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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

NOV 26 2003

LEGEND:

Company A:

Company B:

Company C:

Company D:

Plan X:

Dear

This letter is in response to a request for a ruling letter submitted on your behalf by your authorized representatives on March 6, 2003, as modified by letters dated July 14, 2003, August 4, 2003, August, 18, 2003, August 19, 2003, September 9, 2003, and September 24, 2003, concerning the prepayment of an exempt loan upon termination of an employee stock ownership plan ("ESOP"), and also concerning the allocation of any remaining surplus shares of Company D's common stock.

Company A established Plan X, an ESOP, effective January 1, 1996 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. In connection with the establishment of Plan X, the trustees of its related trust borrowed approximately $3.2 million ("Loan") from a banking corporation on July 31, 1996. The Loan was intended to be an exempt loan as described in Code section 4975(d)(3). The Loan was evidenced by a term loan

agreement and was secured by the pledge of a continuing security interest in the Company A shares that were purchased by Plan X with the proceeds of the Loan.

On April 30, 1998, Company B, a wholly-owned subsidiary of Company C, merged with Company A. Company B was the surviving entity and changed its name to the name of Company A. Pursuant to the merger agreement, each share of Company A common stock held by Plan X was exchanged for 2.06 shares of Company C common stock. Following the merger, Plan X held approximately 393,000 unallocated shares of Company C common stock in its suspense account, and approximately 83,000 shares of Company C common stock allocated to the accounts of Plan X participants. The trustee of Plan X's related trust determined that it was in the best interests of Plan X participants and beneficiaries to refinance the Loan with a loan from Company C ("New Loan"). The New Loan, dated June 29, 1998, was secured by the Company C shares held in the Plan X suspense account, and is currently secured by the Company D shares held in the suspense account pursuant to the merger described below. The New Loan in all material respects, including interest, payment amount, and final payment date, mirrored the Loan, and is also intended to be an exempt loan as described in Code section 4975(d)(3).

In 1999, Company C merged with a wholly-owned subsidiary of Company D. Pursuant to the merger agreement, each share of Company C common stock was exchanged for .2987 of a share of Company D common stock, resulting in Plan X holding Company D common stock.

As a result of the mergers described above, Company A is a wholly-owned subsidiary of Company C, and Company C is a wholly-owned subsidiary of Company D.

Company A has made consistent and substantial contributions to Plan X since its inception in 1996. After applying the exchange ratios of the two mergers described above, your authorized representative determined that 145,086 (62.73%) of the 231,304 shares acquired by Plan X with the proceeds of the Loan have been allocated to participants' accounts. At the time Plan X was established and at the time the subsequent exempt loans occurred, Company A contemplated that Plan X would continue until the exempt loans were repaid and all shares of stock held in the suspense account were allocated to participants. However, Company A decided to terminate Plan X for financial and business reasons. Company A's manufacturing facility is being closed and the employment of most of its employees is being terminated. On December 23, 2002, Company A submitted an application to the Service for a determination letter on the termination of Plan X. To effectuate the termination, Company A will terminate Plan X effective as of the date that the Service approves the termination. Company A or a corporate affiliate will sell a sufficient number of unallocated shares on the public market to repay the outstanding principal balance on the New Loan. Following the sale, any remaining unallocated Company D shares will be allocated to the participants' accounts as earnings. Your authorized representative has represented that the proposed surplus allocation will be made on the basis of account balances and passes the general test for nondiscrimination under Code section 401(a)(4) when tested as employer contributions.

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

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

2. The allocation to participants' accounts of surplus shares remaining in the Plan X suspense account following the repayment of the New Loan may be treated as earnings and not as 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. 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 1996. Of the 231,304 shares acquired by Plan X with the proceeds of the Loan, 145,086 shares (as adjusted for the exchange ratios of the two mergers) have been allocated to participants' accounts. At the time Plan X was established and at the time the subsequent exempt loans occurred, Company A contemplated that Plan X would continue until the exempt loans were repaid and all shares of common stock held in the suspense account were allocated to participants. However, Company A decided to terminate Plan X for financial and business reasons. Company A's facility is being closed and the employment of most of its employees is being terminated. Company A or a corporate affiliate will sell a sufficient number of unallocated shares on the public market to repay the outstanding principal balance on the New Loan.

Accordingly, with respect to your first requested ruling, we conclude that the repayment of the New Loan in connection with the termination of Plan X with the proceeds from the sale of the Company D shares held in the Plan X suspense account will not cause the New 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 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 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 Excise Tax Regulations provides, in part, that an exempt loan must provide for the release from encumbrance 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 play 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.

The shares remaining in Plan X's suspense account following the prepayment of the Loan remain there because it was not necessary to liquidate 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 participants' accounts of surplus shares remaining in the Plan X suspense account following the repayment of the New Loan may be treated as earnings and not as annual additions for purposes of Code section 415(c).

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

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
Deleted copy of ruling letter