

Federal Court Permits Dividend Deduction for Stock Redeemed from ESOP

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On January 14, 2008, the U.S. District Court for the District of Minnesota, on a motion for summary judgment, ruled in *General Mills v. United States*, No. 06-3457 DSD/SRN (D. Minn. Jan. 14, 2008), that a corporation could deduct as dividends amounts it paid to redeem shares of its stock held by an ESOP when participants terminated employment. The court ruled that the dividends paid were deductible under Internal Revenue Code (IRC) section 404(k) and that IRC section 162(k) does not prohibit the cash distribution of redemptive dividends. The court reasoned that payment of dividends was not necessary and incident to the redemption expenses since the redemptions were not mandatory and, at times, the dividends were used by the ESOP for activities other than paying out cash distributions. This ruling is contrary to the Internal Revenue Service (IRS) position set out in Revenue Ruling 2001-6. In explaining its refusal to follow Revenue Ruling 2001-6, the court stated that IRC section 404(k) empowers only the Secretary of the Treasury Department to determine whether an avoidance or evasion of taxation exists. In the court's analysis, since the IRS's Chief Counsel issued Revenue Ruling 2001-6, this interpretation as to what constitutes an avoidance or evasion of taxation was not an authorized determination. Consequently, the court did not feel bound to follow Revenue Ruling 2001-6 and so permitted the dividend deduction. The allowability of this deduction has been challenged over the last several years, with the IRS insisting that the deduction should not be permitted, as it would allow a corporation to claim two deductions for the same economic cost.

In Revenue Ruling 2001-6, the IRS concluded that IRC section 162(k) bars a deduction for payments made in the redemption of stock from an ESOP. This conclusion was based on the fact that IRC section 162(k) disallows a deduction for payments paid in connection with the reacquisition of an issuer's stock and that the redemption payments in connection with the stock of departed ESOP participants are such payments. Thus, the IRS stated that a deduction under IRC section 404(k)(1) for such amounts would constitute, in substance, an evasion of tax.

Two years later, in *Boise Cascade Corporation v. United States*, 329 F.3d 751 (9th Cir. 2003), the Court of Appeals for the Ninth Circuit held that payments made by a corporation to redeem its stock held by its ESOP were deductible as dividends paid under IRC section 404(k) and the deduction is not precluded by IRC section 162(k). The court reasoned that the distribution by the ESOP of the redemption proceeds to the participants was a transaction separate from the redemption transaction.

Despite the Ninth Circuit decision, the IRS and Treasury Department continued to take the position that even if a payment in redemption of stock held by an ESOP were to qualify as an applicable dividend, IRC section 162(k) would disallow a deduction for the amount because such payment would be made in

connection with the reacquisition of the corporation's stock. In October 2006, the Treasury Department finalized regulations under IRC section 404(k) that reiterated the IRS's position that payments made to reacquire stock held by an ESOP are not deductible under IRC section 404(k) because such deduction constitutes, in substance, an avoidance or evasion of taxation. These final regulations could be invalidated, however, since their statutory support is questionable and two courts have now reached the opposite conclusion.

A corporation that is interested in claiming a tax deduction for costs associated with redeeming shares from an ESOP should consult with legal counsel with expertise in this area and proceed cautiously. The IRS has clearly stated its position as evidenced by its issuance of final regulations specifically disallowing the deduction *after* the *General Mills* ruling. This suggests that one district court decision will not, in itself, change the IRS's enforcement position or prevent disallowance of the deduction in other court jurisdictions.

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