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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9282]

RIN 1545-BE74

Dividends Paid Deduction for Stock Held in Employee Stock Ownership Plan

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under sections 162(k) and 404(k) of the Internal Revenue Code (Code) providing that a payment in redemption of employer securities held by an employee stock ownership plan (ESOP) is not deductible. These regulations generally affect administrators of, employers maintaining, participants in, and beneficiaries of ESOPs. In addition, they will affect corporations that make distributions in redemption of stock held in an ESOP.

DATES: *Effective Date:* These regulations are effective on August 30, 2006.

Applicability Dates: These regulations apply with respect to payments to reacquire stock that are made on or after and amounts paid or incurred on or after August 30, 2006. See §§ 1.162(k)-1(c) and 1.404(k)-3, Q&A-2.

FOR FURTHER INFORMATION CONTACT: John T. Ricotta at (202) 622-6060 with respect to section 404(k) or Jennifer D. Sledge at (202) 622-7750 with respect to section 162(k) (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations (26 CFR part 1) under sections 162(k) and 404(k) of the Code.

Section 162(k)(1) generally provides that no deduction otherwise allowable under chapter 1 of the Code is allowed for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). The legislative history of section 162(k) states that the phrase "in connection with" is "intended to be construed broadly." H.R. Conf. Rep. No. 99-841, at 168 (1986).

Section 404(k)(1) provides a deduction for an applicable dividend paid in cash by a C corporation with

respect to applicable employer securities held by an ESOP, as defined in section 4975(e)(7). Section 404(k)(2) generally provides that the term *applicable dividend* means any dividend which, in accordance with the plan provisions, is either paid in cash to plan participants or beneficiaries or paid to the plan and distributed in cash to participants or beneficiaries not later than 90 days after the close of the plan year in which paid. An applicable dividend also includes a dividend which, at the election of participants or their beneficiaries, is payable as provided in the preceding sentence or paid to the plan and reinvested in qualifying employer securities. Finally, an applicable dividend also includes a dividend that is used to make payments on a loan described in section 404(a)(9), the proceeds of which were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid. Under section 404(k)(4), the deduction is allowable in the taxable year of the corporation in which the dividend is paid or distributed to the participant or beneficiary.

Prior to 2002, section 404(k)(5)(A) provided that the Secretary may disallow the deduction under section 404(k) for any dividend if the Secretary determines that such dividend constitutes, in substance, an evasion of taxation. Section 662(b) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (115 Stat. 38, 2001) amended section 404(k)(5)(A) to provide that the Secretary may disallow a deduction under section 404(k) for any dividend the Secretary determines constitutes, in substance, an avoidance or evasion of taxation.

Rev. Rul. 2001-6 (2001-1 CB 491) (see § 601.601(d)(2) of this chapter), states that distributions to participants of amounts paid by an employer to reacquire shares of its stock from the employer's ESOP (redemption proceeds) are made in connection with the reacquisition of the employer's stock and that section 162(k)(1) therefore bars the deduction under these circumstances regardless of whether the distributions to participants would otherwise be deductible under section 404(k). The revenue ruling also states that the treatment of redemption proceeds as "applicable dividends" under section 404(k) would produce such anomalous results that the section cannot reasonably be construed as encompassing such payments. The revenue ruling states that the application of section 404(k) to redemption proceeds not only would

allow employers to claim deductions for payments that do not represent true economic costs, but also, as further explained below, would vitiate important rights and protections for recipients of ESOP distributions. Finally, the ruling states that a deduction would be disallowed under section 404(k)(5)(A) because a deduction under these circumstances would constitute, in substance, an evasion of taxation.

These positions were reiterated in Notice 2002-2, Q&A-11 (2002-2 CB 285) (See § 601.601(d)(2) of this chapter), which states that, in accordance with Rev. Rul. 2001-6, payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants constitute an evasion of taxation under section 404(k)(5)(A) and are not applicable dividends under section 404(k)(1). Moreover, the notice states that any deduction for such payments in redemption of stock is barred under section 162(k).

Notice 2002-2 (Q&A-7) also discusses the tax treatment of section 404(k) dividend distributions, stating that dividends paid in cash to a participant (rather than reinvested at the option of the participant under section 404(k)(2)(A)(iii)) are taxable without regard to the return of basis provisions under section 72, and are not subject to the consent requirements of section 411(a)(11) or the distribution restrictions of section 401(k)(2)(B). In addition, the Notice provides that dividends paid to participants under section 404(k) are not eligible rollover distributions under section 402(c), even if the dividends are distributed at the same time as amounts that do constitute an eligible rollover distribution (or are reported on Form 1099-R (Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.) in accordance with Announcement 85-168).¹ See also § 1.402(c)-2, Q&A-4(e), under which dividends paid on employer securities under section 404(k) are not eligible rollover distributions under section 402(c).

In *Boise Cascade Corporation v. United States*, 329 F.3d 751 (9th Cir. 2003), the Court of Appeals for the Ninth Circuit held that payments made by the issuer of stock to redeem its stock held by its ESOP were deductible as dividends paid under section 404(k), and that the deduction was not

¹ Announcement 85-168 (1985-48 IRB 40) states that section 404(k) distributions are reportable as dividends on a recipient's tax return and that such distributions are fully taxable without regard to return of basis.

precluded by section 162(k). The IRS issued Chief Counsel Notice 2004-038 (October 1, 2004) (available at <http://www.irs.gov/foia> through the *electronic reading room*) to indicate that it disagreed with the Court's interpretation and would continue to assert in any matter in controversy outside the Ninth Circuit that sections 162(k) and 404(k) disallow a deduction for payments to reacquire employer securities held by an ESOP. For any matter in controversy within the Ninth Circuit, agents or district counsel attorneys are to consult the National Office.

A notice of proposed rulemaking containing proposed regulations under sections 162(k) and 404(k) was issued on August 25, 2005 (70 FR 49897) to address two issues: (1) Which corporation is entitled to the deduction for applicable dividends under section 404(k) where the payor and employer are different entities; and (2) whether a payment in redemption of employer securities held by an ESOP is deductible. The issue in the proposed regulations concerning which corporation is entitled to the deduction for applicable dividends under section 404(k) is expected to be addressed in future regulations.

The notice of proposed rulemaking included proposed regulations under section 404(k) that would provide that payments made to reacquire stock held by an ESOP are not deductible under section 404(k) because such payments would not constitute applicable dividends under section 404(k)(2) and a deduction for such payments would constitute, in substance, an avoidance or evasion of taxation within the meaning of section 404(k)(5) because it would allow a corporation to claim two deductions for the same economic cost. It also included proposed regulations under section 162(k) providing that section 162(k), subject to certain exceptions, would disallow any deduction for amounts paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). Finally, the proposed regulations provided that amounts paid or incurred in connection with the reacquisition of stock include amounts paid by a corporation to reacquire its stock from an ESOP that are then distributed by the ESOP to its participants (or their beneficiaries) or otherwise used in a manner described in section 404(k)(2)(A).

A public hearing on the proposed regulations was held on January 18, 2006. After consideration of the comments received, these final regulations adopt without material

change the provisions of the proposed regulations concerning payments in redemption of employer securities held by an ESOP.

Explanation of Provisions

With respect to the treatment of payments in redemption of employer securities, these final regulations adopt the rule of the proposed regulations under which payments made to reacquire stock held by an ESOP are not deductible under section 404(k) because such payments do not constitute applicable dividends under section 404(k)(2) and a deduction for such payments would constitute, in substance, an avoidance or evasion of taxation within the meaning of section 404(k)(5). These final regulations also adopt the rule of the proposed regulations that explicitly provides that section 162(k) disallows any deduction, including any deduction under section 404(k), for amounts paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). In addition, these final regulations adopt the rule of the proposed regulations providing that amounts paid or incurred in connection with the reacquisition of stock include amounts paid by a corporation to reacquire its stock from an ESOP that are then distributed by the ESOP to its participants (or their beneficiaries) or otherwise used in a manner described in section 404(k)(2)(A).

These provisions aroused little opposition and only two comments were received regarding the treatment of payments made to reacquire stock. A trade association representing companies that sponsor ESOPs supported the position of the proposed regulations that a repurchase of shares of ESOP stock from ESOP participants in a stock redemption does not qualify as a deductible dividend under section 404(k).

The other commentator disagreed with the position in the proposed regulations, arguing that redemptions of stock held by an ESOP that are recharacterized as dividends under section 302 nevertheless are proper dividends that should be treated the same as ordinary dividends paid with respect to stock held by an ESOP. The commentator argued that, by enacting section 404(k), Congress intended to allow a double deduction for contributions to purchase employer stock because the value of stock purchased with employer contributions includes the present value of expected future dividends. Thus, the commentator argued, a deduction for

redemptive proceeds should not be characterized as an avoidance or evasion of taxation within the meaning of section 404(k)(5). Finally, the commentator argued that, because the legislative history to section 162(k) does not specifically refer to section 404(k) dividends and section 162 was enacted only two years after section 404(k), section 162(k) does not preclude a deduction for a redemptive dividend under section 404(k).

These arguments are unpersuasive. Although the present value of expected future dividends is an element of the value of shares of stock at any point in time, and Congress did authorize a current deduction for the value of stock contributions to qualified plans, as well as a later deduction for certain dividends paid on those shares under section 404(k), these deductions are carefully limited to dividends actually paid in certain specified ways while the stock is held by the ESOP. There is no evidence that Congress intended to authorize yet another deduction for the full value of the shares upon their redemption. To allow a deduction for redemption proceeds would be to allow a second deduction that includes the present value of dividends that are paid out after the date of distribution from the ESOP, contrary to the intent of the statute. Moreover, the amount of the deduction with respect to a redemption could be many times the amount that would be deducted for that year for a conventional dividend. (In fact, permitting a second deduction for the full value of the shares would allow a corporation to claim one deduction for a share of stock contributed to an ESOP and allocated to an employee early in a tax year and another deduction if the share is redeemed to make a distribution to the employee later in the same tax year.) There is no indication that such a result was intended and there is no obvious purpose that would be served by such a result.

Congress recognized that an arrangement that might be argued to come within the literal language of section 404(k) might nevertheless be inconsistent with its purpose. Congress therefore granted authority to the Secretary, in section 404(k)(5)(A), to disallow a deduction for any dividend that the Secretary finds to be, in substance, an evasion of taxation. The statute was clarified, for years beginning in 2002, to explicitly broaden that authority to permit the Service to disallow any deduction that is an avoidance or evasion of taxation. A deduction for redemption proceeds is both excessive in amount and inconsistent with the purpose of section

404(k), so that this is clearly an appropriate case for the authority under section 404(k)(5)(A) to be exercised.²

The IRS and Treasury Department also continue to believe, as provided in Rev. Rul. 2001-6, that a deduction for redemption of benefit distributions is appropriately disallowed under section 404(k)(5)(A) because a deduction under these circumstances would constitute, in substance, an evasion of taxation. As stated in Rev. Rul. 2001-6, the treatment of redemption proceeds as “applicable dividends” under section 404(k) would produce such anomalous results that the section cannot reasonably be construed as encompassing such payments. As one example, if a redemption of a benefit distribution were an applicable dividend under section 404(k), there would be no reason why such a redemption could only occur once with respect to a participant, so that multiple redemptions (or theoretically even an unlimited number of redemptions)³ might be possible, a result that is clearly not consistent with the intent of section 404(k).

Further, as described in Rev. Rul. 2001-6, the application of section 404(k) to redemption amounts also would vitiate important rights and protections for recipients of ESOP distributions. These important rights and protections include the right to apply the return of basis provisions under section 72 (whereas an applicable dividend under section 404(k) is includible in gross income without regard to return of basis under section 72), and the protection against involuntary cash-outs (section 411(a)(11)). See section 72(e)(5)(D), and Q&A-7 of Notice 2002-2, 2002-1 CB 285. Similarly, if redemption amounts distributed as a normal benefit distribution were treated as an applicable dividend under section 404(k), then a participant would not have the right to elect a direct or indirect rollover with respect to redemption proceeds that are distributed from the ESOP, and any notice provided to the employee as required by section 402(f) would have to

identify the loss of this valuable right to the participant. See § 1.402(c)-2, Q&A-4(e).

Congress also provided for other special treatment for applicable dividends under section 404(k) that would be inconsistent with redemption of a normal benefit distribution being treated as an applicable dividend under section 404(k). Section 72(t)(2)(A)(vi) provides for an exception to the 10 percent additional income tax for early distributions for dividends paid with respect to stock of a corporation which are described in section 404(k). Further, section 404(k)(5)(B) provides that a plan will not violate the requirements of sections 401, 409, or 4975(e)(7) or be engaging in a prohibited transaction merely by reason of distributing an applicable dividend under section 404(k). Thus, for example, a distribution of an applicable dividend under section 404(k) is not subject to the prohibition against in-service distributions of amounts attributable to elective deferrals under section 401(k)(2). Clearly, these broad exceptions under section 72(t)(2)(A)(vi) and 404(k)(5)(B) were not intended to apply to normal benefit distributions from ESOPs, essentially at the election of the employer or distributee.

Finally, even if the IRS declined to exercise its authority under section 404(k)(5)(A), the plain language of section 162(k) precludes the deduction for payments by a corporation to redeem its stock including deductions otherwise allowed under section 404(k). As described under the *Background* section of this preamble, section 162(k) provides that “no deduction otherwise allowable shall be allowed *under this chapter* for any amount paid or incurred by a corporation in connection with the reacquisition of its stock” (emphasis added) and section 404(k) is in the same chapter as section 162(k). The commentator’s attempt to avoid the effect of the plain language of the statute by reference to a supposed negative inference in the legislative history is unavailing.

Accordingly, these regulations adopt the rule in the proposed regulations without material change.

Effective Date

Section 1.162(k)-1 applies with respect to amounts paid or incurred on or after August 30, 2006.

Section 1.404(k)-3 applies with respect to payments to reacquire stock that are made on or after August 30, 2006. Rev. Rul. 2001-6 remains in effect for all periods, including periods before the effective date of this regulation.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are John T. Ricotta, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Jennifer D. Sledge, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.162(k)-1 is also issued under section 26 U.S.C. 162(k). * * *

Section 1.404(k)-3 is also issued under sections 26 U.S.C. 162(k) and 404(k)(5)(A). * * *

■ **Par. 2.** Section 1.162(k)-1 is added to read as follows:

§ 1.162(k)-1 Disallowance of deduction for reacquisition payments.

(a) *In general.* Except as provided in paragraph (b) of this section, no deduction otherwise allowable is allowed under Chapter 1 of the Internal Revenue Code for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). Amounts paid or incurred in connection with the

² Given the special rules of section 409(h) which generally entitle participants to receive cash for employer securities that are not publicly traded, if Congress had so intended, it would likely have identified the interaction of these provisions in light of the potentially large additional deductions such a rule would permit. Cf., *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934).

³ For example, a plan participant might elect to have his or her account balance redeemed to the extent invested in employer securities, and then promptly have the cash reinvested in employer securities, and then could immediately repeat this redemption/reinvestment process with no theoretical limit.

reacquisition of stock include amounts paid by a corporation to reacquire its stock from an ESOP that are used in a manner described in section 404(k)(2)(A). See § 1.404(k)-3.

(b) *Exceptions.* Paragraph (a) of this section does not apply to any—

(1) Deduction allowable under section 163 (relating to interest);

(2) Deduction for amounts that are properly allocable to indebtedness and amortized over the term of such indebtedness;

(3) Deduction for dividends paid (within the meaning of section 561); or

(4) Amount paid or incurred in connection with the redemption of any stock in a regulated investment company that issues only stock which is redeemable upon the demand of the shareholder.

(c) *Effective date.* This section applies with respect to amounts paid or incurred on or after August 30, 2006.

■ **Par. 3.** Section 1.404(k)-3 is added to read as follows:

§ 1.404(k)-3 Disallowance of deduction for reacquisition payments.

Q-1: Are payments to reacquire stock held by an ESOP applicable dividends that are deductible under section 404(k)(1)?

A-1: (a) Payments to reacquire stock held by an ESOP, including reacquisition payments that are used to make benefit distributions to participants or beneficiaries, are not deductible under section 404(k) because—

(1) Those payments do not constitute applicable dividends under section 404(k)(2); and

(2) The treatment of those payments as applicable dividends would constitute, in substance, an avoidance or evasion of taxation within the meaning of section 404(k)(5).

(b) See also § 1.162(k)-1 concerning the disallowance of deductions for amounts paid or incurred by a corporation in connection with the reacquisition of its stock from an ESOP.

Q-2: What is the effective date of this section?

A-2: This section applies with respect to payments to reacquire stock that are made on or after August 30, 2006.

Approved: August 22, 2006.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Eric Solomon,

Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

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DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Part 154

[DoD-2006-OS-0038]

Department of Defense Personnel Security Program Regulation

AGENCY: Office of the Secretary, DoD.

ACTION: Interim final rule.

SUMMARY: This rule is published to streamline personnel security clearance procedures and make the process more efficient within the Department of Defense. This will simplify security processing and allow the deserving public to obtain a security clearance in a more efficient manner.

DATES: This rule is effective September 1, 2006. Written comments received at the address indicated below by October 30, 2006 will be accepted.

ADDRESSES: You may submit comments, identified by docket number and or RIN number and title, by any of the following methods:

• Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.

• Mail: Federal Docket Management System Office, 1160 Defense Pentagon, Washington, DC 20301-1160.

Instructions: All submissions received must include the agency name and docket number or Regulatory Information Number (RIN) for this **Federal Register** document. The general policy for comments and other submissions from members of the public is to make these submissions available for public viewing on the Internet at <http://regulations.gov> as they are received without change, including any personal identifiers or contact information.

FOR FURTHER INFORMATION CONTACT: Charleen Wright, 703-697-3039.

SUPPLEMENTARY INFORMATION: This rule is published as an interim rule because it takes effect on September 1 under the authority of National Security Adviser directing immediate implementation.

Executive Order 12866, "Regulatory Planning and Review"

It has been determined that 32 CFR part 154 is not a significant regulatory action. The rule does not:

(1) Have an annual effect on the economy of \$100 million or more or adversely affect in a material way the economy; a section of the economy; productivity; competition; jobs; the environment; public health or safety; or State, local, or tribal governments or communities;

(2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another Agency;

(3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs, or the rights and obligations of recipients thereof; or

(4) Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive Order.

Unfunded Mandates Reform Act (Sec. 202, Pub. L. 104-4)

It has been certified that this rule does not contain a Federal mandate that may result in the expenditure by State, local and tribal governments, in aggregate, or by the private sector, of \$100 million or more in any one year.

Public Law 96-354, "Regulatory Flexibility Act" (5 U.S.C. 601)

It has been certified that this rule is not subject to the Regulatory Flexibility Act (5 U.S.C. 601) because it would not, if promulgated, have a significant economic impact on a substantial number of small entities. This part will streamline personnel security clearance procedures and make the process more efficient.

Public Law 96-511, "Paperwork Reduction Act" (44 U.S.C. Chapter 35)

It has been certified that this rule does not impose reporting or recordkeeping requirements under the Paperwork Reduction Act of 1995. The reporting and recordkeeping requirements have been submitted to OMB for review.

Executive Order 13132, "Federalism"

It has been certified that this rule does not have federalism implications, as set forth in Executive Order 13132. This rule does not have substantial direct effects on:

(1) The States;

(2) The relationship between the National Government and the States; or

(3) The distribution of power and responsibilities among the various levels of Government.

List of Subjects in 32 CFR Part 154

Classified information; Government employees; Investigations; Security measures.

■ Accordingly, 32 CFR part 154 is amended as follows:

PART 154—DEPARTMENT OF DEFENSE PERSONNEL SECURITY PROGRAM REGULATION

■ 1. The authority citation for 32 CFR part 154 continues to read as follows:

Authority: E.O. 10450, 18 FR 2489, 3 CFR, 1949-1953 Comp., p. 936; E.O. 12356, 47 FR