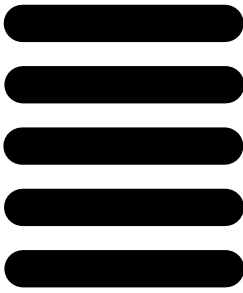




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You Can't Deduct Stock Redemption Payments

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

Just as doctors sometimes have to give bad news to patients about intractable medical problems, tax advisors also must sometimes deliver bad news. That you can't deduct payments made to redeem stock is one of those missives. Sometimes the news is well received. Depending on the extent of the taxpayer's machinations, sometimes it is best delivered early and often as a way of mitigating the substantial expenses involved in contesting such claims.

These were among my thoughts as I read the recent District Court case *Conopco, Inc.*, DC-NJ, 2007-2 USTC ¶150,582 (July 18, 2007). There, the court held that a corporation could not deduct payments made to redeem its stock held in its employee stock ownership plan (ESOP). The court made this holding even though the payments were dividends under Code Sec. 302, because the redemption payments were amounts paid to reacquire the corporation's stock. Thus, they were expressly nondeductible under Code Sec. 162(k).

Architecture of Failure

Why can't one deduct redemption payments? Code Sec. 162(k) says that an otherwise allowable deduction cannot be taken for any amount paid or incurred by a corporation in connection with the reacquisition of its stock (or the stock of any related person). The question whether a company's ESOP falls into this prohibition has been raised before.

In Rev. Rul. 2001-6, 2001-1 CB 491, the IRS ruled that a corporation could not deduct its payments in redemption of stock held by its ESOP that were used to make distributions to terminating ESOP participants. After all, said that ruling, Code Sec. 162(k)(1) prohibits this deduction, because the redemption payments are paid for the reacquisition of stock. Allowing such a deduction

ALSO IN THIS ISSUE

Tax Accrual Workpapers May Be Privileged	3
Stock Option Fundamentals	5

would (in the IRS's view) permit employers to claim deductions for payments that do not represent true costs.

ESOP Considerations

Plus, it could impair the interests of ESOP beneficiaries, including the right to reduce taxes by using return of basis under Code Sec. 72, the right to make rollovers on separation from service, and even protection against involuntary cash-outs. Trumpeting reasons why the deduction could not be allowed here, Rev. Rul. 2001-6 even says that allowing a Code Sec. 404(k)(1) deduction for such amounts would (in substance) be *tax evasion*. This is pretty acerbic stuff.

Interestingly, though, the happy-go-lucky Ninth Circuit Court of Appeals not long thereafter held that a corporation could deduct amounts it paid to redeem shares of its stock held by an ESOP when the

participants terminate employment. [*See Boise Cascade Corps.*, CA-9, 2003-1 USTC ¶15,047, 329 F3d 751 (2003).] The Ninth Circuit reached this salutary result by noting that the payments could be deducted as dividends under Code Sec. 404(k) because they qualified as dividends under Code Sec. 301 (in turn, because they simply did not qualify for exchange treatment under Code Sec. 302). Plus, the Ninth Circuit said that this deduction was not barred by Code Sec. 162(k).

Last Word?

Not to be outdone by the Ninth Circuit (heaven forbid), in 2006 the IRS issued final regulations. The regulations re-enunciate the IRS' view that allowing a deduction for amounts paid to reacquire stock is not proper. After all, voiced the IRS, doesn't that allow a corporation to claim two deductions for the same economic cost?


The corporation gets one deduction for the value of the stock it originally contributes to the ESOP. Then, if it claims a deduction for an amount paid to redeem the same stock, it gets a second bite at the apple. The regulations prevent this double dip, but were not in effect during the tax years in question in *Conopco*.

Just the Facts

We shouldn't imply that *Conopco* was an easy or obvious case. *Conopco* was a publicly held corporation with an ESOP that purchased preferred stock with debt. The trust administering the ESOP had the right to receive all dividends on the preferred, to invest the dividends, *etc.* The ESOP trustee allocated the preferred stock to participating employee accounts.

Of course, the employees participating in the ESOP had no right to receive or hold the shares that were held in their respective accounts. When an employee in the ESOP terminated *Conopco's* employment, the ESOP generally permitted them to elect to receive the value of the preferred stock as cash, as *Conopco* common stock, as an annuity, as distributions rolled into an IRA, or some combination of this panoply of choices.

Yet, *Conopco* had complete authority to direct the trustee to make payments out of



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the trust, and instructed the trustee (when terminating members requested ESOP benefit payments) to redeem the preferred shares in the terminating members' accounts. After receiving redemption proceeds, the trustee would distribute the funds in the form of benefit payments to the terminating employees. There was lots of activity.

In fact, a whopping \$47 million was paid by Conopco to redeem preferred stock from the ESOP from 1994 through 2000. Conopco filed an amended return claiming these amounts were applicable dividends deductible under 404(k)(1). The IRS just said no, and Conopco sued in District Court.

Two-Headed Dragon

It's probably not overstatement to say the IRS hates cases like this. The IRS contended that the redemption distributions could not be deducted because they were simply not dividends under Code Sec. 404(k)(2).

Alternatively, the IRS argued that even if these distributions were dividends, the deductions had to be disallowed under either Code Sec. 162(k), as an evasion of tax under Code Sec. 404(k)(5)(A), or under the "double deduction" doctrine (as in, thou shalt not claim one).

The court had some choices here, though it rejected the argument that these distributions weren't dividends. They were dividends, after all. Still, the District Court agreed with the IRS that Code Sec. 162(k) was a broad provision barring the deduction.

Short Circuit

The District Court threw out the Ninth Circuit view in *Boise Cascade* (who are these flakes in California anyway?). Ultimately, the court found that Conopco's distributions were "amount[s] paid or incurred by a corporation in connection with the reacquisition of its stock." Thus, Code Sec. 162(k) was the last word.