

Internal Revenue Service

200006053
Department of the Treasury

Washington, DC 20224

**Uniform Issue List: 404.00-00
3402.00-00**

Contact Person:

Telephone Number:

In Reference to:

Date: **OP:E:EP:T:3**

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Attention:

NOV 15 1999

Legend

Company A =

Plan X =

Fund M =

Dear Mr.

This in reply to your ruling request of May 2, 1997 submitted on your behalf by your authorized representative, regarding the federal income tax consequences of certain amendments to Plan X. The request was supplemented by a letter dated January 26, 1999. The following facts and representations have been submitted by your authorized representative.

Company A established Plan X on January 1, 1985. Plan X is a cash or deferred arrangement. Plan X is qualified under Code sections 401(a) and 401(k) of the Internal Revenue Code, and the accompanying trust is exempt under Code section 501 (a).

Under Plan X, nonunion employees of Company A and its participating subsidiaries may receive: (1) pre-tax elective contributions pursuant to Code section 401 (k), (2) matching contributions pursuant to Code section 401 (m), (3) profit sharing contributions pursuant to Code section 401 (a), and (4) rollover contributions. Prior to January 1, 1988, certain deductible employee contributions were permitted, and prior to January 1, 1993, employee after-tax contributions were permitted. Union employees covered by Plan X may receive pre-tax elective contributions and rollover contributions.

Plan X offers a number of investment subfunds, including Fund M, which is invested in Company A securities.

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Company A amended Plan X, effective January 1, 1997, to convert the portion of Plan X that is invested in Fund M into an employee stock ownership plan within the meaning of Code section 4975(e)(7) and section 407(d)(6) of the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**"). Therefore, the ESOP consists of all Stock Match Accounts, all Stock **Profit** Sharing Accounts and all other accounts to the extent those accounts are invested in Fund M. This ESOP amendment allows Company A to pay to Plan X participants and beneficiaries any dividends declared on and after January 1, 1997, on Company A stock held in Plan X.

Company A proposes that any dividend paid with respect to Company A stock allocated to the participants' accounts ("**ESOP** Dividends") could be paid in accordance with one of the three dividend passthrough methods described below.

Method 1: ESOP Dividends would be automatically paid directly in cash to the participant or beneficiary.

Method 2: ESOP Dividends would be paid directly in cash to the participant or beneficiary unless the participant or beneficiary files an election against receiving such payment, in which **case**, the dividends would be credited to the participants or beneficiary's accounts as investment gains.

Method 3: ESOP Dividends would be paid directly in cash to the participant or beneficiary only if the participant or beneficiary files an election to receive the payment. Unless such election is made, the dividends would be credited to the participant's or beneficiary's accounts as investment gains.

Company A also amended Plan X to allow special elective deferrals under Code section 401(k) in amounts equal to the amounts that are paid directly to participants as ESOP Dividends. Company A proposes that such elective deferrals would be accomplished through one of the following two procedures:

Procedure A: A participant who receives a **cash** ESOP Dividend payment would be deemed to have made a special salary deferral from the next payroll period equal to the dollar amount of the ESOP Dividend, subject to the limits of Code sections 401 (k), 402(g) and 415, and the regulations thereunder, unless the participant files an election against making such special deferral. Any deferral would be allocated to the participant's Pre-Tax Account and would be invested in Fund M.

Procedure B: A Participant who receives a cash ESOP Dividend payment would make a special salary deferral from the next payroll period equal to the dollar amount of the ESOP Dividend, subject to the limits of Code sections 401 (k), 402(g) and 415 and regulations thereunder, only if the participant files an election to make such special deferral. Any deferral would be allocated to the participant's Pre-Tax Account and would be invested in Fund M.

Based on the foregoing, you request the following rulings:

1. The dividends paid on Company A common stock held by the ESOP portion of Plan X will be deductible under section 404(k) of the Code in the year distributed or paid if such dividends are paid directly to participants (or their beneficiaries) or to the Plan X trustee and distributed (by the trustee or other paying agent) to participants (or their beneficiaries) no later than 90 days after the close of the Plan year in which the dividends are paid to Plan X.
2. If a participant makes a special deferral of current compensation under one of the procedures described above, the amounts so deferred will not constitute wages subject to income tax withholding under section 3402 of the Code.

With respect to your first ruling request, section 404(k)(l) of the Code provides that, in the **case** of a corporation, there shall be allowed as a deduction for a taxable year the amount of any applicable dividend paid in cash by such corporation during the taxable year with respect to applicable employer securities. Such deduction is in addition to the deductions allowed under section 404(a).

Section 404(k)(2) of the Code provides, in relevant part, that the term "applicable dividend" means any dividend which, in accordance with the plan provisions is paid to the plan and is distributed in **cash** to the participants in the plan, or their beneficiaries, not later than 90 days after the close of the plan year in which paid.

Section 404(k)(3) of the Code provides that for purposes of this subsection, "applicable employer securities" means, with respect to any dividend, employer securities which are held on the **record** date for such dividend by an employee stock ownership plan which is maintained by - (A) the corporation paying such dividend, or (B) any other corporation which is a member of a controlled group of corporations (within the meaning of section 409(e)(4) which includes such corporation).

Section 1.404(k)-IT, **Q&A 2** of the Temporary **Income** Tax Regulations provides that the deductibility of dividends paid to plan participants under section 404(k) of the Code is not affected by a plan provision which permits participants to elect to receive or not receive payment of dividends.

Section **404(k)(5)(A)** of the Code provides that the Secretary may disallow the deduction under paragraph (1) for any dividend if the Secretary determined that such dividend constitutes, in substance, an evasion of taxation.

Based upon your representations, the subject dividends on Company A stock allocated to the plan participants' accounts will be paid to the plan participants within 90 days of the close of the plan year, if they do not elect to have the dividends retained in Plan X.

Accordingly, we conclude with respect to your first ruling request that the dividends paid on Company A common stock held by the ESOP portion of Plan X will be deductible under

section 404(k) of the Code in the year distributed or paid if such dividends are paid directly to participants (or their beneficiaries) or to the Plan X trustee and distributed (by the trustee or other paying agent) to participants (or their beneficiaries) no later than 90 days after the close of the Plan year in which the dividends are paid to Plan X.

With respect to your second ruling request, section 402(e)(3) of the Code provides, in part, that contributions made by an employer on behalf of an employee to a trust which is a part of a qualified cash or deferred arrangement shall not be treated as distributed or made available to the employee nor as contributions made to the trust by the employee merely because the arrangement includes provisions under which the employee has an election whether the contributions will be made to the trust or received by the employee in cash.

Section 1.401(k)-1(a)(2) of the **Income Tax Regulations** provides that, generally, a cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a) of the Code.

Section 1.401(k)-1(a)(3)(i) of the regulations provides that a cash or deferred election is any election (or modification of an earlier election) by an employee to have the employer either - (A) provide an amount to the employee in the form of a cash or some other taxable benefit that is not currently available, or (B) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation. A cash or deferred election includes a salary reduction agreement between an employee and employer under which a contribution is made under a plan only if the employee elects to reduce cash compensation or to forgo an increase in cash compensation.

Section 1.401(k)-1(a)(3)(ii) of the regulations provides that a cash or deferred election can only be made with respect to an amount that is not currently available to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to an amount that would (but for the cash or deferred election) **become** currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.

Section 1.401(k)-1(a)(3)(iii) of the regulations provides that cash or another taxable amount is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable amount at the employee's discretion. An amount is not currently available to an employee if there is a significant restriction or limitation on the employee's right to receive the amount before a particular time in the future. The determination of whether an amount is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451 of the Code.

Section 1.401(k)-1(a)(4)(i) of the regulations provides that, a qualified cash or deferred arrangement is a cash or deferred arrangement that satisfies the requirements of paragraphs

(b), (c), (d), and (e) of section **1.401(k)-1** and that is part of a plan that otherwise satisfies the requirements of section 401 (a) of the Code.

Section **1.401(k)-1(a)(4)(ii)** of the regulations provides that, except as otherwise provided in section 1.401(k)-IQ, elective contributions under a qualified cash or deferred arrangement are treated as employer contributions.

Section **1.401(k)-1(a)(4)(iii)** of the regulations provides that, except as provided in section 402(g) of the Code and in section 1.401 (k)-1(f), **elective** contributions under a qualified cash or deferred arrangement are neither includible in an employee's gross income at the time the cash or other taxable amounts would have been **includible** in the employee's gross income (but for the cash or deferred election), nor at the time the elective contributions are contributed to the plan.

Federal income tax withholding under section 3402(a) of the Code is imposed on "wages" as defined in section **3401(a)**. Section **3401(a)(12)(A)** excepts from the definition of wages remuneration paid to, or on behalf of, an employee or his beneficiary from or to a trust described in section 401 (a) which is exempt from tax under section 501 (a) at the time of such payment, unless such payment is made to an employee of the trust as remuneration for services rendered as such employee and not as a beneficiary of the trust. Section **31.3401(a)(12)-1** (a) of the Employment Tax Regulations provides that "wages" does not include any payment made by an employer, on behalf of an employee or his beneficiary, into a trust, if at the time of such payment the trust is exempt from tax under 501(a) as an organization described in section 401(a).

The special salary deferrals made in the manner described above are elective contributions that are treated as employer contributions. Accordingly, with respect to your second ruling request we conclude that if a participant makes a special deferral of current compensation under one of the procedures described above, the amounts so deferred will not constitute wages subject to income tax withholding under section 3402 of the Code.

The above rulings are based on the assumption that Plan X will be qualified under sections 401(a), 401(k), 409, and 4975(e)(1) of the Code, as applicable, and the related trusts will be tax exempt under section 501(a) at the time that the above transaction takes place. In addition, we are assuming that the subject shares allocated to the participants' Plan X accounts are "applicable employer securities", within the meaning of section 404(k)(3) with respect to the subject dividends. We are not expressing any opinion as to whether the language of any particular amendment conforms to the requirements of sections 401(a), 401(k), or 4975 of the Code.

We are also assuming that Plan X will be amended to reflect the dividend passthrough method adopted by Company A for the distribution of dividends, Such method will stay in effect until Plan X is further amended to adopt a different passthrough method.

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In addition, this ruling is also based on the assumption that the proposed dividend does not constitute, in substance, an evasion of taxation within the meaning of section **404(k)(5)(A)** of the Code. We are expressing no opinion as to whether or not the disallowance of deductions provided for in that section would be applicable here.

This ruling is also based on the assumption that ESOP Dividends received on Company A stock will be distributed to all Plan X participants in a manner that does not discriminate among Plan X participants and will not cause the trustee of Plan X to violate the fiduciary requirements of **Title I** of the Employee Retirement **Income** Security Act of 1974.

This ruling is directed only to the taxpayer who requested it and applies only to the Plan as proposed to be amended as of the date of this ruling. Section **6110(j)(3)** of the Code provides that this ruling may not be used or cited as precedent.

A **copy** of this letter has been sent to your authorized representative in accordance with a power of attorney on file in this office,

Sincerely yours,



Frances V. Sloan
Chief, Employee Plans
Technical Branch 3

Enclosures:

Deleted **copy** of letter
Notice of Intention to Disclose

cc:

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