Internal Revenue Service

Department of the Treasury
Washington, DC 20224

200010060

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Contact Person:

Telephone Number:
T:EP:RA:T4

In Reference to:

Date: DEC 17 1999

LEGEND:

Company M =

Trust X =

Plan Y =

Stock A =

Stock B =

Stock C =

Dear

This is in response to a ruling request dated January 26, 1999, submitted by your authorized representative. The request was supplemented by letter dated August 24, 1999. This request concerns the consequences for an employee stock ownership plan ("ESOP") under Internal Revenue Code ("Code") sections 409(h) and 401(a) of a proposed transaction.

In support of your ruling request your authorized representative has presented the following facts:

Company M maintains Plan Y for the benefit of its employees. Plan Y became effective January 1, 1992 and was formed as a result of a merger of two previously existing plans. Plan Y consists of two components, a 401(k) component that represents a continuation of the previously existing 401(k) plan and an Employee Stock Ownership Plan ("ESOP") component that represents a continuation of the previously existing ESOP. Prior to the merger of the 401(k) plan and the ESOP plan, separate trusts had been established for the two plans. As a result of the merger of the two plans the two trusts were restated in to a single master trust, Trust X.

355

Company M has several classes of equity securities outstanding. Only Stock A , B and C are involved in the ruling request. None of which are readily tradeable on an established market as that term is used in section 409(l). Stock A is freely transferable only to "Permitted Transferees" and any attempt to transfer Stock A to a party other than a "Permitted Transferee" gives rise to a series of options by the other stock holders or Company M to purchase such stock.

Stock B may only be owned by employees of Company M or an employee stock ownership plan sponsored by Company M. New shares of Stock B may be issued only (i) in exchange for currently outstanding shares of Stock A or (ii) in exchange for those treasury shares of Stock A that were purchased by Company A in 1991. Company M may exchange shares of Stock B for shares of outstanding Stock A, as long as the exchanging holder concurrently sells to an ESOP the shares of Stock B issued in the exchange. In a letter ruling issued to Company M on December 19, 1991, the Internal Revenue Service concluded that Stock B constituted "employer securities" within the meaning of section 409(l).

Company M matching contributions made pursuant to the terms of the plan are made with shares of Stock B that are released from the loan suspense account as the ESOP repays it current outstanding loan with the contributions made by Company M to Plan Y and the dividends paid on shares of Stock B held by Trust X. Stock B shares so released which remain after the allocation of matching contributions are allocated to the accounts of all participants in the ESOP pro rata according to compensation. Distributions from the ESOP may be made only in cash and participants in the ESOP do not have a right to demand distribution of benefits in the form of Stock B. In the above described letter ruling, the Service determined that this distribution provision was consistent with section 409(h)(2).

All of the outstanding shares of Stock B are held by Plan Y. Company M wishes to increase the stock ownership of Plan X. In order to accomplish this goal Company M proposes the transaction described below.

Company M will issue a newly created series of stock, Stock C. Stock C will have the same dividend and liquidation rights as Stock A and accordingly, will have the same fair market value. Stock C does not have the ESOP Preference dividend rights that Stock B has and thus will not qualify as an employer security as defined in section 409(l). Shareholders of Stock A will be authorized to participate in an exchange of one share of Stock A for one share of Stock C.

Trust X will then purchase Stock C from the shareholders. The exchange of Stock A for Stock C and the subsequent sale of Stock C to the ESOP will be consummated in the following manner. The tender of Stock A to Company M by the shareholder will constitute an irrevocable direction by such shareholder to Company M to tender to Trust X, on such shareholder's behalf, Stock C received by such shareholder in the exchange. The shareholder will receive a cash payment from Trust X equal to the cash value of the shares of Stock C tendered to Trust X by Company M on behalf of the shareholder. The cash payment from Trust X will be funded by a cash contribution by Company M to Trust X in accordance with section 404 of the Code.

The cash contribution will be in addition to Company M's contribution to amortize any outstanding loans used to purchase Stock B. Trust X will not borrow any funds in connection with the purchase or enter into any installment obligation with the selling shareholders. At no time will more than 25% of Plan Y's assets be invested Stock C.

Company M will request a ruling under section 368(1)(E) and 354(a) that the recapitalization and exchange of one share of Stock A for one share of Stock C will be a nontaxable exchange pursuant to those provisions.

Based on the information submitted Company M requests the following rulings:

(1) The acquisition of Stock C by Plan Y will not cause the Plan to fail to meet the requirements of section 4975(e)(7) that the plan be designed to invest in "qualifying employer securities."

(2) That Plan Y will not be considered to have failed to meet the requirements of section 409(h) or 401(a) merely because it does not provide Plan Y participants and beneficiaries the right to demand distribution of the plan benefit in the form of Stock C held by Plan Y.

Revenue Procedure 99-4, 1999-1 I.R.B. 115 ("Rev. Proc." 99-4) establishes certain procedural requirements governing the issuance of letter rulings. Section 6.03 of Rev. Proc. 99-4 provides that the National Office ordinarily will not issue letter rulings on matters involving a plan's qualified status under sections 401 through 420 and section 4975(e). Section 6.03 of further provides that these matters are generally handled by the Key District Offices' determination letter program as provided in Revenue Procedure 99-6, 1999-1 I.R.B. 187. Since ruling request number one and ruling request number two insofar as it relates to section 401(a) involve questions relating to the

qualified status of the plan we must decline to rule on those matters.

Section 4975(e)(7) of the Code defines an employee stock ownership plan as a qualified stock bonus plan designed to invest "primarily in qualifying employer securities." Section 4975(e)(5) defines the term "qualifying employer securities" as an "employer security" within the meaning of section 409(l) of the Code.

Section 4975(e)(7) of the Code also provides that a plan shall not be treated as an employee stock ownership plan unless it meets the requirements of section 409(h) of the Code.

Section 409(h) of the Code provides that a plan meets the requirements of the subsection if a participant who is entitled to a distribution from the plan has the right to demand that his benefit be distributed in the form of employer securities or if the employer securities are not readily tradeable on an established market has a right to require that the employer repurchase employer securities under a fair valuation formula.

Section 409(l) of the Code defines "employer security" as common stock issued by the employer which is readily tradeable on an established securities market. Section 409(l) further provides that if no common stock of the employer meets this requirement, the term "employer securities" means common stock issued by the employer having a combination of voting power and dividend rights equal to or in excess of the class of common stock having the greatest voting rights and the class of common stock having the greatest dividend rights.

Since the stock of Company M is not readily tradeable on an established securities market, "employer securities" for purposes of section 409(l) would be the common stock issued by the employer having a combination of voting power and dividend rights equal to or in excess of the class of common stock having the greatest voting rights and the class of common stock having the greatest dividend rights. The Service has previously ruled that Stock B constitutes "employer securities" for purposes of section 409(l), since it was concluded that Stock B had the greatest voting rights and the greatest dividend rights. Although Stock C was not in existence at the time of this ruling, Stock C does not have the same voting and dividend rights as Stock B, therefore, Stock C is not an "employer security" for purposes of Section 409(l).

Section 409(h) gives employees the right to demand that plan benefits be paid in employer securities. Since Stock C is not an employer security within the meaning of 409(l), section 409(h) does not apply to Stock C. Therefore, in regards to ruling

request number two, we rule that Plan Y will not be considered to have failed to meet the requirements of section 409(h) merely because it does not provide Plan Y participants and beneficiaries the right to demand distribution of the plan benefit in the form of Stock C held by Plan Y.

This ruling is based on the assumption that Plan X will be qualified under section 401(a), 409 and 4975(e) of the Code, as applicable, and the related trust will be tax exempt under section 501(a) at the time the above transaction takes place.

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

A copy of this letter is being sent to your authorized representative in accordance with the power of attorney on file in this office.

Sincerely yours,

John G. Riddle, Jr.
Manager Employee Plans
Technical Group 4
Tax Exempt and Government
Entities Division

Enclosures:
Deleted copy of letter
Notice of Intention to Disclose

cc: