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This pro-dividend rule of Section 404(k) would appear to be absolute in operation. However, the legislative history to the provision indicates that only dividends that are “reasonable” can be deducted, and that the deductibility of dividends also can be limited by general tax evasion principles.

TAM Suggests Limits

Technical Advice Memorandum 9304003 suggests that these potential limits on the Section 404(k) deduction are more real than imagined. In that ruling, an ESOP bought 30% of the stock from the sole shareholder. In a later series of transactions, stock was sold to an unrelated party, the former sole shareholder’s remaining 70% was redeemed, and the majority of the stock was held by the ESOP.

Eventually, the ESOP held 30% and the outsider 70%. The ESOP applied a portion of the proceeds from the redemption to the outstanding debt. Later, the corporation claimed a deduction under Section 404(k) for payments to the ESOP that were applied to the outstanding debt.

What is “Reasonable”?

The question was whether the deduction for a dividend was appropriate here. After all, this transaction was a pro rata redemption of 90% of the stock. While the notion of reasonableness may not be too clear in this context, the TAM suggests that a dividend that is greatly in excess of the dividend that the ESOP sponsor could be expected to pay on a recurring basis should not be regarded as reasonable. The TAM determined that a dividend must be reasonable to be deductible under Section 404(k), and that a dividend is reasonable if it is paid at a rate that

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Problems with Repaying ESOP Loans

by Robert W. Wood • Bancroft & McAlister

These days, it seems more popular to undo Employee Stock Ownership Plan (“ESOP”) buyouts than to do them. Nonetheless, a seller’s incentives to accomplish an ESOP buyout remain strong, because of the ability to sell stock to an ESOP and roll the proceeds over tax-free into marketable securities. A related benefit is the deductibility of dividends on the stock when the dividends are used to repay ESOP-related debt. Plus, under Section 404(k), cash dividends used to repay a qualified ESOP loan do not violate the rule that a tax-qualified retirement plan must be used only for the exclusive benefit of employees.

