Deductible Redemption Payments

By Robert W. Wood • Wood & Porter • San Francisco

M&A TAX REPORT readers recognize the virtual axiom that redemption payments are nondeductible. It seems it could hardly be otherwise. Yet, as with almost everything, there can be exceptions. Not only that, but recently, an exception was applied by a District Court notwithstanding a rigid IRS view (announced in a revenue ruling) to the contrary. Read on.

Run of the Mill

We all know dividends paid by a corporation to its shareholders are not deductible. [Code Sec. 311.] Yet, Code Sec. 404(k) allows deductions for certain amounts paid by the corporation to an employee stock ownership plan (ESOP). These deductions are allowed for dividends paid in cash to the participants or to their beneficiaries, paid to the plan and distributed in cash to participants or beneficiaries within certain time frames, and so on.

Although Code Sec. 162 allows deductions for many business expenses, Code Sec. 162(k) expressly provides that even an otherwise allowable deduction cannot be taken if it is paid or incurred in connection with the reacquisition of corporate stock or the stock of any related person. That smarts. The IRS has long monitored Code Sec. 162(k), and that is hardly new.

Yet, in 1996, Congress expanded the no-deduction rule of Code Sec. 162(k), making it apply not only to redemptions, but also to any stock reacquisition expenses. The latest court case on this subject involved the pre–1996 Act version of Code Sec. 162(k), but it is nevertheless an important decision.

Grist for the Mill

In *General Mills, Inc.*, DC-MN, 2008-1 USTC ¶50,141 (2008), the question was whether General Mills could deduct payments it made to redeem stock held by its ESOP. During the years in question, General Mills, Inc. was the common parent company of an affiliated group. General Mills amended its various retirement plans to include ESOP components. All the ESOP assets were held by a single trust, which purchased General Mills stock for the ESOPs, and financed the purchases with outside loans.

The shares were held in a suspense account initially, but were eventually released to plan participant accounts on the payment of principal and interest on the ESOP loans. General Mills made contributions (and paid dividends) to the ESOPs. General Mills deducted the contributions and dividends under Code Sec. 404(a)(9) and 404(k)(2), respectively.

When a General Mills employee terminated, the trust would distribute the value of the terminated employee's vested ESOP account. The terminating employee could elect either stock or cash. The trust could (and did) use some of the cash proceeds from redemption dividends to satisfy its cash obligations to terminated employees.

Not So Fast

General Mills deducted its payments of cash distribution redemptive dividends. The IRS disagreed. Recognizing that Code Sec. 404(k) and Code Sec. 162(k) did not seem entirely in sync, the IRS said that even if cash distribution redemptive dividends were deductible under the former, they were disallowed under the latter. After all, weren't these amounts paid or incurred by or in connection with a redemption of the company's stock?

The IRS also pointed out that Rev. Rul. 2001-6, IRB 2001-6, 491, expressly disallowed the claimed deduction. Rev. Rul. 2001-6, 2001-1 CB 491, involved an ESOP which allowed distributions in stock or cash. The sponsoring corporation redeemed stock in the participants' accounts prior to such distributions.

The ruling addressed the question whether payments in redemption of the stock for the distribution constituted "applicable dividends" as that phrase is used in Code Sec. 404(k)(1), and thus could be deducted from the corporation's income. Putting aside the ostensible deduction for such dividends provided by Code Sec. 404(k)(1), the ruling concludes that under Code Sec. 162(k)(1), these redemption payments were made in connection with the reacquisition of the corporation's stock.

As such, said the IRS, Code Sec. 162(k)(1) barred the deduction. Reading the two Code sections together, the IRS concluded that these dividends could not be "applicable dividends" within the meaning of Code Sec. 404(k)(1).

Court Decision

General Mills evidently made the right choice handling this tax controversy in federal District Court. After all, the court here concluded that although the cash distribution redemptive dividends arose out of the same general circumstances as the redemptive dividends, they simply were not made as expenditures "in connection with" the redemptive dividends. The District Court construed the "in connection with" language of Code Sec. 162(k) as applying more narrowly.

In fact, the court said this narrow language disallowed deductions for fees and other expenses that were "necessary and incident" to a repurchase, which would otherwise be deductible business expenses. The court found that the cash distribution redemptive dividends were not expenditures "necessary and incident" to the redemptive dividends.

The court had to contend with some case law, as the case authority is mixed. Perhaps most notably, *Boise Cascade Corp.*, CA-9, 2003-1 USTC ¶50,472, 329 F3d 751 (2003), held that a corporation could deduct amounts paid to redeem shares of its stock held by an ESOP when the participants terminated employment. The Ninth Circuit in *Boise Cascade* found that even though Code Sec. 404(k) and Code Sec. 162(k) might work in tandem, payments could be deducted as dividends under Code Sec. 404(k), and these deductions were not barred by Code Sec. 162(k).

Yet, *Conopco*, DC-NJ, 2007-2 USTC ¶50,572 (2007), reached the contrary result. The IRS has not been silent, issuing regulations on August 30, 2006, that plainly shore up its viewpoint that deductions for amounts paid to reacquire stock are flatly improper. Indeed, the final regulations make clear that, in the IRS view, any other rule would allow a double deduction for the same dollars: once at the time the stock is originally contributed to the ESOP, and a second time for the amount paid to redeem the same stock. [*See* Reg. §§1.162(k)-1, 1.404(k)-3.]

These regulations are effective for amounts paid or incurred on or after August 30, 2006. Fortunately for General Mills, these regulations did not apply to the year in question, so the District Court had a free reign.

IRS Ruling

As noted above, Rev. Rul. 2001-6 takes the view that Code Sec. 162(k) trumps Code Sec. 404(k). Nevertheless, the District Court was unpersuaded that Rev. Rul. 2001-6 could be considered a determination by the Treasury Secretary. After all, the IRS Chief Counsel issued the ruling, not the Treasury Secretary. It was the Chief Counsel who concluded that a deduction under Code Sec. 404(k) would essentially constitute tax evasion. That wasn't true, said the District Court. Rev. Rul. 2001-6 was simply not a determination, so was not binding.

Presumably, the District Court would not so easily explain away final regulations, but again, the final regulations did not here apply to the year in question. To the many of us who tend to think something printed in a revenue ruling is rote (the IRS is pretty powerful after all), plucky General Mills gives a good lesson in what we shouldn't take for granted. And, for our friends at the IRS, it's a useful reminder that not all is possible in a revenue ruling.

Ultimately, terminated General Mills employees might election to receive cash and might elect to receive stock. If they elected cash, the trust had a duty (whether or not General Mills agreed to redeem the stock) to pay the employee in cash, the value of his vested ESOP account. General Mills often redeemed the stock held by the trust, so the trust could satisfy its cash distribution obligations.

But plainly, General Mills didn't have to. General Mills could—and sometimes did—reject the request for redemption made by the trust. Similarly, the trust also was not required to use the redemptive dividends to satisfy its cash distribution obligations, and on occasion, it did not do so.

Conclusion

Stock redemptions almost never give rise to tax deductions. ESOPs represent a notable exception to that rule. And, *General Mills* demonstrates that, notwithstanding Rev. Rul. 2001-6, sometimes where there is a redemption, there is a deduction.

CCH
a Wolters Kluwer business

4025 W. Peterson Ave.
Chicago, IL 60646

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH