200018056

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Uniform Issue List: 401.00-00
3402.00-00

Contact Person:

Telephone Number:

In Reference to:
T:EP:RA:T3

Date:

Attention:

Legend:

Company A: =

Plan X =

Plan Y =

Plan Z =

Dear

This is in response to your request for a ruling dated October 7, 1998, submitted by your authorized representative in which rulings are requested under Sections 404(k) and 3402 of the Internal Revenue Code of 1986 (the "Code"). A letter dated March 30, 1999, supplemented the request.

Company A is the parent company of a controlled group of trades or businesses within the meaning of Section 414 of the Code. Members of the controlled group provide electric utility and other energy-related services to customers. Company A sponsors several employee benefit plans for the benefit of employees of the Company and members of the controlled group, including Plan X and Plan Y.

Plan Y, which is currently sponsored by Company A, was originally effective January 1,1977 and was most recently amended and restated effective January 1, 1989. Plan Y is an "employee stock ownership plan" within the meaning of Section 4975(e)(7) of the Code and Section 407(d) of the Employee Retirement Income Security Act ("ERISA"). Plan Y is qualified under section 401(a) of the Code.

The assets of Plan Y are invested in Company A' s common stock. Plan Y was intended to satisfy the tax credit employee stock ownership plan rules under section 409 of the Code that were effective until December 31, 1986. Benefits under Plan Y were frozen effective

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December 31, 1986 in connection with the repeal of section 41 by the Tax Reform Act of 1986. Since that date, Plan Y has continued to hold the contributions made on behalf of participants and their beneficiaries until the participant retires or otherwise becomes eligible for a distribution.

Company A also sponsors Plan X. Plan X was originally effective January 1, 1982 and has since been amended from time to time. Plan X is an employee savings plan with an employer matching contribution and contains a cash or deferred arrangement under section 401(k) of the Code. Plan X is qualified under Code Section 401(a), and the related trust is exempt under Code Section 501(a).

Plan X permits participants to make before-tax and after-tax contributions of up to 15% of the participant's compensation. Company A matches the participant's contributions that do not exceed 6% of compensation, at either a 50% or 75% rate, depending on the participant's years of service. Up to five separate accounts may be maintained under Plan X for each participant, including after-tax regular and supplemental contribution accounts, pre-tax regular and supplemental contribution accounts, and an employer matching account. In addition, a participant may have a transfer account that contains assets that have been transferred to Plan X from other tax-qualified plans.

Twelve investment options are offered to participants under Plan X, including ten mutual funds, a managed income fund and the Company A common stock fund. The Company A Common Stock Fund invests primarily in common stock of Company A. A small portion of the Company A Common Stock Fund may be invested in short-term investments for liquidity purposes to accommodate daily trading. Dividends received on shares of Company common stock held in the Company A Common Stock Fund are used to purchase additional shares of Company A common stock and allocated to the accounts of participants in proportion to their respective interests in the fund.

Participants may invest or redirect their before-tax and after-tax contributions under Plan X to any of the investment options, including the Company A Common Stock Fund. Employer matching contributions are automatically deposited in the Company A Common Stock Fund. Transfer of employer matching contributions from the Company A Common Stock Fund to any other investment fund is prohibited prior to the participant's attainment of age 55. Upon attaining age 55, a participant may transfer all or any portion of his or her employer matching contributions and related earnings to any other investment fund then maintained under Plan X.

On July 15, 1998, the Board of Directors of the Company A voted to merge Plan X and Plan Y into a single plan ("Plan Z"), effective October 1, 1998. It is intended that Plan Z will constitute a stock bonus plan under section 401(a) of the Code and an employee stock ownership plan under section 4975(e)(7) of the Code and Section 407 of ERISA. A determination letter request will be filed with the Service with respect to the qualified status of Plan Z under Code Sections 401(a), 401(k), and 4975(e).

Participants in Plan Z will be allowed to invest their before-tax and after-tax contributions in any of the existing investment options, including the Company A Common Stock Fund. All employer-matching contributions will be paid to Plan Z each payroll period and will automatically be invested in the Company A Common Stock Fund. Participants will not be allowed to transfer employer-matching contributions out of the Company A Common Stock Fund until they attain age 55. Assets attributable to Plan Y will also be invested in the

Fund until they attain age 55. Assets attributable to Plan Y will also be invested in the Company A Common Stock Fund and may not be transferred to other investment options by participants.

As an employee stock ownership plan, Plan Z will be designed to invest primarily in Company A common stock. The Company A Common Stock Fund under Plan Z will consist of the ESOP shares, employer matching contributions, and participant-directed purchases with before-tax and after-tax contributions.

In addition, Plan Z will be amended to provide that dividends paid on common stock held in the Company A Common Stock Fund may be distributed to participants in cash in an amount proportionate to the number of shares of stock held in the participant' s accounts. The amendment will provide that dividends will be distributed in cash to each participant, unless the participant makes an affirmative election to have the dividends remain in Plan Z. Dividends on shares attributable to Plan Y will automatically be paid in cash.

Cash dividends will be paid to participants on a quarterly or other periodic basis, but in no event later than 90 days after the close of the Plan year in which the dividends are paid to Plan Z. If the participant does not wish to receive a cash distribution of the dividend amount, the participant may elect to keep all or a portion of the dividends in Plan. Elections may be made in increments of 25% through the service administrators at any time prior to the last business day of the month immediately preceding the dividend record date. The amount of dividends payable to a participant will be determined based on the number of units of Company A common stock held in the participant's Company A Common Stock Fund on the last business day immediately preceding the ex-dividend date[1]. Activity in a participant's Company A Common Stock fund occurring on or after the last ex-dividend date, but prior to the dividend payment date will be ignored for purposes of determining the amount of the dividends payable to the participant on such dividend payment date.

On the dividend payment date, Company A will pay the dividends on shares held by Plan Z to the Plan Z trustee. Unless the participant has elected otherwise in accordance with the procedures described above, the trustee will distribute the dividends to participants as soon as practicable following the dividend payment date, but no later than 90 days after the end of the plan year. The first distribution of the dividends is expected to be on or about January 30, 1999, which will represent dividends payable for the fourth quarter of 1998 to shareholders of record as of January 9, 1999. Dividends with respect to participants who elect not to receive the cash distribution will be deposited in the Company A Common Stock Fund and reinvested in Company common stock.

Based on the foregoing you request the following rulings:

1. Under the Plan, as amended, dividends paid to Plan Z by Company A with respect to dividend record dates on or after January 1, 1999 and distributed to participants in cash will be deductible by Company A in the year distributed pursuant to section 404(k) of the Code.

[1] The ex-dividend date is the date on or after which a security begins trading without the dividend (cash or stock) included in the contract price of the security. The ex-dividend date typically occurs four days before the record date, which is the date on which a shareholder must officially own shares in order to be entitled to a dividend payment.

Section 404(k)(1) 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)-1T, 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 cash dividends paid to Plan Z by Company A with respect to the dividend record dates on or after January 1, 1999 and distributed to participants in cash will be deductible by Company A in the year distributed pursuant to section 404(k) of the Code.

Federal income tax withholding under section 3402(a) of the Code requires employers to withhold federal income tax from wages as defined in section 3401(a).

Section 3102 of the Code requires employers to withhold the tax imposed by section 3101, that is, the employee portion of tax under the Federal Insurance Contributions Act (FICA), as defined in section 3121(a). Similarly, section 3111 requires the employer to pay the employer portion of the FICA tax on wages as defined in section 3121(a)

Section 3301 of the Code imposes a tax under the Federal Unemployment Tax Act (FUTA), which the employer must may with respect to wages as defined in section 3306(b).

Under section 3401(a) of the Code, "wages" generally means all remuneration for services performed by an employee for his employer. Under sections 3121(a) and 3306(b), "wages" generally means all remuneration for employment.

The dividends paid on common stock held in Plan Z's common stock fund to Plan Z by Company A and distributed to participants in cash appear to be dividends. We understand that they are not remuneration for services or remuneration for employment and thus are not wages.

While section 404(k) of the Code allows a deduction for dividends paid in cash, that section does not change the character of the dividends to remuneration for services or remuneration for employment. Thus, the dividends remain dividends and are not converted to wages. Dividends are not subject to income tax withholding, FICA tax, or FUTA tax.

Accordingly, with respect to your second ruling request we conclude that, under the procedures described above, such cash dividends will not constitute wages subject to income tax withholding, FICA tax, or FUTA tax under sections 3402(a), 3102, 3111, or 3301 of the Code.

The above rulings are based on the assumption that Plan X Plan Y and Plan Z will be qualified under sections 401(a), 401(k), 409, and 4975(e)(7) of the Code, and the related trust 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' accounts in Plan X are "applicable employer securities", within the meaning of section 404(k)(3) with respect to the subject dividends.

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 Z participants in a manner that does not discriminate among Plan Z participants and will not cause the trustee of Plan Z 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. Section 6110(k)(3) of the Code provides that it may not be used or cited by others 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

Frances V. Sloan, Manager
Employee Plans, Technical Branch 3
Tax Exempt and Government Entities Division

Enclosures:
Notice of Intention to Disclose
Deleted Copy of Ruling