

INTERNAL REVENUE SERVICE

June 8, 2001

Number: **200137016**
Release Date: 9/14/2001
CC:ITA:03/TL-N-7532-00
UILC: 263A.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Associate Chief Counsel CC:ITA

SUBJECT: Interaction between Sections 263A and 404(k)

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This Chief Counsel Advice responds to your memorandum dated March 6, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND:

X =
Year 1 =
Year 5 =

ISSUE:

Are dividends paid by corporation X, on stock held by its employee stock ownership plan (ESOP), which would otherwise be deductible by X under section 404(k), subject to capitalization under section 263A.

CONCLUSION:

The dividends are subject to capitalization under section 263A. X must make a reasonable allocation of the dividends to its cost of self-constructed assets.

FACTS:

X, a utility company, claimed deductions for dividends paid into its ESOP for distribution to employee-participants for its Year 1 through Year 5 taxable years. During

those years, X produced self-constructed assets and capitalized roughly 30% of certain labor-related costs, including employee compensation, pension and ESOP contributions, and overheads, as part of its cost of producing the assets. However, none of the dividends paid on stock held by its ESOP, although allowed as a deduction, were capitalized by X as a cost allocable to self-constructed assets.

LAW:

Section 263A provides that the direct costs and an allocable share of the indirect costs (including taxes) of real or tangible personal property produced by the taxpayer must be capitalized.

Treas. Reg. § 1.263A-1(d)(1) provides that self-constructed assets, which are defined as assets produced by a taxpayer for use by the taxpayer in its trade or business, are subject to section 263A.

Treas. Reg. § 1.263A-1(e)(3)(i) provides that taxpayers must capitalize all indirect costs properly allocable to property produced by the taxpayer or acquired for resale. Indirect costs are properly allocable to property produced by the taxpayer when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Taxpayers subject to section 263A must make a reasonable allocation of indirect costs between production, resale, and other activities.

Treas. Reg. § 1.263A-1(e)(3)(ii) lists examples of indirect costs that are required to be capitalized provided they are properly allocable to property produced or acquired for resale. Treas. Reg. § 1.263A-1(e)(3)(ii)(C) provides that pension and other related costs include contributions paid to or made under any stock bonus, pension, profit sharing or annuity plan, or other plan deferring the receipt of compensation, whether or not the plan qualifies under section 401(a), and such costs must be capitalized to the extent they are properly allocable to property produced or property acquired for resale. Contributions to employee plans representing past services must be capitalized in the same manner (and in the same proportion to property currently being acquired or produced) as amounts contributed for current service.

Treas. Reg. § 1.263A-1(e)(3)(ii)(D) provides that all other “employee benefit expenses” (not described in § 1.263A-1(e)(3)(ii)(C)) are required to be capitalized to the extent these expenses are otherwise allowable as deductions under chapter 1 of the Code, and are properly allocable to property produced or property acquired for resale.

Treas. Reg. § 1.263A-2(a)(3)(i) provides that producers must capitalize all indirect costs properly allocable to property produced under section 263A, without regard to whether these costs are incurred before, during, or after the production period.

Section 404(k) provides that, in the case of a C corporation, there shall be

allowed as a deduction for a taxable year the amount of any applicable dividend paid in cash by that corporation during the taxable year with respect to employer securities held by an employee stock ownership plan maintained by the corporation paying that dividend.

Section 404(k)(2) states that an applicable dividend means any dividend paid in accordance with plan provisions which -- (i) is paid in cash to the participants in the plan or their beneficiaries, (ii) is paid to the plan and distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year in which paid, or (iii) is used to make payments on a loan described in section 404(a)(9) the proceeds of which were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

For purposes of sections 72 and 402, section 404(k) dividends are treated as taxable distributions from a qualified plan under Treas. Reg. § 1.404(k)-1T (Q&A-3) and are reportable as plan distributions under section 6047(e) as the Secretary may prescribe.

Announcement 85-168, 1985-48 I.R.B. 40 (December 2, 1985) provides that a plan is to report a section 404(k) dividend distribution on Form 1099-DIV. The announcement also states that:

Although recipients are to report a section 404(k) distribution as a dividend on their tax returns (Form 1040A or 1040), the payment is to be treated, for any other purpose, as a plan distribution and not as investment income.

ANALYSIS:

X, subject to the requirements of section 263A as a producer of self-constructed assets, must capitalize the direct and indirect costs of producing these assets. See §§ 263A(a) and 263A(b)(1). Producers are generally required to capitalize all employee-related costs of production, including direct and indirect labor costs, contributions to pension and other employee plans, and other employee benefit expenses. See §§ 1.263A-1(e)(2)(B) and 1.263A-1(e)(3)(ii)(A), (C) and (D).

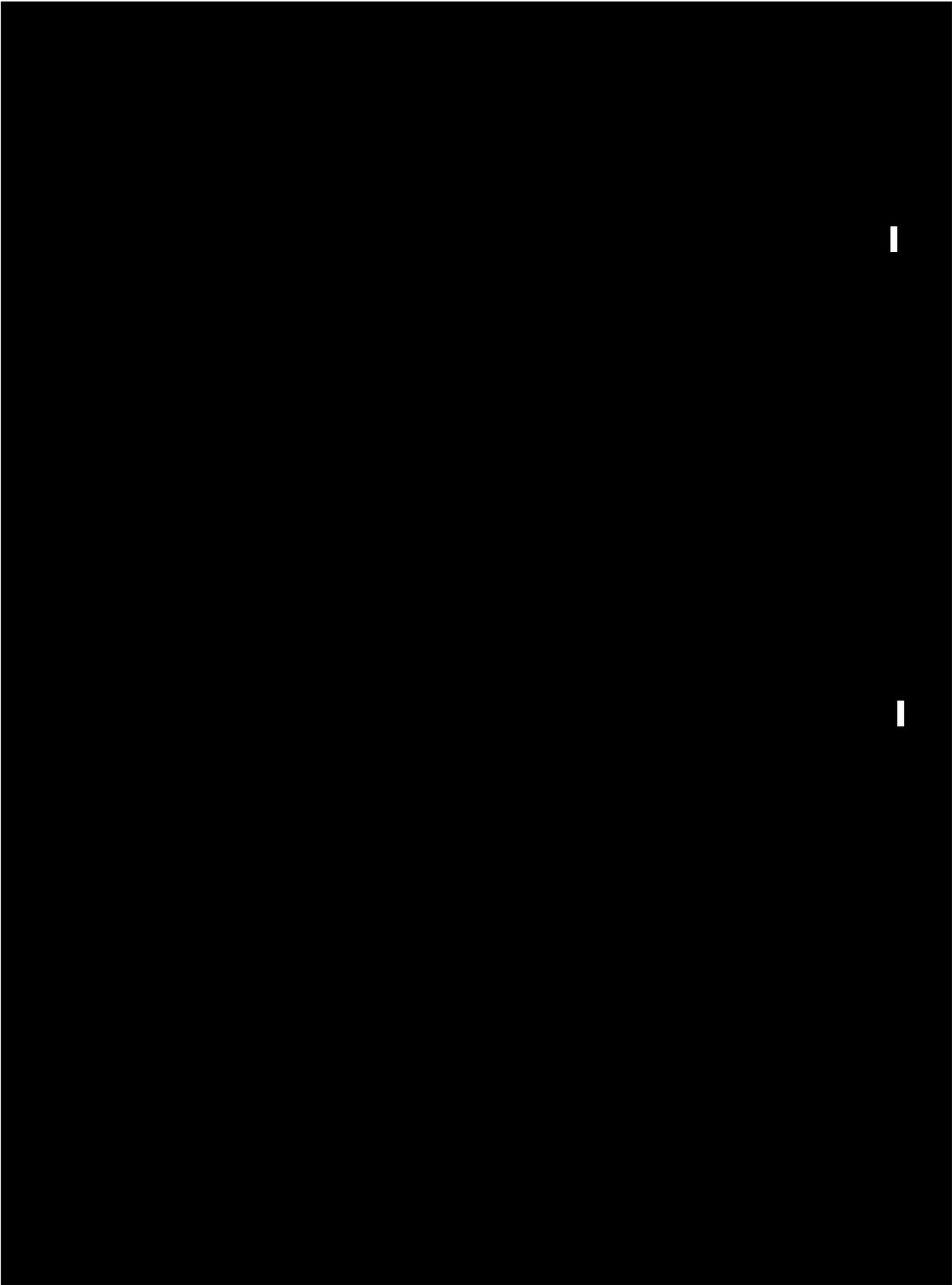
Section 404(k), which is contained in chapter 1, allows as a deduction applicable dividends (“§ 404(k) dividends”) paid in cash by a corporation with respect to employer securities held by an ESOP that it maintains. Such section 404(k) distributions are deductible under section 404(k) as part of a deferred compensation plan for employees to encourage stock ownership among employees. The dividends are deductible without regard to the deduction for pension or profit sharing plan contributions under section 404(a) or without regard to the limits on the employer’s qualified plan contributions under section 404(a). In addition, the dividends must satisfy the requirements of sections 316 and 301 in order to be deductible under section 404(k). However, while these amounts are reportable on a participant’s 1099-DIV, the Service has treated these amounts as distributions from a qualified plan, and not as investment

income, for all other purposes under the Code. (See Treas. Reg. § 1.404(k)-1, and Announcement 85-168, *supra*).

Under Treas. Reg. § 1.263A-1(e)(3)(ii)(D), all employee benefit expenses (except for pension and related costs, which are covered by Treas. Reg. § 1.263A-1(e)(3)(ii)(C)) must be capitalized to the extent they are properly allocable to property produced and otherwise allowable as a deduction under chapter 1 of the Code. Accordingly, in our view, section 404(k) distributions (dividends paid by X on stock held by its ESOP for distribution to employee-participants) constitute an employee benefit expense for purposes of Treas. Reg. § 1.263A-1(e)(3)(ii)(D) and must be capitalized to the extent properly allocable to production activities. X must make a reasonable allocation of those dividends to the cost of self-constructed assets, regardless of whether they are paid before, during, or after the production period. See §§ 1.263A-1(e)(3)(i) and 1.263A-2(a)(3)(i).

Alternatively, it is arguable that section 404(k) dividends should be treated as a pension or other related cost for purposes of Treas. Reg. § 1.263A-1(e)(3)(ii)(C). Classification of those dividends as a plan contribution would be consistent with their treatment by employee-participants as a plan distribution for certain purposes. See Treas. Reg. § 1.404(k)-1T and Announcement 85-168, *supra*. Yet, the classification of section 404(k) distributions as qualified plan contributions under Treas. Reg. § 1.263A-1(e)(3)(ii)(C) seems inconsistent with their character as dividends and with their ability to be deducted by an employer without regard to the employer's deductions for qualified plan contributions under section 404(a). In any event, the end result under Treas. Reg. § 1.263A-1(e)(3)(ii)(C) would be the same as treating section 404(k) dividends as an employee benefit expense under Treas. Reg. § 1.263A-1(e)(3)(ii)(D). In either case, a reasonable allocation of those dividends must be made to production activities.

Capitalization pursuant to section 263A only affects the timing of an otherwise allowable deduction and does not result in denial of that deduction. The treatment of section 404(k) dividends as an employee-related cost that is subject to the capitalization requirements of section 263A is consistent with the special character of these dividends as a deductible expense and X's treatment of its ESOP contributions as a capitalizable cost. Section 404(k) dividends, which give rise to a deduction, clearly represent an employee benefit or a contribution to an employee plan. See *generally* S. REP. NO. 313, 99th Cong., 2d Sess. 677 (1986), where the Committee on Finance states the purpose of an ESOP as "a technique of corporate finance and an employee benefit plan under ERISA designed to create a stock ownership interest for employees". Therefore, it is appropriate to treat section 404(k) dividends as being subject to capitalization under section 263A along with all other labor, pension, and employee benefit costs that are properly allocable to production activities.



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HEATHER MALOY
By: CLIFFORD M. HARBOURT
Senior Technician Reviewer
Branch 3
Income Tax & Accounting