404(k) deduction—were nondeductible redemption expenses of Boise Cascade. Thus, regardless of whether or not the distributions to the participants constituted separate transactions from the redemption payments by Boise Cascade to the ESOP, the Court applied §404(k) incorrectly by attributing the §404(k) deduction entirely to the distributions by the ESOP to the participants.

In sum, Boise Cascade, like Corporation A in Rev. Rul. 2001-6, transferred cash to a shareholder, the ESOP, in full payment for shares of Boise Cascade stock owned by the ESOP. No payments are more clearly "in connection with" a redemption or reacquisition of stock than these, which constituted consideration actually paid by a corporation to a shareholder in exchange for the shareholder's stock in the corporation. Such payments are not merely "fees and other expenditures 'necessary and incident' to repurchase" of stock (<u>Boise Cascade</u>, <u>supra</u> at 758). The §404(k) deduction is predicated on the redemption dividend payments to the ESOP. Because the deduction for an "applicable dividend" was unavailable to Boise Cascade absent payments that were "in connection with" the redemption or reacquisition of stock, §162(k) applies. Once it applies, §162(k) disallows any deduction otherwise allowable under Chapter 1 of the Code, which includes §404. Accordingly, the deduction claimed by Boise Cascade should have been disallowed under §162(k).

<u>3. Vitiation of participant rights</u>

In addition, even if §162(k) did not to apply in these circumstances, the deduction for the distribution of the redemption proceeds to ESOP participants would be disallowed under §404 for the reasons stated in Rev. Rul. 2001-6. As discussed earlier, this revenue ruling concluded that payments in redemption of stock held by an ESOP that are used to make distributions to terminating participants do not constitute "applicable dividends" under §404(k)(1) because such treatment would produce such anomalous results that §404(k) cannot reasonably be construed as encompassing such payments. The revenue ruling states that the application of §404(k) to redemption amounts not only would allow employers to claim deductions for payments that do not represent true economic costs, but would also vitiate important rights and protections for recipients of ESOP distributions, including the right to reduce taxes by utilizing the return of basis provisions under §72, the right to make rollovers of ESOP distributions received upon separation from service and the protection against involuntary cash-outs under

§411(a)(11). For example, a participant receiving a §404(k) distribution of a dividend paid to an ESOP upon the participant's separation from service would not be able to roll the dividend distribution into another qualified plan or individual retirement arrangement. (See section 1.402(c)-2, A-4(e) of the Income Tax Regulations).

4. Section 404(k)'s anti-abuse provision

Finally, Revenue Ruling 2001-6 concluded that to allow a deduction for the redemption proceeds paid to terminating participants constitutes an evasion of taxation under §404(k)(5)(A). Furthermore, for tax years beginning after December 31, 2001, we note that §404(k)(5)(A) was amended to provide that the Secretary may disallow the deduction under §404(k)(1) if the Secretary determines that such dividend constitutes, in substance, either an avoidance or evasion of taxation. We believe the amendment to §404(k)(5)(A) allowing the disallowance in the case of tax avoidance further supports our conclusion that, in years after 2001, a deduction should not be permitted under §404(k) under these circumstances.

Allowing a deduction under §404(k) for a redemption of stock held by an ESOP would permit a corporation to claim two deductions for the same economic cost (to the extent of, e.g., the overlap between the value of the stock contributed and the amount paid to redeem it). Therefore, the argument that the deduction under §404(k) constitutes tax avoidance or evasion is further supported by the doctrine of Charles Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934). The Ilfeld doctrine is a long-standing principle of statutory and regulatory construction. Under the doctrine, courts do not construe statutes or regulations as permitting the practical equivalent of two deductions for the same economic cost absent language in the text "definitely requiring" the double deduction. Charles Ilfeld Co. v. Hernandez, 292 U.S. at 68.[5] Chief Counsel attorneys are required to coordinate Ilfeld arguments with the National Office.

POSITION

For the reasons stated above, the Service's position continues to be that the deduction claimed by Corporation A in Rev. Rul. 2001-6 and by taxpayers such as the taxpayer in Boise Cascade should be disallowed. In cases outside the Ninth Circuit, Chief Counsel attorneys are to continue working with examining agents to identify deductions claimed under §404(k) for redemptions of stock, and to develop and pursue the arguments discussed above, without regard to the decision of the Court of Appeals for the Ninth Circuit. In cases within the Ninth Circuit, examining agents are directed to coordinate with the National Office before challenging deductions under §404(k) for redemptions of stock.

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5 Gitlitz v. Commissioner, 531 U.S. 206, 219-220 (2001), in which the Court allowed a "double windfall," but only because "the Code's plain text permits" it, is distinguishable. Contrary to the situation in Gitlitz, the Code's plain text (specifically §162(k)) explicitly disallows any deduction for the entire redemption expense (including the portion of that expense that duplicates an earlier deduction for a stock transfer). Moreover, even if §162(k) were not in the Code, the provision relied on in claiming the deduction, §404(k), does not plainly permit the double deduction, because it contains an anti-abuse provision authorizing the Secretary to disallow deductions in the case of tax avoidance or evasion.

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