200137065

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

UICs: 162.05-03
401.04-00
402.00-00
404.00-00
4972.00-00

Person to Contact:

Telephone Number:

Refer Reply to:
T:EP:RA:T3

Date:

JUN 2 2 2001

LEGEND:

Company A:

State B:

Partnership C:

Individual D:

Individual E:

Individual F:

Federal Agency G:

Plan X:

Settlement Y:

Court Z:

Consent Order AA:

Month 1:

Dates 2:

Month 3:

Month 4:

Date 5:

Date 6:

Date 7:

356

Amount 1:

Amount 2:

Amount 3:

Number 4:

Gentlemen:

This is in response to the request for letter ruling, submitted on your behalf by your authorized representative, in which you request several letter rulings under sections 162, 401(a)(4), 402, 404, 415, and 4972 of the Internal Revenue Code. The following facts and representations support your ruling request.

Company A, which has its principal office in State B, adopted Plan X effective Date 7. Plan X is a defined contribution plan that provides for elective deferrals under section 401(k) of the Internal Revenue Code and for discretionary employer contributions which your authorized representative asserts is qualified within the meaning of Code section 401(a), and its trust exempt from tax pursuant to Code section 501(a).

During Month 1, 1990, Individual D, the President of Company A, Individual E, the Vice President of Company A, and Individual F, the Director of Finance of Company A, acting as Management of Company A, directed the Trustee of Plan X to purchase Number 4 units of Partnership C for a total cost of Amount 1 payable in eight (8) installments over seven (7) years. Plan X paid a total of Amount 2, which was less than Amount 1, prior to determining that the purchase was not economically feasible.

On one of the dates referenced in Dates 2, Federal Agency G commenced an audit of Plan X which resulted in its filing suit against Company A with Court Z. The suit alleged that Company A, Individual D, Individual E, and Individual F breached their fiduciary duty with respect to Plan X by purchasing units of Partnership C for Plan X. The suit also indicated that Company A was the administrator of Plan X, and that Individuals D, E, and F were members of the Plan X Investment Committee.

After discovery, during Month 3, 1999, the parties to the above-referenced suit agreed to a settlement, Settlement Y, in which Company A would make a restorative payment in the amount of Amount 3 to Plan X on or before Date 5. Amount 3 is less than Amount 2. The settlement provided that Amount 3 would be credited, on a pro rata basis, to the accounts of individuals who were Plan X participants on Date 6, 1999, and who had interests in Partnership C in their Plan X account balances.

Count Z approved the settlement referenced above on the first day of Month 4, 1999 by entering Consent Order AA. Consent Order AA provided, in pertinent part, that the Amount 3 restorative payment would be allocated on a pro rata basis to the individual accounts of individuals who were plan participants on Date 6, 1999. Consent Order AA further provided that Individuals D, E, and F were not to have any portion of Amount 3 allocated to their Plan X accounts.

The Amount 3 restorative (replacement) payment has been made to Plan X.

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

that the restorative (replacement) payment described above

(1) will not constitute a "contribution" or other payment subject to the provisions of either Code section 404 or Code section 4972;

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

(3) did not, when made to Plan X, result in taxable income to affected Plan X participants or beneficiaries; and

(4) will be deductible in full by Company A pursuant to Code section 162.

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

Section 401(a)(4) of the Code generally provides that the contributions or benefits provided under a qualified plan may not discriminate in favor of highly compensated employees. Whether or not contributions under a defined contribution plan are discriminatory is generally determined by comparing the amount of contributions allocated to accounts of highly compensated employees with the amount of contributions allocated to the accounts of nonhighly compensated employees.

Section 415(c) of the Code generally limits the amount of contributions and other additions under a qualified defined contribution plan or tax deferred annuity plan with respect to a participant for any year.

Section 4972(a) of the Code imposes a ten percent (10%) excise tax on the amount of the nondeductible contributions made to any "qualified employer plan", including a plan qualified under section 401(a).on an employer an excise tax on nondeductible contributions to a qualified plan.

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) shalll not be taxable to a participant until actually distributed to the participant.

Generally, amounts contributed to a qualified retirement plan are subject to Code sections 401(a)(4), 404, 415 and 4972. However, payments to a defined contribution plan are not so subject if they are made by the employer in order to restore value to the plan that was lost due to actions which place the employer under a reasonable risk of liability for breach of fiduciary duty. Payments to a plan made by an employer pursuant to a Department of Labor order or to a court-approved settlement to restore lost value would generally be treated as restorative payments and not subject to the Code sections cited above. However, in general, payments made by an employer to a plan to make up for lost value due to general market fluctuations would not be treated as restorative payments. Also, payments made by an employer to a plan which result in different treatment for similarly situated plan participants would not be treated as restorative payments. A determination as to whether plan payments in other circumstances may be treated as restorative payments will be based on all the facts presented.

As indicated above, the "restorative" payment in this case was made by Company A in response to the Court Z approved settlement of a suit filed against it by Federal Agency G. Furthermore, the "restorative payment" which Company A made to Plan X, referenced above, was allocated in a pro rata manner. As a result, it both ensured that all of the affected participants in Plan X recovered a portion of their account balances and also placed them in a position similar to that in which they would have been in the absence of the actions referenced above in which Plan X and Individuals D, E, and F allegedly breached their fiduciary responsibility with respect to Plan X by purchasing units of Partnership C.

Thus, based on the facts and circumstances present in this case, the Service has determined that the payment made by Company A constituted a restorative payment.

Thus, based on the above, we conclude as follows with respect to your first three ruling requests:

that the restorative payment described above

(1) will not constitute a "contribution" or other payment subject to the provisions of either Code section 404 or Code section 4972;

(2) will not adversely affect the qualified status of Plan X pursuant to either Code section 401(a)(4) or Code section 415; and

(3) did not, when made to Plan X, result in taxable income to affected Plan X participants or their beneficiaries.

With respect to your fourth ruling request, Code section 162(a)(1) 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, payments made in settlement of lawsuits or potential lawsuits are deductible if the acts that give 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, and Rev. Rul. 69-491, 1969-2 C.B. 22. Also see Kornhauser v. United States, 276 U.S. 145 (1928), VII-2 C.B. 267 (1928), in which 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 United States v. Hilton Hotels Corp., 397 U.S. 580 (1970); Woodward v. Commissioner, 397 U.S. 572 (1970); and Anchor Coupling Co. v. United States, 427 F.2d 429 (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 was 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.

No court case has been found which deals with the treatment of payments by an employer to reimburse a defined contribution plan for losses suffered by the plan arising from breach of fiduciary responsibility. 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 Rev. Rul. 69-581, 1969-2 C.B. 25, which concluded that payment of liquidated damages and attorney fees under the Fair Labor Standards Act were deductible by the employer.

In the present case, the facts indicate that the restorative payment made to Plan X by Company A was made to resolve potential claims by Federal Agency G against Company A and Individuals D, E, and F, for breach of fiduciary duty incurred in the ordinary course of its trade or business. There is no serious question of its business origin.

Accordingly, with respect to your fourth ruling request, we conclude as follows:

(4) that the proposed replacement payment described above will be deductible in full by Company A pursuant to Code section 162 as a result of its being paid to Plan X.

This ruling letter is based on the assumption that Plan X meets the applicable section 401(a) of the Code qualifications, 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 tax consequences of the transactions described above under any other provisions of the Code.

Additionally, this ruling letter is based on Company A's representations made herein that it entered into Settlement Agreement Y and made the replacement payment described in this letter ruling in order to resolve the claims of Federal Agency G against Company A and Individuals D, E, and F. If, subsequent to the replacement payment, Company A becomes entitled to reimbursement for all or a portion of the replacement payment (from an insurer, or any other source), then Company A should include in income the amount of the reimbursement in accordance with its method of accounting.

The representations herein, like all factual representations made to the Internal Revenue Service in applications for rulings, are subject to verification on audit by Service field personnel.

Furthermore, no opinion is expressed as to the federal tax treatment of the above referenced proposed transaction under other sections of the Code and regulations. Additionally, no opinion is expressed as to the tax treatment of any conditions existing at the time of or effects resulting from the transaction that are not specifically covered by this ruling letter. A copy of this ruling letter should be attached to the appropriate federal income tax return(s) for the taxable year(s) in which the transaction is consummated.

Finally, in your ruling request, you referenced a civil penalty imposed by Federal Agency G as a result of the actions described herein which civil penalty, if waived by Federal Agency G, will be contributed to Plan X. This ruling request does not address said civil penalty. With respect to the civil penalty, you are directed to Rev. Rul. 79-148, 1979-1 C.B. 93, which held, under the origin of claim doctrine, that the amount

paid by a taxpayer to a charitable organization in satisfaction of a judgment condition of probation by a federal district was not deductible under section 162(a) because the amount paid was a fine for purposes of section 162(f).

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

Sincerely yours,

Frances V. Sloan

Frances V. Sloan
Manager, Technical Group 3
Tax Exempt and Government
Entities Division

Enclosures:

Deleted copy of letter ruling
Form 437