DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

200230044

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

MAY 2 2002

Uniform Issue List Numbers: 162.00-00; 401.04-00; 415.02-00; 402.01-00; 404.00-00; 4972.00-00

T:EP:RA:T1

****
****
****

ATTN: ******************
****

Legend:

Employer	=	***************************** ** ****************
Plan X	=	*** ***
Plan Y	=	** ** **********************
Exchange Z	=	
Trust	=	**

Ladies and Gentlemen:

This is in response to a letter dated August 29, 2000, submitted on behalf of the above-named Employer by its authorized representative, and supplemented by additional correspondence dated February 14, June 6, and July 9, 2001. In that correspondence, your authorized representative requests private letter rulings on your behalf, under §§ 162, 401(a), 402, 404, 415, and 4972 of the Internal Revenue Code of 1986 ("Code"), with regard to certain transactions pertaining to Plan X and Plan Y (together, "the Plans") of the Employer. In furtherance of these private ruling requests you provide the following facts, statements, and representations:

The Employer has established and maintains two retirement Plans: Plan X is for the benefit of salaried employees and their beneficiaries; Plan Y is for the benefit of hourly employees and their beneficiaries. The Plans are cash or deferred compensation arrangements, generally described and authorized under sections 401(a)

****

and 401(k) of the Code. By letters issued to the Employer on ******, **** (Plan X), and ******, **** (Plan Y), the Internal Revenue Service ("Service") has determined that the Plans are qualified plans under Code §§ 401(a) and 401(k).

The Plans participate in a master trust ("Trust") maintained by the Employer for various plans. The Trust maintains several investment funds, including a fund where employees may elect to invest in the Employer's common stock (the "Employer Stock Fund"). Shares of Employer common stock are publicly traded.

Each participant is entitled under the Plans to self-direct the investment of his or her account, including any investment in the Employer Stock Fund. Prior to the events giving rise to this ruling request, each participant also was entitled to change his or her investment options on a daily basis through a voice-response and internet system. Under accounting procedures adopted by the Employer for the Plans, investment changes in the Employer Stock Fund were to be made based on the stock's price, at the close of trading on Exchange Z, in effect on the date the participant made an investment election change. The Employer utilized the summary plan description of each of the Plans to notify participants of their authority to direct their account investments, and the procedures by which their investment decisions would be implemented.

During ******* and ********, ****, a nonhighly compensated participant in Plan X made numerous investment changes with respect to the investment of his account in the Employer Stock Fund. The thinly traded nature of the Employer's stock, related delays in effecting actual purchase and sale transactions in the Employer Stock Fund, the amounts this particular participant directed into and out of the fund, and the frequency of such transfers during this period all resulted in significant differences in the values extended to this participant (based on the price of the Employer's stock at the end of a particular trading day) from his investment direction and the value of the Employer's stock when actually purchased or sold. It was not physically possible for the Plan's fiduciaries to complete purchases and sales of the Employer's stock either according to the terms of the Plan or pursuant to the procedures described in the Plans' summary plan descriptions. The effect of the participant's investment activity on the Employer Stock Fund was to cause its unit value to be inappropriately reduced and inaccurate. This administrative failure was discovered in ********, ****, after which a full and complete audit of the Employer Stock Fund was conducted by the Employer. The audit concluded that the fund's unit value was inappropriately reduced and inaccurate during this period, for the reasons set forth above. However, the Plans' summary plan descriptions did not explain to participants any risk or potential risk of investment losses under the Employer's Plans, that might arise from excessive trading by another participant in the Employer Stock Fund.

****

The valuation problems in the Employer Stock Fund were first raised by several participants in ********, ****. After receipt of their monthly account statements, these participants requested an explanation as to the discrepancies in their Employer Stock Fund values. Additionally, after the audit of the Employer Stock Fund was complete and the amount and extent of the administrative failure determined, the labor union representing participants in Plan Y insisted that the Employer restore any lost Employer Stock Fund values to affected participant accounts. The Employer made payments to the Plans and Trust in the belief that the payments were necessary and appropriate not only to make participants "whole" but to forestall and avoid litigation with participants and with the union based on a breach of fiduciary duty claim, which would have resulted if the Employer had taken no action.

In order to correct the inaccurate unit values in the Employer Stock Fund, the Employer made a payment of approximately $******** to the Plans and the Trust in *****, ****. The payment was made in order to restore the affected nonhighly compensated participant accounts that were invested in the Employer Stock Fund during this period to their correct values. Contingent upon receipt of a favorable ruling, the Employer also proposes to make a payment or a contribution of Employer stock (estimated to be approximately $****** or ***** shares) to the Plans and the Trust. This latter payment will restore the accounts of affected highly compensated employees that were invested in the Employer Stock Fund to their appropriate valuations.

Based on foregoing facts, statements, and representations, the Employer requests a ruling that the payments to the Plans and Trust constitute a "restoration payment" and as such will:

(1) not constitute a "contribution" or other payment subject to the provisions of either Code § 404 or Code § 4972;

(2) not adversely affect the qualified status of the Plans pursuant to either Code § 401(a)(4) or Code § 415;

(3) not, when made to the Plans, result in taxable income to affected Plan participants pursuant to Code § 402(a); and

(4) be deductible in full by the Employer pursuant to Code § 162.

With regard to your first three ruling requests, section 401(a)(4) of the Code generally provides that contributions or benefits provided under a retirement plan qualified under Code § 401(a) may not discriminate in favor of highly compensated employees as defined in Code § 414(q).

Section 404(a) of the Code generally provides that contributions made by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan shall be deductible under section 404 subject to the limitations contained therein.

****

Section 415(a) of the Code provides, in pertinent part, that a trust which is part of a profit-sharing or stock bonus plan shall not constitute a qualified trust under section 401(a)if–in the case of a defined contribution plan-contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitations of subsection (c).

Section 1.415-6(b)(1)(i) of the Income Tax Regulations ("Regs.") generally provides that, for defined contribution plan limitation years beginning after December 31, 1986, the term "annual addition" means the sum, credited to a participant's account in any limitation year, of employer contributions, employee contributions, and forfeitures. Such annual additions may include excess deferrals. Section 1.415-6(b)(2) of the Regs. provides that the term "annual addition" includes employer contributions which are made under the plan. Section 1.401(k)-1(a)(4)(ii) provides that elective contributions under a qualified cash or deferred arrangement are treated as employer contributions (and are, therefore, includible in a participant's annual addition under IRC § 415.)

Code § 4972 imposes on an employer an excise tax on nondeductible contributions to a qualified plan. Section 4972(c) defines "nondeductible contributions" as the excess (if any) of the amount contributed for the taxable year by the employer to or under such plan over the amount allowable as a deduction under section 404 for such contributions (determined without regard to subsection (e) thereof), and the amount determined under subsection (c) for the preceding year reduced by the sum of the portion of the amount so determined returned to the employer during the taxable year and the portion of the amount so determined deductible under § 404 for the taxable year (determined without regard to subsection (e) thereof).

Code § 402(a) generally provides that amounts held in a trust that is exempt from tax under Code § 501(a) and that is part of a plan that meets the qualification requirements of Code § 401(a) will not be taxable to participants until such time as such amounts are actually distributed to distributees under such plan.

Neither the Code nor the Regulations promulgated thereunder provide guidance as to whether the Employer's replacement payment should constitute contributions for purposes of the above-referenced sections of the Code.

Generally, amounts contributed to a retirement plan, qualified within the meaning of Code § 401(a), are subject to the requirements and limitations of Code §§ 401(a)(4), 404, 415, and 4972. However, in an appropriate case, the Service may determine that a payment to a plan constitutes a "restorative" payment and, as such, is not subject to the requirements and limitations of Code §§ 401(a)(4), 404, 415, and 4972.

****

Payments made to a plan by an employer in order to restore value to the plan that was lost due to actions which place the employer under a reasonable risk of liability for breach of fiduciary duty will not be subject to the limitations of the Code sections referenced above. Payments to a plan made by an employer pursuant to a Department of Labor order, a court-approved settlement, or a court judgment would generally be treated as restorative payments and not subject to the Code sections referenced above. However, in general, payments made by an employer to a plan to make up for lost value due to general market fluctuations would not be treated as restorative payments. Also, payments made by an employer to a plan which result in different treatment for similarly situated plan participants would not be treated as restorative payments. A determination as to whether plan payments in other circumstances may be treated as restorative payments will be based on all the facts presented.

In this case, the thinly traded nature of the Employer's stock made it impossible for the Plans' fiduciaries to complete trades in the Employer Stock Fund at the end of each business day, as required by the Plans' terms. The resulting improper valuations of the Employer Stock Fund, and the fact that employees were not apprised of the potential for harm to their accounts, placed the Employer at risk of liability for breach of fiduciary duty with respect to its Plans. Moreover, amounts were repaid into the accounts of the Employer's bargaining-unit employees under direct threat from their union of litigation against the Employer for fiduciary breach. Such payments must, therefore, be considered restorative in nature, rather than an attempt to make up the employees' losses arising from general market fluctuations. Further, in order to assure similar treatment for Plan participants similarly situated (as investors in the Employer Stock Fund), the Employer proposes to make additional restorative payments to the accounts of nonunion employees who suffered losses from the improper fund valuations.

Accordingly, based on the facts and circumstances present in this case, the Service has determined that payments made, and to be made, by the Employer to correct improper valuations in the Employer Stock Fund constitute restorative payments.

Further, based on the above, we rule, with respect to your first three ruling requests, that the restorative payments described above:

(1) will not constitute a "contribution" or other payment subject to the provisions of either Code § 404 or Code § 4972:

(2) will not adversely affect the qualified status of Plan X or Plan Y pursuant to either Code § 401(a)(4) or Code § 415; and

(3) did not and will not, when paid into either Plan X or Plan Y, constitute an actual distribution of Plan assets to affected participants or beneficiaries, within the meaning of Code § 402, and,

****

thus, such payments did not and will not, when paid into either Plan X or Plan Y, result in taxable income to those participants or their beneficiaries.

With respect to your fourth ruling request, Code § 162(a)(1) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

In general, payments made in settlement of lawsuits or potential lawsuits are deductible if the acts that give rise to the litigation were performed in the ordinary conduct of the taxpayer's business. See, e.g., Revenue Ruling ("Rev. Rul.") 78-210, 1978-l C.B. 39, and Rev. Rul. 69-491, 1969-2 C.B. 22. Also *see Kornhauser v. United States,* 276 U.S. 145 (1928), VII-2 C.B. 267 (1928), in which the taxpayer claimed entitlement to deduct $10,000 in attorney fees as a business expense because they were incurred to defend a lawsuit brought by a former partner for an accounting. The Court held the attorney fees deductible because the lawsuit proximately resulted from the taxpayer's business.

To determine whether the acts that gave rise to the litigation were ordinary, thus giving rise to deductible payments, one must look to the origin and character of the claim with respect to which a settlement is made rather than to the claim's potential consequences on the taxpayer's business operation. See United *States v. Hilton Hotels* Corp., *397 U.S.* 580(1970); *Woodward v. Commissioner, 397* U.S. 572 (1970); *Anchor Coupling Co. v. United States,* 427 F.2d 429 (7th Cir. 1970), *cert. denied,* 401 U.S. 908(1971). In United States *v. Gilmore, 372* U.S. 39(1963), the Court held that the origin and character of the claim with respect to which an expense was incurred is the controlling test of whether the expense was a deductible business *expense.* The deductibility of an expense depends not on the consequences that may or may not result from the payment, but on whether the claim arises in connection with a taxpayer's business or profit-seeking activities.

In general, all facts pertaining to the controversy are examined to determine the true nature of the settlement payments. Boagni v. Commissioner, 59 T.C. 708(1973). Under the "origin of claim" test, it may be proper to allocate a portion of the settlement payment to claims that were only threatened, as well as those claims that were actually advanced in litigation.

No court case has been found which deals with the treatment of payments by an employer to reimburse a defined contribution plan for losses suffered by the plan arising from breach of fiduciary responsibility. However, there have been many cases with similar fact patterns in which business expense deductions were allowed to taxpayers. In *Butler v. Commissioner,* 17 T.C. 675 (1951). acq., 1952-l C.B. 1, an officer and director of a bankrupt corporation was allowed to deduct a payment in settlement of a suit arising out of profits made by his wife from sales of the corporation's bonds. The court held that the payment by the taxpayer of attorney fees and an additional amount to a bondholders' committee, pursuant to the consent judgment, was deductible. The payment was made to avoid unfavorable publicity and protect the payer's business reputation. In *DeVito v.* Commissioner, T.C. Memo 1979-377, the taxpayer was permitted to deduct a payment in settlement of a lawsuit for breach of a covenant not to compete and breach of fiduciary duties. See also Rev. Rul. 69-581, 1969-2 C.B. 25 (which concluded that payment of liquidated damages and attorney fees under the Fair Labor Standards Act were deductible by the employer).

Rev. Rul. 73-226, 1973-l C.B. 62 provides that payments made to avoid extended controversy and to avoid unfavorable publicity and injury to the taxpayer's business reputation are currently deductible. This is the rule even though there is serious doubt as to the taxpayer's legal liability.

In the present case, the facts are clear: the restorative payments made, and to be made, by the Employer to the Plans and Trust were intended to avoid having the union initiate litigation over the issue of breach of fiduciary duty; and, they are intended to resolve any potential legal claims of nonunion participants by providing relief that places them in a situation, relative to the Employer Stock Fund, that is similar to their unionized co-workers. The issue of breach of fiduciary duty under the Employer's plans arose in the ordinary course of Employer's business, in the process of attempting to provide retirement benefits for employees. There is no serious question of its business origin.

Accordingly, with respect to your fourth ruling request, we hold that:

(4) the restorative payments made, and the proposed restorative payments described above, will be deductible in full by the Employer pursuant to Code § 162 as a result of their being paid into the Plans.

This ruling letter assumes that the Plans meet the applicable qualification requirements of Code § 401(a) and that their related master Trust is tax-exempt within the meaning of § 501(a). The determination as to whether a plan is qualified under § 401(a) is within the jurisdiction of the Manager, Employee Plans Determinations Programs, Cincinnati, Ohio, and the appropriate Area Office of the Employee Plans Examination Division.

Additionally, this ruling letter is based on the Employer's representations that it made, or will make, restorative payments in order to resolve any potential claims of breach of fiduciary duty of certain Plan participants and the threat of litigation by the union representing the Employer's bargaining unit employees. If, subsequent to the replacement payment, the Employer becomes entitled to

****
reimbursement for all or a portion of the replacement payment (from an

insurer, or any other source) then the Employer should include in income the amount of the reimbursement in accordance with its method of accounting.

The representations herein, like all factual representations made to the Internal Revenue Service in applications for rulings, are subject to verification on audit by Service Field personnel.

Furthermore, no opinion is expressed as to the federal tax treatment of the above-referenced transactions and proposed transactions under sections of the Code and Regulations not specifically cited in this ruling letter. Additionally no opinion is expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions or proposed transactions that are not specifically covered by this ruling letter. A copy of this ruling letter should be attached to the appropriate federal income tax return(s) for the taxable year(s) in which the restorative payments are paid into the Plans.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

Copies of this ruling have been sent to your authorized representative in accordance with a power of attorney on file in this office. Should you have any questions pertaining to this letter, you may contact ********************* this office at (202) 283-9575. ************ Government Identification Number is ********.

Sincerely,

Donzell H. Littlejohn

Donzell H. Littlejohn, Acting Manager
Employee Plans Technical Group 1
T:EP:RA:T1

Attachments:
- Deleted Copy of this Private Letter Ruling
- Copy of Cover Letter to the Taxpayer's Authorized Representative
- Notice 437, "Notice of Intention to Disclose"