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

COMMISSIONER
TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION
SIN 414.09-00

JUL 15 2002

T:EP:RA:T2

LEGEND:

Employer A =

State B =

Plan X =

Committee C =

Dear :

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

The following facts and representations have been submitted:

Employer A is an operator of stores in State B. Employer A is a publicly traded corporation whose shares are traded on the New York Stock Exchange.

Employer A sponsors Plan X, which provides for elective deferrals and matching contributions under sections 401(k)

and 401(m) of the Code. Plan X also holds account balances from other plans that were merged into Plan X as well as rollover accounts from participants. Plan X is qualified within the meaning of section 401(a) of the Code and its trust is tax-exempt pursuant to section 501(a) of the Code. Under the provisions of Plan X, Employer A is the plan administrator and named fiduciary within the meaning of the Employment Retirement Income Security Act of 1974 ("ERISA").

Each plan participant has an individual account or accounts. Plan X participants may select from ten investment vehicles and may also invest account balances in common stock of Employer A (Employer A Stock). Prior to January 2001, employer matching contributions were made in shares of Employer A Stock.

On , shares of Employer A Stock were held under Plan X in various participant accounts. As of the close of trading on the shares were trading at per share. On . Employer A announced that it was investigating possible accounting irregularities that, if confirmed, would result in the need to revise earlier reported unaudited financial results for fiscal year 2000. In the announcement, Employer A disclosed that these accounting irregularities would adversely impact its earnings for the fiscal year ended on . At the request of Committee C the president and chief operating officer of Employer A voluntarily relinquished his operating responsibilities. On Employer A announced that based on its preliminary investigation, the accounting irregularities were limited to fictitious general ledger accounting entries made by a small number of personnel at its corporate headquarters. The entries appeared to have been made for the purpose of reducing certain costs and operating expenses and included adjustments to rental merchandise, certain fixed asset write offs and other operating expense, thereby artificially increasing earnings. Based on the preliminary investigation, Employer A expected these matters to have a negative non-cash impact of between and pre-tax on) earnings.

The value of Employer A's stock fell dramatically immediately after the publication of these press releases. Following a brief suspension of trading on the New York Stock Exchange, Employer A Stock was trading at on Employer A Stock held by Plan X on were worth per share less on , or a total drop in value of

Subsequently, Employer A Stock fell to a low of , more than less than the price per share on

Following the announcements, several class actions lawsuits were commenced against Employer A and some of its officers, alleging violations of the Securities Exchange Act of 1934. The plaintiffs alleged that Employer A issued a series of materially false and misleading statements regarding the company's financial condition and results of operations by overstating revenues for The plaintiffs further allege that the class of plaintiffs purchased Employer A Stock at artificially inflated prices as a result of Employer A's materially false and misleading statements and omissions.

In light of the class actions lawsuits already filed against Employer A, and in an effort to restore lost value to participant accounts, avoid further legal action and minimize potential fiduciary claims relating to Plan X, Employer A began making cash payments ("Restorative Payments") to Plan X's trust in . Employer A's board of directors approved the program of Restorative Payments in and announced the program to participants. Under the program, an immediate payment of per share was contributed to a new Restorative Payment Account in Plan X in . The payment is based on the number of shares held in participant accounts on excluding the employer matching account. All participants are 100 percent vested in the value of the Restorative Payments accounts.

A Restorative Payment was made in since the value of Employer A Stock plus was less than . The value used for Employer A Stock was the average trading price for the stock for the 10 trading days preceding The average price was the was added to (the Restorative Payment amount per share in , for a total of The difference between and , or per share was the per share Restorative Payment for

Additional payments will be made in and if conditions specified in Plan X as amended are met. Each of these additional payments are intended to bring the restored value of Employer A Stock held in participants' accounts as of to a value of and through the payments made in and respectively when the amount of the Restorative Payments, together with the market value of Employer A Stock on the New York Stock Exchange are taken into account.

The Restorative Payment will again be based on the average price of Employer A Stock over the 10 trading days preceding . That average price, added to the and per share Restorative Payments is then compared to . The shortfall, if any, is the per share Restorative Payment for . This process is repeated for January 2004 where the benchmark for is per share.

Total Restorative Payments under Plan X as amended are capped at per share over the course of the three years ending in If the trading price of Employer A Stock reaches or more per share for 10 consecutive trading days before there will be no further Restorative Payments.

The intent of the program is to restore a value of about to the shares of Employer A Stock that were held in participant accounts on other than the employer matching account, over the term of the program. If an affected participant terminates employment and takes a distribution of his or her accounts, there will be no further Restorative Payments allocated to that participant other than the initial per share Restorative Payment. Actual investment performance of participant accounts in Plan X, whether or not invested in Employer A Stock, will have no effect on the amount of the Restorative Payments. The determination of each Restorative Payment (other than the initial per share) will be based on values of Employer A Stock and not on the value of any participant account in Plan X. Each participant who had investments in Employer A Stock on (other than the employer matching accounts) will share in the Restorative Payments so long as the participant has an undistributed account balance.

The program provided that the initial Restorative Payments will be invested in a money market account and will not be available for distribution until such time as a favorable letter ruling is issued by the Internal Revenue Service. Once this letter is issued, amounts held in the Restorative Payments Account will be available for participant-directed investments, excluding investments in Employer A Stock.

Based on the foregoing facts and representations you have requested the following rulings:

(1) The Restorative Payments will be deductible in full by Employer A pursuant to Code section 162.

(2) The Restorative Payments will not constitute employer "contributions" or amounts subject to the provisions of Code Sections 404, 415 or 4972.

(3) The Restorative Payments will not adversely affect the qualified status of Plan X under Code Section 401.

(4) The Restorative Payments will not violate non-discrimination rules of Code Section 401(a)(4) and will not be "annual additions" under Code section 415.

(5) The Restorative Payments will not, when made to the Plan, result in taxable income to affected Plan X participants or beneficiaries.

With respect to ruling request one, Section 162(a) of the Code provides that there is 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 gave 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; Rev. Rul 69-491, 1969-2 C.B. 22.

In Kornhauser v. United States, 276 U.S. 145 (1928) VII-2 C.B. 267 (1928), 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 operations. See Woodward v. Commissioner, 397 U.S. 572, 578 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970); Anchor Coupling Co. v. United States, 427 F.2d 429, 433 (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 is 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 fess 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. See also DeVito v. Commissioner, T.C. Memo 1979-377, in which 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.

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 authorities cited. Rev. Rul. 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 situation in which Employer A finds itself arose in the ordinary course of its trade or business. The Restorative Payments to Plan X by Employer A are in direct response to a loss arising out of Employer A's business activities and the effort to address participant concerns about the effect of corporate accounting irregularities on account balances in Plan X. Because the Restorative Payments by Employer A will address or preempt claims arising in the ordinary course of Employer A's business, we conclude with respect to ruling request one, the payments to Plan X are deductible as ordinary and necessary business expenses under section 162 of the Code.

The issue of whether Restorative Payments to a defined contribution plan qualified under section 401(a) of the Code are treated as contributions for purposes of sections 401(a)(4), 404, 415(c) and 4972 is addressed in Revenue Ruling 2002-45, 2002-29 I.R.B.___.

Since Rev. Rul. 2002-45 disposes of the issues raised in ruling requests two through five, the Service will not issue rulings on those requests.

This ruling is based on the assumption that Plan X meets the requirements of section 401(a) of the Code, 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 income tax consequences of the transactions described above under any other provisions of the Code.

Additionally, this ruling is based on the representation made herein that the payments described in this letter ruling will be made in response to potential claims against Employer A. 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.

The representations here, like all factual representations made to the Internal Revenue Service in

applications for rulings, are subject to verification on audit by Service field personnel.

This letter 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.

A copy of this letter is being sent to your authorized representative in accordance with a power of attorney on file in this office.

If you have any questions, please contact T:EP:RA:T2, by telephone at or by fax at (.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Manager, Employee Plans
Technical Group 2
Tax Exempt and Government
Entities Division

Enclosures:
Deleted copy of letter ruling
Notice 437