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Eighth Circuit Has General Mills for Breakfast

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My first encounter with ESOP buyouts was in the case of a closely held business where no third-party buyer was ready, willing and able to make the acquisition. So, we quite literally *created* a buyer: an employee stock ownership plan (ESOP). The ESOP borrowed the money against the strength of the ongoing operations of the business, and we got the sale closed.

Yet it is naive to suggest it was easy. Lord knows, ESOP transactions are complicated, expensive and rife with potential liabilities. In these difficult economic times, however, more than a few prospective sellers have probably looked into (or will look at least fleetingly at) an ESOP transaction. Of course, obtaining the necessary loan would likely be the sticking point today.

These fundamental thoughts were in my mind as I read the Eighth Circuit Court of Appeals' decision in *General Mills, Inc.*, CA-8, 2009-1 USTC ¶50,177 (2009). The court slapped down General Mills' attempt to deduct payments to redeem stock held in its ESOP. It is a significant decision, one that throws this muddled but important area of the tax law into further disarray.

Deductible Dividends?

Every M&A TAX REPORT reader knows that dividends paid to shareholders are generally nondeductible. [*See* Code Sec. 311.] Nevertheless, a corporation *can* deduct certain dividends it pays to an ESOP. Under Code Sec. 404(k), there are four conditions to the deduction. Subject to these technical rules, Code Sec. 404(k) says that a corporation can deduct certain dividends.

On the other hand, Code Sec. 162(k) expressly provides that even an otherwise allowable deduction cannot be taken if it is paid or incurred in connection with the reacquisition of corporate stock or the stock of any related person. The interaction between these

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two rules was made more significant in 1996, when Congress expanded Code Sec. 162(k) to extend its "thou shalt not deduct" mantra beyond mere stock redemptions, to cover *any other* stock reacquisition expenses. There has been a smattering of case law about this development since then, and the latest involves General Mills.

First Victory

The question in the *General Mills* case was whether the company could deduct payments it made to redeem stock held by its ESOP. General Mills was the common parent of an affiliated group, and it amended its various benefit plans to include ESOP components. In fact, General Mills had three ESOPs in all, though a single trust held the assets. With a newly minted ESOP, General Mills sold shares of its stock to the ESOP, financing the purchases with outside loans.

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As is often the case with an ESOP, the shares were held in a suspense account initially, but were eventually released to plan participant accounts. General Mills made contributions and paid dividends to the ESOP. General Mills deducted the contributions and the dividends, respectively, under Code Sec. 404(a)(9) and (k)(2).

The problem came with the inevitable handling of employee terminations. When a General Mills employee terminated employment, the ESOP would distribute the value of the terminated employee's vested account. Terminating employees could elect to receive either cash or stock. As a result, the ESOP trust not infrequently used some cash proceeds from stock redemptions/dividends to satisfy its cash obligations to terminating employees.

IRS Umbrage

This is hardly new. In fact, in Rev. Rul. 2001-6, IRB 2001-6, 491, the IRS considered an ESOP that also allowed distributions in stock or cash. The sponsoring corporation there redeemed stock in the participants' accounts prior to making distributions. Rev. Rul. 2001-6 considers whether payments in redemption of the stock for the distribution constituted "applicable dividends" so as to be deductible under Code Sec. 404(k)(1). The revenue ruling concludes that such redemption payments were made in connection with the reacquisition of the corporation's stock, so a deduction was barred by Code Sec. 162(k)(1).

Notwithstanding the IRS' theory in Rev. Rul. 2001-6, the court in *Boise Cascade Corp.*, CA-9, 2003-1 USTC ¶50,472, 329 F3d 751 (2003), held that a corporation *could* deduct amounts paid to redeem shares of its stock held by an ESOP when participants terminated employment. The Ninth Circuit in *Boise Cascade* recognized that Code Secs. 404(k) and 162(k) might work in tandem, but it found nothing in Code Sec. 162(k) to bar the deduction.

Thereafter, in 2006, the IRS issued regulations plainly stating that deductions for amounts paid to reacquire stock are flatly improper. [*See* Reg. §§1.162(k)-1 and 1.404(k)-3.] The gist of the IRS viewpoint is that a denial of the deduction is necessary to prevent a double tax benefit: one deduction at the time stock is originally contributed to an ESOP, and a second tax benefit at the time an amount is paid to redeem the same stock. The Treasury's Regulations are effective for amounts paid or incurred on or after August 30, 2006, but they were not in affect in the years effecting General Mills.

Court Victory

General Mills litigated its claimed deductions in Federal District Court in Minnesota, achieving a significant victory. [*See* Wood, *Deductible Redemption Payments*, M&A TAX REP., Mar. 2008, at 6.] The District Court concluded that, while the cash distribution redemptive dividends General Mills made arose out of the same *circumstances* as the redemptive dividends, they simply were not expenditures made "in connection with" the redemptive dividends. The court focused on the "in connection with" language in Code Sec. 162(k).

The court viewed this narrow language as disallowing deductions for fees and other expenses that were "necessary and incident" to a repurchase, but that would otherwise be deductible business expenses. In *General Mills*, in contrast, cash distribution redemptive dividends were simply not expenditures that were necessary and incident to the redemptive dividends. The District Court in *General Mills* navigated the pro-taxpayer decision in *Boise Cascade*, comparing it with the contrary result reached in *Conopco*, DC-NJ, 2007-2 USTC ¶50,572 (2007).

In addition to these decisions, the Tax Court had reached a holding denying the deduction in *Ralston Purina Co.*, 131 TC No. 4, Dec. 57,534 (2008). Considering all the arguments, the District Court in Minnesota lined up with *Boise Cascade*, allowing General Mills to deduct what were indisputably whopping deductions.

One for the IRS

All that changed when the Eighth Circuit got the *General Mills* case. Reversing the District Court, the Eighth Circuit has now ruled that payments to participants that were routed through the ESOP were "applicable dividends" and thus were nondeductible. The Eighth Circuit criticized the District Court, saying that it failed to recognize that the "deduction otherwise allowable" here *was* the deduction for the "applicable dividend" and *that* was barred by Code Sec. 162(k)(1).

The Eighth Circuit described the transaction as consisting of two connected steps:

1. The redemptive dividend
2. The cash distribution redemptive dividend

The Eighth Circuit said there were three possible interpretations here of "applicable dividend":

1. The redemptive dividend in isolation
2. The cash distribution redemptive dividend in isolation
3. The redemptive dividend combined with the cash distribution redemptive dividend

It was this third interpretation that had to be correct, the appellate said.

The Eighth Circuit also criticized the Ninth Circuit holding in *Boise Cascade* to the effect that an isolated cash distribution redemptive dividend was not "in connection with" the company's stock redemption. In an odd "how close a connection is it" examination of the facts, the Ninth Circuit opted in favor of deductibility, while the Eight Circuit has said the connections were close enough (at least in *General Mills'* case) to preclude deductibility.

Conopco Case

Conopco was a more interesting case. Conopco was a publicly held corporation with an ESOP that purchased preferred stock with debt. The trust administering the ESOP had the right to receive all dividends on the preferred stock, to invest the dividends, *etc.* The ESOP trustee allocated the preferred stock to participating employee accounts.

The employees participating in the ESOP had no right to receive or hold the shares that were held in their respective accounts. When an employee in the ESOP terminated Conopco's employment, the ESOP generally permitted them to elect to receive the value of the preferred stock as cash, as Conopco common stock, as an annuity, as distributions rolled into an IRA, or some combination of this panoply of choices.

Conopco had complete authority to direct the trustee to make payments out of the trust and instructed the trustee (when terminating members requested ESOP benefit payments) to redeem the preferred shares in the terminating members' accounts. After receiving redemption proceeds, the trustee would distribute the funds in the form of benefit payments to the terminating employees.

There was lots of activity. In fact, a whopping $47 million was paid by Conopco to redeem preferred stock from the ESOP from 1994 through 2000. Conopco filed an amended return claiming these amounts were applicable dividends deductible under Code Sec. 404(k)(1). The IRS denied the claims, and Conopco sued in District Court.

The IRS contended that the redemption distributions could not be deducted because they were simply not dividends under Code Sec. 404(k)(2). Alternatively, the IRS argued that even if these distributions *were* dividends, the deductions had to be disallowed under either Code Sec. 162(k), as an evasion of tax under Code Sec. 404(k)(5)(A), or under the "double deduction" doctrine (as in, "thou shalt not claim one").

The court had some choices here, though it rejected the argument that these distributions weren't dividends. The court rejected the *Boise Cascade* view and held that Conopco's distributions were amounts paid or incurred in connection with the reacquisition of its stock. The District Court agreed with the IRS that Code Sec. 162(k) was a broad provision barring the deduction.

Conclusion

It's always interesting to find disputes between the Circuit Courts, and we clearly have one going now between the Eighth and Ninth Circuits. It's probably unlikely we'll see a lot more cases in this area, simply because the IRS has made its position quite clear in the 2006 final regulations.