Internal Revenue Service Department of the Treasury

Washington, DC 20224

Uniform Issue Nos: 162.05-03
401.04-00
404.00-00
402.08-00
415.00-00
4972,01-00

Contact Person:

Telephone Number:

In Reference to:
T:EP:RA:T3

Date:
JUN 26 2000

LEGEND:

Company A:

State B:

Company C:

Plan X:

Plan Y:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Date 6:

Federal Agency D:

Trustee W:

$:

Gentlemen:

This is in response to the , request for letter ruling, submitted on your behalf by your authorized representative, as supplemented by correspondence dated , in which you request several letter rulings under sections 162, 401(a)(4), 401(a)(16), 402, 404, 415 and 4912 of the Internal Revenue Code. The following facts and representations support your ruling request.

Company A, which has its principal office in State B, adopted Plan X effective Date 1. Plan X is a defined contribution, profit-sharing, plan which contains a cash or deferred arrangement described in Code section 401(k) which

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your authorized representative asserts is qualified within the meaning of Code section 401(a), and its trust exempt from tax pursuant to Code section 501(a).

Effective Date 2, a wholly owned subsidiary merged into Company C which caused Company C to become a wholly owned subsidiary of Company A. As of Date 2, Company C maintained Plan Y, a profit sharing plan containing a cash or deferred arrangement described in Code section 401(k). Plan X and Plan Y were restated effective Date 3. Plan X and Plan Y were maintained as separate plans until Date 4 when the assets of Plan Y were merged with the assets of Plan X in one trust. Plan X is the qualified plan that resulted from the Date 4 merger. Trustee W is the trustee of the merged plans.

Your authorized representative asserts on your behalf that Companies A and C file a consolidated Federal Tax Return.

From 1992 until 1997, section 9.2 of Plan Y provided that a participant may elect to receive a distribution of his or her vested account balance as of the date of his or her termination of employment. Section 9.5(A) of Plan Y further provided that the account balance of a participant who requested a distribution of his vested account balance is "determined as of the most recent practicable Valuation Date (defined as the last business day of the month) preceding the date the Participant's distribution is to be made".

The period of time from the date as of which an account was valued and the date it was distributed averaged two to three and one-half months as measured from the Valuation Date. During that period, the value of an account remained fixed; thus, participants whose accounts were distributed during the 1992 through 1997 calendar years did not receive allocations of investment gains or losses for the period between the date an account was valued and the date a distribution was actually made. All earnings on a terminated participant's account were reallocated to the remaining Plan participants.

Federal Agency D, which has jurisdiction over issues arising under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), and some Plan participants who received distributions upon termination of employment between 1992 and 1997 questioned whether said distributions should have reflected investment earnings and losses during the period between the Valuation Date and the date of actual distribution.

In a letter dated Date 5 from Federal Agency D to Company C, Federal Agency D advised Company C of the results of an investigation it had undertaken with respect to the loss of earnings referenced above. In its letter, Federal Agency D advised Company C that the fiduciaries of the Plan were in violation of several provisions of ERISA as a result of the Plan's failure to pay terminated Plan participants earnings, as measured from the Valuation Date to the date of payment, on their distributions. In its letter, Federal Agency D also advised Company C that affected Plan participants were denied a substantial amount of earnings. Furthermore, in its letter, Federal Agency D advised Company C that "it is our view that, so long as you continue to deny participants their earnings on their distributions, you will be in violation of ERISA as stated above and liable for any past and future lost earnings accrued as a result of this practice". Company C was also advised that it would

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continue to be in violation of ERISA until participant earnings were restored to the terminated participants, and failure to restore the lost earnings "may result in the referral of this matter to the Office of the Solicitor of Federal Agency D for possible legal action". Moreover, Company C was advised that even if Federal Agency D decided not to take any legal action, Company C would be "subject to suit by other parties including Plan fiduciaries and Plan participants or their beneficiaries".

In response to Federal Agency D's conclusions referenced above, on Date 6, 1999, Company A, on behalf of Company C, made a "restorative payment" in the amount of $ to Plan X. Such payment is being held in an unallocated Plan X trust account for the benefit of former Plan Y participants who received distributions from 1992 to 1997 and will be used to compensate such participants for potential lost earnings between the dates as of which the values of affected participants' accounts were fixed in connection with impending distributions and the dates on which the distributions were actually made.

The above-referenced Plan X trust account will be maintained for a period of two years after affected participants are notified of their additional plan distributions(s), or, if earlier, until the date that the last distribution check is cashed. At the end of such two year period, any undistributed amounts remaining in the trust account will be reallocated to the accounts of Plan X participants. If a missing affected participant subsequently requests his or her distribution, then the amount forfeited will be restored and distributed to such participant.

Each participant who received a distribution from Plan Y from 1992 to 1997 and who would have experienced a gain if investment gains and losses had been allocated to his or her account will be credited with a compensatory distribution consisting of two components: an "investment adjustment" and an "interest adjustment". The sum of the two components approximates what an affected plan participant would have if the participant had received the "investment adjustment" as part of his or her actual adjustment and had invested the amount of the "investment adjustment". The "investment adjustment" is based upon the weighted average investment return of all investment funds offered under Plan Y, and the "interest adjustment" is based upon the applicable federal rate, compounded quarterly, in effect under Code section 1274. Your authorized representative has asserted that no restored participant account will exceed the amount that would have been in the account but for the fact that earnings were not credited as indicated above.

Based on the above, you, through your authorized representative, request the following letter rulings:

that the proposed restorative payment described, above, to the extent used to reimburse affected plan Y participants for lost earnings as indicated above

(1) will not constitute a "contribution" or other payment subject to the provisions of either Code section 404 or Code section 4912;

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(2) will not adversely affect the qualified status of Plan X, or its related trust, pursuant to either Code section 401(a) (4), 415, or Code section 401(a)(16);

(3) will not, when made to Plan X (or the trust described herein), result in taxable income to Plan X participants or their beneficiaries under Code section 402; and

(4) will be deductible in full by Company A pursuant to Code section 162.

YOU, through your authorized representative, also request the following letter ruling.

(5) That distributions from the Plan X trust account, referenced above, will be "eligible rollover distributions" within the meaning of Code section 402(c)(4) in accordance with the requirements of said Code section.

With respect to your first three ruling requests, section 401(a)(4) of the Code provides that the contributions or benefits provided under a retirement plan qualified under section 401(a) of the Code may not discriminate in favor of highly compensated employees as defined in section 414(q) of the Code.

Section 404(a) of the Code generally provides that contributions made by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan shall be deductible under section 404 subject to the limitations contained therein.

Section 401(a) (16) of the Code provides, generally, that a trust shall not constitute a qualified trust under this section if the plan of which such trust is a part provides for benefits or contributions which exceed the limitations of section 415.

Section 415(a) of the Code provides, in part, that a trust which is part of a pension, profit-sharing, or stock bonus plan shall not constitute a qualified trust under section 401(a) if-

(A) in the case of a defined benefit plan, the plan provides for the payment of benefits with respect to a participant which exceeds the limitations of subsection (b),
or

(B) in the case of a defined contribution plan, contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitations of subsection (c).

Section 415(e) of the Code provides limitations on employer contributions and benefits in the case where an individual is a participant in both a defined benefit and a defined contribution plan maintained by the same employer.

Section 1.415-6(b)(2) of the Income Tax Regulations provides that the term "annual additions" includes employer contributions which are made under the plan. Section 1.415-6(b) (2) further provides that the Commissioner may, in an appropriate case, considering all of the facts and circumstances, treat transactions between the plan and the employer or certain allocations to participants' accounts as giving rise to annual additions.

Code section 4972 imposes on an employer an excise tax on nondeductible contributions to a qualified plan. Section 4972(c) defines "nondeductible contributions" as the excess (if any) of the amount contributed for the taxable year by the employer to or under such plan over the amount allowable as a deduction under section 404 for such contributions (determined without regard to subsection (e) thereof), and the amount determined under subsection (c) for the preceding year reduced by the sum of the portion of the amount so determined returned to the employer during the taxable year and the portion of the amount so determined deductible under section 404 for the taxable year (determined without regard to subsection (e) thereof).

Code section 402(a) generally provides that amounts held in a trust that is exempt from tax under Code section 501(a) and that is part of a plan that meets the qualification requirements of Code section 401(a) will not be taxable to participants until such time as such amounts are actually distributed to distributees under such plan.

Neither the Code nor the Income Tax Regulations promulgated thereunder provide guidance as to whether Company A's proposed restorative payment should constitute contributions for purposes of the above-referenced sections of the Code.

In this case, the payment which Company A made to Plan X, which payment is referred to above, will ensure that the affected participants in Plan Y, which was merged into Plan X on Date 4, receive amounts representing investment gains to which they are entitled and which they would have received absent the administrative errors referenced above.

As indicated by the facts of this case, the replacement payment was made by Company A in response to potential claims against Company C, a member of a controlled group of which Company A is the parent. The replacement payment was initially unallocated, but will, within a period not to exceed two years, be paid to Plan Y participants that incurred loss as a result of the failure of the Plan Y administrator to add investment earnings to the amounts of their lump sum distributions.

Thus, based on the above, we conclude as follows with respect to your first three ruling requests:

that the proposed restorative payment, described above, to the extent used to reimburse affected Plan Y participants for lost earnings as indicated above

(1) will not constitute a "contribution" or other payment

subject to the provisions of either Code section 404 or Code section 4912;

(2) will not adversely affect the qualified status Of Plan X, or its related trust, pursuant to either Code section 401(a) (4), 415 or Code section 401(a) (16); and

(3) will not, when made to the Plan X trust account, described herein, result in taxable income to affected Plan X participants or their beneficiaries under Code section 402.

With respect to your fourth ruling request, Code section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

In general, payments made in settlement of lawsuits or potential lawsuits are deductible if the acts that give rise to the litigation were performed in the ordinary conduct of the taxpayer's business.

In Kornhauser v. United States, 276 U.S. 145 (1928), VII-2 C.B. 267 (1928), the taxpayer claimed entitlement to deduct $10,000 in attorney fees as a business expense because they were incurred to defend a lawsuit brought by a former partner for an accounting. The Court held the attorney fees deductible because the lawsuit proximately resulted from the taxpayer's business.

In Cochrane v. Commissioner, 23 B.T.A. 202 (1931), acq. X-Z C.B. 14 (1931), an attorney paid $10,000 to a client to compensate for not adequately protecting the client's interests. The court held that the payment was an ordinary and necessary expense of the attorney's business.

In Butler v. Commissioner, 17 T.C. 675 (1951), acq., 1952-l C.B. 1, an officer and director of a bankrupt corporation was allowed to deduct a payment in settlement of a suit arising out of profits made by his wife from sales of the corporation's bonds. The court held that the payment by the taxpayer of attorney fees and an additional amount to a bondholders committee, pursuant to the consent judgment, was deductible. The payment was made to avoid unfavorable publicity and protect the payor's business reputation.

In Pepper v. Commissioner, 36 T.C. 886 (19611, acq., 1962-l C.B. 4, the court held that the payments made by an attorney to repay loans made to another person upon his recommendation during the course of his business were deductible since the payments were made to protect the attorney's practice. There is no requirements that there be a legal obligation to make an expenditure before it can qualify as deductible. The expenditure must only be ordinary and appropriate to the conduct of the taxpayer's business.

In United States v. Gilmore, 372 U.S. 39 (1963), the Court held that the origin and character of the claim with respect to which an expense was incurred is the controlling test of whether the expense was a deductible business expense. The deductibility of an expense depends not on the consequences that

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may or may not result from the payment, but on whether the claim arises in connection with a taxpayer's business or profit-seeking activities.

In Commissioner v. Tellier, 383 U.S. 687, 689 (1966), the Court construed the term "necessary" in the context of section 162's ordinary and necessary business expense requirement, as imposing only the minimal requirement that the expense be "appropriate and helpful" for the development of the taxpayer's business.

No court case has been found which deals with the treatment of payments by an employer to reimburse a defined contribution plan for losses suffered by the plan arising from breach of fiduciary responsibility. However, there have been many cases with similar fact patterns in which business expense deductions were allowed to taxpayers. Additional examples include Abbott v. Commissioner, 38 B.T.A. 1290 (1938) (a $10,000 liability incurred in connection with being regularly engaged in the business of serving in a fiduciary capacity); Macy v. Commissioner, 19 T.C. 409 (19521 (expenditures by executors and trustees to settle objections to their final account); Federation Bank & Trust Co. v. Commissioner, 27 T.C. 960 (1957) (the payment, by a trust company, of claims arising from alleged mismanagement of the liquidation of a bank's assets for the benefit of former depositors); and DeVito v. Commissioner, T.C. Memo 1973-377, in which the taxpayer was permitted to deduct a payment in settlement of a lawsuit for breach of a covenant not to compete and breach of fiduciary duties.

The Service's position, with respect to the deductibility of payments made to resolve actual or potential claims of legal liability, or to uphold business reputation, is consistent with the case authorities cited. Revenue Ruling 73-226, 1973-l C.B. 62, 63, states:

> Payments made "to avoid extended controversy and the expense of litigation" and "to avoid unfavorable publicity and injury to (the taxpayer's) business reputation" are currently deductible. This is the rule even though there is serious doubt as to the taxpayer's legal liability. Laurence M. Marks v. Commissioner, 27 T.C. 464, 467 (1956), acq., 1966-1 C.B. 2. Payments to settle and compromise litigation are business expenses if the motive is to protect the taxpayer "from a possible lawsuit and the exposure to liability, added legal fees, and damages to its reputation." Old Town Corp. v. Commissioner, 37 T.C. 845, 859 (1962), acq., 1962-2 C.B. 5.

In the present case, the facts indicate that the restorative payment to Plan X, in which former participants in Plan Y participate, by Company A was made to resolve actual or potential claims against Company C, a member of the same controlled group as Company A, for breach(es) of fiduciary duty which arose because Plan Y participant accounts were not credited with investment earnings for the period of time between the Valuation date(s) and the date that distributions to affected Plan Y participants were actually made.
The situation in which Company A finds itself arose in the ordinary course of Company C's trade or business. There is no serious question of its business

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origin. Substantial authority holds that payments of the type described herein, made to satisfy or preempt similar claims arising in the ordinary course of a trade or business, are deductible business expenses.

Accordingly, with respect to your fourth ruling request, we conclude as follows:

that the proposed restorative payment, described above, to the extent used to reimburse affected Plan Y participants for lost earnings as indicated above

(4) will be deductible in full by Company A pursuant to Code section 162.

With respect to your fifth ruling request, Code section 402(c)(1) provides that, if an employee transfers any portion of an eligible rollover distribution into an eligible retirement plan, the amount so transferred shall not be includible in income for the taxable year in which paid.

Code section 402(c)(4) provides that an "eligible rollover distribution" is a distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust; except that such term shall not include-

(A) any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made-

(i) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or

(ii) for a specified period of 10 years or more, and

(B) any distribution to the extent such distribution is required under section 401(a)(9).

Code section 402(c)(8)(B) defines an eligible retirement plan to include, an individual retirement account described in Code section 408(a), an individual retirement annuity described in Code section 408(b); a qualified trust, and an annuity plan described in Code section 403(a).

Code section 402(c) provides, generally, that section 402(c)(1) shall not apply to any transfer of a distribution made after the 60th day following the day on which the distributee received the property distributed.

Code section 402(c), by its terms, refers to distributions made from a Code section 401(a) retirement plan. The distributions in this case will be made from the Plan X trust account created to hold the restorative payment referenced herein. The trust account was created for the sole purposes of holding additional amounts due and making distributions to affected Plan participants in (former) Plan Y, which had been merged into Plan X.

Accordingly, with respect to your fifth ruling request, the Service concludes as follows:

(5) That distributions from the Plan X trust account, referenced above, will be "eligible rollover distributions" within the meaning of Code section 402(c)(4) in accordance with the provisions of said Code section.

This ruling letter is based on the assumption that Plan X meets the applicable section 401(a) of the Code qualifications, and that its related trust is tax-exempt within the meaning of section 501(a) of the Code. It also assumes that Plan Y met the applicable section 401(a) of the Code qualifications, and that its related trust was tax-exempt within the meaning of section 501(a) of the Code at all times relevant thereto. No opinion is expressed as to the federal tax consequences of the transactions described above under any other provisions of the Code and regulations.

Additionally, this ruling letter is based on the representation made herein that the payments described in this letter ruling will be made to resolve potential claims for breach of fiduciary duty relating to the management of Plan Y. Finally, no opinion is expressed as to the tax treatment of any conditions existing at the time of or effects resulting from the transaction that are not specifically covered by this ruling letter.

The representations herein, like all factual representations made to the Internal Revenue Service in applications for rulings, are subject to verification on audit by Service field personnel.

Pursuant to a power of attorney on file with this office, a copy of this letter ruling is being sent to your authorized representative.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan
Chief, Employee Plans
Technical Group 3
Tax Exempt and Governmental
Entities Division

Enclosures:

Deleted copy of letter ruling
Form 437