Internal Revenue Service

Index Nos: 162.05-03
401.04-03
402.02-01
404.00-00
415.02-01
4972.00-00

Department of the Treasury

Washington, DC 20224

199913047

Contact Person:

Telephone Number:

In Reference to:
OP:E:EP:T:3

Date:
JAN 5 1999

LEGEND:

Company A:

State B:

Company C:

Individual D:

Individual E:

Individual F:

Federal Agency G:

Plan X:

Agreement Y:

Date 1:

Date 2:

Date 3:

Date 4:

Dates 5:

Date 6:

Sum 1:

Sum 2;

Sum 3:

Gentlemen:

This is in response to the , request for letter ruling, submitted on your behalf by your authorized representative, as supplemented by correspondence dated , and , in which you request several letter rulings under sections 162, 401(a)(4), 402, 404, 415, and 4972 of the Internal Revenue Code. The following facts and representations support your ruling request.

Company A, which has its principal office in State B, adopted Plan X effective Date 3. Plan X is a defined contribution, employee stock ownership, plan which your authorized representative asserts is qualified within the meaning of Code section 401(a), and its trust exempt from tax pursuant to Code section 501(a). Individuals D, E, and F are some of the trustees of Plan X. Individual D was the President of Company A at the time the transaction described herein occurred; Individual E was the Chief Financial Officer and Treasurer of Company A at the time the transaction described herein occurred; and Individual F was the Corporate Secretary of Company A at the time the transaction described herein occurred

Section 1.41 of Plan X defines "plan administrator" as the "employer". Section 1.56 of Plan X indicates that the Plan X Trustee is "the party or parties, individual or corporate, named in this Agreement and any duly appointed additional or successor Trustees or Trustees acting hereunder". Section 4.1(b) of Plan X provides, in pertinent part that... "in determining the fair market value of Company Stock for purposes of the Plan, the Plan Administrator and Trustee shall utilize generally accepted methods of valuing corporate stock for purposes of arm's-length business transactions". Section 13.2 of Plan X provides, in pertinent part, that ..."the Trustee shall have the exclusive authority and discretion to manage and control the assets of the Plan, to invest and reinvest the principal and income of the Trust Fund..."

On Date 1, Plan X offered to purchase at least 45,341 shares of Company A stock at Sum 1 per share from the existing shareholders. In conjunction with this tender offer, Company C, a professional insurance agency appraiser, provided a statement to the trustees of Plan X which indicated that, in its professional opinion, the per share fair market value of Company A stock was Sum 3, which amount exceeded Sum 1.

On Date 2, Plan X made its tender offer pursuant to which it purchased 45,842 shares of Company A stock at Sum 1 per share.

During Date 4, Federal Agency G advised Company A and Plan X that it was investigating the above-referenced sale of stock on the ground that Plan X overpaid for the Company A stock it purchased pursuant to the Date 2 tender offer thereby violating the prohibited transaction rules of section 406 of Title I of the Employee Retirement Income Act of 1974 (ERISA). Under Title I of ERISA, Federal Agency G had authority to commence a legal action against all of the trustees of Plan X and against Company A itself. In addition, Company A's liability for the transaction stemmed from its contractual obligation to indemnify the trustees of Plan X for any liability that might arise as a result of their positions with respect to Plan X.

After prolonged negotiation, during Dates 5, Settlement Agreement Y was entered into between representatives of Company A and Plan X, including the trustees of Plan X, and Federal Agency G. Federal Agency G had expressly told attorneys representing Company A that Federal Agency G would absolutely and immediately initiate legal proceedings absent Settlement Agreement Y. Under the terms of Settlement Agreement Y, Company A agreed to make a replacement payment in the amount of Sum 2 to Plan X which sum represented the amount which Federal Agency G maintained Plan X overpaid for the stock of Company A that it purchased on Date 2 as noted above. Company A represents that it entered into Settlement Agreement Y and made the replacement payment in order to avoid litigation costs and resolve the potential claims of Federal Agency G against the trustees of Plan X.

On Date 6, Company A paid Sum 2 to Plan X. As noted in Settlement Agreement Y, Sum 2 "shall be credited to the accounts of the participants in the Plan on a pro rata basis consistent with the terms of the Plan".

Based on the above, you, through your authorized representative, request the following letter rulings:

that the replacement payment described above

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

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

(3) will not, when made to Plan X, result in taxable income to affected Plan X participants or beneficiaries; and

(4) will be deductible in full by Company A pursuant to Code section 162.

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

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 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 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 415(e) of the Code provides limitations on employer contributions and benefits in the case where an individual is a participant in both a defined benefit and a defined contribution plan maintained by the same employer.

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).

Code section 402(a) generally provides that amounts held in a trust that is exempt from tax under Code section 501(a) and that is part of a plan that meets the qualification requirements of Code section 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 Income Tax Regulations promulgated thereunder provide guidance as to whether Company A's replacement payment should constitute contributions for purposes of the above-referenced sections of the Code.

In this case, the payment, referred to above, which Company A made to Plan X will ensure that the affected participants in Plan X recover a portion of their account balances and place them in a position similar to that in which they would have been in the absence of the actions referenced above pursuant to which the trustees of Plan X allegedly overpaid for the stock of Company A. Thus, it is reasonable to characterize this payment as a replacement payment.

As indicated by the facts of this case, the replacement payment was made by Company A in response to a complaint made against it by Federal Agency G. The replacement payment will be allocated to the accounts of participants under Plan X that incurred loss as a result of the Plan X's trustees allegedly overpaying for Company A stock in such manner as required under Plan X provisions.

Thus, based on the above, we conclude as follows with respect to your first three ruling requests:

that the replacement payment described above

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

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

(3) will not, when made to Plan X, result in taxable income to affected Plan X participants or beneficiaries.

With respect to your fourth ruling request, 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 law suit and obtain a release from all claims under a franchise agreement is deductible under section 162 of the Code. 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); 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 (1963), 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 bondholders committee, pursuant to the consent judgment, was deductible. The payment was made to avoid unfavorable publicity and protect the payor'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 replacement payment made to Plan X by Company A will be made to resolve potential claims by Federal Agency G against the trustees of Plan X for which the trustees are entitled to indemnification by Company A. The situation in which Company 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 preempt similar claims arising in the ordinary course of a trade or business, are deductible business expenses.

Accordingly, with respect to your fourth ruling request, we conclude as follows:

(4) that the proposed replacement payment described above will be deductible in full by Company A pursuant to Code section 162 when paid.

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

Additionally, this ruling letter is based on Company A's representations made herein that it entered into Settlement Agreement Y and made the replacement payment described in this letter ruling in order to avoid litigation costs and resolve the potential claims of Federal Agency G against the trustees of Plan X. If, subsequent to the replacement payment, Company A becomes entitled to reimbursement for all or a portion of the replacement

payment (from Company C, an insurer, or any other source), then Company A 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 proposed transaction under other sections of the Code and regulations. Finally, no opinion is expressed as to the tax treatment of any conditions existing at the time of or effects resulting from the transaction 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 transaction is consummated.

Pursuant to a power of attorney on file with this office, a copy of this letter ruling is being sent to your authorized representative.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan
Chief, Employee Plans
Technical Branch 3

Enclosures:

Deleted copy of letter ruling
Form 437