SIG INDEX # 4975.04-02

Internal Revenue Service

200014043

Department of the Treasury

Washington, DC 20224

Contact Person:
xxxxx

Telephone Number:
xxxxx

In Reference to:
T:EP:RA:T2/50-06967

Date:
JAN 12 2000

▷ xxxxx
xxxxx
xxxxx

Attn: xxxxx

Legend:

Corporation A = xxxxx

Plan X = xxxxx

Dear xxxxx:

This letter is in response to a ruling request submitted on your behalf by your authorized representative on xxxxx, 1998, as supplemented by letters dated xxxxx, 1998, xxxxx, 1999 and xxxxx, 1999. The request concerns the consequences for an employee stock ownership plan ("ESOP") under Internal Revenue Code sections 4975(d)(3), 4975(e)(7) and 415(c)(2) of a proposed election under Code section 1362.

The following facts and representations have been submitted in support of the rulings requested:

Effective xxxxx, 1997, Corporation A established Plan X, an ESOP which is intended to meet the requirements of Code sections 401(a) and 4975(e)(7). Corporation A also maintains a defined benefit plan and a profit-sharing plan with a cash or deferred arrangement feature.

Plan X financed the purchase of Corporation A stock by borrowing funds from Corporation A ("Corporate Loan"), and by issuing to each selling shareholder promissory notes guaranteed by Corporation A ("Seller Notes"). The Corporate Loan and Seller Notes together constitute the "Plan X Loans" referred to herein. You represent that the Plan X Loans are exempt within the meaning of section 54.4975-7(b) of the Excise Tax Regulations.

Plan X pledged as collateral for the Corporate Loan those shares of Corporation A stock attributable to the cash consideration paid pursuant to the tender offer. The shares of Corporation A stock attributable to the cash consider-

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ation along with the shares of Corporation A stock attributable to Seller Notes were credited to a single suspense account under Plan X which, you represent, complies in all respects with the requirements of section 54.4975-11(c) of the regulations.

As contributions by Corporation A to Plan X and dividends on unallocated shares of Corporation A stock are used to make principal and interest payments on the Plan X Loans, a pro rata portion of the shares credited to the Plan X suspense account is released from such account and is allocated to individual participant accounts under Plan X pursuant to an allocation formula set forth in the Plan X document.

Corporation A intends to elect, in accordance with the provisions of Code section 1362, Subchapter S corporate status. Corporation A will amend Plan X to provide that S Corporation distributions from Corporation A with respect to unallocated shares will be used to repay the loans. The S Corporation distributions will consist of dividends to the extent that Corporation A has accumulated earnings and profits from its prior status as a C corporation and amounts coming from Corporation A's accumulated adjustments account ("AAA") maintained in accordance with Code section 1368. The AAA is not increased by capital contributions. All amounts held within it would be payable as dividends under Code section 301 if Corporation A remained a C Corporation.

Based on the above facts and representations, the following rulings have been requested:

1. If Corporation A makes an election under Subchapter S of the Code, Corporation A's S Corporation Distributions made with respect to unallocated securities of Corporation A held by Plan X may be used to make principal and interest payments on the Plan X Loans without violating the requirements of section 4975(d)(3) of the Code and its accompanying regulations.

2. If S Corporation Distributions, as described above, made by Corporation A with respect to unallocated securities of Corporation A held by Plan X are used to repay the Plan X Loans, such amounts, and the release and allocation of Corporation A securities from the Plan X suspense account attributable to such amounts, do not constitute "annual additions" within the meaning of section 415(c)(2) of the Code.

Code section 401(a) provides that a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for

the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section if certain requirements are met.

Code section 4975(e)(7) generally defines an ESOP as a defined contribution plan which is a stock bonus plan which is qualified under Code section 401(a), and which is designed to invest primarily in qualifying employer securities.

Code section 4975 imposes a tax on prohibited transactions, but provides an exemption in section 4975(d)(3) for a loan to a leveraged ESOP (as defined in section 4975(e)(7)) if such loan is primarily for the benefit of participants and beneficiaries of the plan. Requirements concerning the interest rate and collateral must also be met.

Section 54.4975-7(b)(2)(ii) of the regulations provides that an exempt loan will be subjected to special scrutiny to ensure that they are primarily for the benefit of participants and their beneficiaries.

Section 54.4975-7(b)(3) of the regulations states that an exempt loan must be primarily for the benefit of the ESOP participants and their beneficiaries, and that all of the surrounding facts and circumstances will be considered in determining whether the loan satisfies this requirement. It further states that no loan will satisfy this requirement unless it satisfies the requirements of section 54.4975-7(b)(5) of the regulations.

Section 54.4975-7(b)(5) of the regulations states in part that 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 obligation under the loan, and (iii) earnings attributable to such collateral and the investment of such contributions. Section 54.4975-7(b)(5) further states that payments made with respect to an exempt loan by the ESOP during a plan year must not exceed an amount equal to the sum of such contributions and earnings received during or prior to the year less such payments in prior years.

Section 54.4975-11(c) of the regulations provides that all assets acquired by an ESOP with the proceeds of an exempt loan under Code section 4975(d)(3) must be added to and maintained in a suspense account. They are to be withdrawn from the suspense account by applying the

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applicable regulations as if all securities in the suspense account were encumbered.

In this case, the subject S Corporation Distributions consisting of amounts from either accumulated earnings and profits or from the AAA are earnings attributable to unallocated securities of Corporation A held in the suspense account as assets acquired by Plan X with the proceeds of the Plan X Loans. Accordingly, with respect to ruling request one, we conclude that use of such amounts to make principal and interest payments on the Plan X Loans will not cause the Plan X Loans to fail to satisfy Code section 4975(d)(3).

Code section 415(a) provides, in pertinent part, that a trust which is part of a pension, profit-sharing or stock bonus plan will not constitute a qualified trust under Code section 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 limitation of subsection (c).

Code section 415(c)(1) provides that contributions and other additions with respect to a participant exceed the limitations of this subsection if, when expressed as an annual addition (as defined below), such annual addition is greater than the lesser of $30,000, or 25 percent of the participant's compensation.

Code section 415(c)(2), defines an "annual addition" as the sum for any year of employer contributions, employee contributions and forfeitures.

With respect to ruling request two, we conclude that since the subject S Corporation Distributions are earnings, such Distributions made by Corporation A with respect to the unallocated securities of Corporation A held by Plan X used to repay the Plan X Loans, and the release and allocation of Corporation A securities from Plan X attributable to such amounts, do not constitute "annual additions" within the meaning of Code section 415(c)(2).

This ruling letter is based on the assumption that Plan X will continue to be otherwise qualified under Code sections 401(a) and 4975(e)(7) at all relevant times. Also, this ruling is based on the assumption the AAA satisfies the requirements of Code section 1368 at all relevant times.

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

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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.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2
Tax Exempt and Government Entities Division

Enclosures:
Copy of ruling
Deleted copy of ruling
Notice of Intention to Disclose

cc:
xxxxx Key District Office
Attn: Chief, EP/EO

xxxxx, Esquire

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