

IRS Issues Guidance on Deductibility of Redemption Payments to ESOPs

December 3, 2004

The Office of Chief Counsel of the IRS recently issued guidance to its attorneys regarding deductions claimed by corporate taxpayers under Section 404(k) of the Internal Revenue Code (the "Code") in connection with redemptions of stock held by ESOPs. The guidance was issued in the form of a Chief Counsel Notice (CC-2004-038), dated October 1, 2004. The Notice addresses the proper tax treatment of payments made by the sponsor of an ESOP in connection with purchases of shares of the sponsor's stock from the ESOP, where the purchase price is distributed by the ESOP to the participants from whose accounts the stock has been redeemed. Some ESOP companies have claimed tax deductions for these payments, on the theory that the payments constitute "dividends" for federal income tax purposes that are deductible under Section 404(k) of the Code. This position was upheld by the Court of Appeals for the Ninth Circuit, in 2003, in the case of *Boise Cascade Corp. v. U.S.* However, the Chief Counsel of the IRS has taken a contrary position in Notice CC-2004-038 and has announced that the IRS will not follow the *Boise Cascade* decision in jurisdictions outside the Ninth Circuit.

Section 404(k) of the Code authorizes a C corporation to take tax deductions for dividends paid on shares held by an ESOP if the dividends are (i) paid to the participants in the ESOP; (ii) applied to repay a loan that financed the purchase of the shares upon which the dividends are paid; or (iii) used to purchase additional shares of the plan sponsor's stock. It does not appear that Section 404(k) was originally intended to enable ESOP companies to deduct amounts paid to redeem shares from ESOPs. However, this is what some ESOP companies have done, contending that the redemption payments constitute "dividends" for tax purposes.

Although it is beyond the scope of this article to describe all of the complex rules for determining when distributions from a corporation constitute "dividends" for tax purposes, it can generally be stated that one of the hallmarks of a dividend is a receipt by shareholders of cash without a meaningful change in their ownership interest in the corporation. Where the shares allocated to the account of a terminated employee are redeemed from an ESOP, the redemption may result in only a very small change in the ESOP's ownership interest, even though the former employee's ownership interest is completely terminated. In this circumstance, some companies have claimed that payments made in redemption of ESOP shares constitute dividends. This argument was rejected by the IRS in Revenue Ruling 2001-6, but in 2003, the Ninth Circuit reached the opposite result in the *Boise Cascade* case. The parties in *Boise Cascade* stipulated that if the ESOP, rather than the participants

in the ESOP, were considered to have owned the stock that was redeemed, the redemptions would not result in a meaningful reduction of the ESOP's proportionate interest, and therefore the redemption payments would be "dividends" for purposes of Section 404(k) of the Code. The court concluded that the redemption payments in question were in fact "dividends" and were deductible under Section 404(k). Some commentators have viewed this stipulation as a bad strategic move by the IRS and have speculated that *Boise Cascade* might have been decided differently had there been no stipulation.

In the recently issued Notice, the IRS has reaffirmed the position that it took in Revenue Ruling 2001-6 and has stated that it considers the *Boise Cascade* case to have been incorrectly decided. There are four components of the IRS argument. First, according to the IRS, a redemption of shares from an ESOP generally is not a "dividend" for federal income tax purposes because where a corporation redeems stock from a shareholder that does not have actual or effective control of the corporation after the redemption, the reduction in the shareholder's interest generally has been treated as meaningful. However, where an ESOP does have control over the plan sponsor, this argument will not apply. Because of the factual nature of the question whether an ESOP has actual or effective control over a plan sponsor, IRS attorneys are advised in Notice CC-2004-038 to discuss this issue with the national office of the IRS.

As a second basis for its position, the IRS contends that any claim by an ESOP company for a tax deduction in connection with payments made in redemption of shares held by the ESOP are barred by Section 162(k) of the Code, which denies deductions that otherwise would be allowed for any payments that are made in connection with a corporation's reacquisition of its own stock. The third basis for the IRS position is that, even if Section 162(k) does not apply, no deduction should be allowed under Section 404(k) of the Code because this would invalidate important rights and protections for ESOP participants, including the right to reduce taxes on benefit distributions under certain provisions of the Code, the right to roll benefit distributions over to other tax-qualified plans upon separation from service, and the protection against involuntary cash-outs. None of these rights and protections apply to dividends. Finally, the IRS takes the position that to allow a deduction for redemption payments to terminating ESOP participants would constitute either an avoidance or evasion of taxation, and the IRS has the authority to disallow deductions claimed under Section 404(k) for any dividends that constitute an avoidance or evasion of taxation.

In light of the position taken by the IRS in Chief Counsel Notice CC-2004-038, we would advise ESOP companies to proceed with caution, and only with the advice of counsel, with respect to any claims for tax deductions in connection with redemptions of shares from their ESOPs.

Mark Your Calendars for January 26, 2005: Morgan Lewis Sponsors Upcoming Meeting of The ESOP Association's Illinois Chapter

Midwestern companies and professionals will want to be sure to attend the meeting of the Illinois Chapter of the ESOP Association, to be held at the Radisson Hotel, Chicago, on January 26, 2005. Morgan, Lewis & Bockius LLP will be a sponsor of the event. For registration information, contact Richard Duffy, Chapter Development Officer, at 603.898.4228.

If you have questions about this or any other *Morgan Lewis on ESOPs* newsletter article, please contact the Morgan Lewis attorney who routinely handles your legal affairs or any member of the ESOP Team listed below.

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