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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

201440027

JUL 10 2014

UIL Numbers: 162.00-00, 401.04-00, 402.00-00, 415.00-00, and 4972.02-00

SE:T:EP:RA:T1

Legend:

Trustee A =

Employer B =

Plan C =

Administrator D =

Individual E =

Financial Institution F =

Financial Institution G =

Financial Institution H =

Administrator I =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5 =

Amount 6 =

Amount 7 =

Amount 8 =

Dear :

This is in response to a request dated April 29, 2013, as supplemented by correspondence dated April 23, 2014, and June 18, 2014, submitted by your authorized representative on your behalf, concerning the characterization and tax consequences of certain proposed payments to a defined contribution plan.

The following facts and representations in support of your request have been submitted under penalties of perjury:

Plan C is a profit sharing plan maintained by Employer B for the benefit of its employees. Plan C was established effective January 1, 1989, and is intended to be qualified under section 401(a) of the Code. The adoption agreement for Plan C provides that Trustee A is the trustee of Plan C, and Employer B is the Plan Administrator for Plan C. Trustee A is the sole proprietor of Employer B and a participant in Plan C.

Prior to July 15, 2009, contributions to Plan C consisted of discretionary employer contributions. Effective July 15, 2009, Plan C executed an adoption agreement for a non-standardized prototype 401(k) profit sharing plan that had received an EGTRRA opinion letter from the Internal Revenue Service ("Service") dated March 31, 2008. Effective July 15, 2009, Plan C also provided elective deferrals and matching contributions. The assets of Plan C are invested in a pooled investment account. Participants in Plan C do not direct any investments.

From 2005 through late 2012, Trustee A experienced knee and back problems, and chronic pain. Trustee A had six surgeries in 2005, 2007, 2009, 2011, mid-2012, and late 2012, and was prescribed painkillers to help relieve the pain. During this time, Trustee A gradually became addicted to the painkillers.

In 2001, Employer B hired Administrator D to administer Plan C. Employer B represents that Administrator D, through its principal, Individual E, was responsible for allocating Employer B contributions to participant accounts, as well as maintaining records for all transactions pertaining to Plan C. In 2009, the Department of Labor ("DOL") contacted Trustee A regarding an investigation into fraudulent activity with respect to Plan C and Individual E. The ensuing DOL investigation revealed that Individual E wrongfully diverted approximately Amount 1 from Plan C during the period from October 2002 through May 2007 into her personal accounts and for her personal use. In addition, the DOL investigation revealed that from October 2003 through April 2007, Individual E knowingly made false statements and concealed facts in violation of Title I of the Employee Retirement Income Security Act of 1974 ("ERISA").

Upon learning of the results of the DOL investigation, Trustee A, as trustee and named fiduciary for Plan C, took several steps to protect the interests of Plan C participants and to recover the misappropriated plan assets. Trustee A filed a civil claim against Financial Institutions F, G, and H, alleging that the financial institutions allowed the fraudulent deposits to Individual E's personal accounts and corresponding debits from Plan C accounts, despite invalid endorsements. Employer B and Financial Institutions F, G and H entered into a settlement agreement, pursuant to which Trustee A recovered a total of Amount 2 for Plan C. Trustee A also filed a claim under Plan C's surety bond policy and secured a payment of Amount 3.

Federal criminal charges were brought against Individual E. As part of her plea agreement to settle the charges of theft or embezzlement from an employee benefit plan and for false statements and concealments in ERISA documents, Individual E agreed to return Amount 4 to Plan C.

Trustee A represents that Amounts 2, 3 and 4 have been deposited into Plan C's pooled investment account.

Employer B represents that although the DOL could have pursued fiduciary breach actions against Trustee A or Employer B, and that it did bring charges against other, unrelated employee benefit plan trustees from which Individual E had misappropriated funds, the DOL has elected not to pursue fiduciary breach charges against Trustee A or Employer B. Employer B states that the DOL's decision is a result of Employer B's agreement to restore any and all losses to Plan C participants that could not be recovered from third parties. Employer B informed Plan C participants of its intention, in an effort to forestall participant lawsuits against Trustee A and Employer B for breach of fiduciary duties to Plan C.

Employer B hired Administrator I to administer Plan C and to calculate the total losses to Plan C as a result of Individual E's actions, net of the restorative payments already made to Plan C (Amounts 2, 3 and 4). Administrator I determined that there were 12 affected participants, including Trustee A. Although Administrator I lacked the information necessary to determine the losses for years 2002 and 2003, it calculated that the total principal loss to Plan C from 2004 through 2008 equals Amount 6. Administrator I calculated the lost earnings on Amount 6, determined through April 4, 2011, as an amount equal to Amount 7. Earnings were calculated based on Plan C's actual earnings rate beginning with the 2004 year through April 4, 2011, with the total estimated loss equal to Amount 8. Trustee A represents that the information regarding the losses incurred by Plan C were conveyed to the United States Probation Office in regard to Individual E.

Employer B proposes to make a restorative payment of Amount 5 to Plan C to resolve any potential claims against Employer B and Trustee A. Employer B represents that Amount 5, when added to Amounts 2, 3 and 4, will restore Plan C participant accounts to where they would have been had the misappropriations not occurred. Employer B represents that the restorative payments will be allocated to all affected participants, including Trustee A's account, of the affected Plan C participants as determined by Employer B and as calculated independently by Administrator I.

Based on the preceding facts and representations, your authorized representative has requested the following rulings on your behalf:

1. The restorative payments from third parties and Employer B will not constitute employer contributions or amounts subject to provisions of sections 404(a)(3), 415(c) or 4972 of the Internal Revenue Code ("Code").

2. The restorative payments from third parties and Employer B will not adversely affect the qualified status of the Plan under section 401(a) of the Code.

3. The restorative payments from third parties and Employer B will not, when made to Plan C, result in taxable income to Plan C participants.

4. The restorative payments from Employer B will be deductible in full pursuant to section 162 of the Code as an ordinary and necessary business expense.

With respect to ruling requests (1), (2), and (3), section 401(a)(4) of the Code provides generally that the contributions or benefits provided under a qualified plan may not discriminate in favor of highly compensated employees.

Section 402(a) of the Code generally provides that any amount actually distributed to any distributee by an employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall not be taxable to a participant until actually distributed to the participant.

Section 404(a) of the Code generally provides that contributions paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, if otherwise deductible, are deductible under section 404, subject to the limitations under section 404(a).

Section 415(a) of the Code 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, in the case of a defined contribution plan, contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitations of section 415(c).

Section 1.415(c)-1(b)(2)(i) of the federal Income Tax Regulations ("Regulations") provides that the term "annual additions" includes employer contributions credited to the participant's account for the limitation year.

Section 1.415(c)-1(b)(2)(ii)(C) of the Regulations provides that a restorative payment that is allocated to a participant's account does not give rise to an annual addition for any limitation year. It further provides that:

> Restorative payments are payments made to restore losses to a plan resulting from actions by a fiduciary for which there is reasonable risk of liability for breach of a fiduciary duty under Title I of ERISA or under other applicable federal or state law, where plan participants who are similarly situated are treated similarly with respect to the payments. Generally, payments to a defined contribution plan are restorative payments 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 such a breach of fiduciary duty (other than a breach of fiduciary duty arising from failure to remit contributions to the plan).

Section 4972 of the Code imposes on an employer a ten percent excise tax on the amount of the nondeductible contributions made to any "qualified employer plan," including a plan qualified under section 401(a).

Section 4972(c) of the Code 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).

Revenue Ruling 2002-45, 2002-2 C.B. 116 ("Rev. Rul. 2002-45"), applies a facts and circumstances test to determine whether a payment to a plan qualified under section 401(a) of the Code is a restorative payment or a contribution to the plan. Under Rev. Rul. 2002-45, payments made merely to replenish a participant's account in a defined contribution plan after investment losses are to be treated as contributions. However, payments that are made to restore some or all of the account's losses due to an action (or failure to act) that creates a reasonable risk of liability are restorative payments. In addition, in order to be a restorative payment, the payment does not need to be the result of legal action; it only needs to be made as a result of a reasonable determination that there is a reasonable risk of liability. Rev. Rul. 2002-45 also provides that the amount of a restorative payment cannot exceed the amount lost, including appropriate adjustments for earnings. A restorative payment is not taken into account under section 410(a)(4), 415(c), or 401(k)(3) or (m). In addition, a restorative payment is not subject to the provisions of section 404 or 4972.

Applying the reasoning of Rev. Rul. 2002-45 in this case, Employer B has made a reasonable determination that there was a reasonable risk of liability for breach of fiduciary duty as a result of the losses sustained by Plan C through the fraudulent action of Administrator D and Individual E. In addition, the payments which Employer B intends to make to Plan C are designed to ensure that the affected Plan C participants' accounts are restored. Further, Employer B has indicated that the DOL conditioned its decision not to pursue fiduciary liability claims against Employer B or Trustee A on the making of the restorative payments and that the DOL had pursued claims against fiduciaries of other, unrelated plans with funds misappropriated by Individual E. But for the promised restorative payments, it is reasonably likely that either the DOL or Plan C participants would pursue fiduciary breach actions against Employer B and Trustee A. Based on the above, it is reasonable to characterize this payment as a restorative payment, rather than as a plan contribution or as an annual addition.

Employer B represents that the restorative payments will be allocated to all affected participants, including Trustee A's account, according to the value of the accounts of the affected Plan C participants as determined by Employer B and as calculated independently by Administrator I. Employer B proposes that all affected Plan C participants, including Trustee A, will be treated similarly, and all Plan C accounts will be restored.

Based on the foregoing, we conclude that the restorative payments pursuant to the proposed transaction will not constitute a contribution or other payment subject to the provisions of either section 404 or 4972 of the Code; will not adversely affect the qualified status of Plan C pursuant to either section 401(a)(4) or 415 of the Code; and will not, when made, result in taxable income to affected Plan C participants or beneficiaries under section 402(a)(1) of the Code. However, in no case will amounts paid in excess of the amount lost (including appropriate adjustments to reflect lost earnings) be considered restorative payments.

With respect to ruling request (4), section 162 of the Code provides that there shall be 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, the Service views payments made in settlement of lawsuits or potential lawsuits as deductible if the acts that gave rise to the litigation or potential litigation were performed in the ordinary conduct of the taxpayer's business. See, e.g., Rev. Rul. 80-119, 1980-1; Rev. Rul. 78-210, 1978-1 C.B. 39; Rev. Rul. 73-226, 1973-1 C.B. 62. This view is consistent with a series of cases holding that payments to settle litigation or threatened litigation (including for claims of fiduciary breach) are ordinary and necessary business expenses, and therefore deductible, if the threatened litigation arises out of the taxpayer's business, and the corresponding payments are made to protect a taxpayer's business from the liability of a possible lawsuit, added legal fees and damages to the taxpayer's business. See, e.g., Butler v. Commissioner, 17 T.C. 675 (1951), acq., 1952-1 C.B. 1; Marks v. Commissioner, 27 T.C. 464 (1956), acq., 1966-2 C.B. 2; Old Town Corp. v. Commissioner, 37 T.C. 845, (1962), acq., 1962-2 C.B. 5.

In this case, Administrator D was hired to perform certain ordinary and necessary administrative tasks for Plan C, which is sponsored by Employer B for the benefit of its employees. Individual E, acting as principal of Administrator D, misappropriated Plan C assets during the course of performing these functions, and the losses incurred by Plan C arose in the ordinary conduct of Employer B's business. Employer B has represented that the proposed restorative payments will be made to forestall litigation that might potentially arise as a result of Individual E's actions. Accordingly, with respect to ruling request four, we conclude that the proposed restorative payments made by Employer B would be ordinary and necessary business expenses deductible under section 162 of the Code.

This ruling is based on the assumption that Plan C otherwise 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.

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 as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter ruling is being sent to the taxpayer's authorized representative.

If you wish to inquire about this ruling, please contact
. Please address all correspondence to SE:T:EP:RA:T1.

Sincerely yours,

Carlton A. Watkins

Carlton A. Watkins, Manager
Employee Plans Technical Group 1

Enclosures:
Deleted copy of ruling letter
Notice of Intention to Disclose

cc: