

Publications

Deductibility of ESOP Dividends After EGTRRA: Time to Revamp the Administration of ESOP Dividends

PUBLISHED

06/12/2002

SERVICES

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) liberalized the ESOP dividend deduction rules by adding a new provision to section 404(k) of the Internal Revenue Code (Code). See Code section 404(k)(2)(A)(iii). Effective for taxable years beginning on or after January 1, 2002, a company may claim a deduction for dividends paid to an ESOP if the participant or beneficiary may elect to have the dividend paid in cash (either directly or through the ESOP) or paid to the ESOP and subsequently reinvested in employer securities held by the ESOP. Prior to EGTRRA, a company could deduct dividends paid to an ESOP and subsequently reinvested in employer securities held by the ESOP only if the dividends initially were distributed in cash to the participant. (Before and after EGTRRA, dividends used to make ESOP loan payments are also deductible.) Recent IRS guidance, in the format of questions and answers, clarifies some of the details of this new Code provision. See Notice 2002-2.

A. The Problem Addressed by the New EGTRRA Provision

Prior to EGTRRA, companies could deduct dividends paid with respect to employer securities held in an ESOP only under the following circumstances:

- if the dividends were paid in cash to the participants;
- if the dividends were paid to the ESOP and subsequently distributed in cash to participants within 90 days after the close of the plan year in which the dividend was paid; or
- if the dividends were used to make payments on an ESOP loan, provided the dividends were paid on employer securities actually acquired with the proceeds of the ESOP loan.

In order to claim the deduction, some companies sponsoring non-leveraged ESOPs provided for the automatic distribution of ESOP dividends. Participants in these plans had no choice but to receive the dividends; they could not defer the taxation of the dividends.

Some companies not only wanted to claim the deduction for ESOP dividends, but also wanted to allow reinvestment of the dividends in the ESOP. They did not want to automatically distribute the dividends. These companies implemented administrative procedures whereby ESOP dividends were paid to the ESOP, but — instead of automatically being distributed in cash to participants — they were retained in the ESOP pursuant to participant elections, essentially as a 401(k) contribution. The effect of these participant elections was that the participants were treated as if they received the dividends in cash and subsequently contributed the cash to the ESOP in a cash-or-deferred election, where it was invested in employer securities. The Service approved such arrangements in a series of private letter rulings, (see, e.g., PLR 199938040), but the procedures required for these elections were complex and IRS limits sometimes prevented increases in 401(k) deferrals.

Now that companies may deduct reinvested ESOP dividends, companies using the procedures outlined in the private letter rulings can simplify the administration of their ESOPs. Reinvesting the dividends will still involve some administrative burdens, and a participant election process will still be necessary. However, the administration of these elections will be less complicated than prior to EGTRRA. It is likely that this new provision will encourage companies that did not either cash out dividends, or allow an election to take dividends in cash in the past, to consider allowing such an election in order to take advantage of the new deduction.

B. Plan Administration Requirements and Implications

Participant Elections — In order to claim a deduction for reinvested ESOP dividends, a company's ESOP must allow participants to elect between having the dividends allocable to his or her ESOP account reinvested in the ESOP or distributed in cash. Beneficiaries and inactive participants, as well as active participants, may make this election. See Notice 2002-2 (Q&A 12). This election may be made in the form of a "negative" election, whereby dividends will be automatically reinvested unless a participant affirmatively elects otherwise.

The election must be offered pursuant to the terms of the plan under procedures that satisfy the following requirements:

Participants must be given a reasonable opportunity in which to make the election before the dividends are paid or distributed to them; Participants must be given a reasonable opportunity to change their elections at least annually; and If there is a change in the plan terms governing the manner in which the dividends are paid or distributed, participants must be given a reasonable opportunity to make elections under the new plan terms before the first dividends subject to the new plan terms are paid or distributed.

See Notice 2002-2 (Q&As 2 and 3).

As part of the election process, participants who also participate in a 401(k) plan should be made aware of the fact that if they take a hardship withdrawal from the 401(k) plan, they must elect to receive cash dividends. See Notice 2002-2 (Q&A 8). A company might want to draft its election forms to provide for automatic cash distributions in the event that a participant receives a hardship withdrawal.

Other Requirements — Several additional requirements must be met before a company can claim the deduction for reinvested dividends:

The plan must be designated as an ESOP, and comply with the Code provisions applicable to ESOPs, no later than the record date established for the payment of the dividends. The recent IRS guidance expressly states that a plan may not be retroactively designated as an ESOP.

A participant must be fully vested in any dividend for which an election is permitted, even if the dividend is reinvested. See Notice 2002-2 (Q&A 9). Accordingly, an ESOP must either (i) fully vest all dividends for which participants may make an election, regardless of whether the participant is vested in the underlying securities; or (ii) limit the availability of the election to fully vested participants, which would raise nondiscrimination concerns.

As under pre-EGTRRA law, the dividends must be paid with respect to "employer securities." See Code section 404(k)(6). Generally, employer securities means common stock issued by the employer (or by an employer in the controlled group), which is readily tradable on an established securities market. If the employer securities are not readily tradable, they must meet certain criteria pertaining to voting power and dividend rights. See Code section 409(l)(2).

Treatment of Dividends For Other Plan Purposes — The recent IRS guidance clarifies that reinvested dividends will be treated as earnings; thus, they will not be subject to the limitations on contributions under Code sections 415, 402(g), 401(k), or section 401(m).

Consistent with this approach, when reinvested dividends are ultimately distributed, they will be subject to the Code provisions generally applicable to distributions from tax-qualified plans. The guidance does not address what effect, if any, this may have on the calculation of “net unrealized appreciation” on employer stock.

Similarly, dividends that are paid in cash are not subject to the limitations on contributions found in Code sections 415, 402(g), 401(k), or section 401(m). However, in contrast to reinvested dividends, dividends that are distributed in cash are not subject to the Code provisions generally applicable to distributions from tax-qualified retirement plans. For example, they are not subject to the 10% penalty or basis recovery provisions of section 72; the consent provisions of section 411(a)(11); the distribution restrictions of section 401(k); or the rollover provisions. See Notice 2002-2 (Q&As 6 and 7).

Plan Amendments — ESOPs will have to be amended to take advantage of this new law, and the amendment must comply with recent guidance applicable to EGTRRA amendments. This guidance requires a “good faith” amendment by the end of the plan year in which the first taxable year of the company for which the deduction is being sought ends. Generally, this means that if a company wants to implement this provision as soon as possible, i.e., beginning with its 2002 fiscal year, it will have to amend the plan by the end of the first plan year ending after the start of its 2002 fiscal year. For example, if a company wants to implement this provision as of April 1, 2002, the first day of its 2002 fiscal year, then a good faith amendment must be adopted by December 31, 2002 if the company’s ESOP is a calendar year plan. This “good faith” amendment need not encompass the guidance offered in Notice 2002-2. A final EGTRRA amendment must be adopted by the end of the EGTRRA remedial amendment period, which currently is the last day of the first plan year beginning on or after January 1, 2005. See Notice 2002-2 (Q&A 13). See also Notices 2001-42 and 2001-57.

C. Other Deduction Issues

Timing of the Deduction — The timing of the deduction depends on whether the dividend is reinvested or distributed in cash. If the dividend is reinvested, the company may claim a deduction for the taxable year in which the dividends are reinvested, or the year in which the participant election becomes irrevocable, if later. If the dividend is distributed to the participant in cash, the company may claim a deduction for the taxable year in which the payment is made to the participant.

Pre-2002 Dividends — A question arises as to whether a company can deduct pre-fiscal year 2002 dividends that are reinvested in employer securities pursuant to a participant election. The IRS guidance provides that companies may claim deductions under the new law for dividends paid in the 2001 fiscal year, if they are either irrevocably reinvested or distributed in the 2002 fiscal year; companies may not claim deductions for dividends paid prior to January 1, 2001, regardless of when the dividends are distributed or irrevocably reinvested.

Earnings on Dividends — Sometimes an ESOP does not immediately allocate cash dividends to participants, but instead, invests the dividends in an interest-bearing fund for a period of time. A question arises as to whether a company may deduct the earnings. For example, assume that a cash dividend is paid to an ESOP in early April 2002. The ESOP invests the dividend in a money market account. Subsequently, the dividend is distributed to a participant in February 2003. The IRS guidance provides that, effective for taxable years beginning on or after January 1, 2003, the company may not treat the earnings as dividends and so the earnings may not be deducted under Code section 404(k), whether or not the dividends are reinvested or distributed. However, investment losses attributable to dividends will reduce the amount that may be deductible. See Notice 2002-2 (Q&A 5). The purpose of the delayed effective date is to give recordkeepers time to implement systems to track investment earnings and losses.

The IRS guidance suggests that the earnings cannot be distributed from the plan without violating various Code sections. See Notice 2002-2 (Q&A 5). Presumably, such earnings must be maintained in the ESOP as earnings on plan assets until the participant is eligible for regular distributions.

Dividends as “Tax Evasion” — The IRS may disallow the deduction if the dividend constitutes, in substance, an avoidance or evasion of tax. The IRS guidance states that this encompasses a right to disallow a deduction for unreasonable dividends. The notice clarifies that dividends paid with respect to common stock primarily and regularly traded on an established securities market (within the meaning of Treas. Reg. Sec. 54.4975-7(b)(1)(iv)) are presumed to be reasonable. In other cases, whether or not a dividend is reasonable will be determined by comparing the dividend rate of employer securities held by the ESOP with the dividend rate of regularly traded securities of comparable companies (i.e., comparable with respect to size, earnings, debt-equity structure, dividend history, and industry). As under current law, payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants constitutes tax evasion.

D. Unresolved Issues

Although the guidance on the reinvestment of ESOP dividends is fairly comprehensive, there are several issues that remain unclear:

To what extent must dividends be paid in cash if a participant elects a hardship distribution from a 401(k) plan? For example, if a participant requests a hardship distribution from his 401(k) plan in January, must he elect cash with respect to ESOP dividends that will be distributed in March, assuming that the dividends will be paid too late to alleviate his hardship?

Should distributed dividends be taken into account in determining whether a participant has satisfied the minimum distribution requirements?

If a partially vested participant is permitted to make an election regarding the vested portion of any dividends, and he elects to receive such portion in cash, may the nonvested portion of the dividend that is not distributed be aggregated with the rest of his account, or must it be accounted for separately? Accounting for it separately would be burdensome, but aggregating it might result in a portion of it being vested. For example, if the participant is 50% vested in his account and nonvested dividends are not separately accounted for, they will become 50% vested.

E. Implications

Companies that sponsor ESOPs should review their ESOP's treatment of dividends. If the ESOP only provides for the distribution of cash dividends, the Company should consider amending the plan to allow participants to elect to have the dividends reinvested. If the ESOP permits the reinvestment of dividends, but only after the dividends are treated as if they had been distributed in cash, the Company should consider amending the plan to simplify the reinvestment process.

Companies that sponsor stock bonus plans should consider amending their plans into ESOPs in order to take advantage of the new expanded ability to deduct ESOP dividends.