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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200213033

Index Numbers: 415.02-01, 4975.04-02

T:EP:RA:T1

JAN 2 2002

Attn:

Legend:

Company A.....

Company B.....

Plan X.....

Exchange.....

Dear :

This is in response to a letter dated April 3, 2001, submitted on your behalf by your authorized representative in which you requested rulings regarding the repayment of an exempt loan. The following facts and representations were submitted in connection with your request.

Company A serves as a holding company for Company B. Company A maintains Plan X for its employees and the employees of Company B. Plan X is an ESOP intended to be qualified under section 401(a) and 4975(e)(7) of the Internal Revenue Code (the "Code"). Company A also maintains two other plans, a defined benefit plan and a defined contribution plan, for the employees of Company A and Company B.

Plan X was established in 1996. On November 14, 1997, Plan X received a determination letter from the Service that it was qualified under Code sections 401(a) and 4975(e)(7). On , Plan X acquired shares of Company A's common stock for $ a share in connection with an initial public offering. The acquisition was financed through a loan from Company A to Plan X (the "Loan"). To secure the Loan, the trustees of Plan X executed a promissory note (the "Note") and entered into a stock pledge agreement with the taxpayer ("Stock Pledge Agreement"), on . Pursuant to the terms of the Note, the Loan was to be repaid in equal annual installments of principal, plus interest at percent above the prime rate, as defined in the Note. The initial interest rate was determined on the closing date of the initial public offering, and subsequent interest rates were to be determined on October 1 of each year thereafter, beginning with October 1, 1997. The first payment of principal and interest was due on September 30, 1997, and subsequent payments were due on September 30 of each

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year thereafter through 2006. Principal and interest could be repaid at any time without penalty.

Under the Stock Pledge Agreement, the stock purchased with the proceeds from the Loan was pledged to Company A as security and allocated to the suspense account under Plan X. Shares have been and will be released each year in the ratio that the principal payments made during the plan year bear to the original principal amount of the Loan.

Company A and Company B have made contributions to Plan X for plan years ending September 30, 1997 through September 30, 2000 of $, $, and $, respectively. These contributions plus dividends paid on unallocated shares have been used to pay the principal and interest on the Loan. As of September 30, 2000, a total of . shares have been released from Plan X's suspense account and allocated to participants' accounts, with , shares held unallocated in the suspense account. The principal balance of the Loan as of that date was $ As of , the closing price of the stock on the Exchange was $ per share. Thus, the value of the unallocated shares was $, or $ more than the then outstanding balance of the Loan.

Company A proposes to terminate Plan X immediately following the record date for Company A's dividend for the quarter ending September 30, 2001. Company A wishes to terminate Plan X due to the adverse impact Plan X is having on Company A's financial accounting and reporting due to the requirements of Financial Accounting Standards Board Statement of Position 93-6, "Employers' Accounting for Employee Stock Ownership Plans." Company A will make a final contribution to Plan X for plan year ending September 30, 2001, in the amount of $, or 1/10th of the original loan amount, plus interest. Company A will redeem a sufficient number of unallocated shares, based on the closing price of the stock on the date of the redemption, to repay the outstanding principal balance on the Loan plus accrued interest. Any remaining shares will be allocated to participants' accounts as earnings. In the event the total value of unallocated shares is not sufficient to repay the Loan, Company A will forgive the loan balance.

Company A anticipates that after the contribution to Plan X for the year ending September 30, 2001, and based on anticipated dividends through to the date of plan termination, a total of shares will have been allocated to accounts and shares will remain unallocated. The remaining principal balance will equal $ shares will have to be redeemed to repay the Loan. After repaying the Loan, shares will remain in the suspense account for allocation to participants' accounts.

Based on the information submitted and the above facts and representations, you request the following letter rulings:

(1) The repayment of the Loan in connection with the termination of Plan X with the proceeds from a redemption of the shares held in the suspense account will not cause the Loan to violate the requirements of exemption under Code section 4975(d)(3).

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(2) The allocations of surplus shares remaining in the suspense account following the repayment of the Loan to participants' accounts may be treated as earnings and not as annual additions under Code section 415(c).

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

Regarding ruling request (1), pursuant to Code section 4975(d)(3)(A), an ESOP loan will be 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 plan participants and beneficiaries. Under section 54.4975-7(b)(3) of the regulations, whether a loan satisfies the "primary benefit requirement" will be determined based on all the surrounding facts and circumstances. 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 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.

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. Section 54.4975-7(b)(5) 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 the regulation.

In this case, Company A intends to terminate Plan X and as part of the termination, will redeem shares of Company A stock held in the suspense account and apply the redemption

proceeds to satisfy the outstanding balance of the Loan. Any shares remaining after the redemption will be allocated to participants' accounts. The unallocated shares served as collateral for the Loan, and repayment of the Loan will be made with the proceeds from the redemption of unallocated shares. Substantial contributions to Plan X have been made on a continuing basis since 1997 resulting in a significant repayment of the Loan. Based on all the facts and circumstances of this case, we conclude, with respect to ruling request (1), that the repayment of the Loan in connection with the termination of Plan X with the proceeds from a redemption of the shares held in the suspense account will not cause the Loan to violate the requirements of exemption under Code section 4975(d)(3).

Regarding ruling request (2), Code section 415 provides that a trust which is part of a pension, profit sharing, or stock bonus plan will not constitute a qualified trust under 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 limitations of subsection (c).

Code section 414(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, such annual addition is greater than the lesser of $30,000 or 25 percent of the participant's compensation.

Under Code section 415(c)(2), 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 "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 1.415-6(g) of the regulations sets forth special rules for ESOPs. Section 1.415-6(g)(5) provides that for purposes of applying the limitations of Code section 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 section 415 merely because annual additions under section 415(c) are calculated with respect to employer contributions used to repay an exempt loan rather than with respect to securities allocated to participants.

In this case, the proceeds from the redemption 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. These amounts are not employer contributions, employee contributions or forfeitures and hence do not fall within the definition of annual addition as defined in Code section 415(c)(2). As

stated previously, section 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. Since the amounts that will be used to repay the loan are not employer contributions, they will not constitute annual additions under section 54.4975-11(a)(8)(ii) in this situation.

As noted above, section 1.415-6(b)(2)(i) of the regulations provides that the Commissioner may, in appropriate cases, considering all the facts and circumstances, treat certain allocations to participant accounts as giving rise to annual additions. 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). 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.

The above rulings are based on the assumption that the Loan from Company A to Plan X is exempt under Code section 4975(d)(3) and that Plan X qualifies under sections 401(a) and 4975(e)(7) at all relevant times.

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 requirements under sections 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 who requested it. Code section 6110(j)(3) provides that this ruling may not be used or cited by others as precedent.

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

Should you have any concerns regarding this letter, please contact .

Sincerely yours,

John Swieca, Manager
Employee Plans Technical Branch 1
Tax Exempt and Government Entities Divisions

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cc:

Enclosures:
Notice 437
Deleted copy of ruling