

Part I

Section 404.--Deduction For Contributions Of An Employer To An Employees' Trust Or Annuity Plan And Compensation Under A Deferred-Payment Plan

Rev. Rul. 2001-6

ISSUE

Whether payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants constitute "applicable dividends" under section 404(k)(1) of the Internal Revenue Code that are deductible.

FACTS

Corporation A (a C corporation) has a single class of voting common stock outstanding. Corporation A maintains an employee stock ownership plan (ESOP), as defined in section 4975(e)(7) of the Internal Revenue Code (Code), 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.

Under the plan, participants may elect to take a distribution in cash or stock at retirement or termination of employment. In the current year, 100 participants with account balances from \$2,000 to \$200,000, 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 sections 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.

LAW AND ANALYSIS

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 section 465(b)(3)(C)).

Section 404(k)(1) of the Code 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 section 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 section 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.

Section 404(k)(5)(A) provides 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.

Under these facts, redemption payments are paid in connection with the “reacquisition” of the issuer’s stock. Thus, section 162(k)(1) bars the deduction of such payments without regard to whether they would otherwise be deductible under section 404(k).

Moreover, the treatment of redemption proceeds as “applicable dividends” under section 404(k) would produce such anomalous results that section 404(k) cannot reasonably be construed as encompassing such payments. See, e.g., Helvering v. Hammel, 311 U.S. 504, 510-511 (1941) (the words of a statute must be given “a restricted rather than a literal or usual meaning . . . where acceptance of that meaning would lead to absurd results . . . or would thwart the obvious purpose of the statute.”) The application of section 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 section 72, the right to make rollovers of ESOP distributions received upon separation from service, and the protection against involuntary cash-outs. See sections 72(e)(5)(D) and 411(a)(11)(C); section 1.402(c)-2, A-4(e) of the Income Tax Regulations. Therefore, the term “applicable dividends” under section 404(k) does not include amounts paid for the redemption of stock held by an ESOP, whether or not such redemption proceeds constitute dividends under sections 301, 302, and 316.

Further, section 404(k)(5)(A) authorizes the Secretary to disallow a deduction under section 404(k)(1) for any dividend that constitutes, in substance, an evasion of taxation. Pursuant to section 404(k)(5)(A), a deduction under section 404(k)(1) would be disallowed for payments in redemption of employer securities used to make distributions to terminating ESOP participants because such treatment would constitute, in substance, an evasion of taxation.

HOLDING

Payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants are not deductible. In addition, such payments do not constitute “applicable dividends” under section 404(k)(1) of the Internal Revenue Code. This revenue ruling applies without regard to whether there is appreciation in the employer securities in the ESOP.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Steven J. Linder of the Employee Plans, Tax Exempt and Government Entities Division (T:EP) and John T. Ricotta of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service between the hours of 1:30 and 3:30 p.m. Eastern time, Monday through Thursday, by calling (202) 283-9516. Mr. Linder's number is (202) 283-9888. Mr. Ricotta's number is (202) 622-6060. (These telephone numbers are not toll-free.)