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Letter Ruling 98-4: Treatment of an ESOP's Distribution of Cash Derived from Dividends

February 13, 1998

On behalf of your client, ***** ("Corporation"), and its employees you requested a letter ruling on the Massachusetts personal tax treatment of certain distributions by the Corporation Profit Sharing Trust and Employee Stock Ownership Plan ("ESOP"). You describe the facts as follows. The "Corporation" has established an ESOP, a type of qualified retirement plan that is required to limit investments to stock of the employer corporation.^[1] Since the ESOP owns stock of the employer corporation, the ESOP receives any cash dividends. The ESOP will distribute an amount equal to the cash dividends it receives to employees who are plan participants in the ESOP. Upon the ESOP's distribution of cash to the plan participants, the Corporation is allowed a deduction for dividends paid under IRC § 404(k). For federal purposes, the ESOP reports the cash distribution it makes to plan participants on Form 1099-Div, Box 1A (Gross Dividends). The instructions for Form 1099-Div, Box 1A state that "[a]lthough you should report the ESOP distribution as a dividend on your [federal] income tax return, treat it as a plan distribution, not as investment income, for any other purpose." See Revenue Ruling 72-99, 1972-1 C.B. 115.

Issues

- 1) Are the dividends received by the ESOP and then distributed by the ESOP to the plan participants characterized as dividend income subject to tax as Part A income or as qualified plan income subject to tax as Part B income?
- 2) How is an ESOP's distribution of cash derived from dividends reported on Massachusetts Form 1 by a Massachusetts resident who is a plan participant?

Discussion

Issue 1: Massachusetts gross income equals federal gross income, as defined under the Internal Revenue Code, as amended on January 1, 1988 and in effect for the taxable year, with certain modifications. M.G.L. c. 62, §§ 1(c), 1(d), 2(a). None of the modifications made to federal gross income in arriving at Massachusetts gross income affect distributions from an ESOP. See M.G.L. c. 62, § 2(a). Massachusetts divides gross income into three parts: Part A, Part B and Part C. M.G.L. c. 62, § 2(b). Part A gross income includes dividend income. Part A taxable income is taxed at 12 percent. M.G.L. c. 62, §§ 2(b)(1), 4(a). Part B gross income includes cash distributions from a qualified plan. Part B taxable income is taxed at 5.95 percent. M.G.L. c. 62, §§ 2(b)(2), 4(b). Part C gross income, which includes Massachusetts long-term capital gain or loss, is not relevant for this discussion.

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Chapter 62 makes no specific provision regarding the classification of cash distributions from an ESOP. For Massachusetts purposes, a "dividend" is any item of federal gross income which is treated as a dividend under the provisions of the Internal Revenue Code. M.G.L. c. 62, § 1(e). Under federal law, cash distributions from an ESOP are not treated as dividends, but as qualified plan distributions. See IRC § 72(e)(5) and Treas. Reg. § 1.404(k)-1T (Q&A 3).^[2] See also Revenue Ruling 72-99, 1972-1 C.B. 115 and *Clayton v. United States*, 33 Fed. Cl. 628, *affirmed*, 96-1 U.S. Tax Cas. (CCH) P 50,314. Massachusetts adopts this federal treatment. Thus, for Massachusetts purposes, cash distributions by an ESOP to plan participants have the character of qualified plan income even though any part of the distribution might be derived from dividends. As qualified plan income, the distributions are part B gross income.

Issue 2: The amount of distribution from the ESOP should be reported on 1996 Form 1, line 4 as taxable pension and annuity income. In addition, the same amount should be reported on 1996 Form 1, Schedule B, lines 2 and 7. The distribution is reported on line 2 to conform with federal reporting and on line 7 to remove the amount from the calculation of interest and dividend income subject to tax at 12 percent. In addition, a statement should be attached explaining that the excludable dividends on line 7 represent distributions from a qualified plan that are reported on Form 1, line 4.

Conclusion

Under the facts stated above, it is ruled that:

- 1) Cash distributions by an ESOP to plan participants have the character of qualified plan income even though some or all of the distribution might be derived from dividends. As qualified plan income, the distributions are Part B income.

- 2) Amounts reported as dividends on Form 1099-Div that are attributable to distributions from an ESOP should be reported on Form 1, line 4 and on Form 1, Schedule B, lines 2 and 7, with a statement attached explaining that the excludable dividends on line 7 represent distributions from a qualified plan that are reported on Form 1, line 4.

Very truly yours,

/s/Mitchell Adams

Mitchell Adams
Commissioner of Revenue

MA:HMP:smh

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^[1] We assume that the ESOP established by the Corporation properly qualifies as an employee stock ownership plan under IRC § 4975(e)(7).

^[2] Treasury Reg. § 1.404(k)-1T(Q&A 3) reads:

"Q-3: Are dividends paid in cash directly to plan participants by the corporation and dividends paid to the plan and then distributed in cash to plan participants under section 404(k) treated as distributions under the plan holding stock to which the dividends relate for purposes of sections 72, 401 and 402?"

A-3: Generally, yes. However, a deductible dividend under section 404(k) is treated for purposes

of section 72 as paid under a contract separate from any other contract that is part of the plan. Thus, a deductible dividend is treated as a plan distribution and as paid under a separate contract providing only for payment of deductible dividends. Therefore, a deductible dividend under section 404(k) is a taxable plan distribution even though an employee has unrecovered employee contributions or basis in the plan.”