

Redemption Payments: Deduct or Capitalize?

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OK, usually you don't have a choice about deducting or capitalizing redemption payments, but sometimes you may. Indeed, in the March 2008 issue of the M&A TAX REPORT, we covered the seemingly oxymoronic topic of deductible redemption payments. [See Wood, *Deductible Redemption Payments*, M&A TAX REP., Mar. 2008, at 6.] Despite the normal rule that redemption payments are nondeductible, Section 404(k) of the Internal Revenue Code ("Code Sec.") allows deductions for certain amounts paid by a corporation to an employee stock ownership plan (ESOP). In March, I reported on *General Mills, Inc.*, DC-MN, 2008-1 USTC ¶50,141 (2008).

The issue in that case was whether General Mills could deduct payments it made to redeem stock held by its ESOP. There was good reason for the redemptions, since the redemptions were needed to pay off ESOP participants who were exiting the plan. The IRS disagreed with the deduction, but General Mills prevailed in District Court.

Code Sec. 162: Trump Card?

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 sounds definitive. Plus, in 1996, Congress expanded this provision to apply not only to redemptions, but also to *any* stock reacquisition expenses. *General Mills* involved the pre-1996 Act version of Code Sec. 162(k).

Ralston Purina

Now, the Tax Court in a reviewed decision (meaning all the judges participate) has said a corporation cannot deduct payments to redeem stock held in its ESOP. In so holding, the Tax Court disagreed with *General Mills*. The new Tax Court case is *Ralston Purina*, 131 TC —, No. 4 (2008).

Yet, arguably the most important decision on this point is *Boise Cascade Corps*, CA-9, 2001-1 USTC ¶50,472, 329 F3d 751 (2003). In *Boise Cascade*, the Ninth Circuit allowed a deduction for amounts paid to redeem shares of stock held by an ESOP because the sales arose on

the termination of participants' employment. Even though Code Sec. 404(k) and Code Sec. 162(k) might work in tandem, said the Ninth Circuit, payments could *still* be deducted as dividends under Code Sec. 404(k), and they were not barred by Code Sec. 162(k).

This may be coming to a head, for the Tax Court in *Ralston Purina* rejected the Ninth Circuit view. Much more to the Tax Court's liking was *Conopco, Inc.*, DC-NJ (unpublished opinion), 2007-2 USTC ¶50,582. In *Conopco*, the IRS prevailed. Of course, in addition to pushing its agenda in case law, the IRS has been active on the regulatory front too, issuing final regulations that bar the deduction. [See Reg. §1.162(k)-1; see also Reg. §1.404(k)-3.] These regulations are effective for amounts paid or incurred on or after August 30, 2006.

Split in Circuits?

Ralston Purina set up its ESOP in 1989 and authorized convertible preferred stock, which could only be issued in the name of the ESOP trustee. Plus, this class of convertible preferred was not readily tradable. These shares could receive cumulative cash dividends only when, as and if declared.

Ralston Purina's ESOP purchased a number of shares of this stock. Employee participation ended upon termination of employment, regardless of the reason for that termination. As with so many similar plans, terminated participants could either cash out their investment of the ESOP or make other elections.

Significantly, the plan could, in its sole discretion, require *Ralston Purina* to redeem shares at any time upon notice, whenever necessary to provide required distributions to terminated participants, or to make payments on the ESOP loan. The payment to terminate a participant could be made—at the plan's option—in cash or in shares of *Ralston Purina* common stock.

In 1994 and 1995, *Ralston Purina* redeemed a large number of preferred shares and made distributions to participants. *Ralston Purina* claimed a deduction under Code Sec. 404(k) for the amount it paid to the plan to redeem the shares. The Tax Court ruled that Code Sec. 162(k) barred the deduction.

Revenue Ruling Too

Apart from the mixed case law, and the regulations that kill the deduction for amounts paid on income after August 30, 2006, there's also a revenue ruling. Rev. Rul. 2001-6, 2001-1 CB 491, involved an ESOP that allowed distributions in stock or cash. The sponsoring corporation redeemed stock in the participants' accounts prior to such distributions.

The ruling addressed the question of 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).

Tax Avoidance?

Interestingly, Judge Swift wrote a concurring opinion, arguing that the deduction shouldn't have been allowed under Code Sec. 404(k)(5). That section disallows deductions for any dividend if the IRS determines that the dividend constitutes, in substance, an evasion of tax. That seems a stretch, but his argument was that allowing a deduction for redemption dividends would constitute impermissible tax evasion. Perhaps that argument might fly if the final regulations were applicable, but they only kicked in for amounts paid or incurred on or after August 30, 2006. Still, Judge Swift said they were relevant, since they were consistent with Rev. Rul. 2001-6, 2001-1 CB 491.

Not So Fast

We probably haven't heard the last of this flap. With *Ralston Purina* (which is appealable to the Eight Circuit), it certainly seems possible that we may have a split in the circuits in the offing. ESOPs can be wonderful vehicles, but they can also be quite expensive.

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