



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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NOV - 4 2004

SE.T:EP:PA.T3

LEGEND:

Company A:

Plan X:

Dear

This letter is in response to a request for a ruling letter submitted on your behalf by your authorized representative on April 15, 2004, as supplemented by correspondence dated June 4, 2004, and September 15, 2004, concerning the prepayment of an exempt loan upon termination of an employee stock ownership plan ("ESOP").

Company A established Plan X, an ESOP, effective [REDACTED], for the benefit of its employees. Company A is wholly owned by Plan X. 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 \$ [REDACTED] ("Loan") from Company A on [REDACTED]. Company A borrowed the funds loaned to Plan X from a bank. The Loan was intended to be an exempt loan as described in Code section 4975(d)(3). The Loan 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. These shares were all placed in the Plan X suspense account. Company A fully intended that Plan X would continue until the Loan was entirely repaid and all shares of Company A stock were allocated to participants. Company A has made consistent and substantial contributions to Plan X resulting in significant payment of the Loan. Approximately one-third of the shares have been allocated to participants' accounts.

At the time the purchase and sale transaction took place, the anticipated contributions to Plan X, calculated based on Company A's payroll, were not sufficient to make the payments required under the Loan under the limitations then in effect. The shortfall was projected to be made up using a reasonable level of dividends paid by Company A on both allocated and unallocated shares. Company A elected to be taxed as an S corporation as of [REDACTED]. Subsequently, Company A concluded at that time that using dividends on S corporation shares held in participants' accounts to make loan payments might be inconsistent with the Service's interpretation of Code section 404(k).

Plan X has never used dividends on shares held in participants' accounts to make Loan payments. From [REDACTED] through [REDACTED] Plan X was able to make the required Loan payments because Company A paid higher dividends than was planned. However, due to decreased demand for Company A's products, Company A began to reduce the number of its employees, resulting in a corresponding decrease in eligible compensation. Also, dividends have not to date been paid for [REDACTED] and [REDACTED]. For [REDACTED] through [REDACTED], Company A contributed very nearly the largest amount it could without exceeding the limits of Code sections 415 and 404, but such contributions were less than 60% of the required Loan payment. Default did not occur because of substantial prepayments on the Loan in earlier years and because Company A granted an extension in [REDACTED]. These prepayments were funded by employer contributions and by dividends on shares held in the Plan X suspense account.

Company A does not anticipate that its Board of Directors will declare any substantial dividend because Company A is not performing well enough. Company A's contribution to Plan X, plus the dividends on shares held in the Plan X suspense account, are no longer sufficient to make the required payments on the Loan, and this situation is not expected to change in the future. Company A has concluded that the only feasible and cost effective way to avoid defaulting on the Loan in [REDACTED] is to terminate Plan X, which it proposes to do.

Company A proposes to redeem a sufficient number of the unallocated shares in Plan X's suspense account, based on the fair market value of the shares redeemed, to repay the outstanding principal balance of the Loan plus accrued interest. The fair market value of the shares to be redeemed will be determined by an independent appraiser as of the date of redemption. The redeemed shares will be retired. Company A expects that the total value of the unallocated shares will not be sufficient to repay the Loan, in which event Company A will forgive the loan balance. If said value of the unallocated shares exceeds the Loan balance, the excess will be allocated among participants' accounts as earnings.

As a result of the proposed transaction, participants' accounts will increase in value because the redemption of the unallocated shares will not reduce the value of Company A. Thus, the same total value will be divided by a lesser number of shares (that is, the original number less the redeemed shares). The higher per share value will increase the value of the participants' accounts.

Your authorized representative has requested rulings to the effect of the following on your behalf:

1. The repayment of the Loan in connection with the termination of Plan X with the proceeds of the redemption of the unallocated stock held in the Plan X suspense account will not cause the Loan or any part thereof to fail to meet the exemption requirements under Code section 4975(d)(3) and its related regulations.
2. Neither the forgiveness of the balance of the Loan by Company A nor the resulting increase in the value of the allocated shares will constitute annual additions to participants' accounts 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 [REDACTED]. Approximately one-third of the shares purchased 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 Loan occurred, Company A intended that Plan X would continue until the Loan was 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. The decreased demand for Company A's products has caused Company A to reduce the number of its employees. The corresponding decrease in eligible compensation, together with the limits of Code sections 404 and 415, will prevent Company A from making contributions to Plan X in an amount sufficient for Plan X to make payments on the Loan. Company A intends to terminate Plan X to prevent Plan X from defaulting on the Loan. Company A also intends to redeem a sufficient number of the unallocated shares in Plan X's suspense account, based on the fair market value (as described above) of the shares redeemed, to repay the outstanding principal balance of the Loan plus accrued interest. Company A expects that the total value of the unallocated shares will not be sufficient to repay the Loan, in which event Company A will forgive the loan balance.

Accordingly, with respect to your first requested ruling, we conclude that the repayment of the Loan in connection with the termination of Plan X with the proceeds of the redemption of the unallocated stock held in the Plan X suspense account will not cause the Loan or any part thereof to fail to meet the exemption requirements under Code section 4975(d)(3) and its related regulations.

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

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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, Company A does not expect that any shares will remain in the suspense account following the redemption. The value of participants' accounts containing Company A shares will increase because there will be fewer outstanding shares to reflect the value of Company A after the redemption. Under the facts and circumstances described above, there will be no annual additions within the meaning of section 415(c)(2) of the Code or section 1.415-6(b)(2)(i) of the Income Tax Regulations.

Accordingly, we conclude with respect to your second requested ruling that neither the forgiveness of the balance of the Loan by Company A nor the resulting increase in the value of the allocated shares will constitute annual additions to participants' accounts for purposes of Code section 415(c).

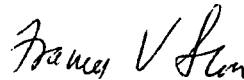
This ruling letter is based on the assumption that Plan X is qualified under Code section 401(a) at all times relevant to the transaction described herein and that it is an ESOP as described in section 4975(e)(7).

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.

The original 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, Manager
Employee Plans Technical Group 3

Enclosures
Notice 437
Deleted copy of ruling letter