

Circuits Split on Deductibility of Proceeds From Stock Redemption Used to Satisfy ESOP Distribution Obligations

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An Internal Revenue Service (IRS) official recently commented at an American Law Institute-American Bar Association conference that the IRS will continue to litigate the issue of whether a corporation is entitled to a deduction under Section 404(k)(1) of the Internal Revenue Code (the Code) for payments used to redeem its stock to satisfy the distribution obligations under its employee stock ownership plan (ESOP). *See* Young, “IRS Will Continue Litigating ESOP-Related Deduction,” *Tax Notes*, March 23, 2009, p. 1434. This comment appears to be in response to the Eighth Circuit’s decision on this issue in *General Mills v. United States*, 554 F.3d 727 (8th Cir. 2009), which although favorable to the IRS, is contrary to the decision reached by the Ninth Circuit in *Boise Cascade v. United States*, 329 F.3d 751 (9th Cir. 2003).

On January 26, 2009, the Eighth Circuit held in *General Mills* that General Mills was not entitled to a deduction under Section 404(k)(1) of the Code for the proceeds from a stock redemption where the proceeds were used to satisfy cash distributions made by the ESOP trust to terminated employees. Section 404(k)(1) of the Code allows companies to take a tax deduction for “applicable dividends” on ESOP shares. An “applicable dividend” is defined in Section 404(k)(2)(A)(ii) of the Code to include any dividend that is paid to a plan and is distributed in cash to participants in a plan or their beneficiaries not later than 90 days after the close of the plan year in which paid. General Mills had three ESOPs and one ESOP trust that held the ESOPs’ assets. Upon a participant’s termination of employment with General Mills, the ESOP trust distributed to the participant the value of the participant’s ESOP account. A participant could elect to receive the value of his or her ESOP account in cash or in General Mills’ stock. If a participant elected to receive cash, the ESOP trust could satisfy its obligation to the participant by requesting that General Mills redeem shares of its common stock from the ESOP trust. The ESOP trust would then use the proceeds it received from the redemption of the shares (the “redemptive dividends”) to fund its obligation to make the cash distributions to the participants (the “cash distribution redemptive dividends”). The district court found in favor of General Mills, which treated the redemptive dividends as deductible dividends under Section 404(k)(1) of the Code. The U.S. government appealed the district court’s decision.

The Eighth Circuit, in reversing the district court’s opinion, found that Section 162(k)(1) of the Code barred General Mills from taking the deduction under Section 404(k)(1) of the Code. During the time at issue, Section 162(k)(1) stated that “Except as provided in paragraph (2), no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred by a corporation in connection with the redemption of its stock.” The Eighth Circuit disagreed with the Ninth Circuit’s analysis in *Boise Cascade*, which found that a redemptive dividend and a cash distribution redemptive

dividend were two entirely separate transactions, and a cash distribution dividend was not made “in connection with” the company’s stock redemption. By narrowly interpreting the phrase “in connection with,” the Ninth Circuit held a cash distribution dividend was not barred by Section 162(k)(1). The Eighth Circuit interpreted the “applicable dividend” in Section 404(k)(2)(A)(ii) as two connected steps, the redemptive dividend and the cash distribution redemptive dividend. The Eighth Circuit, unlike the district court and the Ninth Circuit, broadly interpreted the phrase “in connection with” and held that it could not “rule that one step is ‘in connection with’ the stock redemption while the other step is not.” Since General Mills acknowledged that the redemptive dividend was “in connection with” the stock redemption, the Eighth Circuit found that both the redemptive dividend and the cash distribution redemptive dividend were “in connection with” the stock redemption and that Section 162(k)(1) therefore barred General Mills’ deduction.

Due to the circuit split on whether a corporation is entitled to a deduction under Section 404(k)(1) of the Code on payments used to redeem its stock to satisfy the distribution obligations under its ESOP and the IRS’s statement that it will continue to litigate this issue, the U.S. Supreme Court may ultimately have to resolve this issue.

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