Executive Compensation
& Benefits

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IRS Changes Reporting Requirements for Section 404(k) Dividends From ESOPs

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Internal Revenue Service Announcement 2008-56 changes the reporting of cash dividends on employer securities distributed from an employee stock ownership plan ("ESOP") under section 404(k) of the Internal Revenue Code ("IRC") by now requiring such dividends to be reported on a separate Form 1099-R instead of Form 1099-DIV. This change applies only to an ESOP's distribution of cash dividends. Dividends on ESOP employer securities that the corporation pays directly to ESOP participants or their beneficiaries will continue to be reported on Form 1099-DIV. The change in reporting will apply to ESOP dividend distributions made on or after January 1, 2009.

Background

Under IRC section 404(k), a C corporation that maintains an ESOP may deduct from its taxable income the amount of any dividends on employer securities held by the ESOP if, in accordance with plan provisions, either (i) the corporation pays such dividend directly to ESOP participants or their beneficiaries or (ii) the dividend is paid first to the ESOP and then distributed by the ESOP in cash to participants or their beneficiaries within 90 days after the close of the plan year in which the dividend was paid.

Cash dividend distributions made by an ESOP as provided in clause (ii) above receive special tax treatment. For example, such dividend distributions are not subject to the 10% additional tax on early plan distributions under IRC section 72(t), are not eligible rollover distributions under IRS section 402(c)(4), are not subject to withholding under IRC section 3405(e), and are not taken into account when determining if the required minimum distributions have been made under IRC section 401(a)(9). Also, backup withholding under IRC section 3406 does not apply to distributions of such dividends because they are reportable under IRC section 6047, not sections 6041 or 6042.

New Reporting Requirement

As per Announcement 2008-56, cash dividend distributions made by an ESOP on or after January 1, 2009 will be reported on a separate Form 1099-R that does not report any other plan distributions. If there are any other distributions from the plan that are not cash dividends on ESOP employer securities, they must be reported on a separate Form 1099-R. The IRS has indicated that a special code for box 7 will be added to the Form 1099-R instructions to highlight the special tax treatment and rollover restrictions applicable to the dividend distribution.

Announcement 2008-56 did not change the reporting requirements for dividends on ESOP employer securities that a corporation pays directly to ESOP participants or their beneficiaries. Those dividend distributions will continue to be reported on Form 1099-DIV in accordance with the instructions to that form.

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