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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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415.00-00

Contact Person:

Telephone Number:

In Reference to:

Date: OP:E:EP:T3

Attention:

JUN 2 2000

Re:

Legend:

Company A =

Trust B =

Bank C =

Firm D =

Plan X =

Plan Y =

Dear

This is in reply to your request for a ruling dated September 17, 1999, concerning the federal income tax consequences of the repayment of exempt loans under section 4975 of the Internal Revenue Code ("Code"), and the treatment under section 415 of the Code of the allocation of the proceeds of a sale of stock held by Plan X to participants' accounts. Letters dated February 17, 2000, and May 30, 2000, supplemented the request.

Company A established Plan X, an employee stock ownership plan, effective January 1, 1985. Plan X is intended to comply with sections 401(a), 501(a), and 4975(e)(7) of the Code. Plan X contains a leverage provision which permits Plan X to borrow funds through a loan intended to comply with section 4975(d) of the Code. In 1985, Plan X borrowed $3,400,000, from a third party lender in order to purchase 137,259 shares

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(30.95%) of the Company A's common stock from seventeen (17) individual shareholders. The loan was paid over ten years and all shares acquired by Plan X in connection with such loan were allocated to participants.

In 1994, Plan X borrowed $5,000,006 from Company A to purchase 172,414 shares of Company A stock directly from Company A. Since 1994, six additional exempt loans, of a total principal amount of $2,682,486 have been made to Plan X. The proceeds of five of the additional loans were used by Plan X in order to enable it to repurchase distributed shares. One of the additional loans was used to repurchase 23,550 shares from a share holder who had not previously been a participant in Plan X and was not used to satisfy repurchase obligations. All seven loans (since 1994) are intended to be exempt loans under section 54.4975-7(b) of the Income Tax Regulations. As of December 31, 1998, there were seven outstanding loans ("Loans") with an aggregate outstanding loan balance of $5,761,823. Contributions to Plan X by Company A and cash dividends on shares of Company A stock held by Plan X are used by Plan X to make payments on the Loans. The shares of Company A stock purchased with the 1994 Loan are held unallocated in a suspense account and are pledged as collateral for the Loans. The shares purchased with the six additional loans were placed in an unallocated suspense account, and placed as collateral for the loan. As payments are made on the Loans, shares of Company A stock are released from the suspense account and allocated to the participants' accounts.

Trust B, a wholly owned bank subsidiary of Company A, currently acts as the Trustee of Plan X. Company A's Board of Directors has approved the appointment of Bank C as an independent trustee with respect to the portion of the trust's assets that are held unallocated in the suspense account. Trust B will remain as Trustee with respect to the portion of the trust assets that are not in the suspense account.

Company A has now decided to terminate Plan X. Company A's Board of Directors decided to terminate Plan X after reviewing all alternatives available, including restructuring the Loans. This decision is primarily due to the substantial negative impact on Company A's earnings and stock value of continued maintenance of Plan X and repayment of the Loans. The issues considered by Company A's Board of Directors in reaching the decision to terminate Plan X are as follows:

1. There has been a significant increase in the value of the Company A common stock acquired by Plan X in connection with the exempt loans and in connection with Plan X's initial acquisition of Company A common Stock in 1985. The fair market value of the Company A common stock increased from $25.00 per share in 1985 to $34.00 per share in 1994 and then to $58.00 per share in 1997. The value dropped to $50.00 per share as of December 31, 1998. (This dip in value occurred in the fall of 1998 when other stocks dropped also, particularly bank stocks.) This overall 100% increase in the value of the Company A common stock has dramatically increased the Company A's repurchase liability.

2. There has been a significant decrease in the number of employees of Company A between 1994 and the present. The number of employees in 1994 was 238, which dropped

to a low of 184 in 1996, a 23% decrease. The current number of employees is 198, which results in an overall decrease, from 1994 to the present, of 17%.

3. The Financial Accounting Standards Board imposed a requirement, in Statement of Position 93-6, ("SOP 93-6") to the effect that, for financial statement reporting purposes, shares of Company A common stock purchased by Plan X are accounted for, as they are released from the "loan suspense account" thereunder, at their current fair market value rather than at their substantially lower cost to Plan X. SOP 93-6 also requires that dividends received on unallocated shares be recorded as a compensation expense. These new accounting rules, which became effective November 22, 1993, combined with the 100% increase in the value of Company A common stock and the 17% decrease in the number of employees, causes an extraordinarily large compensation expense being charged to Company A's earnings each year. The charges, in turn, have materially affected the financial performance of Company A which, in turn, can also adversely affect the value of Company A common stock. Plan X expense increased from $158,000 in 1994 to $828,000 in 1998, and projections indicate that Plan X expenses may exceed $1,300,000 by the year 2004.

4. As of December 31, 1998, 14.83% (119,761 shares), worth $5,988,050 at the December 31, 1998 value, of the stock of Company A has been allocated to participants' Plan X accounts.

5. Company A's employees are also covered by Plan Y, a "401(k)" plan to which Corporation A makes regular matching contributions with respect to participants' salary redirection contributions thereunder. In 1994, retirement benefit expense (both Plan X and Plan Y), expressed as a percentage of total employee salaries equaled 4.80%; in 1998 it was 12.50%, and projections for 2004 are 19.06%. By comparison, Company A peer group, consisting of other banks similarly located, has average retirement benefit expense of 4% of total employee compensation.

As part of the termination of Plan X, the Loans must be repaid. To accomplish this, a portion of the unallocated shares of Company A common stock held in the suspense account under Plan X will be sold to Company A at no less than fair market value. Fair market value will be determined by Bank C, based upon a valuation performed by Firm D an independent third-party appraisal firm. A fairness opinion will also be obtained from Firm D to the effect that the transaction is fair to the participants and Plan X from both a financial point of view and a transactional point of view. The sales proceeds will be used to repay the Loans.

The shares of Company A common stock remaining in the suspense account after the Loans are repaid will be allocated as earnings on Plan X assets to the participants' accounts in the same proportion as each participant's respective compensation bears to the total compensation of all participants in Plan X. Upon termination of Plan X, participants' accounts will be transferred, in a trustee-to-trustee transfer, from Plan X to a new qualified stock bonus plan that is being established by the Company A on behalf of its employees.

Based on the foregoing, the following rulings are being requested:

1. The use of the proceeds of the sale of unallocated stock held by Plan X to repay Plan X's indebtedness will not cause the Loans to fail to satisfy the requirements for exemption under section 4975 of the Code.

2. Any allocations made to the accounts of the participants of Plan X as a result of the proposed transaction will be treated as earnings, and therefore will not constitute annual additions to participants' accounts for purposes of section 415 of the Code when allocated to the participants' accounts.

With respect to your first ruling request, an employee stock ownership plan ("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. 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 (the "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) 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.

With respect to repayment of an exempt loan, section 54.4975-7(b)(5) of the regulations indicates that the employer has the primary responsibility for repayment through contributions to the plan. This section 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.

Plan X will sell a portion of the shares of Company A common stock held unallocated in the suspense account by Plan X to Company A. Plan X will use the proceeds of the sale of the unallocated shares in Plan A's suspense account to repay the outstanding balance of the Loans. The exemption provided by section 4975(d)(3) of the Code will not fail to be met merely because a trustee sells employer securities held in the unallocated suspense account and repays exempt loans, if such transactions satisfy the primary benefit rule.

In this case, Company A has made consistent and substantial contributions to Plan X since its inception in 1985. At the time Plan X was established and at the time the subsequent Loans occurred, Company A contemplated that Plan X would continue until the original loan and the subsequent Loans were repaid and all shares of Company A common stock were allocated to participants. Of the 172,414 shares acquired with the 1994 Loan, 56,642 shares have been allocated to participants' accounts.

Company A is selling a portion of the unallocated shares of Company A common stock and repaying the Loans with the proceeds in order for Company A to terminate Plan X. Additionally, Company A will establish a new stock bonus plan, contributions to which will be made in shares of Company A common stock, for the benefit of its employees.

Accordingly, with respect to your first ruling request, we conclude that the use of the proceeds of the sale of unallocated stock held by Plan X to repay Plan X's indebtedness will not cause the Loans to fail to satisfy the requirements for exemption under section 4975 of the Code.

With respect to your second ruling request, section 415(a) of the Code provides that contributions and other additions under a defined contribution plan with respect to a participant for any taxable year may not exceed the limits of subsection (c). Section 415(a)(1)(B) of the Code, generally, prohibits contributions and other additions under all defined contribution plans of an employer, including an ESOP, with respect to any participant for any limitation year from exceeding the limitations in section 415(c). Section 415(c)(1) of the Code provides that contributions and other additions with respect to a participant shall not, when expressed as an "annual addition" to the participant's account, exceed the lesser of (A) $30,000 or (B) 25% of the participant's compensation. Section

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

Section 415(c)(6) of the Code provides that if no more than one-third of the employer contributions to an employee stock ownership plan are allocated to highly compensated employees, then certain forfeitures and certain contributions used to repay interest on the exempt loan are not subject to the limitations imposed by section 415.

Section 1.415-6(g) of the Income Tax Regulations sets forth special rules for employee stock ownership plans. 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 regulations, 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 regulations provides that the Commissioner may, in appropriate cases, considering all of the facts and circumstances, treat certain allocations to participant accounts as giving rise to annual additions.

Section 54.4975-7(b)(8)(i) of the regulations provides, in part, that an exempt loan must provide for the release from encumbrance under this subdivision (i) of plan assets used as collateral for the loan. For each plan year during the duration of the loan, the number of securities released must equal the number of encumbered securities held immediately before release for the current plan year multiplied by a fraction. The numerator of the fraction is the amount of the principal and interest paid for the year. The denominator of the fraction is the sum of the numerator plus the principal and interest to be paid for all future years.

Section 54.4975-ll(a)(8)(ii) of the regulations states that an ESOP will not fail to meet the requirements of section 401(a)(l 6) of the Code, merely because annual additions under section 415(c) of the Code are calculated with respect to employer contributions used to repay an exempt loan rather than with respect to securities allocated to participants.

The amounts that will remain in Plan X's suspense account following the sale of the shares and the use of the proceeds to repay the Loans result from the sale of employer securities to Company A in a transaction that is part of a plan termination. Plan X is being represented in this transaction by an independent discretionary trustee who is represented by independent trust counsel. Furthermore, the trustee will have obtained from Firm D, an independent third party valuation firm, an appraisal of the fair market value of the securities to be sold and a fairness opinion as to the fairness of the transaction from a financial point of view to the participants and to Plan X. These amounts, although received from the employer, are being used to purchase Company A stock as part of a plan termination, rather than being contributed to Plan X. Accordingly, such amounts are not employer contributions. Because these amounts also are not employee contributions or forfeitures, they do not fall within the definition of annual addition, as defined in section 415(c)(2) of the Code. Accordingly, because the amounts used to repay the loan will not be employer

contributions, there is no annual addition under section 54.4975-11(a)(8)(ii) of the regulations in this situation.

As previously noted, section 1.415-6(b)(2)(i) of the regulations provides that the Commissioner may, in appropriate cases, considering all of the facts and circumstances, treat certain allocations to participant accounts as giving rise to annual additions. In the present case the proceeds in the suspense account result from the repayment of the loan following the sale of the unallocated plan assets to Company A subject to the agreement by the independent discretionary trustee based upon the fair market value appraisal and fairness opinion provided by a third party appraiser, as part of the termination of Plan X. Subsequently, the trust will be terminated and the assets transferred in a trustee-to-trustee transfer to another plan. In this transaction we have determined that no employer contributions were used to repay the loan. Accordingly, in our view, the facts and circumstances of the present case do not support the recharacterization of the ESOP suspense account allocations as annual additions under the authority of section 1.415-6(b)(2)(i).

Accordingly, we conclude with respect to your second ruling request that any allocations made to the accounts of the participants of Plan X as a result of the proposed transaction will be treated as earnings, and therefore will not constitute annual additions to participants' accounts for purposes of section 415 of the Code when allocated to participants accounts.

The above rulings are based on the assumption that Plan X will be otherwise qualified under sections 401(a) and 401(k) of the Code, and the related trust will be tax exempt under section 501(a) at the time that the above transaction takes place.

This ruling is directed only to the taxpayer who requested it and applies only to Plan X as proposed to be amended as of the date of this ruling. Section 6110(j)(3) of the Code provides that this ruling may not be used or cited as precedent

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

Sincerely,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans, Technical Branch 3
Tax Exempt and Government Entities Division

Enclosures:
Deleted copy of letter
Notice of Intention to Disclose