

TAX UPDATE

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We Just Disagree—What Is the Meaning of In Connection With?
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ESOP Redemption Payments and Deductions

Courts disagree from time to time, and this week we look at a case where the United States Tax Court stated its disagreement with the 2003 decision in the case of *Boise Cascade v. United States*, 329 F3d 751, issued by the Ninth Circuit Court of Appeals. The majority opinion in the case of *Ralston Purina Company v. Commissioner*, 131 TC No. 4, specifically took issue with the Ninth Circuit's view of what Congress meant in IRC §162(k) which denies a deduction for expenses incurred by a corporation “in connection with” a redemption of its stock.

While the case in question specifically involved whether Ralston Purina could obtain a tax deduction for amounts paid to its ESOP to redeem its stock, a specific issue that arguably may have been rendered moot for any current transaction by revised regulations issued after the date of the transaction in this case, the concept of what are expenses incurred in connection with a redemption of stock may apply in many other arenas.

Making the Connection

The underlying case involved a payment by Ralston Purina in 1994 and 1995 to its employe Savings Investment Plan (SIP) to redeem preferred stock, payments that were distributed to employees that had terminated employment with Ralston Purina. Purina argued that since the payment would be essentially equivalent to a dividend under the provisions of §302(b)(1), since the relative interest of the SIP as a shareholder was not changed by the redemption.

Under §404(k), a corporation may take a deduction for an “applicable dividend” as defined in §404(k)(2) paid to an ESOP. To be an “applicable dividend” the dividend must meet the following test:

- (2) Applicable dividend. -- For purposes of this subsection --
- (A) In general. -- The term "applicable dividend" means any dividend which, in accordance with the plan provisions --
- (i) is paid in cash to the participants in the plan or their beneficiaries,
 - (ii) is paid to the plan and is distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year in which paid, or
 - (iii) is used to make payments on a loan described in subsection (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.

In Ralston Purina's view, since they now had a dividend and the amount had been paid out to the plan participants, they had fulfilled the requirements to claim a current deduction. Ralston Purina had taken this position in the tax dispute following the issuance of the decision in *Boise Cascade* noted above, where the Ninth Circuit had ruled that in a very similar case the deduction was properly allowable.

The IRS objected to this view of the matter. The Tax Court noted that

Respondent maintains that the issue was incorrectly decided by the Court of Appeals for the Ninth Circuit and challenges the claimed deductions on three grounds: (1) The redemption dividends are not applicable dividends within the meaning of section 404(k); but (2) even if the redemption dividends otherwise constitute applicable dividends as defined by section 404(k), their deduction should be disallowed as evasions of taxation under section 404(k)(5); and (3) even if the redemption dividends are otherwise allowable as deductions under section 404(k), they are disallowed as amounts paid by a

corporation in connection with the redemption of its stock within the meaning of section 162(k).

For clarity, §404(k)(5)(A) provides that “The Secretary may disallow the deduction under paragraph (1) for any dividend if the Secretary determines that such dividend constitutes, in substance, an avoidance or evasion of taxation.” Not surprisingly, the IRS believes this transaction would meet that test.

However, the Tax Court decided that it handle this case without considering the provision of §404, instead deciding that §162(k) would be sufficient grounds upon which to rule. As the majority opinion notes:

In reaching our decision we need not traverse petitioner's convoluted arguments in support of its position that the redemption dividends qualify as applicable dividends under section 404(k)(2), or respondent's arguments regarding section 404(k)(5), because in our view section 162(k) precludes that result in any event, notwithstanding the contrary position taken by the Court of Appeals.

Expenses In Connection With A Redemption

So what exactly does this infamous §162(k) say? It reads as follows:

(k) Stock redemption expenses

(1) In general

Except as provided in paragraph (2), 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 or of the stock of any related person (as defined in section 465(b)(3)(C)).

(2) Exceptions

Paragraph (1) shall not apply to--

(A) Certain specific deductions

Any--

(i) deduction allowable under section 163 (relating to interest),

(ii) deduction for amounts which are properly allocable to indebtedness and amortized over the term of such indebtedness,

or

(iii) deduction for dividends paid (within the meaning of section 561).

(B) Stock of certain regulated investment companies

Any amount paid or incurred in connection with the redemption of any stock in a regulated investment company which issues only stock which is redeemable upon the demand of the shareholder.

In dealing with this provision in a similar situation, the Ninth Circuit Court of Appeals in *Boise Cascade* decided that, in fact, the redemption of shares from the ESOP and the payment of those amounts to the former employees was not sufficiently linked to make the deduction one of an expense paid “in connection with” a redemption, noting

Here, we are confronted with two segregable transactions: the stock redemption by Boise Cascade and subsequent distributions to the Plan Participants by the Trustee. The two are not ineluctably linked. In fact, the transactions were entirely separate.

First, although the Plan provided that redemption of the convertible preferred stock was required upon employment termination, distribution of the amount redeemed did not automatically occur. Indeed, if the Participant had a vested Plan account greater than \$3,500, the Participant could defer distribution of the account balance. The record indicates that there were Participants who so chose in 1989.

Second, the redemption of the convertible preferred stock was not a prerequisite to the Trustee's duty to make distributions under the terms of the Plan. The Plan allowed the Participant to defer distribution until death, disability or retirement under certain circumstances unrelated to the act of stock redemption. The Participant also had certain rights to control whether the distribution was to be made in a lump sum, or in time payments. Thus, the terms of the Plan make it plain that the triggering event for the Trustee's duty to distribute payments is the election of the Participant, not the redemption of the stock.

The government also attempts to set up a false dichotomy between Boise Cascade's position and the "plain language" of the statute. It argues that if §162(k)'s disallowance were not to apply to transactions of this type, then the statute would have limited it to "amounts paid by a corporation to redeem its stock," rather than amounts paid "in connection" with the redemption of the stock. However, the legislative history explains why the alternative language proposed by the government would be too narrow for the purposes of the statute:

The Act denies a deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock. Congress intended that amounts subject to this provision will include amounts paid to repurchase stock; premiums paid for the stock; legal, accounting, brokerage, transfer agent, appraisal and similar fees incurred in connection with the repurchase; and any other expenditure that is necessary or incident to the repurchase, whether representing costs incurred by the purchasing corporation or by the selling shareholder (and paid or reimbursed by the purchasing corporation), or incurred by persons or entities related to either.

General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99th Cong., Pub.L.No. 99-514, at 278 (1987). Thus, the disallowance for payments "in connection with" the redemption of stock captures fees and other expenditures "necessary and incident" to repurchase which would otherwise be deductible business expenses. Yet as the language of the Plan makes clear, the distributions to the employees are a separate obligation from the corporation's obligation to the Trust to redeem the convertible preferred stock and thus are not "necessary or incident" to the redemption in the manner contemplated by the statute.

In the Ninth's view, as the payment did not materially reduce the ESOP's interest in the employer, the payment was one that had to be treated as a dividend—and the later payment was deductible under §404, and was not blocked by §162(k).

The Ninth Circuit decided that the "origin of the claim" doctrine is the proper one to apply, citing back to its 1994 decision in *In re Kroy, Ltd. v. United States*, 94-2 USTC ¶150,316. In that case, the Court explained:

The government's interpretation of IRC §162(k) requires that the business purpose for the use of the borrowed funds be ascertained to determine deductibility. Under the Government's theory, if the business purpose for borrowing the funds is to redeem stock, then expenditures, such as the Loan Fees, are not deductible. However, if the funds are borrowed for some other business purpose, then the identical expenditures may be deductible. This is the uncertainty which the Supreme Court rejected in *Gilmore* and *Woodward*.

Therefore, we agree with Kroy. IRC §162(k) and the "origin of the claim" test are consistent if the expenses which have their "origin" in a stock redemption transaction are nondeductible, and other expenses having origin in a separate, although related, transaction remain deductible as ordinary and necessary business expenses under IRC §162(a). By contrast, the consequence of the government's position is that IRC §162(k) overrules the "origin of the claim" test established by the Supreme Court several years

before IRC §162(k) was enacted. There is no support for this result.

The U.S. District Court of Minnesota in January of this year came to the same conclusion, citing the *Boise Cascade* decision in its decision in *General Mills, Inc. v. United States*, 2008-1 USTC ¶50,141.

Being Respectfully Disagreeable

The Tax Court, however, did not agree with the Ninth Circuit's view on this matter. It summarized the Ninth Circuit's view as follows:

Section 162(k) itself is an exception to the general rule of section 162(a) that permits a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". It prohibits deductions for expenses that would ordinarily be deductible business expenses but for the fact that those expenses were made in connection with a repurchase of stock. In the words of the court in *Boise Cascade Corp. v. United States*, supra at 756: "Section 162(k) prohibits deductions claimed as a consequence of a stock redemption. Thus, it acts as a disallowance provision for otherwise allowable non-capital deductions incurred in connection with a stock redemption transaction." *Boise Cascade Corp.* goes on to say that "the key question is whether distributions to the [ESOP] Participants were payments made 'in connection with' the redemption of the convertible preferred stock." *Id.* at 757.

In a nutshell, *Boise Cascade Corp.* appears to proceed on the premise that if distribution payments to the withdrawing ESOP participants are made "in connection with" redemption of stock, then section 162(k) disallows a deduction for the amounts paid. The Court of Appeals then held that the payments were not made in connection with the redemption of its stock. *Id.* at 757-758.

The Tax Court notes that the *Boise Cascade* decision relied on the *Kroy* opinion that stated the "origin of the claim" test was the proper test when §162(k) was raised by the IRS. The Tax Court noted that it had previously rejected the holding in *Kroy*, noting:

We specifically rejected the Court of Appeals' narrow interpretation of the phrase "in connection with" in *United States v. Kroy (Europe) Ltd.*, supra. See *Fort Howard Corp. & Subs. v. Commissioner*, 103 T.C. 345 (1994). In *Fort Howard*, we noted that Congress had expressly intended the phrase to be construed broadly, to include all deductions necessary or incident to a redemption transaction. *Id.* at 353-354 (citing S. Rept. 99-313, at 223 (1986), 1986-3 C.B. (Vol. 3) 1, 223). We also relied heavily on the opinion of the Court of Appeals for the Eighth Circuit in *Huntsman v. Commissioner*, 905 F.2d 1182 (8th Cir. 1990), revg. 91 T.C. 917 (1988), which held that the phrase "in connection with" should be broadly construed.

The Court noted that in its view the origin of the claim test was simply irrelevant in this case, holding:

We concluded that the origin of the claim test had no bearing on the section 162(k) inquiry, rejecting Kroy's assumption that the "in connection with" test under section 162(k) must be fashioned in such a way as to be consistent with the origin of the claim test. We also concluded that Congress could not have intended section 162(k) as a mere clarification of existing law, because section 162(k) prohibits deductions that are "otherwise allowable" under present law. *Fort Howard Corp. & Subs. v. Commissioner*, supra at 356. Two years after our Opinion in *Fort Howard*, Congress enacted retroactive relief for the borrowing expenses involved in both *Fort Howard* and *Kroy*. See *Fort Howard Corp. & Subs. v. Commissioner*, 107 T.C. 187 (1996).

I suspect the Ninth Circuit might view Congress as rejecting the holding of the Tax Court, but that isn't the view the Tax Court held—rather they viewed that action as changing the law.

However, after this analysis, the Court then goes on to claim that “in connection with” doesn't really matter, holding:

Ultimately, our holding in this case does not depend on our interpretation of the phrase "in connection with" because we conclude that Congress expressly intended section 162(k) to prohibit deduction of the funds used to effect a redemption. See *infra* pp. 21-22.

The Tax Court goes on to note, though, that Ralston Purina ends up arguing both that the transactions are connected (in order to obtain a deduction under §404(k)) and then are not connected (in order to avoid the application of §162(k)), noting:

Petitioner urges us to adopt the Court of Appeals for the Ninth Circuit's reasoning, arguing that while the transaction as a whole qualifies for a deduction under section 404(k), the distribution payments from the SIP to terminating employees are not connected with petitioner's redemption of its preferred stock and thus do not run afoul of section 162(k).

We note at the outset that this line of argument appears to be facially inconsistent. Petitioner first argues that the redemption payments from petitioner to the SIP and the distribution payments from the SIP to the employees are linked in an integrated transaction, so that the transaction fits within one of the transactions permissible under section 404(k) -- a dividend payment from a corporation to a plan and a distribution of those proceeds to departing employees. Petitioner then argues that these payments are in fact not connected for purposes of section 162(k). Petitioner seems to want it both ways; it relies on the integrated form of the transaction to justify a section 404(k) deduction

only to deny that form in another context. See *Portland Golf Club v. Commissioner*, 497 U.S. 154, 168 (1990) (noting an "inherent contradiction" where taxpayer relied on two methods of calculation to simultaneously show actual losses and an intent to profit).

The Tax Court indicates next that it believes the Ninth Circuit didn't approach the question properly, and when that is done there is a linkage to a stock redemption. The Tax Court notes:

Section 162(k) bars the deduction of "otherwise allowable" deductions that are made in connection with a repurchase of stock. The deduction sought is the section 404(k) deduction. Section 404(k)(1) provides that a corporation is entitled to a deduction for "any applicable dividend" that it pays with respect to applicable employer securities. (We shall assume, *arguendo*, that deductions for the payments petitioner made here would normally be allowable under section 404(k).) A deduction under section 404(k) is not allowable unless the transaction qualifies as an applicable dividend. Thus, the proper question for section 162(k) purposes is whether the otherwise deductible applicable dividends that petitioner paid are "in connection with" a repurchase of stock. To answer this question, we must identify the transaction that constitutes the applicable dividend.

The Court found more problems with the Ninth Circuit approach in analyzing the §404(k) issue, noting as follows:

As for what payment in this case could constitute an applicable dividend under section 404(k), there are three possibilities: (1) The redemption payment from petitioner to the SIP, (2) the distribution payments from the SIP to departing employees, or (3) the redemption payment to the SIP and the distribution from the SIP as an integrated transaction. The court in *Boise Cascade Corp. v. United States*, *supra*, without analysis of section 404(k), determined that the second option was correct -- that the distribution payment from the plan to the departing employees was the deductible applicable dividend to be analyzed under section 162(k). *Id.* at 754 ("if the distributions to the employees were a distribution under § 301, then they were a 'dividend' for the purposes of § 316 and the deduction provided for in § 404(k) applies"). For the reasons discussed below, that position is unsupported under section 404(k). Rather, it is both the redemption payment and the distribution of that payment, as an integrated transaction, that constitutes the applicable dividend under section 404(k).

The Tax Court notes that in order to get a deduction under §404(k) an integrated set of events has to occur. The action by the sponsor, taken alone, would not have allowed a deduction under §404(k). As the Tax Court noted:

Petitioner made payments in redemption of the preferred stock held by the SIP. The redemption payments were made by petitioner (the corporation) to the SIP (the plan). The SIP properly distributed those payments. The redemption payments fit the technical

definition of a dividend for purposes of sections 301 and 316, because the redemptions did not result in a meaningful reduction in the ESOP's proportionate interest in petitioner. See sec. 302(b). However, they would not have been applicable dividends unless the SIP later distributed those payments in the prescribed manner.

Similarly, if the ESOP has simply paid out the balance to the participants, that wouldn't have enabled a deduction. The Court notes:

Distribution payments from the SIP to terminating employees, standing alone, do not fit the definition of applicable dividends for two reasons. First, an applicable dividend must be paid by the corporation, and the SIP is not the corporation -- petitioner is. Second, the distributions from the SIP are not dividends at all, because a dividend is defined as a payment by a corporation to its shareholders. Sec. 316(a). The SIP is the owner of the preferred stock; it cannot be the payor of dividends under section 316.

Thus, in the Tax Court's view, the deduction under §404(k)(2) requires viewing both parties actions as a unified whole:

These distribution payments represent only the distribution of the proceeds of a dividend paid by petitioner to the SIP. Thus, a distribution payment alone cannot be an applicable dividend as that term is defined under section 404(k). Rather, both sides of these redemption transactions -- redemption and distribution -- are necessary for the transactions to fit the definition of applicable dividends found in section 404(k).

The Tax Court thus concludes:

Petitioner's payments of these asserted applicable dividends were certainly in connection with a repurchase of stock. The first part of the applicable dividend transaction was the redemption. The funds of the transaction, passed from petitioner to the SIP to the departing employees, are the same funds used to repurchase stock. Section 162(k) bars a deduction for the payment of funds used to repurchase stock. See S. Rept. 99-313, at 223 (1986), 1986-3 C.B. (Vol. 3) 1, 223 ("The committee intends that amounts subject to this provision will include amounts paid to repurchase stock"). Therefore, the first part of the integrated transaction -- the redemption of stock from the SIP--ensures that section 162(k) bars the deduction of any portion of the transaction.

As a result, we hold that section 162(k) prevents petitioner from claiming as deductions the amounts it paid to repurchase its own stock from its ESOP which were then distributed to terminating employees. For the reasons given, we respectfully decline to follow the contrary result reached on almost identical facts by the U.S. Court of Appeals for the Ninth Circuit in *Boise Cascade Corp. v. United States*, 329 F.3d 751 (9th Cir. 2003).

The Tax Court notes in a footnote reference that while the *General Mills* court followed the Ninth's reasoning, another U.S. District Court in New Jersey rejected the Ninth's reasoning in a manner similar to the Tax Court (see *Conopco, Inc. v. United States*, 2007-2 USTC ¶50,582).

The IRS's New Guidance

In a concurring opinion, Tax Court Judge Swift chose to note that §404(k)(5)'s anti-abuse language could also be used to disallow the deduction. In his view, the IRS had issued Revenue Ruling 2001-6 that held that such redemption payments were not deductible under §414(k)(2). The Court noted that ruling was issued prior to Ralston Purina making this claim, even though the years involved were earlier. He notes:

I would note that the Commissioner's disallowance of deductions under section 404(k)(1), based on the discretion given to him in section 404(k)(5)(A), need not involve an analysis and findings of "badges of fraud" typically associated with prosecutions under section 7201 of affirmative attempts by taxpayers to engage in willful tax evasion and with determinations of willful civil tax fraud penalties under section 6663. See, e.g., *Spies v. United States*, 317 U.S. 492, 499 (1943).

Indeed, in this case petitioner filed its corporate Federal income tax returns for 1994 and 1995 without claiming deductions for redemption dividends. At this time no underpayments of tax are associated with the claimed section 404(k)(1) deductions. Not until December 9, 2003 (2 years after Rev. Rul. 2001-6, supra, was issued), did petitioner file (via its second amendment to petition herein) claims for refund for 1994 and 1995, asking respondent and this Court to consider the deductibility of petitioner's redemption dividends and if allowed to refund overpayments of taxes paid. There are no "badges of fraud" to be found here, and respondent does not contend otherwise. Rather, respondent simply contends that allowance of petitioner's claimed redemption dividend deductions would be improper and would give rise to under payments of Federal income taxes which the Commissioner, exercising his discretion under section 404(k)(5)(A), has described as tax evasion.

Judge Nims also notes that in the interim, the IRS has now issued regulations that specifically hold that such a payment is one that §404(k)(5)(A) will apply to:

Lastly, as stated, in 2006 the Secretary promulgated final regulations reflecting the position set forth in Revenue Ruling 2001-6. See sec. 1.162(k)(1), Income Tax Regs.; sec. 1.404(k)-3, Q&A-1, Income Tax Regs. ("Payments to reacquire stock held by an ESOP * * * used to make benefit distributions to participants" are not allowed under section 404(k)(2) and (5)). Although the regulations apply only prospectively and only to amounts paid or incurred after August 30, 2006, secs. 1.162(k)-1(c), 1.404(k)-3, Q&A-2, Income Tax Regs., the regulations are relevant as they are consistent with Rev.

Rul. 2001-6, supra, see *Smiley v. Citibank* (S.D.), N.A., 517 U.S. 735, 744 n.3 (1996) ("Where * * * a court is addressing transactions that occurred at a time when there was no clear agency guidance, it would be absurd to ignore the agency's current authoritative pronouncement of what the statute means.").

Where We Stand

As noted, the IRS now has regulations in place that label this transaction of a type that would not be allowed a deduction, and given §404(k)(5)'s language granting authority to the IRS in this area, it would appear that current transactions would face a very real uphill battle to obtain a deduction.

However, the methods used by both Courts in analyzing payments made in connection with a redemption is of interest for taxpayers that find themselves with situations where payments may appear to be “traceable” to a redemption. While later actions may have rendered both the *Kroy* decision (due to Congress now specifically allowing the type of deduction in *Kroy*) and *Boise Cascade* fact pattern (with IRS regulations now specifying this as an avoidance transaction) irrelevant for the same specific transactions, these aren't the only times a taxpayer may face this issue.