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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Significant Index Number: 4975.00-00

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4975.00-00
409.00-00

Contact Person:

Telephone Number:

In Reference to:

Date:

T:EP:RA:T3

FEB 9, 2000

LEGEND:

Company A:

Plan X:

Dear

This is in response to a request for a private letter ruling, dated March 22, 1999, as supplemented by correspondence dated September 3, 1999, November 30, 1999, and January 14, 2000, which was submitted on your behalf by your authorized representative concerning certain proposed transactions. Your authorized representative submitted the following facts and representations in support of the ruling request.

Company A established Plan X effective November 1, 1991, for the benefit of its employees. Plan X is a stock bonus plan qualified under section 401(a) of the Internal Revenue Code and an employee stock ownership plan ("ESOP") which meets the requirements of Code section 4975(e)(7). In 1991, Plan X's related trust borrowed $ in an exempt loan intended to comply with Code section 4975(d)(3) to purchase shares of Company common stock. This represented 63% of Company A's common stock at that time. Pursuant to the terms of the stock pledge agreement executed in conjunction with the exempt loan agreement, all of the shares purchased with the proceeds of the exempt loan and subsequently placed in the ESOP suspense account are held as security for the exempt loan. At the time that Plan X was established and leveraged, Company A fully intended to make contributions to Plan X so that Plan X could repay the exempt loan and all of the shares held as collateral could be released from suspense and allocated to participants' accounts. However, for reasons described below, Company A terminated Plan X effective October 31, 1998. As of that date, Company A had made recurring and substantial principal contributions to Plan X of approximately $, leaving a balance due on the exempt loan of $. As of October 31, 1997, approximately 50% of the shares originally purchased by Plan X have been released from suspense and allocated to Plan X participants.

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During the period of time that Plan X was in existence, Company A represents that its business and market changed dramatically, resulting in the need for increased capital spending. In order to remain competitive, Company A increased capital spending and estimated that additional capital needs would be substantial. Company A also anticipated that relocation would be necessary because of the expansion of an airport adjacent to real property owned by Company A.

While searching for a new plant location in 1998, Company A was approached by a third party to discuss merger. After negotiations, Company A received an unsolicited offer to combine its business with this third party ("Merger Partner"). Company A and Merger Partner signed a letter of intent on November 19, 1998, to begin the process of merger of Company A into an entity controlled by Merger Partner. Pursuant to the letter of intent, Company A and Merger Partner will adopt a two-stage approach to the complete integration of Merger Partner's operations and certain lines of Company A's businesses. In the first stage, Company A and Merger Partner will form a limited liability company ("LLC"), and each will transfer its operating assets to this company. After the transfer, Company A will represent approximately one-third of the value of the LLC. Company A and Merger Partner began actively and jointly conducting their businesses as of January 1, 1999. The second stage will be a merger (or its equivalent) by transfer of capital assets after the success of the LLC is determined to be mutually satisfactory and following Internal Revenue Service approvals of the termination of Plan X. The termination of Plan X was included as a condition because Plan X does not meet the long-term financing goals of Merger Partner. The letter of intent states in part that the merger is conditioned upon and subject to Company A's termination of Plan X and receipt of a favorable determination from the Service with respect to its termination of Plan X and a favorable private letter ruling from the Service regarding the retirement of the exempt loan. The termination of Plan X is necessary because Plan X does not meet the long-term financing goals of Merger Partner.

As required by the letter of intent, the exempt loan will be retired after the redemption by Company A of the unallocated shares held by Plan X. As of October 31, 1997, Plan X held unallocated shares and allocated shares. Upon redemption, Company A transferred cash equal to the purchase price of allocated and unallocated shares to the trustee of Plan X. Plan X used the proceeds related to the unallocated shares to pay off the exempt loan to the extent possible. Company A forgave the remaining debt.

Pursuant to the letter of intent, employees of Company A will become immediately eligible to participate in a plan sponsored by the LLC. Company A intends to make final distributions to Plan X participants after receiving a favorable ruling and determination letter from the Service. Plan X participants will be allowed to rollover these distributions into the plan sponsored by the LLC.

Based on the above facts and representations, your authorized representative has requested the following rulings on your behalf:

1. The termination of Plan X and sale of shares held in its related trust to Company A as contemplated by the Transaction will not cause the exempt loan to fail to satisfy the requirements for exemption from the prohibited transaction rules under Code section 4975 and regulations thereunder, and specifically, (1) the Transaction does not violate the primary benefit requirement of Code section 4975(d)(3)(A); (2) the Transaction does not violate section 54.4975-7(b)(8) of the Excise Tax Regulations relating to release from encumbrance; and (3) the Transaction does not violate the requirement of an exempt loan relating to its specific term as provided under section 54.4975-7(b)(13) of the regulations.

2. The proceeds received on sale of unallocated shares are a permissible source of repayment of the exempt loan under section 54.4975-7(b)(5) of the regulations.

Four additional ruling requests were withdrawn by your authorized representative in the letter dated November 30, 1999.

With respect to your ruling requests, Code section 4975(e)(7) provides that an ESOP is an arrangement designed to invest primarily in employer securities within the meaning of section 409(l). An ESOP must be part of a stock bonus plan qualified under section 401(a) of the Code, or a stock bonus plan 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 Excise Tax Regulations. An ESOP generally uses employer contributions to the plan to repay the exempt loan.

Under Code section 4975(d)(3)(A), 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 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)(8) of the regulations requires that an exempt loan must provide for the release from encumbrance of the employer securities used as collateral for the loan using either of the two methods described therein.

Section 54.4975-7(b)(13) of the regulations provides that an exempt loan must be for a specific term and must not be payable upon demand, except upon default.

In this case, Company A made recurring, substantial and timely payments to Plan X totaling approximately $ over a seven-year period, resulting in the allocation to participant accounts of approximately 50 percent of the shares held in Plan X's unallocated suspense account. When Plan X was established, Company A fully intended to continue to make payments on the exempt loan until maturity and all stock was allocated. However, in 1998, Company A received an unsolicited offer to merge with an unrelated identity and has begun this process in accordance with a letter of intent signed by both parties. The letter of intent provides that the termination of Plan X is a prerequisite for the merger. Plan X is being terminated and a determination letter is being sought from the appropriate district office.

Upon consideration of all of the surrounding facts and circumstances of this case, in accordance with section 54.4975-7(b)(3) of the regulations, we conclude with respect to your first requested ruling that the termination of Plan X and sale of shares held in its related trust to Company A as contemplated by the Transaction will not cause the exempt loan to fail to satisfy the requirements for exemption from the prohibited transaction rules under Code section 4975 and regulations thereunder, and specifically, (1) the Transaction does not violate the primary benefit requirement of Code section 4975(d)(3)(A); (2) the Transaction does not violate section 54.4975-7(b)(8) of the Excise Tax Regulations relating to release from encumbrance; and (3) the Transaction does not violate the requirement of an exempt loan relating to its specific term as provided under section 54.4975-7(b)(13) of the regulations.

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.

In this case, Plan X will use the proceeds from the redemption of the stock acquired with an exempt loan and held in the suspense account to pay off the exempt loan. Therefore, with respect to your second requested ruling, we conclude that the proceeds received on sale of

unallocated shares are a permissible source of repayment of the exempt loan under section 54.4975-7(b)(5) of the regulations.

This ruling letter assumes that Plan X is qualified under Code section 401(a), and its related trust exempt from tax under section 501(a), at all times relevant thereto. It also assumes that Plan X meets the requirements of Code section 4975(e)(7).

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

Pursuant to a power of attorney on file in this office, the original of this letter is being sent to your authorized representative.

Sincerely yours,

Frances V. Sloan

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

Enclosures
Notice 437
Deleted copy of ruling letter

Original to: