UIC 4975.04-02

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

MAY 19 2006

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T: EP: RA: T3

LEGEND:

Company A:

Company B:

Plan X:

Dear

This letter is in response to a request for a ruling letter submitted on your behalf by your authorized representative on September 16, 2004, as supplemented by correspondence dated June 10, 2005, November 11, 2005, November 22, 2005, January 13, 2006, January 24, 2006, February 23, 2006, April 5, 2006, and May 15, 2006, concerning the prepayment of an exempt loan upon termination of an employee stock ownership plan ("ESOP").

Company A established Plan X, an ESOP, effective January 1, 1986, for the benefit of its employees. Plan X is intended to be qualified under section 401(a) of the Internal Revenue Code ("Code") and to meet the requirements of section 4975(e)(7) of the Code.

Plan X had several loans which were intended to be exempt loans as described in Code section 4975(d)(3) [collectively, the "Loans"]. The Loans were consolidated as of October 1, 2004, and are represented by one note with a maturity date of December 31, 2006 (the "2004 Loan"). The shares purchased with the proceeds of the Loans were pledged as collateral for the Loans and were placed in Plan X's suspense account. Plan X's unallocated employer stock continued to be pledged as collateral for the 2004 Loan. At the time of the Loans, Company A contemplated that

Plan X would continue beyond the repayment of the Loans and the allocation to participants' accounts of all of the Company A shares held in the Plan X suspense account. Company A has made substantial and recurring contributions to Plan X resulting in significant payment of the Loans. As of December 31, 2005, approximately 51 percent of the employer securities purchased by Plan X with the proceeds of the Loans had been allocated to participant accounts in Plan X.

Effective November 9, 2005, Company A entered into an agreement and plan of merger with Company B. Pursuant to this agreement, Company A merged with and into Company B on April 1, 2006, with Company B being the survivor corporation of the merger transaction. Plan X will be terminated as of the effective date of the merger. Termination of Plan X is a condition of this merger.

As a result of the merger, the Company A stock held in Plan X (both allocated to participant accounts and unallocated in the suspense account) was exchanged for Company B stock and cash. The cash received which is attributable to the unallocated shares held in the Plan X suspense account will be applied first to repay the 2004 Loan. The trustee of Plan X will then sell a sufficient number of shares of unallocated stock held in the Plan X suspense account to repay the balance due on the 2004 Loan. In accordance with the terms of Plan X, the remaining shares of Company B stock held in the Plan X suspense account will be allocated to the accounts of eligible Plan X participants in the same proportion that each such participant's compensation for the prior plan year bears to the total compensation of all participants for such prior plan year.

Your authorized representatives have requested rulings to the effect of the following on your behalf:

1. The repayment of the 2004 Loan with (a) the cash received for the exchange of unallocated employer stock in connection with the corporate merger of Company A and Company B and (b) the cash proceeds from the sale of part of the unallocated employer stock by Plan X will not cause the 2004 Loan to violate the requirements for exemption under Code section 4975(d)(3).

2. The allocation to Plan X participants' accounts of the excess unallocated employer stock following the retirement of the 2004 Loan will not constitute annual additions for purposes of Code section 415(c).

With respect to your first requested ruling, an ESOP is designed to invest primarily in employer securities. An ESOP must be part of a stock bonus plan qualified under section 401(a) of the Code, or a stock bonus plan in a money purchase plan qualified under section 401(a). A leveraged ESOP borrows funds which it uses to purchase employer securities, usually from the employer. The ESOP loan or loans are generally from the employer or guaranteed by the employer. The acquired employer securities are held in a suspense account pending allocation to the accounts of plan participants in accordance with the rules of section 54.4975-11(d) of the Excise Tax Regulations ("regulations"). An ESOP generally uses employer contributions to the plan and cash dividends on employer stock held by the plan to repay the exempt loan.

Under section 4975(d)(3)(A) of the Code, an ESOP loan generally is exempt from the prohibitions provided in section 4975(c) and the excise taxes imposed by sections 4975(a) and (b) only if the loan is primarily for the benefit of the participants and beneficiaries of the plan ("primary benefit requirement"). Section 54.4975-7(b)(3) of 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 the employer stock, whether contributions to the ESOP are recurring and substantial, and the extent to which the method of 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.

Section 54.4975-7(b) of the regulations indicates that the employer has the primary responsibility for the repayment of an exempt loan through contributions to the plan. Section 54.4975-7(b)(6) provides for the repayment of an exempt loan in the event of default. However, the exemption provided by section 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 the transaction satisfies the primary benefit requirement based on all the surrounding facts and circumstances.

Section 54.4975-7(b)(5) of the regulations also provides that the only assets of an ESOP that may be given as collateral on an exempt loan are qualifying employer securities of two classes: those acquired with the proceeds of the loan and those that were used as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan. No person entitled to payment under the exempt loan shall have any right to assets of the ESOP other than: (i) collateral given for the loan, (ii) contributions (other than contributions of employer securities) that are made under an ESOP to meet its obligations under the loan, and (iii) earnings attributable to such collateral and the investment of such contributions.

Section 54.4975-7(b)(5) of the regulations does not establish a per se prohibition against exempt loan prepayment by an ESOP. However, as noted above, if an ESOP contemplates prepaying an exempt loan, the funds used to prepay the loan must be limited as described in this regulation.

In this case, Company A has made consistent and substantial contributions to Plan X since its inception in 1986. More than one-half the shares purchased with the proceeds of the Loans have been allocated to participants' accounts. At the time Plan X was established and at the time the Loans occurred, Company A intended that Plan X would continue until the Loans were repaid and all shares of common stock held in the suspense account were allocated to participants. However, Company A has merged into Company B, and the termination of Plan X is a condition of the merger. Pursuant to the merger, Company A stock held in Plan X was exchanged for Company B stock and cash. The cash received which is attributable to the unallocated shares held in the Plan X suspense account will be applied first to repay the 2004 Loan. The trustee of Plan X will then sell a sufficient number of shares of unallocated stock held in the Plan X suspense account to repay the balance due on the 2004 Loan. In accordance with the terms of Plan X, the remaining shares of Company B stock held in the Plan X suspense account will be

allocated to the accounts of eligible Plan X participants in the same proportion that each such participant's compensation for the prior plan year bears to the total compensation of all participants for such prior plan year.

Accordingly, with respect to your first requested ruling, we conclude that the repayment of the 2004 Loan with (a) the cash received for the exchange of unallocated employer stock in connection with the corporate merger of Company A and Company B and (b) the cash proceeds from the sale of part of the unallocated employer stock by Plan X will not cause the 2004 Loan to violate the requirements for exemption under Code section 4975(d)(3).

With respect to your second requested ruling, section 415(a) of the Code provides that contributions and other additions under a defined contribution plan (including an ESOP) with respect to a participant for any taxable year may not exceed the limits of subsection (c). Section 415(c)(1) of the Code states that contributions and other additions with respect to a participant exceed the limitation of this subsection if, when expressed as an "annual addition" to the participant's account, such annual addition is greater than the lesser of $40,000 or 100% of the participant's compensation. Section 415(c)(2) generally defines "annual addition" as the sum for any year of employer contributions, the employee contributions, and forfeitures.

Section 1.415-6(g) of the Income Tax Regulations sets forth special rules for ESOPs. Section 1.415-6(g)(5) provides, in part, that for purposes of applying the limitations of section 415(c) of the Code and section 1.415-6(g) of the Income Tax Regulations to an ESOP to which an exempt loan has been made, 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 1.415-6(b)(2)(i) of the Income Tax Regulations provides in part that the Commissioner may, in appropriate cases, considering all of the facts and circumstances, treat transactions between the plan and the employer as giving rise to annual additions.

In the present case, the shares remaining in Plan X's suspense account following the prepayment of the 2004 Loan remain there because it was not necessary to sell them to prepay the Loan. Thus, they reflect the extent of the appreciation in the value of the shares held in the suspense account and are, in effect, earnings, and are properly treated as such as part of the termination of Plan X. Since the shares remaining in Plan X's suspense account are treated as earnings, they do not constitute annual additions under section 1.415-6(b)(2)(i) of the regulations upon their allocation to participants' accounts in this situation.

Accordingly, we conclude with respect to your second requested ruling that the allocation to Plan X participants' accounts of the excess unallocated employer stock following the retirement of the 2004 Loan will not constitute annual additions for purposes of Code section 415(c).

This ruling letter is based on the assumption that Plan X is qualified under Code section 401(a), including section 401(a)(4), at all times relevant to the transaction described herein and that it is an ESOP as described in section 4975(e)(7).

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 section 404(a)(1)(A) and section 404(a)(1)(B) of ERISA that fiduciaries discharge their duties for the exclusive purpose of providing benefits to participants and their beneficiaries in a prudent manner. Therefore, we express no opinion as to whether the subject transactions are consistent with such provisions.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

A copy of this ruling letter has been sent to your authorized representative in accordance with a power of attorney on file with this office.

If you have any questions, please contact
Please refer to SE:T:EP:RA:T3.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Group 3

Enclosures
Notice 437
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cc: