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

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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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OP:E:EP:T2

Legend:

Employer M = xxxxx

Plan X = xxxxx

Department M = xxxxx

Court C = xxxxx

State A = xxxxx

Dear xxxxx:

This is in response to your ruling request dated May 17, 1999 (submitted under cover letter dated June 22, 1999), as supplemented by correspondence dated June 2, November 21, December 29, 2000, February 21, April 16, April 30, and October 31, 2001, on behalf of Employer M, regarding amounts due Plan X as described below, and whether such amounts received by Plan X constitute annual additions under section 415 of the Internal Revenue Code.

The following facts and representations have been submitted:

Employer M, an insurance company, established Plan X as of January 2, 1992. Plan X is an employee stock ownership plan ("ESOP") which meets the requirements of Code section 4975(e)(7). In June 1992, Plan X borrowed approximately $1,000,000.00 from Employer M and used that amount to purchase 416,000 shares of Employer M stock in an exempt loan transaction, intended to meet the requirements of Code section 4975(d)(3). Under the promissory note evidencing this transaction ("Note"), the amount borrowed is secured by a Pledge Agreement covering the acquired stock. The Note further provides for ten equal annual payments and in the event of default in payment of any of these

installments, the loan is due and payable to the extent of such default with a stated interest rate applied. The 416,000 shares were credited to a suspense account consistent with the requirements for an exempt loan under Excise Tax Regulation section 54.4975-11(c).

At the time that Plan X was leveraged, Employer M intended to make contributions to Plan X over the life of the exempt loan so that Plan X could repay the exempt loan and all the pledged shares could be released from the suspense account and allocated to the participants' Plan X accounts. In 1992, a contribution was made to Plan X with which Plan X made one installment payment and an additional principal payment on the Note resulting in the release of approximately 52,000 shares from the Plan X suspense account and their subsequent allocation. No additional payments were made, as further explained below.

In xxxx, before the second loan installment was due, the State A Department of Insurance determined that Employer M was insolvent and proceedings were commenced in Court C for the liquidation of Employer M. As part of the proceedings, the director of the State A Department of Insurance and his successors in office was appointed receiver for Employer M on xxxx, xxxxx.

In January 1994, Employer M's Board of Directors decided to terminate Plan X. The receiver for Employer M received a favorable determination letter on Plan X's termination from the appropriate Internal Revenue Service Area Office, issued on November 29, 1994. On termination of Plan X, the shares of Employer M stock, which had previously been allocated to the participants' individual accounts, and Plan X's cash assets were distributed to the participants. In 1998, the Plan X Trustees filed a claim in the Employer M liquidation proceedings. Prior to that, no action was taken regarding the unallocated shares of Employer M stock because all parties believed that the Employer M stock had no value.

With Employer M's liquidation approaching completion, you now represent that the assets of Employer M in liquidation will exceed approved claims so that a liquidating distribution to shareholders, including Plan X, will occur. Employer M intends to setoff the amounts due it under the Note against the liquidating distribution to be made to Plan X in exchange for its Employer M stock. The setoff ("setoff") consists of the default amount determined under the Note in accordance with section 54.4975-7(b)(6) of the regulations and all other amounts owing under the Note. Under current projections, Employer M represents that the liquidating distribution to Plan X less the setoff may be approximately $12,000,000.00.

Employer M has amended Plan X to comply with legislative changes since 1994 and to address the anticipated liquidating distribution. Plan X, as so amended, received a favorable determination letter upon plan termination from the Service, issued on February 13, 2001. Employer M now proposes to amend section 7(d)(3) of Plan X to provide for allocating the amounts Plan X will receive upon the liquidation of Employer M to participants on a compensation basis.

Based on the foregoing facts and representations, the following rulings are requested:

1. That the setoff by Employer M of the amount due it on the ESOP loan against the liquidating distribution due Plan X with respect to Employer M stock owned of record by Plan X will not cause the loan to fail to meet the requirements for exemption under Code section 4975.

2. That the allocation, as earnings of the trust fund in accordance with amended section 7(d)(3) of the Plan X document, of the liquidating distribution from Employer M in exchange for Employer M stock is proper, and that such liquidating distribution does not constitute an annual addition as defined in section 415 of the Code.

An employee stock ownership ("ESOP") is 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 plan and a money purchase plan qualified under Code 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 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.

Section 4975 of the Code, in general, prohibits transactions between an employer and a plan sponsored by the employer. Code Section 4975(a) imposes a tax on each prohibited transaction as defined in Code section 4975(c) at a rate equal to 15 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period. The tax imposed by Code section 4975 shall be paid by any qualified person who participates in the prohibited transaction (other than a fiduciary acting only as such).

Section 4975(d)(3) of the Code provides that if (A) a loan to a leveraged ESOP is primarily for the benefit of participants and beneficiaries of the plan, and (B) such loan is at a reasonable rate of interest, and any collateral which is given to a disqualified person by the plan consists only of qualifying employer securities (as defined in subsection (e)(8)), a loan from an employer to an ESOP it sponsors is exempt from the prohibitions of Code section 4975(c).

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 requirement that the loan be primarily for the benefit of the ESOP participants.

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 of an exempt loan through contributions to the plan. This section

further provides that the only assets of an ESOP that may be given as collateral on an exempt loan are qualifying 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)(6) of the regulations states that in the event of default upon an exempt loan, the value of plan assets transferred in satisfaction of the loan must not exceed the amount of default. If the lender is a disqualified person, a loan must provide for a transfer of plan assets upon default only upon and to the extent of the failure of the plan to meet the payment schedule of the loan. Under sections 54.4975-7(b)(5) and (6) of the regulations, the employer stock pledged as collateral and earnings thereon may be used to repay an exempt loan in default.

In this case, Employer M intended to make future contributions to Plan X so that the ESOP loan would be repaid and all stock allocated. One contribution was made, but Employer M was determined insolvent and ceased operations before the date the second annual ESOP loan installment was due. A receiver was appointed to liquidate Employer M and no further contributions were made to Plan X. Since Employer M is being liquidated and Plan X has been terminated, the default amount and all other amounts owing under the loan will be repaid through the setoff against the liquidating distribution to Plan X with respect to its Employer M common stock.

Accordingly, upon consideration of all the surrounding facts and circumstances in accordance with section 54.4975-7(b)(3) and sections 54.4975-7(b)(5) and (6) of the regulations, we conclude, with respect to ruling request one, that the setoff by Employer M of the securities pledged as collateral for the exempt loan, as described above, against the liquidating distribution due Plan X will not cause the loan to fail to meet the requirements for exemption under Code section 4975(d)(3).

With respect to ruling request two, Code section 415(a)(1) 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 limitation of subsection (c).

Section 415(c)(1) of the Code provides that contributions and other additions with respect to a participant exceed the limitation of this subsection if when expressed as an "annual addition" (within the meaning of paragraph (2)) to the participant's account, such annual addition is greater than the lesser of (A) $30,000 or, (B) 25 percent of the participant's compensation.

Section 415(c)(2) of the Code defines "annual addition" as the sum for any year of employer contributions, employee contributions, and forfeitures.

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 participants' accounts as giving rise to annual additions.

Section 54.4975-11(d)(3) of the regulations provides, in part, that income with respect to securities acquired with the proceeds of an exempt loan shall be allocated as income of the plan except to the extent that the ESOP provides for the use of income from securities to repay the loan.

Section 54.4975-11(a)(ii) of the regulations states that an ESOP will not fail to meet requirements of Code section 401(a)(16) merely because annual additions under Code 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.

Employer M has been declared insolvent and Plan X has been terminated. The liquidation distribution will be received by Plan X as part of the plan termination process, rather than as an employer contribution. Accordingly, such amounts are not employer contributions. Because these amounts also are not employee contributions or forfeitures, they do not fall within the definition of annual additions, as defined in section 415(c)(2) of the Code. Accordingly, because the amounts used to repay the loan will not be employer contributions, there is no annual addition under section 54.4975-11(a)(8)(ii) of the regulations in this situation.

As previously noted, 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. In this case, Employer M has been declared insolvent and Plan X has been terminated. The proposed allocations to be made to the participants' accounts result from proceeds the trust will receive as a result of the liquidation of Employer M. Accordingly, in our view, the facts and circumstances of the present case do not support the recharacterization of the proceeds Plan X will receive as a result of the liquidation of Employer M as annual additions under the authority of section 1.415-6(b)(2)(i) of the regulations.

Accordingly, we conclude with respect to your second ruling request that any allocations made to the accounts of the participants of Plan X as a result of the liquidation of Employer M will be treated as earnings, and will not constitute annual additions to participants' accounts for purposes of Code section 415 when such proceeds from the liquidation distribution are allocated to participants' accounts.

The above rulings are based on the assumption that Plan X will be qualified under Code section 401(a), and the related trust will be tax exempt under Code

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 and applies only to Plan X as proposed to be amended as of the date of this ruling. Code section 6111(j)(3) provides that this ruling may not be used or cited 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. If you have any questions about this ruling, please contact xxxxx, #xx-xxxx of T:EP:RA:T2 at (202) xxx-xxxx.

Sincerely,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Employee Plans, Technical Group 2
Tax Exempt and Government Entities Division

Enclosures:
Notice 437
Deleted copy of ruling letter

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