Uniform Issue List No. 4975.00-00
Uniform Issue List No. 415.00-00

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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

2/25/03

T:EP:RA:T1

Legend:

Company A

Plan X

Buyer C

This is in response to a ruling request dated August 6, 2002, as supplemented by additional correspondence dated January 2, 2003 and January 22, 2003, from your authorized representative, concerning the Federal tax consequences of the prepayment of an exempt loan from Company A to Plan X, and the allocation of excess sale proceeds to the accounts of Plan X participants.

The following facts and representations have been submitted:

Company A established Plan X, an ESOP, effective July 1, 1997. The Internal Revenue Service (the "Service") issued a favorable determination letter, dated August 20, 1999, with regard to the qualification of Plan X under §401(a), §501(a) and §4975(e)(7) of the Internal Revenue Code (the "Code"). Company A subsequently restated Plan X effective as of July 1, 2001. The Service issued a favorable determination letter, dated April 10, 2002, with regard to the qualification of Plan X, as restated.

On August 13, 1998, Plan X purchased 24,700 shares of Company A's class A common stock from two of Company A's shareholders for $180 per share, or $4,446,000 in the aggregate. Such purchase was financed in part by means of a loan ("Loan") from Company A to Plan X in the amount of $4,174,000 and a

contribution to Plan X by Company A in the amount of $272,000 for the plan year ended June 30, 1998. The shares purchased with the proceeds of the Loan were pledged as collateral for the Loan. The shares were placed in a suspense account and are released from encumbrance as the Loan is repaid.

Company A established Plan X and made the Loan with the expectation that the Loan would be repaid in accordance with its seven-year repayment schedule, and that Company A would maintain Plan X until all of the stock purchased by Plan X was allocated to participants' accounts in accordance with the terms of Plan X. Company A has made significant and recurring contributions to Plan X, and the balance of the Loan has been reduced to approximately $2,502,501.21. As of June 30, 2002, approximately 50% of the shares originally purchased by Plan X were allocated to participants' accounts with the remaining shares held in the Plan X suspense account.

In April 2002, Buyer C offered to purchase all of the issued and outstanding stock of Company A for a price in excess of its appraised value. The trustee of Plan X has determined that a sale of Plan X's company stock to Buyer C would be in the best interests of the Plan X participants and their beneficiaries. The other shareholders of Company A have also agreed to sell their shares to Buyer C.

In conjunction with the transaction, the employee benefit plans maintained by Company A will be terminated. In light of the financial benefits to Company A, its employees and shareholders from the proposed transaction, the Board of Directors of Company A has approved the termination of Plan X, subject to the issuance of a favorable determination letter regarding the qualified status of Plan X as terminated. Company A has prepared an application to the Service for a determination letter finding that Plan X is qualified upon termination.

On or about August 28, 2002, all of Company A's shareholders, including Plan X, sold all of their shares of Company A stock to Buyer C, and Buyer C became the sole shareholder of Company A. Upon receipt of a favorable ruling, the proceeds from the sale of unallocated shares will be used by the Trustee of Plan X to repay the Loan. Any proceeds remaining from the sale of unallocated shares after the prepayment of the Loan ('Excess Sale Proceeds") will be allocated to participants' accounts pro rata based on compensation, in accordance with the terms of Plan X.

Based on the foregoing facts and representations, you requested the following rulings:

1. That the use of proceeds from the sale of unallocated stock held by Plan X to repay the Loan will not cause the Loan to fail to satisfy the requirements for exemption under §4975(d)(3) of the Code.

2. That the allocation of Excess Sale Proceeds to participants' accounts in Plan X will not constitute annual additions to those participants' accounts.

Under §4975(d)(3)(A) of the Code, an ESOP loan generally is exempt from the prohibitions provided in §4975(c) and the excise taxes imposed by §4975(a) and (b) only if the loan is primarily for the benefit of the participants and beneficiaries of the plan (the "primary benefit requirement"). Section 54.4975-7(b)(3) of the Federal Excise Tax Regulations (the "Regulations") provides that all of the surrounding facts and circumstances will be considered in determining whether an ESOP loan satisfies the primary benefit requirement. Among the relevant facts and circumstances are whether the transaction promotes employee ownership of employer stock, whether contributions to the ESOP are recurring and substantial, and the extent to which the method or repayment of the loan benefits the employees. All aspects of the loan transaction, including the method of repayment, will be scrutinized to determine whether the primary benefit requirement is satisfied.

Under §54.4975-7(b) of the Regulations, the employer has the primary responsibility for the repayment of an exempt loan through contributions to the plan. Other sources of repayment of an exempt loan are the earnings attributable to contributions and collateral for the loan in the event of default. However, the exemption provided by §4975(d)(3) of the Code, and described in the associated regulations, will not fail to be met merely because the trustee sells the unallocated suspense account shares and uses the proceeds to repay the exempt loan, if such transaction satisfies the primary benefit requirement based on all the surrounding facts and circumstances.

Plan X's Trustee has sold all of the shares of Company A's unallocated stock held by Plan X to Buyer C, and will use the proceeds from the sale to repay the Loan. In this case, Company A has made consistent and substantial contributions to Plan X since its inception. At the time Plan X was established, Company A contemplated that the ESOP would continue until the Loan was repaid, using contributions from Company A, and all of the shares were allocated. When the Loan was incurred, Company A did not anticipate that Buyer C would offer to purchase all of its issued and outstanding stock for a price in excess of its appraised value.

Upon consideration of all of the surrounding facts and circumstances of this case, in accordance with §54.4975-7(b)(3) of the Regulations, we conclude, with respect to ruling request one, that the use of the proceeds of the sale of unallocated stock held by Plan X to repay the Loan will not cause the Loan to fail to satisfy the requirements for exemption under §4975(d)(3) of the Code.

With respect to ruling request 2, §415 of the Code provides that a trust which is part of a pension, profit sharing, or stock bonus plan will not constitute a qualified trust under §401(a) if, in the case of a defined contribution plan, contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitations of subsection (c).

Section 415(c)(1) of the Code provides that contributions and other additions with respect to a participant exceed the limitations of this subsection if, when expressed as an annual addition, such annual addition is greater than the lesser of $ 40,000 or 100 percent of the participant's compensation.

Under §415(c)(2) of the Code, an annual addition is defined as the sum for any year of employer contributions, employee contributions, and forfeitures.

Section 1.415-6(b)(2)(i) of the Federal Income Tax Regulations (the "Income Tax Regulations") provides that the Commissioner may, in appropriate cases, considering all of the facts and circumstances, treat certain allocations to participants' accounts as giving rise to annual additions.

Section 1.415-6(g) of the Income Tax Regulations sets forth special rules for ESOPs. Section 1.415-6(g)(5) provides that for purposes of applying the limitations of Code §415(c), the amount of employer contributions which is considered an annual addition for the limitation year is calculated with respect to employer contributions of both principal and interest used to repay the exempt loan for that limitation year.

Section 54.4975-11(a)(8)(ii) of the Regulations provides that an ESOP will not fail to satisfy the requirements of Code §415 merely because annual additions under §415(c) are calculated with respect to employer contributions used to repay an exempt loan rather than with respect to securities allocated to participants' accounts.

In this case, the proceeds from the sale will be used to repay the principal and interest accrued under the Loan upon plan termination with shares remaining in the suspense account due to the increase in the fair market value of the stock acquired with the proceeds from the Loan. The Excess Sale Proceeds are not employer contributions, employee contributions or forfeitures and hence do not

fall within the definition of annual addition as defined in §415(c)(2) of the Code. As stated previously, §54.4975-11(a)(8)(ii) of the Regulations permits the calculation of annual additions for ESOP participants on the basis of employer contributions used to repay an exempt loan, rather than on the basis of the value of employer securities allocated to participants' accounts. Under this regulation, the increase in value of the securities is not treated as an annual addition.

As noted above, §1.415-6(b)(2)(i) of the Income Tax Regulations provides that the Commissioner may, in appropriate cases, considering all the facts and circumstances, treat certain allocations to participants' accounts as giving rise to annual additions. In our view, the facts and circumstances of the present case do not support the re-characterization of the Excess Sale Proceeds as annual additions under the authority of §1.415-6(b)(2)(i). We believe that the amounts remaining in the suspense account after repayment of the Loan constitute earnings on the suspense account assets and therefore, will not constitute annual additions when allocated to participants' accounts. Thus we conclude with respect to ruling request 2 that the allocation of Excess Sale Proceeds to participants' accounts under Plan X will not constitute annual additions under §415(c) of the Code.

In reaching these conclusions, we have assumed, without deciding that (i) the Loan extended by Company A to Plan X is an exempt loan under §4975(d)(3) of the Code at all relevant times, (ii) Plan X qualifies as a stock bonus plan under §401(a) and constitutes an ESOP under §4975(e)(7) at all relevant times, and (iii) any allocations made to the accounts of the participants of Plan X as a result of employer contributions used to repay the Loan or other annual additions will not exceed the limitations of §415.

No opinion is expressed as to the federal tax consequences of the transaction described above under any other provisions of the Code. Further, we express no opinion as to whether the proposed termination of Plan X complies with the requirements of §§401(a) and 4975(e)(7) of the Code. This matter is within the jurisdiction of the Employee Plans Determinations Office in Cincinnati Ohio.

We note that the Department of Labor has jurisdiction with respect to the provisions of Part 4 of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), including the requirement in §§404(a)(1)(A) and 404(a)(1)(B) of ERISA that fiduciaries discharge their duties for the exclusive purpose of providing benefits to participants and their beneficiaries and in a prudent manner. Therefore, we express no opinion as to whether the subject transactions are consistent with such provisions.

This ruling is directed only to the taxpayer that requested it. Section 6110(k) of the Code provides that it may not be used or cited by others as precedent.

The original of this ruling is being sent to your authorized representative pursuant to a power of attorney on file in this office. Should you have any questions pertaining to this ruling, you may contact , of this office at .

Sincerely yours,

Andrew E. Zuckerman
Manager, Employee Plans
Technical Branch 1