

5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-133578-05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at <http://www.irs.gov/regs>, or via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS-REG-133578-05).

**FOR FURTHER INFORMATION CONTACT:**

Concerning the regulations, John T. Ricotta at (202) 622-6060 with respect to section 404(k) or Martin Huck at (202) 622-7750 with respect to section 162(k); concerning submission of comments or to request a public hearing, Robin Jones at (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background and Explanation of Provisions**

This document contains proposed regulations under sections 162(k) and 404(k) of the Internal Revenue Code (Code). These regulations address two issues that have arisen in the application of these sections. The first issue arises in a case in which the applicable employer securities held in an employee stock ownership plan (ESOP) are not securities of the corporation or corporations that maintain the plan. The issue is which corporation is entitled to the deduction under section 404(k) for certain dividends paid with respect to the stock held in the ESOP. The second issue is whether payments in redemption of stock held by an ESOP are deductible.

*Code and Regulations*

Section 404(a) provides that contributions paid by an employer to or under a stock bonus, pension, profit sharing, or annuity plan are deductible under section 404(a), if they would be otherwise deductible, within the limitations of that section. Section 404(k)(1) 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 held by an ESOP. The deduction under section 404(k) is in addition to the deductions allowed under section 404(a).

Section 4975(e)(7) provides, in relevant part, that an ESOP is a defined contribution plan that is a stock bonus

plan qualified under section 401(a) and designed to invest primarily in qualifying employer securities. Section 4975(e)(8) states that the term *qualifying employer security* means any employer security within the meaning of section 409(l). Section 409(l) generally provides that the term *employer security* means common stock issued by the employer (or a corporation that is a member of the same controlled group) that is readily tradable on an established securities market, if the corporation (or a member of the controlled group) has common stock that is readily tradable on an established securities market. Section 409(l)(4)(A) provides that, for purposes of section 409(l), the term *controlled group of corporations* has the meaning given to that term by section 1563(a) (determined without regard to subsections (a)(4) and (e)(3)(C) of section 1563). Section 409(l)(4)(B) provides that, for purposes of section 409(l)(4)(A), if a common parent owns directly stock possessing at least 50 percent of the voting power of all classes of stock and at least 50 percent of each class of nonvoting stock in a first tier subsidiary, such subsidiary (and all corporations below it in the chain which would meet the 80 percent test of section 1563(a) if the first tier subsidiary were the common parent) are treated as includible corporations.

Section 404(k)(2), for taxable years beginning on or after January 1, 2002, generally provides that the term *applicable dividend* means any dividend which, in accordance with the plan provisions—(i) is paid in cash to the participants in the plan or their beneficiaries, (ii) 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, (iii) is, at the election of such participants or their beneficiaries—(I) payable as provided in clause (i) or (ii), or (II) paid to the plan and reinvested in qualifying employer securities, or (iv) is used to make payments on a loan described in section 404(a)(9), the proceeds of which were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is 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.

Prior to 2002, section 404(k)(5)(A) provided that the Secretary may disallow the deduction under section 404(k) for any dividend if the Secretary determines that such dividend constitutes, in substance, an evasion of

**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 1**

[REG-133578-05]

RIN 1545-BE74

**Dividends Paid Deduction for Stock Held in Employee Stock Ownership Plan**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed regulations under sections 162(k) and 404(k) of the Internal Revenue Code (Code) relating to employee stock ownership plans (ESOPs). The regulations provide guidance concerning which corporation is entitled to the deduction for applicable dividends under section 404(k). These regulations also clarify that a payment in redemption of employer securities held by an ESOP is not deductible. These regulations will affect administrators of, employers maintaining, participants in, and beneficiaries of ESOPs. In addition, they will affect corporations that make distributions in redemption of stock held in an ESOP.

**DATES:** Written or electronic comments and requests for a public hearing must be received by November 23, 2005.

**ADDRESSES:** Send submissions to: CC:PA:LPD:PR (REG-133578-05), room

taxation. Section 662(b) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (115 Stat. 38, 2001) amended section 404(k)(5)(A) to provide that the Secretary may disallow a deduction under section 404(k) for any dividend the Secretary determines constitutes, in substance, an avoidance or evasion of taxation. The amendment is effective for tax years after December 31, 2001.

Section 162(k)(1) generally provides that no deduction otherwise allowable under chapter 1 of the Code is allowed for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). The legislative history of section 162(k) states that the phrase "in connection with" is "intended to be construed broadly." H.R. Conf. Rep. No. 99-841, at 168 (1986).

#### *Corporation Entitled to Section 404(k) Deduction*

An ESOP may benefit employees of more than one corporation. In addition, an ESOP may be maintained by a corporation other than the payor of a dividend. In these cases, the issue arises as to which entity is entitled to the deduction provided under section 404(k). Assume, for example, that a publicly traded corporation owns all of the stock of a subsidiary. The subsidiary operates a trade or business with employees in the U.S. and maintains an ESOP that holds stock of its parent for its employees. If the parent distributes a dividend with respect to its stock held in the ESOP maintained by the subsidiary, questions have arisen as to whether the parent or subsidiary is entitled to the deduction under section 404(k). This question arises in cases in which the parent and subsidiary file a consolidated return as well as in cases in which the parent and subsidiary do not file a consolidated return.

The IRS and Treasury Department believe that the statutory language of section 404(k) clearly provides that only the payor of the applicable dividend is entitled to the deduction under section 404(k), regardless of whether the employees of multiple corporations benefit under the ESOP and regardless of whether another member of the controlled group maintains the ESOP. Therefore, in the example above, the parent, not the subsidiary, is entitled to the deduction under section 404(k).

#### *Treatment of Payments Made To Reacquire Stock*

Some corporations have claimed deductions under section 404(k) for payments in redemption of stock held

by an ESOP that are used to make benefit distributions to participants or beneficiaries, including distributions of a participant's account balance upon severance from employment. These taxpayers have argued that the payments in redemption qualify as dividends under sections 301 and 316 and, therefore, are deductible under section 404(k).

In Rev. Rul. 2001-6 (2001-1 C.B. 491), the IRS concluded that section 162(k) bars a deduction for payments made in redemption of stock from an ESOP. This conclusion was based on the fact that section 162(k)(1) disallows a deduction for payments paid in connection with the reacquisition of an issuer's stock and that the redemption payments are such payments. The IRS also concluded that such payments were not applicable dividends under section 404(k)(1). The IRS reasoned that allowing a deduction for redemption amounts 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. Finally, the IRS stated that a deduction under section 404(k)(1) for such amounts would constitute, in substance, an evasion of tax.

In *Boise Cascade Corporation v. United States*, 329 F.3d 751 (9th Cir. 2003), the Court of Appeals for the Ninth Circuit held that payments made by a corporation to redeem its stock held by its ESOP were deductible as dividends paid under section 404(k), and that the deduction was not precluded by section 162(k). The court reasoned that the distribution by the ESOP of the redemption proceeds to the participants was a transaction separate from the redemption transaction. Therefore, the court concluded that the distribution did not constitute a payment *in connection with* the corporation's reacquisition of its stock, and section 162(k) did not bar the deduction of such payments.

For the reasons stated in Rev. Rul. 2001-6, the IRS and Treasury Department continue to believe that allowing a deduction for amounts paid to reacquire stock is inconsistent with the intent of, and policies underlying, section 404. In addition, the IRS and Treasury Department believe that allowing such a deduction would constitute, in substance, an avoidance or evasion of taxation within the meaning of section 404(k)(5)(A) because it would allow a corporation to claim two deductions for the same economic cost:

once for the value of the stock originally contributed to the ESOP and again for the amount paid to redeem the same stock. See *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934). Moreover, despite the Ninth Circuit's conclusion in *Boise Cascade*, the IRS and Treasury Department continue to believe that, even if a payment in redemption of stock held by an ESOP were to qualify as an applicable dividend, section 162(k) would disallow a deduction for that amount because such payment would be in connection with the reacquisition of the corporation's stock.

This notice of proposed rulemaking, therefore, includes proposed regulations under section 404(k) that confirm that payments made to reacquire stock held by an ESOP are not deductible under section 404(k) because such payments do not constitute applicable dividends under section 404(k)(2) and a deduction for such payments would constitute, in substance, an avoidance or evasion of taxation within the meaning of section 404(k)(5). It also includes proposed regulations under section 162(k) that provide that section 162(k), subject to certain exceptions, disallows any deduction for amounts paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). The proposed regulations also provide that amounts paid or incurred in connection with the reacquisition of stock include amounts paid by a corporation to reacquire its stock from an ESOP that are then distributed by the ESOP to its participants (or their beneficiaries) or otherwise used in a manner described in section 404(k)(2)(A).

#### **Proposed Effective Date**

These regulations are proposed to be effective on the date of issuance of final regulations. However, before these regulations become effective, the IRS will continue to assert in any matter in controversy outside of the Ninth Circuit that sections 162(k) and 404(k) disallow a deduction for payments to reacquire employer securities held by an ESOP. See Chief Counsel Notice 2004-038 (October 1, 2004) available at <http://www.irs.gov/foia> through the *electronic reading room*.

#### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure

Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

### Drafting Information

The principal authors of these regulations are John T. Ricotta, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Martin Huck of Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury participated in the development of these regulations.

### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

**Paragraph 1.** The authority citation for part 1 is amended to read, in part, as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*.

Section 1.162(k)-1 is also issued under 26 U.S.C. 162(k) \* \* \*.

Section 1.404(k)-3 is also issued under 26 U.S.C. 162(k) and 404(k)(5)(A) \* \* \*.

**Par. 2.** Section 1.162(k)-1 is added to read as follows:

#### § 1.162(k)-1 Disallowance of deduction for reacquisition payments.

(a) *In general.* Except as provided in paragraph (b) of this section, no deduction otherwise allowable is allowed under Chapter 1 of the Internal Revenue Code for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). Amounts paid or incurred in connection with the reacquisition of stock include amounts paid by a corporation to reacquire its stock from an ESOP that are used in a manner described in section 404(k)(2)(A). See § 1.404(k)-3.

(b) *Exceptions.* Paragraph (a) of this section does not apply to any—

(i) Deduction allowable under section 163 (relating to interest);

(ii) Deduction for amounts that are properly allocable to indebtedness and amortized over the term of such indebtedness;

(iii) Deduction for dividends paid (within the meaning of section 561); or

(iv) Amount paid or incurred in connection with the redemption of any stock in a regulated investment company that issues only stock which is redeemable upon the demand of the shareholder.

(c) *Effective date.* This section applies with respect to amounts paid or incurred on or after the date these regulations are published as final regulations in the **Federal Register**.

**Par. 3.** Section 1.404(k)-2 is added to read as follows:

#### § 1.404(k)-2 Dividends paid by corporation not maintaining ESOP.

Q-1: What corporation is entitled to the deduction provided under section 404(k) for applicable dividends paid on applicable employer securities of a C corporation held by an ESOP if the ESOP benefits employees of more than one corporation or if the corporation paying the dividend is not the corporation maintaining the plan?

A-1: (a) *In general.* Under section 404(k), only the corporation paying the dividend is entitled to the deduction with respect to applicable employer securities held by an ESOP. Thus, no deduction is permitted to a corporation maintaining the ESOP if that corporation does not pay the dividend.

(b) *Example.* (i) *Facts.* S is a U.S. corporation that is wholly owned by P, an entity organized under the laws of Country A that is classified as a corporation for Federal income tax purposes. P is not engaged in a U.S. trade or business. P has a single class of common stock that is listed on a stock exchange in a foreign country. In

addition, these shares are listed on the New York Stock Exchange, in the form of American Depositary Shares, and are actively traded through American Depositary Receipts (ADRs) meeting the requirements of section 409(l). S maintains an ESOP for its employees. The ESOP holds ADRs of P on Date X and receives a dividend with respect to those employer securities. The dividends received by the ESOP constitute applicable dividends as described in section 404(k)(2).

(ii) *Conclusion.* P, as the payor of the dividend, is entitled to a deduction under section 404(k) with respect to the dividends, although as a foreign corporation P does not obtain a U.S. tax benefit from the deduction. No corporation other than the corporation paying the dividend is entitled to the deduction under section 404(k). Thus, because S did not pay the dividends, S is not entitled to a deduction under section 404(k). The answer would be the same if P is a U.S. C corporation.

Q-2: What is the effective date of this section?

A-2: This section applies with respect to dividends paid on or after the date these regulations are published as final regulations in the **Federal Register**.

**Par. 4.** Section 1.404(k)-3 is added to read as follows:

#### § 1.404(k)-3 Disallowance of deduction for reacquisition payments.

Q-1: Are payments to reacquire stock held by an ESOP applicable dividends that are deductible under section 404(k)(1)?

A-1: (a) Payments to reacquire stock held by an ESOP, including reacquisition payments that are used to make benefit distributions to participants or beneficiaries, are not deductible under section 404(k) because—

(1) Those payments do not constitute applicable dividends under section 404(k)(2); and

(2) The treatment of those payments as *applicable dividends* would constitute, in substance, an avoidance or evasion on taxation within the meaning of section 404(k)(5).

(b) See § 1.162(k)-1 concerning the disallowance of deductions for amounts paid or incurred by a corporation in connection with the reacquisition of its stock from an ESOP.

Q-2: What is the effective date of this section?

A-2: This section applies with respect to payments to reacquire stock that are made on or after the date these

regulations are published as final regulations in the **Federal Register**.

**Mark E. Matthews,**

*Deputy Commissioner for Services and Enforcement.*

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