Nixed ESOP Redemption Payments

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Many M&A TAX REPORT readers do not regularly encounter Employee Stock Ownership Plans (ESOPs). Still, there's been no shortage of interest in (and authority concerning) ESOPs over the last few years. This is particularly so concerning the tax treatment of redemptions.

To review our recent hit parade on this subject, THE M&A TAX REPORT covered *Deductible Redemption Payments,* M&A TAX REP., Mar. 2008, at 6, then reported when the *Eighth Circuit has General Mills for Breakfast,* M&A TAX REP., Mar. 2009, at 1, and most recently, wrote *More on ESOP Redemption Deductions,* M&A TAX REP., May 2009, at 5.

Now, there's more news to report, with the Third Circuit in *Conopco, Inc.*, CA-3, 2009-2 USTC ¶50,492 (2009) affirming the district court holding that a corporation could not deduct payments to redeem stock held in its ESOP. These payments, said the Third Circuit, were to *reacquire* the stock and thus were not deductible under our old friend Internal Revenue Code Section ("Code Sec.") 162(k).

ESOP Benefits

ESOPs, as M&A TAX REPORT readers surely know, are special employee benefit plans designed to hold employer stock. Although the deals are certainly not free from complexity or difficulty, more than a few businesses have found ESOP gold. After all, if they are unable to locate a prospective buyer for the business, it may be possible to create an ESOP and then to sell the business (or at least part of it) to the ESOP.

If one can navigate the various requirements—that certainly include fiduciary concerns and valuation difficulties—the economic and tax benefits can be truly outstanding. Deductible contributions, favorable interest provisions and even estate planning advantages can be had. Turning to more mundane operations, though, one continuing question is the extent to which a corporation in such a circumstance can deduct payments made to the ESOP.

We know, of course, that dividends paid by a corporation to its shareholders are not deductible. [Code Sec. 311.] Nevertheless, Code Sec. 404(k) allows a corporation to deduct the amount of certain dividends it pays to an ESOP. A deduction is permitted if the dividend is:

- paid in cash to the participants or their beneficiaries;
- paid to the ESOP and distributed in cash to participants or beneficiaries not later than 90 days after the close of the plan year;
- at the election of the participants or beneficiaries, either payable as provided in the first two rules above, or paid to the plan and then reinvested in qualifying employer securities; or
- used to make payments on an ESOP loan that was used to acquire the employer securities.

In the face of these rules provided by Code Sec. 404(k)(2), however, one faces the deduction denial of Code Sec. 162(k)(1).

Code Sec. 162(k) Trump Card

That section disallows any deduction for an amount paid or incurred by a corporation in connection with a reacquisition of its stock. But between Code Secs. 162(k)(1) and 404(k)(2), which rule takes precedence? The IRS position on this is pretty darn clear.

In fact, Rev. Rul. 2001-6, 2001-1 CB 491, says that a corporation cannot deduct its payments in redemption of stock held by its ESOP. Code Sec. 162(k)(1) bars the deduction, says the IRS, because the redemption payments are paid for the reacquisition of stock. Of course, that's just the IRS.

Notwithstanding the IRS position, the Ninth Circuit disagreed in *Boise Cascade Corp.*, CA-9, 91 AFTR 2nd 2003-2280 (2003). In a similar case, the Tax Court in *Ralston Purina Company and Subsidiaries,* 131 TC No. 4, Dec. 57,534 (2008), agreed with the IRS, saying the deduction would not be allowed. The district court had ruled for the taxpayer in *General Mills*, but the Eighth Circuit sided with the IRS. [*See General Mills, Inc.*, CA-8, 2009-1 USTC ¶50, 177 (2009).]

Now, the Third Circuit has given the IRS another victory in *Conopco.* Conopco had an ESOP holding preferred Conopco stock. When terminating employees requested ESOP benefit payments, Conopco would redeem the preferred shares in terminating employee accounts. That redemption and resulting cash would enable the trustee of the ESOP to distribute those moneys.

Conopco deducted the payments. Predictably, the IRS disagreed. When the matter reached the Third Circuit, the Appeals Court focused on the question whether such payments were made "in connection with the reacquisition of its stock." The Third Circuit concluded that Code Sec. 162(k)(1) disallowed Conopco's deductions.

In doing so, the court referred favorably to the Eighth Circuit decision in *General Mills*, and to the Tax Court decision in *Ralston Purina Co.* Conopco's primary argument was that although these payments might *look* prohibited, they were flatly not barred by Code Sec. 162(k)(1). After all, argued Conopco, the trust's distribution of benefits to participants was not made "in connection with" the redemption. Conopco relied on *Boise Cascade.* The Third Circuit disagreed and ruled for the IRS.

Tempest in a Teapot?

M&A TAX REPORT readers may recall that in 2006, the IRS issued final regulations that were meant to solidify its position that no deduction would be allowed in these circumstances. These regulations were not in effect when the deductions claimed by Conopco and the various other companies noted here were claimed. A taxpayer would face an even tougher battle on this point under the 2006 final regulations, which probably means this spate of ESOP redemption payment authorities will soon be petering out.