

# Questions and Answers Regarding Dividend Elections Under Section 404(k) and ESOPs Holding S Corporation Stock

## Notice 2002-2

### I. Purpose

This notice provides guidance in question and answer format regarding the changes made to § 404(k) of the Internal Revenue Code (Code) by section 662 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (Pub. L. No. 107-16) enacted on June 7, 2001. This notice also provides guidance on the effective date of § 409(p) of the Code, as added by section 656 of EGTRRA, regarding the allocation of stock in an S corporation held by an employee stock ownership plan (ESOP), as defined in § 4975(e)(7) of the Code.

### II. Background

Section 404(k) provides a deduction for applicable dividends paid on applicable employer securities of a C corpora-

tion held by an ESOP. Under § 404(k) prior to its amendment by EGTRRA, an applicable dividend included a dividend that is paid in cash to participants or their beneficiaries or paid to the ESOP and distributed in cash to participants or their beneficiaries not later than 90 days after the end of the plan year in which the dividends were paid by the corporation. Effective for taxable years of the corporation beginning on or after January 1, 2002, section 662 of EGTRRA amended the definition of applicable dividend by adding new § 404(k)(2)(A)(iii) of the Code to allow a deduction for dividends paid on employer securities held by the ESOP and with respect to which participants or beneficiaries are provided an election to have the dividend paid in cash to participants or beneficiaries pursuant to § 404(k)(2)(A)(i), paid to the ESOP and distributed in cash to participants or beneficiaries not later than 90 days after the close of the plan year in which paid pursuant to § 404(k)(2)(A)(ii), or paid to the ESOP and reinvested in qualifying employer securities. The deduction under § 404(k) is available both with respect to dividends that the participant or beneficiary elects to reinvest and with respect to dividends that the participant or beneficiary elects to receive in cash.

Section 404(k)(5)(A) prior to its amendment by EGTRRA provided that the Secretary of the Treasury may disallow a deduction under § 404(k)(1) if the Secretary determines that the dividend constitutes, in substance, an evasion of taxation. Section 662 of EGTRRA also amended § 404(k)(5)(A) of the Code to provide that the Secretary may disallow a deduction under § 404(k)(1) if the Secretary determines that the dividend constitutes, in substance, an avoidance or evasion of taxation.

Section 656 of EGTRRA amended § 409 of the Code to add a new subsection (p) regarding the allocation of employer securities consisting of stock in an S corporation. Section 656(d)(1) of EGTRRA provides that § 409(p) of the Code applies to plan years beginning after December 31, 2004. However, section 656(d)(2) provides that § 409(p) of the Code applies to plan years ending after March 14, 2001 (the date the provision was introduced in committee), in the case of any ESOP established after March 14,

2001, or in the case of an ESOP established on or before March 14, 2001, if employer securities held by the ESOP consist of stock in a corporation with respect to which an election to be an S corporation under § 1362(a) of the Code is not in effect on such date.

### III. Questions and Answers

For purposes of this notice, the term “dividend” means a dividend paid with respect to applicable employer securities that otherwise satisfies the requirements of § 404(k)(2) and the term “employer securities” means employer securities as defined in § 404(k)(6). References to participants include beneficiaries.

**Q-1**—What is the effective date of § 404(k)(2)(A)(iii), as added by section 662 of EGTRRA?

**A-1**—(a) Section 404(k)(2)(A)(iii), as added by section 662 of EGTRRA, is effective for taxable years of a corporation beginning on or after January 1, 2002. In order for dividends with respect to which an election is provided to be applicable dividends under § 404(k)(2) of the Code for a taxable year beginning on or after January 1, 2002, the election provided must comply with § 404(k)(2)(iii) (accordingly, Q&A-2 of § 1.404(k)-1T of the temporary Income Tax Regulations no longer reflects current law).

(b) A dividend subject to an election by ESOP participants is an applicable dividend under § 404(k)(2)(A)(iii) if the election provided with respect to the dividend complies with Q&A-2 and Q&A-3 and if, based on the timing rules in Q&A-4, the deduction for the dividend is allowed for a taxable year beginning on or after January 1, 2002. Therefore, if an ESOP offers participants an election between reinvestment in employer securities and distribution with respect to dividends paid by a corporation to the ESOP in 2001 and all other applicable requirements of § 404(k) are satisfied, a dividend that a participant elects to reinvest is an applicable dividend and the corporation is allowed a deduction for 2002 if the later of the date on which the dividend is reinvested in employer securities or the date on which the participant’s election becomes irrevocable occurs in 2002. A dividend paid by a corporation to an ESOP in 2001 that a participant elects to receive in a distribution is an applicable

dividend and such corporation is allowed a deduction for 2002 if the date of the distribution occurs in 2002. Dividends paid by a corporation to an ESOP in 2001 do not fail to be applicable dividends with respect to which a corporation is allowed a deduction in 2002 solely because participants were offered an election in 2001 between reinvestment and distribution, except to the extent that such dividends were actually distributed to participants in 2001.

(c) In no event is a dividend an applicable dividend under § 404(k)(2)(A)(iii) if such dividend was paid by a corporation to an ESOP before January 1, 2001.

**Q-2**—What dividend elections can be offered to ESOP participants under § 404(k)(2)(A)(iii)?

**A-2**—Under § 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.

An ESOP can also offer participants a choice among both of the options described in (a) and the option described in (b).

**Q-3**—What are the requirements for participant elections under § 404(k)(2)(A)(iii)?

**A-3**—In order for dividends subject to an election to be applicable dividends under 404(k)(2)(A)(iii), the election must be provided in a manner that satisfies the following requirements:

(a) A participant must be given a reasonable opportunity before a dividend is paid or distributed to the participant in which to make the election.

(b) A participant must have a reasonable opportunity to change a dividend election at least annually.

(c) If there is a change in the plan terms governing the manner in which the dividends are paid or distributed to

participants, a participant must be given a reasonable opportunity to make an election under the new plan terms prior to the date on which the first dividend subject to the new plan terms is paid or distributed.

An ESOP does not fail to comply with the requirements of this Q&A-3 solely because it provides that, if a participant fails to make an affirmative dividend election, one of the options offered to participants is treated as a default election.

**Q-4**—When are dividends with respect to which an election is provided pursuant to Q&A-3 deductible by the employer corporation under § 404(k)(2)(A)(iii)?

**A-4**—(a) Dividends reinvested in employer securities pursuant to an election that satisfies the requirements of Q&A-3 of this notice are deductible in the later of the taxable year of the corporation in which (i) the dividends are reinvested in employer securities at the participant’s election or (ii) the participant’s election becomes irrevocable.

(b) Dividends paid to participants or paid to the ESOP and distributed to participants within 90 days after the end of the plan year are deductible in the taxable year of the corporation in which the dividend is paid or distributed to the participant.

(c) An election is not considered made until the date the election becomes irrevocable. Therefore, for purposes of (a), dividends are not considered to be reinvested at the participant’s election prior to the time that the participant’s election becomes irrevocable.

**Q-5**—Where dividends on employer securities are paid to participants not later than 90 days after the close of the plan year in which the dividends are paid by the corporation, can earnings on those dividends be deducted under § 404(k) if they are paid to plan participants at the same time and in the same manner? Do losses reduce the amount that may be deducted under 404(k)?

**A-5**—(a) Section 404(k) allows a deduction for dividends paid on applicable employer securities if the requirements of that section are satisfied. Earnings on dividends held in the plan do not constitute dividends within the meaning of § 404(k) and accordingly are not deductible under that section. Investment

losses attributable to the dividends, or the reduction of the dividend amount paid to the ESOP by the corporation through tax withholding (e.g., by a foreign country with respect to dividends paid by a foreign corporation) or other means, reduce the amount of dividend that is available for reinvestment or distribution to participants and therefore reduce the amount that is deductible under § 404(k).

For example, assume that dividends of \$2 per share are paid to an ESOP and invested in employer securities prior to the time when participants elect either to have the dividends reinvested in employer securities or to receive a distribution of the dividends within 90 days of the end of the plan year. During the period between when the dividends are paid by the corporation to the ESOP and when participant elections become irrevocable, the fund suffers investment losses of 50%, so that the amount of the dividend remaining is \$1 per share. The deduction available with respect to participants who elect reinvestment is determined based on \$1 of dividends per share. During the period between when participant elections become irrevocable and dividends are distributed to participants who elect a distribution, the fund suffers further losses, so that the amount of the dividend remaining is 75¢. The ESOP pays the remaining dividends (75¢ per share) and is allowed a deduction with respect to participants who elect a distribution based on a dividend of 75¢ per share, regardless of whether non-dividend amounts are paid to participants by the ESOP.

Section 404(k)(5)(B) provides that a plan is not treated as violating the requirements of § 401, 409, or 4975(e)(7) merely by reason of any payment described in § 404(k)(2)(A). The distribution of amounts not attributable to dividends from a participant's account does not constitute a payment or distribution described in § 404(k)(2) and accordingly could be treated as violating the requirements of § 401, 409 or 4975.

(b) The guidance provided in this Q&A-5 is not applicable for deductions taken in taxable years beginning before January 1, 2003.

**Q-6**—Are dividends that are paid or reinvested as provided in § 404(k)(2)(A)(iii) treated as annual additions for

purposes of the limitations on contributions to defined contribution plans under § 415(c), elective contributions under § 401(k), employee contributions under § 401(m), or elective deferrals under § 402(g)?

**A-6**—No. The payment or reinvestment of dividends under § 404(k)(2)(A)(iii) does not constitute an employer contribution, employee contribution or forfeiture under § 415(c)(2). Consequently, these dividends are not annual additions for purposes of § 415(c). In addition, these dividends are not elective deferrals for purposes of § 402(g), elective contributions for purposes of § 401(k), or employee contributions for purposes of § 401(m).

**Q-7**—If, pursuant to an election satisfying the requirements of Q&A-2 and 3 of this notice, dividends are paid to the plan and reinvested in qualifying employer securities, how are those dividends treated under the ESOP?

**A-7**—Dividends that are reinvested in qualifying employer securities at the participant's election lose their identity as dividends and are treated as earnings in the same manner as dividends with respect to which a participant is not provided an election. Therefore, for example, dividends reinvested at a participant's election are no longer eligible for the exception to the early distribution tax under § 72(t)(2)(A)(vi) for dividends paid on employer securities under § 404(k). Similarly, such amounts are no longer treated as dividends for purposes of § 72, 402, 411(a)(11) or 401(k).

In contrast, dividends paid in cash to a participant pursuant to an election under § 404(k)(2)(A)(iii) are taxable without regard to the return of basis provisions under § 72, and are not subject to the consent requirements of § 411(a)(11) or the restrictions of § 401(k)(2)(B). In addition, dividends paid to participants under § 404(k) are not eligible rollover distributions under § 402(c), even if the dividends are distributed at the same time as amounts that do constitute an eligible rollover distribution (or are reported on a 1099-R in accordance with Announcement 85-168, 1985-48 I.R.B. 40). Therefore, if, prior to the date a participant receives a distribution, such participant has made an irrevocable election offered by the ESOP under § 404(k)(2)(A)(iii) to

have dividends distributed, any dividends subject to that election are distributed under § 404(k) and are not eligible rollover distributions. The corporation is allowed a deduction with respect to such dividends for the year in which the distribution is paid to the participant.

**Q-8**—In order to receive a hardship distribution from a qualified cash or deferred arrangement, must an employee who is also a participant in an ESOP elect to receive either a payment of dividends in cash from the employer or a payment of dividends to the plan followed by a cash distribution to the participant?

**A-8**—Under § 1.401(k)-1(d)(2) of the Income Tax Regulations, a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if the employee has obtained all distributions currently available under all plans maintained by the employer. See § 1.401(k)-1(d)(2)(iii)(B)(4) or (iv)(B)(2). For purposes of satisfying these hardship distribution requirements, a participant in an ESOP that offers a dividend reinvestment election under Q&A-2 and 3 of this notice must elect to receive dividends to the extent currently available to the participant under the ESOP.

**Q-9**—What are the vesting requirements for dividends with respect to which a corporation is allowed a deduction under § 404(k)?

**A-9**—Participants must be fully vested in dividends with respect to which a corporation claims a deduction under § 404(k). Prior to its amendment by EGTRRA, a corporation was allowed a deduction only with respect to dividends that were paid in cash or distributed to participants and therefore were nonforfeitable with respect to the participant who received the distribution (and with respect to which a deduction was allowable). Under § 404(k)(2)(A)(iii), a corporation is permitted to offer participants an election between receipt of a dividend in cash or reinvestment in employer securities under the ESOP and is allowed a deduction without regard to the participant's election. Therefore, an ESOP must provide that a participant is fully vested

in any dividend with respect to which the participant is offered an election under § 404(k)(2)(A)(iii). This requirement applies to applicable dividends under § 404(k)(2)(A)(iii) for taxable years of a corporation beginning on or after January 1, 2002. An ESOP can comply with this requirement by providing that participants are fully vested in dividends with respect to which an election under § 404(k)(2)(A)(iii) is offered, without regard to whether the participant is vested in the stock with respect to which the dividend is paid. Alternatively, an ESOP can comply with this requirement by offering an election under § 404(k)(2)(A)(iii) only to vested participants. See § 1.401(a)(4)-4(b)(2)(ii)(2)(B).

**Q-10**—In order for an applicable dividend on stock held by an ESOP to be deductible under 404(k), when must the plan be an ESOP?

**A-10**—Under § 404(k)(1), the applicable dividends must be paid with respect to applicable employer securities. Section 404(k)(3) provides that, for this purpose, applicable employer securities are employer securities held on the record date for a dividend by an ESOP maintained by the corporation paying such dividend or any other corporation which is a member of the controlled group of corporations (within the meaning of § 409(l)(4)) that includes such corporation. In order to satisfy this requirement, the ESOP must be designated as an ESOP no later than the record date for such dividend and must comply with the other requirements of § 4975(e) as of a date no later than the record date. The retroactive designation of a plan as an ESOP does not satisfy the requirement that a plan be designated as an ESOP no later than the record date.

**Q-11**—When does the payment of a dividend constitute an avoidance or evasion of taxation resulting in the disallowance of the deduction under § 404(k)(5)(A)?

**A-11**—As amended by § 662 of EGTRRA, § 404(k)(5)(A) provides that the Secretary may disallow a deduction for any dividend under § 404(k)(1) if the Secretary determines that the dividend constitutes, in substance, an avoidance or evasion of taxation. This includes the authority to disallow a deduction for unreasonable dividends. With respect to

dividends reinvested under § 404(k)(2)(A)(iii), a dividend paid on common stock that is primarily and regularly traded on an established securities market (within the meaning of § 54.4975-7(b)(1)(iv) of the Pension Excise Tax Regulations) is presumed to be a reasonable dividend. In the case of a corporation with no outstanding common stock (determined on a controlled group basis) that is primarily and regularly traded on an established securities market, a determination regarding whether the dividend is reasonable is made by comparing the dividend rate on the stock held by the ESOP with the dividend rate for common stock of comparable corporations whose stock is primarily and regularly traded on an established securities market. Whether a closely held corporation is comparable to a corporation whose stock is primarily and regularly traded on an established securities market is determined by comparing relevant corporate characteristics such as industry, size of the corporation, earnings, debt-equity structure, and dividend history.

As under prior law, payments in redemption of stock held by an ESOP that are used to make distributions to terminating ESOP participants constitute an evasion of taxation under § 404(k)(5)(A) and are not applicable dividends under § 404(k)(1). See Rev. Rul. 2001-6 (2001-6 I.R.B. 491). Moreover, any deduction for such payments in redemption of stock is barred under § 162(k).

**Q-12**—Can an ESOP offer a dividend election to an ESOP participant who terminates employment but does not receive a distribution of his or her account balance?

**A-12**—A participant who terminates employment but does not receive a distribution of his or her account balance continues to be a participant in the ESOP. An ESOP may provide that the same election under § 404(k)(2)(A)(iii) is offered to all participants, including both active participants and participants who are no longer active participants in the ESOP, and the corporation is allowed a deduction with respect to all dividends subject to the election. Cf. § 1.401(a)(4)-5(b); § 1.410(b)-2(c)(1).

**Q-13**—When does an ESOP have to be amended for the changes made by § 662 of EGTRRA?

**A-13**—An ESOP has a remedial amendment period under § 401(b), ending not prior to the last day of the first plan year beginning on or after January 1, 2005, in which to adopt any needed retroactive remedial amendment with regard to section 662 of EGTRRA. Amendments necessary to establish an ESOP or for compliance with the requirements of § 4975(e) of the Code are not amendments with regard to section 662 of EGTRRA.

Under Notice 2001-42 (2001-30 I.R.B. 70) the availability of the EGTRRA remedial amendment period is conditioned on the timely adoption of a good faith EGTRRA plan amendment for section 662 of EGTRRA. A good faith EGTRRA plan amendment is timely if it is adopted no later than the later of (i) the end of the plan year in which the EGTRRA change in the qualification requirement is required to be, or is optionally, put into effect under the plan, or (ii) the end of the GUST remedial amendment period for the plan. See also Notice 2001-57 (2001-38 I.R.B. 279). Therefore, a good faith plan amendment for section 662 of EGTRRA must be adopted by the end of the plan year in which the first taxable year of the corporation for which the deduction is being sought ends.

For purposes of determining whether a plan provision is a disqualifying provision under Notice 2001-42, a plan sponsor will not fail to have adopted a timely good faith amendment with respect to section 662 solely because the amendment does not specifically address the guidance provided in this notice. For example, an amendment does not fail to be a timely good faith amendment solely because it does not address vesting of dividends with respect to which an election is provided. However, the plan must operate in accordance with this guidance, effective as of January 1, 2002. See Notice 2001-57, sec. III (In General).

**Q-14**—The following examples illustrate the rules that appear in the questions and answers of this notice:

*Example 1* (i) Corporation A is a calendar year C corporation that maintains an ESOP. The ESOP provided that dividends paid by the corporation during 2001 would be paid to the ESOP and accumulated for distribution within 90 days of plan year end. Corporation A pays quarterly dividends to its ESOP during 2001. The ESOP accumulates these dividends during 2001 for payment to participants

within 90 days of the end of the plan year and invests the dividends in a short-term investment fund. The ESOP is amended to provide that participants can elect, in accordance with Q&A-2 and 3 of this notice, a distribution in cash of 2001 dividends within the first 90 days of 2002 or reinvestment of such dividends in employer securities within the first 90 days of 2002.

(ii) Because the 2001 dividends are distributed to participants or reinvested at the participant's election in 2002, Corporation A is allowed a deduction with respect to the 2001 dividends for 2002. In taxable years beginning on or after January 1, 2003, the amount of this deduction cannot exceed the amount of the dividends available for distribution or reinvestment.

*Example 2* (i) Corporation B is a calendar year C corporation that maintains an ESOP that accumulates dividends during the year for distribution within 90 days of the end of the plan year. In 2002, the ESOP is amended to provide participants with an election with respect to dividends paid by Corporation B in 2002. A participant's election to have a dividend distributed or reinvested in employer securities becomes irrevocable when the dividend is paid to the ESOP. The ESOP provides that dividends are invested in employer securities as soon as possible after the dividend is paid to the ESOP for those participants who elect to have dividends reinvested in employer securities. All 2002 dividends that participants elect to reinvest are actually reinvested in employer securities during 2002. The ESOP also provides that the dividends to be distributed based on participant elections are invested in a short-term investment fund. This fund does not incur losses prior to the distribution of the dividends. Distributions are made to participants during the first 90 days of 2003.

(ii) Corporation B is entitled to a deduction for 2002 for the amount of the dividends reinvested in employer securities in 2002. Corporation B is also entitled to a deduction for 2003 for the amount of dividends distributed to participants in 2003. Because Corporation B did not incur any losses with respect to the dividends that were accumulated for distribution, Corporation B's deduction is equal to the dividends paid by Corporation B.

**Q-15**—By what date must a corporation have filed a valid election to be treated as an S corporation under § 1362(a) of the Code in order for the delayed effective date in section 656(d)(1) of EGTRRA to apply to an ESOP maintained by the corporation?

**A-15**—Section 656(d)(1) provides that section 409(p) of the Code, as added by EGTRRA, applies to an ESOP for plan years beginning after December 31, 2004. Section 656(d)(2) of EGTRRA, however, provides that § 409(p) of the Code applies to plan years ending after March 14, 2001, if the ESOP is established after that date or, in the case of an ESOP established on or before March 14, 2001, the employer securities held by the plan consist of stock in a corporation with respect

to which an election under § 1362(a) to be an S corporation is not in effect on that date. For this purpose, a corporation does not have an election in effect on March 14, 2001, unless a valid election was actually filed on or before that date and is effective with respect to such corporation on or before that date. For example, a corporation that, on a date after March 14, 2001, files an election to be treated as an S corporation under § 1362(a) effective as of January 1, 2001, did not have an election under section 1362(a) in effect on March 14, 2001. Accordingly, § 409(p), as added by EGTRRA, applies to an ESOP maintained by such corporation beginning with the first plan year ending after March 14, 2001.

#### IV. Drafting Information

The principal drafters of this notice are Steven Linder of the Employee Plans, Tax Exempt and Government Entities Division and John Ricotta of the Office of Chief Counsel. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Linder may be reached at (202) 283-9888; Mr. Ricotta may be reached at (202) 622-6060. The telephone numbers in the preceding sentence are not toll-free.