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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply to:

OP:E:EP:T:3

Date: JUN 28 1999

Attention:

Legend:

Company A =

Company B =

Union M =

Plan X =

Plan Y =

Plan Z =

Dear

This is in response to your request for a ruling dated October 14, 1996, 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") with respect to amendments to Plan X. The request was supplemented by letters dated April 29, 1998, November 10, 1998, and December 28, 1998.

Company A, a wholly-owned subsidiary of Company B, established Plan X on January 1, 1975, for the benefit of Company A employees. Plan X is an employee stock ownership plan under section 4975(e)(7) of the Code and is qualified under section 401(a) of the Code, and its related trust is exempt under section 501(a).

Plan X invests exclusively in the stock of Company B.

Company A established Plan Y on April 1, 1987. Under Plan Y, nonunion employees of Company A and Company B can make before-tax contributions pursuant to section 401(k) of the Code, and receive matching employer contributions. Plan Y is a qualified plan under sections 401(a) and 401(k) of the Code and the trust is exempt under section 501(a).

Company A also established Plan Z on January 1, 1993. Under Plan Z, employees of Company A who are members of Union M can make before-tax contributions pursuant to section 401 (k), and receive matching employer contributions. Plan Z is a qualified plan under sections 401(a) and 401(k) of the Code and the trust is exempt under section 501(a).

Plan Y and Plan Z provide that employees can elect to invest salary deferrals and after-tax contributions among nine investment funds. Participants in Plan Y can borrow funds from their account, subject to certain limits and conditions.

Plan X currently allows participants and beneficiaries of Plan X to receive dividends (the "ESOP Dividends") directly in cash. Plan X was amended, effective January 1, 1996, to clarify that the ESOP Dividends may be paid out under one of the following dividend pass-through methods:

(a) **Method 1**: Participants and beneficiaries may elect to receive direct cash payment of ESOP Dividends by making the appropriate election with the Plan X administrator.

(b) **Method 2**: ESOP Dividends are automatically paid directly to active employees, but an individual employee will receive ESOP Dividends only to the extent that an equal amount of tax-deferred contributions could be made by the employee to Plan Y or Plan Z, as appropriate, within the limits of sections 402(g) and 415 of the Code. All ESOP Dividends with respect to beneficiaries and nonactive employees (terminated/retired employees) are paid in accordance with method 1 above.

(c) **Method 3:** ESOP Dividends are automatically paid out in accordance with method 2 above and, in addition, employees may elect to receive direct cash payment of all ESOP Dividends that would otherwise be retained by the ESOP, or may elect not to receive any such dividends (i.e., reinvest within Plan X) by making the appropriate election with the Plan X administrator.

Plan X will also be amended to provide that any ESOP Dividends to be paid directly to a participant or beneficiary will be made to an agent of the trustee of Plan X ("Paying Agent"), or to the trustee of the ESOP Plan and then distributed to the participants and beneficiaries (either directly or through an agent of the trustee) within 90 days of the close of the plan year in which the ESOP Dividends were paid.

Procedurally, Company A proposes that ESOP Dividends on Company B common stock be paid to active and non-active employees (e.g., terminated/retired employees) either directly by the trustee or indirectly through the Paying Agent, in accordance with the procedure outlined below.

Effective for the plan year beginning January 1, 1996, the ESOP Dividend would be processed as follows:

(a) For participants who receive the ESOP Dividends in cash and whose Salary Reduction Agreement provides for a deferral of compensation (as described in greater detail below and

as subject to applicable Code limitations) for any payroll period, the Paying Agent would increase the amount of the next payroll check to each such employee entitled to receive payment of the ESOP Dividend in cash, and include a notice that the payroll check includes the amount of the ESOP Dividend. The amount of compensation equal to the ESOP Dividend which would be deferred to either Plan Y or Plan Z would be deducted from the participant's compensation and contributed to the appropriate Plan for that period.

(b) For participants who receive the ESOP Dividends in cash and do not correspondingly increase their elective deferrals, the Paying Agent would increase the amount of the next payroll check to each such employee entitled to receive payment of the ESOP Dividend in cash, and include a notice that the payroll check includes the amount of the ESOP Dividend.

(c) For participants who do not receive all or a portion of their ESOP Dividends in cash, such participants' ESOP Dividends that are not received in cash would be paid directly by Company B to the trustee of Plan X.

Based on the foregoing you request the following rulings:

1. The dividends paid on Company B common stock held by Plan X will be deductible in the year distributed or paid under section 404(k) of the Code, if such dividends are paid directly to participants (or their beneficiaries) by the Paying Agent (as agent for the trustee) or by the trustee no later than 90 days after the close of the plan year in which dividends are paid to Plan X.

2. If a participant defers current compensation in an amount equal to the ESOP Dividends distributed to the participant, under the procedures described above, the amounts so deferred will not constitute wages subject to income tax withholding under section 3402 of the Code.

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 on shares of Company B common stock will be deductible in the year distributed or paid under section 404(k) of the Code, if such dividends are paid directly to participants (or their beneficiaries) by the Paying Agent (as agent for the trustee) or by the trustee no later than 90 days after the close of the plan year in which the dividends are paid to Plan X.

With respect to your second ruling request, section 402(e)(3) of the Code provides, in part, that contributions made by an employer on behalf of an employee to a trust which is a part of a qualified cash or deferred arrangement shall not be treated as distributed or made available to the employee nor as contributions made to the trust by the employee merely because the arrangement includes provisions under which the employee has an election whether the contributions will be made to the trust or received by the employee in cash.

Section 1.401(k)-1(a)(2) of the Income Tax Regulations provides that, generally, a cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a) of the Code.

Section 1.401(k)-1(a)(3)(i) of the regulations provides that a cash or deferred election is any election (or modification of an earlier election) by an employee to have the employer either - (A) provide an amount to the employee in the form of a cash or some other taxable benefit that is not currently available, or (B) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation. A cash or deferred election includes a salary reduction agreement between an employee and employer under which a contribution is made under a plan only if the employee elects to reduce cash compensation or to forgo an increase in cash compensation.

Section 1.401(k)-1(a)(3)(ii) of the regulations provides that a cash or deferred election can only be made with respect to an amount that is not currently available to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to an amount that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.

Section 1.401(k)-1(a)(3)(iii) of the regulations provides that cash or another taxable amount is currently available to the employee if it has been paid to the employee or if the employee is able

currently to receive the cash or other taxable amount at the employee's discretion. An amount is not currently available to an employee if there is a significant restriction or limitation on the employee's right to receive the amount before a particular time in the future. The determination of whether an amount is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451 of the Code.

Section 1.401(k)-1(a)(4)(i) of the regulations provides that, a qualified cash or deferred arrangement is a cash or deferred arrangement that satisfies the requirements of paragraphs (b), (c), (d), and (e) of section 1.401(k)-1 and that is part of a plan that otherwise satisfies the requirements of section 401(a) of the Code.

Section 1.401(k)-1(a)(4)(ii) of the regulations provides that, except as otherwise provided in section 1.401(k)-1(f), elective contributions under a qualified cash or deferred arrangement are treated as employer contributions.

Section 1.401(k)-1(a)(4)(iii) of the regulations provides that, except as provided in section 402(g) of the Code and in section 1.401(k)-1(f), elective contributions under a qualified cash or deferred arrangement are neither includible in an employee's gross income at the time the cash or other taxable amounts would have been includible in the employee's gross income (but for the cash or deferred election), nor at the time the elective contributions are contributed to the plan.

Federal income tax withholding under section 3402(a) of the Code is imposed on "wages" as defined in section 3401(a). Section 3401(a)(12)(A) excepts from the definition of wages remuneration paid to, or on behalf of, an employee or his beneficiary from or to a trust described in section 401(a) which is exempt from tax under section 501(a) at the time of such payment, unless such payment is made to an employee of the trust as remuneration for services rendered as such employee and not as a beneficiary of the trust. Section 31.3401(a)(12)-1(a) of the Employment Tax Regulations provides that "wages" does not include any payment made by an employer, on behalf of an employee or his beneficiary, into a trust, if at the time of such payment the trust is exempt from tax under 501(a) as an organization described in section 401(a).

Accordingly, with respect to your second ruling request we conclude that if a participant defers current compensation in an amount equal to the ESOP Dividends distributed to the participant, under the procedures described above, the amounts so deferred will not constitute wages subject to income tax withholding under section 3402 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.

We are also assuming that Plan X will be amended to reflect the dividend passthrough method adopted by Company A for the distribution of dividends. Such method will stay in effect until the Plan X is further amended to adopt a different passthrough method.

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 X participants in a manner that does not discriminate among Plan X participants and will not cause the trustee of Plan X 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
Chief, Employee Plans
Technical Branch 3

Enclosures:
Notice of Intention to Disclose
Deleted Copy of Ruling

CC: