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Internal Revenue Service

Department of the Treasury

199938052

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to: OP:E:EP:T:3

Date: JUL 2 1999

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 March 5, 1998, as supplemented by letters dated August 3, 1998, and November 6, 1998. This request concerns the consequences for an employee stock ownership plan ("ESOP") under Internal Revenue Code ("Code") sections 401(a), 4975(d)(3) and 4975(e)(7) of a proposed election under Code section 1362.

Your authorized representative has submitted the following facts and representations in support of the requested rulings:

Company A established Plan X effective as of August 30, 1989. Plan X is a leveraged ESOP which is intended to meet the requirements of Code sections 401(a) and 4975(e)(7). The most recent favorable determination letter for Plan X is dated August 30, 1995.

In 1989, Plan X used the proceeds of a private placement borrowing to purchase Company A common shares. In 1995, Plan X borrowed funds from Company A to purchase most of the remaining shares and to repay the original loan. This loan ("Exempt Loan") is intended to be an exempt loan as described in Code section 4975(d)(3). The Exempt Loan is to be repaid over a 15-year period commencing in 1995, using deductible Company A contributions to Plan X and cash dividends on allocated and unallocated Company A stock held by Plan X. Collateral for the Exempt Loan consists of unallocated shares of stock held in a suspense account. When Plan X makes its annual payments on this loan, these shares are released and allocated to participants' accounts in accordance with the terms of Plan X and applicable sections of the Excise Tax Regulations. As the lender, Company A has no recourse against these allocated shares.

Company A intends to elect, in accordance with the provisions of Code section 1362, to be an S corporation. The fiduciaries of Plan X will be asked to consent to this election. Assuming that this consent is obtained and the election becomes valid, Company A intends to amend Plan X to become a stock bonus and money purchase pension plan. Shares of Company A stock held by Plan X both prior to and subsequent to the S corporation election are qualifying employer securities within the meaning of Code section 409(l). Following this election, Plan X will continue to be invested primarily in such securities.

Company A intends to make the maximum deductible contribution permitted under Code section 404. To the extent that such a contribution is not sufficient to make the annual Exempt Loan payments, Plan X will first use earnings on unallocated shares, and then, if necessary, earnings on allocated shares. These earnings may include dividends to the extent that Company A has accumulated earnings and profits from its prior status as a C corporation. If employer contributions and dividends are not sufficient to make the annual Exempt Loan payment, then additional amounts will come from Company A's accumulated adjustments account ("AAA") maintained in accordance with Code section 1368. The AAA is not increased by capital contributions. All amounts held within it would be payable as dividends under Code section 301 if Company A remained a C corporation. If earnings on allocated shares are used to make Exempt Loan payments, the shares released from the suspense account will first be allocated to participants' accounts on a fair market value basis according to the amount of earnings taken from each such account to make the Exempt Loan payment.

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

1. A valid S Corporation election by Company A will not affect Plan X's qualified status under section 401(a) of the Code, nor Plan X's status as an ESOP within the meaning of section 4975(e)(7) of the Code.

2. To the extent that the Plan X fiduciaries use the earnings (whether dividends or otherwise) received on unallocated shares of Company A stock held in the suspense account to repay the Exempt Loan, the transactions will not cause the Exempt Loan to fail to satisfy section 4975(d)(3) of the Code.

3. To the extent that the Plan X fiduciaries use the earnings (whether dividends or otherwise) received on allocated shares of Company A stock held in participants' accounts to repay the Exempt Loan, the transactions will not cause the Exempt Loan to fail to satisfy section 4975(d)(3) of the Code.

4. The replacement of earnings on allocated shares of Company A stock used to repay the Exempt Loan will not result in annual additions to participants' accounts under section 415 of the Code.

Code section 401(a) provides that a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive

benefit of his employees or their beneficiaries shall constitute a qualified trust under this section if certain requirements are met.

Code section 4975(e)(7) generally defines an ESOP as a defined contribution plan which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities.

Section 6.03 of Revenue Procedure 99-4, 1999-1 I.R.B. 115, provides that the national office of the Service ordinarily will not issue letter rulings on matters involving a plan's qualified status under sections 401 through 420 and section 4975(e)(7). These matters are generally handled by the key district offices' determination letter program.

Since your first requested ruling involves Plan X's qualified status under Code sections 401(a) and 4975(e)(7), we decline to rule in accordance with the revenue procedure.

Code section 4975 imposes a tax on prohibited transactions, but provides an exemption in section 4975(d)(3) for a loan to a leveraged ESOP (as defined in section 4975(e)(7)) if such loan is primarily for the benefit of participants and beneficiaries of the plan. Requirements concerning the interest rate and collateral must also be met.

Section 54.4975-7(b)(2)(ii) provides that exempt loans will be subjected to special scrutiny to ensure that they are primarily for the benefit of participants and their beneficiaries.

Section 54.4975-7(b)(3) of the regulations states that an exempt loan must be primarily for the benefit of the ESOP participants and their beneficiaries, and that all of the surrounding facts and circumstances will be considered in determining whether the loan satisfies this requirement. It further states that no loan will satisfy this requirement unless it satisfies the requirements of section 54.4975-7(b)(5).

Section 54.4975-7(b)(5) of the regulations states in part that 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. The regulation further states that the payments made with respect to an exempt loan by the ESOP during a plan year must not exceed an amount equal to the sum of such contributions and earnings received during or prior to the year less such payments in prior years.

In the present case, since the unallocated shares are held in the suspense account as collateral for the Exempt Loan, the earnings attributable to such shares may be used to make payments on the Exempt Loan to the extent that these earnings are from either accumulated earnings and profits or from the AAA. Therefore, with respect to your second requested ruling, we conclude that to the extent that the Plan X fiduciaries use the earnings (whether dividends or otherwise) received on unallocated shares of Company A stock held in the suspense account to repay the Exempt Loan, the transactions will not cause the Exempt Loan to fail to satisfy section

4975(d)(3) of the Code if such earnings are from either accumulated earnings and profits or from the AAA maintained by Company A.

However, section 54.4975-7(b)(5) of the regulations does not provide that exempt loan payments may be made from earnings on shares allocated to participants' accounts. Therefore, such a transaction fails to meet the requirements of sections 54.4975-7(b)(5) and 54.4975-7(b)(3). Accordingly, with respect to your third requested ruling, we conclude that, to the extent that the Plan X fiduciaries use the earnings (whether dividends or otherwise) received on allocated shares of Company A stock held in participants' accounts to repay the Exempt Loan, the transactions will cause the Exempt Loan to fail to satisfy section 4975(d)(3) of the Code.

Our response to your third requested ruling renders your fourth requested ruling moot, so it is not necessary to provide a response to it.

This ruling letter is based on the assumption that Plan X continues to be otherwise qualified under Code sections 401(a) and 4975(e)(7) at all relevant times. This ruling is also based on the assumption that the AAA satisfies the requirements of Code section 1368 at all relevant times.

This ruling 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.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan
Chief, Employee Plans
Technical Branch 3

Enclosures
Notice 437
Deleted copy of ruling letter

cc: