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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JUL 13 2006

T:EP:RA:T3

UICs: 162.00-00, 401.04-00, 402.00-00, 415.00-00, 4972.02-00,.
4979.00-00

ATTN:
President

LEGEND:

Company A:

Company B:

Taxpayer C:

Individual D:

Spouse E:

Government Agency E:

Plan X:

Plan Y:

Plan Z:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Percentage 1:

Percentage 2:

Amount 1:

Dear :

This is in response to the letter ruling request dated , as revised on and, as supplemented, on , , and , , in which you, through your authorized representative, request a series of letter rulings under sections 162, 401(a)(4), 402, 415, 4972 and 4979 of the Internal Revenue Code ("Code"). The following facts and representations support your ruling request.

FACTS:

Taxpayer C is the sole shareholder, President, and sole director of Company A. As such he is a full-time employee of the corporation. Taxpayer C is also the sole shareholder of Company B. Company A and Company B established Plan Z and Plans X and Y respectively, on Date 1, 1971. There are numerous participants in Plan Z. Taxpayer C was the sole participant in Plan X and Plan Y.

Plans X, Y, and Z either are or were defined contribution plans represented to be qualified within the meaning of Code section 401(a).

Individual D, who was the sole trustee of Plans X, Y, and Z from 1971 until Date 2, 1997, was convicted of felony criminal offenses relating to his administration of the plans. Said offenses related to his diversion of funds from Plan Z to his own personal use. The trustee's actions resulted in a depletion of approximately Percentage 1 of the total assets of Plan Z valued as of Date 3, 1997. Taxpayer C replaced Individual D as trustee of the plans effective Date 2, 1997.

Government Agency E investigated the transactions described above and issued letters in both June, 1999 and March, 2000 summarizing its investigation. Government Agency E concluded that Company A and its Board of Directors and/or corporate officers had violated several provisions of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Government Agency E indicated that its principal concern was that Company A and its officers and directors had failed to exercise prudent oversight over the trustee's activities. The letter made clear that under ERISA, Taxpayer C was considered a fiduciary with respect to the management of Plan Z. The June, 1999 letter stated in part:

> In your Trustee and company owner/officer capacities, you have exercised discretionary authority and control over the administration of the Plan and

management of its assets as a fiduciary with in the meaning of Section 3(21)(A) of ERISA.

Taxpayer C instituted a plan to restore participant account balances in Plan Z. Government Agency E accepted said Restoration Plan. Under the restoration plan, a portion of the amounts in Plans X and Y would be reallocated to participants, other than Taxpayer C, in Plan Z. This would be accomplished by the termination of Plans X and Y, the transfer of the Taxpayer C's account balances in Plans X and Y to Taxpayer C's account in Plan Z, the distribution of said amounts from Taxpayer C's Plan Z account, and the subsequent recontribution/reallocation of those amounts to the accounts of affected Plan Z participants other than Taxpayer C. Said reallocation is consistent with relevant provisions of Plan Z.

Similarly, Company A recovered an amount, Amount 1, under a restitution bond that was also allocated to Plan Z and affected participants (except Taxpayer C) thereof.

It has been represented that the above actions, including the termination of Plans X and Y and the recontribution/reallocation to the accounts of affected Plan Z participants, occurred during calendar year 2000. It has also been represented that the recontribution/reallocation was based upon the account balances of affected Plan Z participants as of Date 3, 1997 and was made with the intent of bringing said account balances to Percentage 2 of their Date 3, 1997 values. The effect of the recontribution/reallocation was a proportional recontribution/reallocation based on the amount(s) of affected participant account balances as of said Date 3, 1997.

Documentation submitted with this ruling request indicates that Taxpayer C's spouse, Spouse E, in a writing dated Date 5, 2000, consented to the above-referenced transfer(s) and reallocation(s). Spouse E's signature on said writing was notarized.

As a result of the restoration plan proposed and subsequently put into effect by Taxpayer C, Government Agency E agreed to pursue no further remedies at this time relating to the possible violations of ERISA provisions by Taxpayer C. This is reflected in a letter dated Date 4, 2000, signed by a representative of Government Agency E, which has been submitted to the Internal Revenue Service in conjunction with this letter ruling request.

Based on the above facts and representations, you, through your authorized representative, request the following letter rulings:

That the transaction (including the receipt of the restitution bond referenced above) described above:

1. will not adversely affect the qualified status of Plan Z pursuant to either Code section 401(a)(4) or Code section 415;
2. will not constitute a "contribution" or other payment to Plan Z subject to the provisions of either Code section 404 or section 4972;
3. will not constitute a contribution to Plan Z for purposes of Code section 4979;
4. will not, when made to a plan (Plan Z), result in taxable income to affected Plan Z participants or their beneficiaries;
5. That "Taxpayer C is entitled to deduct the amount of the deemed distribution, when transferred to Plan Z for the benefit of other plan participants, as an ordinary and necessary business expense under Code section 162; and
6. That Taxpayer C's releasing amounts from his Plan Z account in order to contribute them to the accounts of affected Plan Z participants (as described above) gave rise to a taxable distribution to Taxpayer C pursuant to Code section 402(a).

LAW AND ANALYSIS:

With respect to your first four ruling requests, Code section 401(a)(4) generally provides that the contributions or benefits provided under a qualified retirement plan may not discriminate in favor of highly compensated employees.

Code section 404(a) provides that if contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, then such contributions or compensation shall not be deductible under this chapter; but, if they would otherwise be deductible, they shall be deductible under this section, however, subject to the limitations contained therein.

Code section 415(a) provides, in part, that a trust which is part of a pension, profit-sharing, or stock bonus plan shall not constitute a qualified trust under section 401(a) if: A) in the case of a defined benefit plan, the plan provides for the payment of benefits with respect to a participant which exceeds the limitations of subsection (b); or, B) in the case of defined contribution plan, contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitations of subsection (c).

Section 1.415-6(b)(2) of the Income Tax Regulations provides that the term "annual additions" includes employer contributions which are made under the plan. Section 1.415-6(b)(2) further provides that the Commissioner may, in an appropriate case, considering all of the facts and circumstances, treat transactions between the plan and the employer or certain allocations to participants' accounts as giving rise to annual additions.

Code section 4972 imposes on an employer an excise tax on nondeductible contributions to a qualified plan. Section 4972(c) defines "nondeductible contributions" as the excess (if any) of the amount contributed for the taxable year by the employer to or under such plan over the amount allowable as a deduction under section 404 for such contributions (determined without regard to subsection (e) thereof), and the amount determined under subsection (c) for the preceding year reduced by the sum of the portion of the amount so determined returned to the employer during the taxable year and the portion of the amount so determined deductible under section 404 for the taxable year (determined without regard to subsection (e) thereof).

Code section 4979 imposes a 10 percent excise tax on the sum of any excess contributions and any excess aggregate contributions under a "plan", if the excess contributions and the excess aggregate contributions are not distributed before the close of the first 2 ½ months of the following plan year. For purposes of section 4979, a "plan" includes a plan qualified under either Code section 401(a) or section 403(a). In general, excess contributions are the excess of employer contributions contributed to the plan on behalf of highly compensated employees over the maximum amount of such contributions that are permitted under limitations found in the Code. In general, excess aggregate contributions are the excess of matching contributions and after-tax employee contributions made to a plan on behalf of highly compensated employees over the maximum amounts of such contributions permitted under limitations found in the Code.

Code section 402(a) generally provides that amounts held in a trust that is exempt from tax under Code section 501(a) and that is part of a plan that meets the qualification requirements of Code section 401(a) will not be taxable until such time as such amounts are actually distributed to distributees under such plan.

Revenue Ruling 2002-45, 2002-29 I.R.B. 116 (July 22, 2002) established guidance with respect to restorative payments to qualified pension, profit-sharing, and stock bonus plans. It provides that a payment made to a qualified defined contribution plan is not treated as a contribution to the plan, and accordingly is not subject to the Code provisions described above, if the payment is made to restore losses to the plan resulting from actions by a fiduciary for which there is a reasonable risk of liability for breach of a fiduciary duty under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), and plan participants who are similarly situated are treated similarly with respect to the payment. For purposes of this revenue ruling, these payments are referred to as restorative payments.

The determination of whether a payment to a qualified defined contribution plan is treated as a restorative payment, rather than as a contribution, is based on all of the relevant facts and circumstances. As a general rule, payments to a defined contribution plan are restorative payments for purposes of the revenue ruling only if the payments are made in order to restore some or all of the plan's losses due to an action (or a failure to act) that creates a reasonable risk of liability for breach of fiduciary duty. In contrast, payments made to a plan to make up for losses due to market fluctuations and that are not attributable to a fiduciary breach are generally treated as contributions and not as restorative payments. In no case will amounts paid in excess of the amount lost (including appropriate adjustments to reflect lost earnings) be considered restorative payments. Furthermore, payments that result in different treatment for similarly situated plan participants are not restorative payments. The failure to allocate a share of the payment to the account of a fiduciary responsible for the losses does not result in different treatment for similarly situated participants. In no event are payments required under a plan or necessary to comply with a requirement of the Code considered restorative payments, even if the payments are delayed or otherwise made in circumstances under which there has been a breach of fiduciary duty.

Company A and Taxpayer C have determined, based on the facts and circumstances of this case that there is a reasonable risk of liability for fiduciary breach on the part of Taxpayer C stemming from the actions of Individual D described above. This belief is substantiated by the correspondence received by Taxpayer C from Government Agency E referred to previously.

In this case, the payments to the accounts of affected Plan Z participants (other than Taxpayer C) which Taxpayer C made by the means described above, which payments are referred to above, will ensure that the affected participants in Plan Z recover a significant portion of their account balances and place them in the position similar to that in which they would have been in the absence of the actions giving rise to the breach of fiduciary duty on the part of Taxpayer C. Thus, it is reasonable to characterize this payment as a replacement payment rather than a plan contribution or annual addition.

As indicated by the facts of this case, the replacement payment has been made by Taxpayer C in response to the results of the investigation undertaken by Government Agency E concerning the actions of Individual D pursuant to which Individual D diverted a significant portion of the assets of Plan Z to his own use. The replacement payment was allocated to the accounts of participants and beneficiaries under Plan Z that incurred principal loss as a result of Individual D's actions. The payment was allocated to the accounts of these participants on a pro rata basis in relation to the value each account lost due to the actions of Individual D. Accordingly, plan participants who were similarly situated were treated similarly with regard to the allocation of the payment. The fact that the account of the plan fiduciary responsible for the loss, Taxpayer C, was not allocated any part of the payment does not change this conclusion. Accordingly, we conclude that the distribution of amounts from Taxpayer C's Plan Z account and subsequent recontribution of said amounts to the accounts of affected Plan Z participants (other than Taxpayer C) was a restorative payment.

Thus, with respect to your first through fourth ruling requests, we conclude as follows:

That the transaction described above:

1. will not adversely affect the qualified status of Plan Z pursuant to either Code section 401(a)(4) or Code section 415;

2. will not constitute a "contribution" or other payment to Plan Z subject to the provisions of either Code section 404 or section 4972;

3. will not constitute a contribution to Plan Z for purposes of Code section 4979; and

4. will not, when made to a plan (Plan Z), result in taxable income to affected Plan Z participants or their beneficiaries.

With respect to your fifth ruling request, section 162(a) 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. The performance of services as an employee constitutes a trade or business. Section 1.162-17(a). Furthermore, generally, being employed as a corporate officer constitutes a trade or business. See Hochschild v. Commissioner, 161 F.2d 817, (2d Cir. 1947); Commissioner v. Peoples Pittsburgh Trust Co., 60 F.2d 187, 189 (3d Cir. 1932), aff'g. 21 BTA 588 (1930). In his capacity as President of Company A, Taxpayer C was conducting a 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 operation. See Woodward v. Commissioner, 397 U.S. 572, 578 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970); and 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 made by an officer or director of a corporation sponsoring an employee plan to reimburse the plan for losses suffered by the plan arising from the officer or director's breach of fiduciary responsibilities. 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 fees 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.

The payments made by Taxpayer C to Plan Z are in direct response to a potential claim against Taxpayer C for liability arising as a result of the breach of fiduciary responsibility as officer and director of Company A in the course of his business activities. Because the payments address or preempt claims arising in the ordinary course of the trade or business of Taxpayer C as officer and director of the company, such payments to the Plan are deductible as ordinary and necessary business expenses under section 162.

Thus, with respect to the fifth ruling request, we conclude as follows:

> 5. That "Taxpayer C is entitled to deduct the amount of the deemed distribution, when transferred to Plan Z for the benefit of plan participants (other than Taxpayer C), as an ordinary and necessary business expense under Code section 162.

Since Taxpayer C's trade or business is that of an employee performing services, the expenses are subject to the limitation described in section 67(a) of the Internal Revenue Code.

Your revised fifth ruling request asks that Taxpayer C be entitled to deduct the amount transferred to Plan Z for the benefit of other plan participants as either (1) an ordinary and necessary business expense as a fiduciary under Code Section 162, (2) an ordinary and necessary expense of Taxpayer C incurred in connection with the management, conservation or maintenance of property held for the production of income, under Code section 212; or (3) as an unreimbursed but deductible business expense on Schedule A of Taxpayer C's Form 1040." In light of our response to the fifth ruling request, given above, the Service will not address either subparagraph (2) or subparagraph (3) of said fifth ruling request.

With respect to the sixth requested letter ruling, Code section 402(a) generally provides that amounts held in a trust that is exempt from tax under Code section 501(a) and that is part of a plan that meets the qualification requirements of Code section 401(a) will not be taxable until such time as such amounts are actually distributed to distributes under such plan.

Code section 402 contains provisions, including the rollover provisions of section 402(c), which may result in the deferral of taxation on distributions from a plan participant's account in a defined contribution plan.

In this case, we note that amounts were taken and distributed from Taxpayer C's account in Plan Z and contributed/allocated to the accounts of other Plan Z participants as noted above. Said taking/reallocation constituted a distribution within the meaning of Code section 402(a). Furthermore, said reallocation did not constitute either a rollover within the meaning of Code section 402(c) or any other permissible mechanism of deferring taxation on the distribution.

Thus, with respect to your sixth ruling request, we conclude as follows:

6. That Taxpayer C's releasing amounts from his Plan Z account and receiving said amounts in order to contribute them to the accounts of affected Plan Z participants (as described above) gave rise to a taxable distribution to Taxpayer C pursuant to Code section 402(a).

Please note that our responses to the fifth and sixth ruling request will result in a taxable distribution under Code section 402(a) and an offset deduction under Code section 162.

This letter is based on the assumption that each plan referenced therein is or was qualified within the meaning of Code section 401(a) at all times relevant thereto. It also assumes the correctness of all assertions and representations made with respect thereto including, but not limited to, the representation that the recontribution/reallocation to the accounts of affected Plan Z participants was proportional to their account balances as of Date3, 1997.

No opinion is expressed as to the tax treatment of the transaction described herein under the provisions of any other section of either the Code or regulations, which may be applicable thereto.

This letter 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 as precedent.

If you wish to inquire about this ruling, please contact (ID: -) at 202- - (phone) or 202- (FAX). Please address all correspondence to SE:T:EP:RA:T3.

Sincerely yours,

Frances V. Sloan, Manager,
Employee Plans Technical Group 3

Enclosures:

Deleted copy of ruling letter
Notice of Intention to Disclose