

200350017



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Uniform Issue List: 0404.00-00

SEP 17 2003

T:EP:RA:T3

Attention:

Legend

Company A =

Company Stock B =

Stock Fund M =

Plan X =

Dear

This is in response to your request dated March 22, 2002, for a private letter ruling submitted by your authorized representative concerning deductions under section 404(k) of the Internal Revenue Code (the "Code"). Letters dated September 20, 2002, December 6, 2002, January 14, 2003, and March 25, 2003, supplemented the request. Your representative has submitted the following facts and representations:

Company A maintains Plan X for the benefit of its employees, the employees of wholly owned subsidiaries and the employees of certain other related corporations. Plan X is a defined contribution plan that is qualified under section 401(a) of the Code, and includes a cash or deferred arrangement under section 401(k). Plan X provides for (1) employee elective deferrals under section 401(k), (2) employee after-tax contributions, (3) employer matching contributions as described in section 1.401(m)-1(f)(12) of the Income Tax Regulations (the "regulations"), and (4) rollover contributions.

Participants' accounts are divided into two "Sources". A participant's pre-tax contributions and earnings thereon make up one source, referred to herein as "Source A". All other contributions and earnings thereon make up the second source, referred to herein as

"Source B". Each participant directs the investment of the contributions made to each source in multiples of 1 percent among several investment alternatives including Company A Common stock Fund ("Stock Fund M"), which consists of shares of common stock of Company A ("Company Stock B"). All Source A contributions on the employee's behalf are invested pursuant to the employee's direction until the employee changes direction. The new investment direction has no effect on previous Source A contributions and earnings thereon.

A participant may also direct the transfer of previously invested funds among the investment alternatives. A participant may direct to have amounts allocated to his or her account transferred to new investment vehicles available under the plan.

Dividends on Company Stock B stock held in participants' accounts will be reinvested or received directly by the participant in accordance with the following proposed replacement for paragraph 5 of Article XI of Plan X:

"...any dividend paid with respect to shares of Company [B Stock] allocated to the account holder's accounts as of the record date of such dividend will be, as elected by the account holder prior to the payment date in the form and matter required by Company [A], (1) distributed in cash to the account holder as soon as administratively practicable following the date such dividend is paid by Company [A] (but in no event later than 90 days following the end of the Plan Year in which such dividend is paid by ...Company [A]) or (2) retained by the Trustee for credit to the account holder's accounts in [Stock Fund M]."

Company A has informed participants of their right to elect to receive dividends paid on shares of Company Stock B allocated as of the record dates of such dividends to their accounts. Each participant who has Company Stock B allocated as of the record dates of such dividends to their accounts will be entitled to make this election, which will apply to all dividends on Company Stock B allocated that are paid after the election is delivered to Company A or its delegate, unless and until the participant revokes or amends the election. A participant who does not make the election will be deemed to have elected to have dividends retained in Plan X. To the extent a participant elects to receive dividends, such dividends will be paid directly by Company A to the participant. To the extent a participant has not elected to receive dividends, such dividends shall be allocated to the participant's account under Plan X and invested in Stock Fund M.

After the dividends are allocated to a participants account and reinvested in Stock Fund M, they become subject to the participant's investment direction and may be transferred into other investment options available under the plan.

Based on the foregoing you request the following rulings:

1. Dividends that are paid by Company A on Company Stock B held in Plan X as of the record date of the dividends and that are retained in Plan X pursuant to a participant's election, are deductible under section 404(k) of the Code for the year in which the dividends are first invested in Stock Fund M.
2. Dividends that are paid by Company A on Company B Stock held in Plan A as of the record date of the dividends and that are distributed to participants pursuant to their elections, are deductible under section 404(k) of the Code on Company A's corporate income tax return for the year in which the dividends are paid to the participants.

With respect to your ruling requests, section 404(k)(1) of the Code provides that, in the case of a corporation, there shall be 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. Such deduction is in addition to the deductions allowed under section 404(a).

Section 404(k)(2) of the Code provides, in relevant part, that the term "applicable dividend" means any dividend which, in accordance with the plan provisions is paid to the plan and is distributed in cash to the participants in the plan, or their beneficiaries, not later than 90 days after the close of the plan year in which paid.

Section 404(k)(3) of the Code provides that for purposes of this subsection, "applicable employer securities" means, with respect to any dividend, employer securities which are held on the record date for such dividend by an employee stock ownership plan which is maintained by - (A) the corporation paying such dividend, or (B) any other corporation which is a member of a controlled group of corporations (within the meaning of section 409(e)(4) which includes such corporation).

Section 1.404(k)-1T, Q&A 2 of the Temporary Income Tax Regulations provides that the deductibility of dividends paid to plan participants under section 404(k) of the Code is not affected by a plan provision, which permits participants to elect to receive or not receive payment of dividends.

Section 404(k)(5)(A) of the Code provides that the Secretary may disallow the deduction under paragraph (1) for any dividend if the Secretary determined that such dividend constitutes, in substance, an evasion of taxation.

Notice 2002-2, 2002-2 IRB 285, states in Q&A 2, that a dividend is deductible if participants are offered an election between (1) either payment of dividends in cash directly to the participants, or payment to the ESOP and distribution in cash to participants within 90 days after the close of the plan year, and (2) payments of dividends to the ESOP and reinvestment in employer securities.

Q&A 3 of Notice 2002-2 that the election must be provided in a manner that satisfies the following requirements: (a) A participant must be given a reasonable opportunity before a dividend is paid or distributed to the participant in which to make the election. (b) A participant must have a reasonable opportunity to change a dividend election at least annually. (c) If there is a change in the plan terms governing the manner in which the dividends are paid or distributed to participants, a participant must be given a reasonable opportunity to make an election under the new plan terms prior to the date on which the first dividend subject to the new plan terms is paid or distributed. This Q&A goes on to state that an ESOP does not fail to comply with the requirements of Q&A-3 solely because it provides that, if a participant fails to make an affirmative dividend election, one of the options offered to participants is treated as a default election.[add]

Q&A 4 of Notice 2002-2 states when dividends are deductible. Q&A 4 states, in part, that for dividends that are retained in the plan, deductibility is the later of the corporation's income tax year in which (1) the dividends are reinvested in employer securities at the participant's election, or (2) the participant's election becomes irrevocable; and for dividends

that are paid to participants, deductibility is in the income tax year of the corporation in which the dividend is paid or distributed to the participant.

Based upon your representations, the subject dividends on Company A stock allocated to the plan participants' accounts will be subject to a participant's election to receive such amounts directly (but in no event later than 90 days following the end of the Plan year in which the dividend is paid) or to have such dividends placed in Plan X and reinvested in Company Stock B. This is in conformance with Q&A 2 of Notice 2002-2.

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

1. Dividends that are paid by Company A on Company Stock B held in Plan X as of the record date of the dividends and that are retained in Plan X pursuant to a participant's elections, are deductible under section 404(k) of the Code for the year in which the dividends are invested in Stock Fund M pursuant to paragraph 5 of Article XI of Plan X as amended.

2. Dividends that are paid by Company A on Company B Stock held in Plan A as of the record date of the dividends and that are distributed to participants pursuant to their elections, are deductible under section 404(k) of the Code on Company A's corporate income tax return for the year in which the dividends are paid to the participants.

No opinion is expressed as to the federal tax consequences of the transaction described above under any other provisions of the Code.

The above rulings are based on the assumption that Plan X and Plan Y will be otherwise qualified under section 401(a) of the Code, and the related trusts will be tax exempt under section 501(a). We also assume that the subject Company Stock B is employer securities as described in section 404(e) with regard to Plan X participants. In addition we assume that the dividend election otherwise meets the requirements of Q&A-3 of Notice 2002-2.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

A copy of this letter is being sent to your authorized representative in accordance with a power of attorney on file in this office. If you have any questions concerning this private letter ruling, please contact \*\*\*\*\* (ID \*\*\*\*\* ) at (\*\*\*) \*\*\*-\*\*\*\* (not a toll-free number).

Sincerely Yours,



Frances V. Sloan, Manager  
Employee Plans Technical Group 3  
Tax Exempt and Government Entities Division

Enclosures:

Notice of Intention to Disclose  
Deleted Copy of Ruling

CC: