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

200237026

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JUN 18 2002

T:EP:RA:T3

UIL: 4975.00-00

LEGEND:

Company A:

Company B:

Company C:

Country H:

Dear

This is in response to a request for a private letter ruling dated October 29, 2001, as supplemented by correspondence dated January 10, 2002, January 28, 2002, and February 7, 2002, submitted on your behalf by your authorized representatives, concerning the tax treatment of dividends paid on stock held by an employee stock ownership plan ("ESOP") within the meaning of section 4975(e)(7) of the Internal Revenue Code. In support of your request, your authorized representatives have presented the following facts and representations:

Company A is a United States corporation, which is wholly owned by Company B, another United States corporation. Company B is wholly owned by Company C, which is a corporation in Country H and is subject to tax under Code section 881 on income that is not connected with a United States trade or business. The shares of Company C's common stock ("Company C Stock")

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The timing of corporate events, including dividend payments, occurs on the same day worldwide. Company C Stock is traded on the New York,

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stock exchanges.

Company A maintains two retirement plans (the "Plans") for its employees that include a cash-or-deferred arrangement under Code section 401(k), and are qualified under Code section 401(a). Company A intends to designate a portion of each Plan as an ESOP ("Proposed ESOPs") that will hold Company C Stock. Company A will apply for determination letters from the appropriate Service area on the Proposed ESOPs. Company C pays dividends on its stock to shareholders once a year. The Proposed ESOPs would permit all participants to elect either to receive the dividends paid with respect to the Company C Stock held in the Proposed ESOPs, net of any tax withheld by Company C as required under Country H law, or to reinvest the net dividends in Company C Stock in the Proposed ESOPs.

Under Country H law, tax is automatically withheld on payments of dividends by a Country H corporation to foreign shareholders. Dividends paid by Company C with respect to Company C Stock to be held in the Proposed ESOPs are subject to withholding at a rate of approximately *** percent. As owner of the shares to which the dividends relate and on behalf of the participants whose accounts hold the shares, the Proposed ESOPs can recover a portion of the withholding directly from Country H, resulting in a net withholding rate of *** percent on these dividends. Thus, only *** percent of each dividend declared on Company C stock held in the Proposed ESOPs would be subject to the election described above.

Specifically, participants in the Proposed ESOPs with accounts invested in Company C stock as of the dividend record date will receive the dividend less the full amount of Country H withholding tax. This amount will be credited to participants' accounts on the dividend payment date. In addition, an agent for the trustee of the Proposed ESOPs will file for a partial refund of the withholding tax on behalf of all such participants. The partial refund will be received and allocated to the participants' accounts approximately 10 weeks after the dividend payment date. Only participants with Company C Stock allocated to their accounts as of the record date receive the refund. Because the annual dividend is declared and payable in the spring, participants in the Proposed ESOPs will receive both the initial net dividend and the partial refund in the same plan

year and the same taxable year of Company A. Both the dividend and the partial refund will either be reinvested or distributed within that plan year. The balance of the dividend that will be withheld by the Country H tax authorities is not available for refund.

Company A will deduct only the amount of the dividends credited to the participants' accounts: both the initial net dividend payment and the amount refunded, but not the amount of the dividend withheld that is non-refundable.

Based on the above facts and representations, Company A requests the following rulings:

1. Shares of Company C Stock are "qualifying employer securities" under Code sections 4975(e)(8) and 409(l)(1);

2. Shares of Company C Stock are "applicable employer securities" under Code section 404(k)(3); and

3. Net dividends paid on Company C Stock and subject to the participant elections described above are deductible by Company A under Code section 404(k)(2)(A)(iii), as added by the Economic Growth and Tax Relief Reconciliation Act of 2001 for taxable years beginning on or after January 1, 2002.

Code section 4975(e)(7) provides in pertinent part that the term "employee stock ownership plan" means a defined contribution plan that is a stock bonus plan qualified under section 401(a) and designed to invest primarily in qualifying employer securities.

Code section 4975(e)(8) states that the term "qualifying employer security" means any employer security within the meaning of section 409(l).

Code section 409(l)(1) states, in general, that the term "employer securities" means common stock issued by the employer (or by a corporation which is a member of the same controlled group) which is readily tradable on an established securities market. Section 409(l)(4) provides, in general, that for purposes of this subsection, the term "controlled group of corporations" has the meaning given to such term by section 1563(a) (determined without regard to subsections (a)(4) and (e)(3)(C) of section 1563).

Code section 1563(a)(1)(A) defines a parent-subsidiary controlled group of corporations as one or more chains of corporations connected through stock ownership with a common parent corporation if (A) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of all shares of all classes of stock of each of the corporations, except the common parent corporation, is owned (within the meaning of subsection (d)(1)) by one or more of the other corporations; and (B) the common parent owns (within the meaning of subsection (d)(1)) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

Code section 1563(b)(2)(C) provides that a corporation which is a member of a controlled group of corporations on December 31 of any taxable year shall be treated as an excluded member of such group for the taxable year including such December 31 if such corporation is a foreign corporation subject to tax under section 881 for such taxable year.

Section 1.46-8(b)(4)(i) of the Income Tax Regulations provides, in part, that employer securities are common stock, and securities convertible into common stock, of the employer or of a corporation that is a member of a controlled group of corporations including the employer. Membership in a controlled group for purposes of this section is determined under section 414(b) of the Code.

Section 1.414(b)-1(a) of the Regulations provides, in part, that for purposes of Code section 414 the term "members of a controlled group" means two or more corporations connected through stock ownership described in Code section 1563(a)(1), (2), or (3), whether or not such corporations are "component members of a controlled group" within the meaning of section 1563(b).

Even though section 1.46-8(b)(4)(i) of the regulations applies by its terms to TRASOPs, we believe that it also extends to ESOPs for purposes of Code section 409(l). Therefore, the determination of whether a controlled group exists in the present situation will be made without regard to section 1563(b), which would operate to exclude Company C if it were applicable. Since it is not applicable pursuant to section 1.414(b)-1(a) of the regulations, Company C is included in the controlled group together with Company A and Company B for purposes of section 409(l).

The Service has previously ruled that until regulations are issued defining "readily tradable on an established securities market" under Code section 409(l), this term would be considered to have the same general meaning as "publicly traded" under section 54. 4975-7(b)(1)(iv) of the Excise Tax Regulations (T.D. 7506, August 30, 1977). Section 54.4975-7(b)(1)(iv) states that the term "publicly traded" refers to a security that is listed on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 or that is quoted on a system sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act. Company C Stock is traded on the New York Stock Exchange, which is a national securities exchange registered under section 6 of the Securities Exchange Act of 1934.

Accordingly, with respect to your first requested ruling, we conclude that shares of Company C stock are "qualifying employer securities" under Code sections 4975(e)(8) and 409(l)(1).

With respect to your second and third requested rulings, Code section 404(k)(1) provides that, in the case of a C 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 shall be in addition to the deduction allowed under section 404(a).

Code section 404(k)(2), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), (P.L. 107-16) 115 Stat.38, June 7, 2001, for taxable years beginning on or after January 1, 2002, generally provides that the term "applicable dividend" means any dividend which, in accordance with the plan provisions --

(i) is paid in cash to the participants in the plan or their beneficiaries,

(ii) is paid to the plan and is distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year in which paid,

(iii) is, at the election of such participants or their beneficiaries – (I) payable as provided in clause (i) or (ii), or (II) paid to the plan and reinvested in qualifying employer securities, or

(iv) is used to make payments on a loan described in section 404(a)(9), the proceeds of which were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

Code section 404(k)(3) provides that, for purposes of this subsection, the term "applicable employer securities" means, with respect to any dividend, employer securities which are held on the record date for such dividend by an ESOP 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(l)(4)) which includes such corporation.

Code section 404(k)(5)(A) provides that the Secretary may disallow the deduction under paragraph (1) for any dividend if the Secretary determines that such dividend constitutes, in substance, an avoidance or evasion of taxation.

Notice 2002-2, 2002-2 I.R.B. 285, Q & A-2, states in pertinent part that, under Code section 404(k)(2)(A)(iii), the election provided to ESOP participants with respect to dividends paid on applicable employer securities must be offered in accordance with the terms of the plan and offer participants an election between:

(a) Either (i) the payment of dividends in cash to participants or (ii) the payment to the ESOP and distribution in cash to participants not later than 90 days after the close of the plan year in which the dividends are paid by the corporation, and,
(b) The payment of dividends to the ESOP and reinvestment in employer securities.

In the present case, Company A will maintain the Proposed ESOPs which will hold employer securities (Company C Stock) upon which Company C pays dividends. We determined above that Company A and Company C are members of a controlled group for purposes of Code section 409(l). Therefore, with respect to your second requested ruling, we conclude that shares of Company C Stock are "applicable employer securities" under Code section 404(k)(3).

With respect to your third requested ruling, the Proposed ESOPs will permit participants to elect either to receive from the Proposed ESOPs the dividends paid on Company C Stock, net of the

withheld tax that will not be refunded as described above, or to reinvest these net dividends in Company C Stock. Participants will receive both the initial net dividend and the partial refund in the same plan year and the same taxable year of Company A. Both the initial net dividend and the partial refund will either be reinvested or distributed within that same plan year.

Accordingly, based on the facts and circumstances of this case, we conclude with respect to your third requested ruling, that net dividends paid on Company C Stock and subject to the participant elections described above are deductible by Company A under Code section 404(k)(2)(A)(iii), as added by EGTRRA for taxable years beginning on or after January 1,

This ruling letter is based on the assumption that the Proposed ESOPs will be qualified under Code section 401(a) and that they will meet the requirements of section 4975(e)(7), and that their related trusts will be tax-exempt under section 501(a) at all times relevant to the transactions described herein.

This ruling letter is also based on the assumption that the participant elections described above meet the requirements set forth in Notice 2002-2.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

If you have any questions about this letter, please contact Alice V. Lynch (ID 50-04478) at (202) 283-9582). Please refer to T:EP:RA:T:3.

The original of this letter and a copy have been sent to your authorized representatives in accordance with the 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 437
Deleted copy of ruling letter