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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JAN 30, 2003
T:EP:RA:T1

Attn:

Legend:

Employer A =

Company B =

Company C =

Company D =

Company E =

Plan X =

Law Firm Y =

Dear :

This letter is in response to your ruling request dated May 25, 2001, as supplemented by additional correspondence dated March 28, 2002, September 27, 2002, and November 19, 2002, from your authorized representative, concerning the characterization and tax consequences of certain proposed payments by Employer A to Plan X.

Your authorized representative submitted the following facts and representations with the request:

Employer A sponsors Plan X, which is a defined contribution plan under section 401(a) of the Internal Revenue Code that provides for mandatory employee elective deferrals and employer contributions. Company D administered Plan X during the period July 11, 1990 though late 1997. For the 1999 plan year, there were 29 participants and assets totaling $5,527,436 at year end.

On July 11, 1990, Plan X loaned to Company B the sum of four hundred thousand dollars ($400,000). The loan was facilitated through a service provider to the Plan, Company D. The loan was evidenced by a second trust deed note and secured by a second deed of trust, also dated July 11, 1990. Company B is unrelated to both Employer A and Plan X and, therefore, your authorized representative asserts is not a disqualified person within the meaning of Code section 4975(e)(2). The real property securing the loan was the clinic facility where Company B's medical practice is located. The original trust deed note provided for interest on the outstanding principal balance at eleven per cent and monthly payments of nine hundred eighty dollars and twelve cents ($989.12). The payment amount was insufficient to amortize the loan. The note included a right in the holder to demand payment in full at any time after sixty months from July 11, 1990.

The original trust deed securing the loan was assigned to the Plan by an assignment of trust deed dated July 15, 1990. The assignment of trust deed was never recorded.

On December 1, 1996, Plan X made a further loan to Company C, believed by the Plan to be related to Company B. That loan was in the amount of five hundred eight thousand six hundred nineteen dollars and fifty-nine cents ($508,619.59). The note executed in connection with the loan provided for monthly payments of four thousand nine hundred eight dollars and twenty-nine cents ($4,908.29) and a right in the holder to accelerate and demand payment in full no later than December 1, 1999. Interest on the note accrued at the rate of twelve per cent per annum.

On December 27, 1996, Company B executed and delivered to Plan X an amendment to the second trust deed, increasing the principal amount of the outstanding indebtedness from four hundred thousand dollars to six hundred ten thousand three hundred twelve dollars and seventy three cents ($610,312.73). The increase in the principal indebtedness amount was required because, as noted above, the monthly payments of nine hundred eighty dollars and twelve cents ($980.12), were insufficient to amortize the interest accruing on the original note.

In late 1997, the accountant for Companies B and C, the borrowers on the notes held by Plan X, contacted the trustees of Plan X to discuss the possibility of a discounted re-finance of the indebtedness. Companies B and C had located a third-party who was willing to take out the position of the Plan, but only at the discounted amount of $912,500. Prior to accepting the offer, the trustees investigated the financial status of Companies B and C and determined that they had a current negative net worth of $915,240 and an annual negative net income of approximately $44,000. Based upon an appraisal report by a certified appraiser and a commitment for title insurance issued by Company E, and further considering the outstanding balance on the senior lien on the property which preceded the Plan's interest, the trustees determined that there was only $765,000 equity in the property to secure the indebtedness owed to Plan X. In other words, the value of Plan X's collateral was approximately $150,000 less than the amount being offered through the re-finance of the indebtedness. The trustees concluded that if they did not accept the discounted payoff, Plan X would face certain foreclosure of its junior lien interest by the senior lien holder. The trustees concluded, therefore, to accept the $912,500 payment. These funds were not provided by Companies B and C, but by a third-party who purchased the position of the Plan as second lien holder. The payment of $912,500 was made to the Plan's authorized representative on December 17, 1997. On February 3, 1998, the representative deposited $915,314.01 in Plan X.

Employer A proposes to pay to Plan X an amount sufficient to reinstate part of the amounts lost to the accounts of all Plan participants (excepting the accounts of the Plan's trustees) who were adversely affected by the investment of assets of Plan X in Companies B and C. The amount will be deposited in a single cash payment.

In order to ensure that Plan X participants are not harmed by the investment decisions of the trustees and to avoid possible claims of liability from participants, Employer A has made a $98,000 payment to Plan X. Employer A has allocated appropriate amounts to the individual participants in the Plan to reflect the loss on the discounted promissory notes, and to restore the accounts of the participants. The accounts of the four trustees, who also are officers of Employer A and participants in Plan X, were not adjusted by Employer A because the trustees concluded that they may have personal culpability under ERISA sections 404 and 409, and thus were not entitled to have their Plan X accounts restored.

Beginning in September 1996, Plan X engaged the services of Law Firm Y to review the Plan's investment portfolio and, in particular, to investigate the sufficiency of documentation and collateralization of various loans made by the Plan. Based upon the initial findings of Law Firm Y in November 1996, Plan X determined to terminate the services of the Plan's trustee and investment advisor. Law Firm Y was also engaged to assist Plan X in connection with the termination of those services and the transfer of services and appointment of new trustees for the Plan. Beginning in January 1997, Law Firm Y commenced working with a forensic accountant retained by the Plan. At the suggestion of Law Firm Y, a broad investigation of the Plan's investments was undertaken for the purpose of reconciling the investments, the Plan's bank accounts, and its records. Law Firm Y and the accountant also evaluated the Plan's investment portfolio and the various mortgages and loans which Plan X held at the time. The fees incurred in connection with the foregoing services were compiled and submitted to the Plan, which paid these fees as part of the expenses incurred by Plan X for the year ended March 31, 1998. During that same plan year, Law Firm Y assisted Plan X with negotiations to resolve and settle the loans made to Companies B and C. Through the plan year ended in March 1999, Law Firm Y further assisted Plan X with significant loan collection efforts with respect to other investments. These collection efforts were successful and resulted in receipt by Plan X of certain other obligations.

The Department of Labor has specifically questioned the fees incurred by Plan X for legal and accounting expenses in the Plan years ended March 31, 1998 and 1999, during which Plan X paid a total of $67,373.00 in professional fees. The Department of Labor has alleged that these fees were incurred solely as a result of Plan X's prior imprudent investments and failure of Plan X fiduciaries to monitor appropriately Plan X's former investment advisor and trustee.

In order to resolve the matter with the Department of Labor, Employer A has elected to repay to Plan X the pro-rata portion of the legal and accounting expenses incurred by Plan X at the same ratio as reimbursed to the Plan for the losses incurred in connection with the joint ventures with Companies B and C, plus earnings thereon. This amount has been calculated to be $23,513.00, and will be contributed and allocated to the accounts of those participants in the same fashion as the $98,000 replacement payment.

Based on the foregoing facts and representations, your authorized representative requests rulings that the proposed payments by Employer A to Plan X:

1) will not be treated as an excess contribution to Plan X under Code section 404 and will not be subject to the excise tax on excess contributions under Code section 4972;

2) will be treated as a restorative payment to Plan X and, therefore allocated as such, rather than as a contribution under Code section 404;

3) as a restorative payment, will not be subject to limitations on allocations under Code section 415(c); and

4) will be deductible by Employer A under Code section 162 as an ordinary and necessary business expense, and not under Code section 404.

Regarding ruling requests one, two, and three, Code section 404(a) provides if contributions are paid by am employer to or under a stock bonus, pension, profit-sharing, or annuity plan or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under this chapter; but, if they would otherwise be deductible, they shall be deductible under this section, however, subject to the limitations contained therein.

Code section 415(a) provides, in part, that a trust which is part of a pension, profit-sharing, or stock bonus plan shall not constitute a qualified trust under section 401(a) if: A) in the case of a defined benefit plan, the plan provides for the payment of benefits with respect to a participant which exceeds the limitations of subsection (b); or, B) in the case of 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)(2) of the Income Tax Regulations provides that the term "annual additions" includes employer contributions which are made under the plan. Section 1.415-6(b)(2) further provides that the Commissioner may, in an appropriate case, considering all of the facts and circumstances, treat transactions between the plan and the employer or certain allocations to participants' accounts as giving rise to annual additions.

Code section 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 section 404 for the taxable year (determined without regard to subsection (e) thereof).

Revenue Ruling 2002-45, 2002-29 I.R.B. 116, established guidance with respect to restorative payments to qualified pension, profit-sharing, and stock bonus plans. It provides that a payment made to a qualified defined contribution plan is not treated as a contribution to the plan, and accordingly is not subject to the Code provisions described above, if the payment is made to restore losses to the plan resulting from actions by a fiduciary for which there is a reasonable risk of liability for breach of a fiduciary duty under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), and plan participants who are similarly situated are treated similarly with respect to the payment. For purposes of this revenue ruling, these payments are referred to as restorative payments.

The determination of whether a payment to a qualified defined contribution plan is treated as a restorative payment, rather than as a contribution, is based on all of the relevant facts and circumstances. As a general rule, payments to a defined contribution plan are restorative payments for purposes of the revenue ruling only if the payments are made in order to restore some or all of the plan's losses due to an action (or a failure to act) that creates a reasonable risk of liability for breach of fiduciary duty. In contrast, payments make to a plan to make up for losses due to market fluctuations and that are not attributable to a fiduciary breach are generally treated as contributions and not as restorative payments. In no case will amounts paid in excess of the amount lost (including appropriate adjustments to reflect lost earnings) be considered restorative payments. Furthermore, payments that result in different treatment for similarly situated plan participants are not restorative payments. The failure to allocate a share of the payment to the account of a fiduciary responsible for the losses does not result in different treatment for similarly situated participants. In no event are payments required under a plan or necessary to comply with a requirement of the Code considered restorative payments, even if the payments are delayed or otherwise made in circumstances under which there has been a breach of fiduciary duty.

Employer A has determined, based on the facts and circumstances of the investments in Companies B and C, that there is a reasonable risk of liability for fiduciary breach on account of these investments. In particular, Employer A took into account that the monthly payments required under the notes were not sufficient to amortize the loan, and that it had failed to record the assignment of the deed of trust.

In this case, the payment which Employer A intends to make to Plan X, which payment is referred to above, will ensure that the affected participants in Plan X recover a significant portion of their account balances and place them in the position similar to that in which they would have been in the absence of the defaulted payment. Thus, it is reasonable to characterize this payment as a replacement payment rather than a plan contribution or annual addition.

As indicated by the facts of this case, the replacement payment will be made by Employer A in response to potential claims against Employer A and individuals responsible for investing Plan X assets. The replacement payment will be allocated to the accounts of participants and beneficiaries under Plan X that incurred principal loss as a result of the defaulted payments to Plan X. The payment will be allocated to the accounts of these participants on a pro rata basis in relation to the value each account lost due to the investment of plan assets in Company B and Company C. Accordingly, plan participants who are similarly situated will be treated similarly with regard to the allocation of the payment. The fact that the accounts of the plan fiduciaries responsible for the investment will not be allocated any part of the payment does not change this conclusion. Accordingly, we conclude that the payment of the $98,000 to Plan X is a restorative payment.

In addition, you have asked us to rule on whether the payment of $23,513 to Plan X in repayment of certain plan expenses, pursuant to an agreement with the Department of Labor, is a restorative payment. The Department of Labor alleged that certain legal and accounting expenses paid from the assets of Plan X were incurred solely as a result of Plan X's imprudent investments and the failure of Plan X fiduciaries to monitor appropriately its former investment advisor and trustee. Furthermore, you have represented that the $23,513 payment will be allocated among the accounts of participants in Plan X in the same fashion as the $98,000 restorative payment. Accordingly, we conclude that the payment of the $23,513 to Plan X is also a restorative payment.

Thus, based on the above, we conclude the proposed restorative payments: 1) will not be treated as an excess contribution to Plan X under Code section 404 and will not be subject to the excise tax on excess contributions under Code section 4972; 2) will be treated as a restorative payment to Plan X and, therefore allocated as such, rather than as a contribution under Code section 404; and 3) as a restorative payment, will not be subject to limitations on allocations under Code section 415(c).

Regarding ruling request four, Code section 162(a) 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., Rev. Rul. 78-210, 1978-1 C.B. 39, and Rev. Rul. 69-491, 1969-2 C.B. 22. Rev. Rul. 79-208, 1979-2 C.B. 79, is consistent, holding that payment of an amount to settle a lawsuit and obtain a release from all claims under a franchise agreement is deductible under section 162. 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 approximately 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); and Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970), cert. denied, 401 U.S. 908 (1971). See also United States v. Gilmore, 372 U.S. 39 (1973), in which 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, 713 (1973). Under the "origin of the 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. See Rev. Rul. 80-119, 1980-1 C.B. 40; and DeMink v. United States, 448 F.2d 867 (9th Cir. 1971).

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., 1952-1 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 bondholder's committee, pursuant to the consent judgment, was deductible. The payment was made to avoid unfavorable publicity and protect to 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.

The Service's position, with respect to the deductibility of payments made to resolve actual or potential claims of legal liability, or to uphold business reputation, is consistent with the case authorities cited. Revenue Ruling 73-226, 1973-1 C.B. 62, 63, states: payments made "to avoid extended controversy and the expense of litigation" 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. Laurence M. Marks v. Commissioner, 27 T.C. 464, 467 (1956), acq., 1966-1 C.B. 2. Payments to settle and compromise litigation are business expenses if the motive is to protect the taxpayer "from a possible lawsuit and the exposure to liability, added legal fees, and damages to its reputation." Old Town Corp. v. Commissioner, 37 T.C. 845, 859 (1962), acq., 1962-2 C.B. 5.

In the present case, the facts indicate that the $98,000 replacement payment to Plan X by Employer A was made to resolve potential claims against Employer A. As discussed above, Employer A rightly determined that there is a reasonable risk of liability for fiduciary breach. Furthermore, it was determined above that the proposed payment by Employer A to Plan X would be a restorative payment for purposes of sections 404, 415(c), and 4972. The situation in which Employer A finds itself arose in the ordinary course of its trade or business. There is no serious question of its business origin. Substantial authority holds that payments of the type described herein, made to satisfy or pre-empt similar claims arising in the ordinary course of a trade or business, are deductible business expenses.

Therefore, with respect to ruling request four, we conclude that the proposed payments by Employer A to Plan X are restorative payments, and as such will be deductible by Employer A under Code section 162 as an ordinary and necessary business expense, and not under Code section 404.

This ruling is based on the assumption that Plan X otherwise meets the requirements of Code section 401(a), and that its related trust is tax-exempt within the meaning of Code section 501(a). No opinion is expressed as to the Federal income tax consequences or the transactions described above under any other provisions of the Code.

Additionally, the representations made herein that the payments described in this letter ruling will be made to resolve potential claims for breach of fiduciary duty, like all factual representations made to the Internal Revenue Service in applications for rulings, are subject to verification on audit by Service field personnel.

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

If you have any questions, please call , T:EP:RA:T1 at

Sincerely yours,

Manager, Employee Plans
Technical Group 1

Enclosures:
Deleted copy of letter
Notice of Intention to Disclose

cc: