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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JUN 14 2005

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SE:T:EP: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 representatives on May 4, 2004, as supplemented by correspondence dated August 9, 2004, October 8, 2004, March 15, 2005, and April 13, 2005,concerning the prepayment of an exempt loan upon termination of an employee stock ownership plan ("ESOP"). Your authorized representatives have submitted the following facts and representations in support of this request.

Company A, a C corporation, established Plan X, a portion of which is a leveraged ESOP, effective January 1, 1964, for the benefit of its employees. The ESOP portion of Plan X consists of the Company Stock Accounts (as defined in section 1.10 of Plan X, which is described below) of participants and the Plan X suspense account which holds unallocated Company A stock. 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. Plan X contains a cash or deferred arrangement as described in Code section 401(k). Plan X provides that directed investments may be offered to participants, but this offer has not been made. There are no Code section 401(k) safe harbor provisions in Plan X. No qualified nonelective contributions within the meaning of Code section 401(m)(4)(C) or qualified matching contributions have ever been made to Plan X. Plan X provides that only matching contributions and discretionary contributions can be invested in Company A stock. No assets attributable to participants' pre-tax contributions have ever been invested in Company A stock.

In 1994, Plan X purchased shares of Company A common stock for approximately $, using the proceeds of a loan intended to be an exempt loan as described in Code section 4975(d)(3) ["1994 Loan"]. All of the shares purchased with the proceeds of the 1994 Loan have been allocated to participants' accounts. In 1998, Plan X purchased shares of Company A common stock for $, using the proceeds of a loan intended to be an exempt loan as described in Code section 4975(d)(3) ["1998 Loan"]. The 1998 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 1998 Loan. These shares were all placed in the Plan X suspense account. As of December 31, 2003, shares of Company A common stock were held in the Plan X suspense account and shares of Company A common stock were held in the accounts of Plan X participants. At the time of the 1998 Loan, Company A contemplated that Plan X would continue beyond the repayment of the 1998 Loan and the allocation to participants' accounts of all of the Company A shares held in the Plan X suspense account. Company A has made substantial and recurring contributions to Plan X resulting in significant payment of the 1998 Loan.

Section 1.4 of Plan X provides that "Aggregate Account" means, with respect to any participant the value of all accounts maintained on behalf of a participant, whether attributable to employer or employee contributions. The term "Account" may refer to any or all of the following accounts: Company Stock Account, Other Investments Account, Participant's Account, Participant's Elective Deferral Contribution Account, and Participant's Rollover Account.

Section 1.10 of Plan X states that "Company Stock Account" means the account of a participant which is credited with the shares of Company A purchased and paid for by the trust fund, or contributed to the trust fund pursuant to section 4.4(c), as adjusted for distributions, earnings, losses and expenses attributable thereto, to the extent held in the form of Company A stock. Your authorized representative has represented that Company A stock which has been released from the Plan X suspense account is held only in the Company Stock Account.

Section 1.44 of Plan X states that "Other Investments Account" means the Account of a participant which is credited with his share of the net gain (or loss) of Plan X and employer contributions in other than Company A stock and which is debited with payments made to pay for Company A stock. Section 1.44 further states that a separate accounting shall be maintained with respect to that portion of the Other Investments Account attributable to elective deferral contributions, matching contributions, and discretionary contributions. Section 1.44 also states that elective deferral contributions shall not be used to pay for Company A stock.

Section 1.46 of Plan X states that "Participant's Account" means the account established and maintained by the administrator for Plan X for each participant with respect to his total interest in Plan X resulting from Company A's matching contributions and Company A's discretionary contributions. Section 1.46 further states that a separate accounting shall be maintained with respect to that portion of the Participant's Account attributable to Company A discretionary contributions made pursuant to Plan X section 4.1(a) and Company A matching contributions made pursuant to section 4.1(b).

Section 1.47 of Plan X provides that "Participant's Elective Deferral Contribution Account" means the account established and maintained by the Plan X administrator for each participant with respect to his total interest in Plan X resulting from the participant's elective deferral contributions. Section 1.47 further provides that a separate accounting shall be maintained with respect to that portion of the Participant's Elective Deferral Contribution Account attributable to elective deferral contributions pursuant to section 4.2 and any employer qualified non-elective contributions pursuant to section 4.1(d).

Your authorized representative has represented that payments on the 1998 Loan are made with cash debited from that part of the participant's Other Investments Account which is for Company A matching contributions. The stock which is then released from the Plan X suspense account is allocated to the participant's Company Stock Account.

Nearly 80 percent of the Plan X participants are employed by one division in Company A. This division has faced, and will continue to face, significant challenges to its business from a large national competitor. Between 1997 and 2002, Company A closed 7 of its 18 stores in this division and reduced employees in this division from approximately 1,600 to approximately 750. As a result, the number of Plan X participants has been steadily decreasing over the last 10 years. Company A anticipates that continued competition from its competitor will force it to close 5 more stores in this division with a large reduction in the division's employees.

As a result of these substantial business challenges, Company A proposes to terminate Plan X in 2004 for financial and business reasons. Upon the termination of Plan X, Company A will redeem the number of Company A shares held in the Plan X suspense account that are equal in value (as determined by Plan X's independent appraiser on the date of such redemption) to the then outstanding balance of the 1998 Loan. The trustees of Plan X will simultaneously use the redemption proceeds to repay the then outstanding balance of the 1998 Loan. The remaining balance in Plan X's suspense account, which is estimated to be approximately 294,000 shares based upon Plan X's December 31, 2003 appraisal report, will then be allocated to Company Stock Accounts of Plan X participants on the basis of their account balances as of Plan X's termination date. Your authorized representative has represented that this proposed surplus allocation passes the general test for nondiscrimination under section 401(a)(4) of the Code when tested as employer contributions. After receipt of a favorable determination letter from the Service on the termination of Plan X, the balances credited to participants' Company Stock Accounts in Plan X will be distributed to them.

Company A proposes to establish a new profit-sharing plan, intended to be qualified under Code section 401(a), which will include a cash or deferred arrangement as described in section 401(k) (the "401(k) Profit Sharing Plan"). All Plan X participants will be eligible to participate in the 401(k) Profit Sharing Plan on its effective date. Elective deferrals and matching contributions contained in the Other Investment Account described in Plan X section 1.44, in the Participant's Account described in Plan X section 1.46, and in the Participant's Elective Deferral Contribution Account described in Plan X section 1.47 will be transferred from Plan X to the 401(k) Profit Sharing Plan. In addition, discretionary employer contributions contained in the Participant's Account described in Plan X section 1.46 will be transferred from Plan X to the 401(k) Profit

Sharing Plan, as will be the Participant's Rollover Account referenced in Plan X section 1.4. Your authorized representative has represented that all transfers will be in compliance with Code section 414(l).

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

1. The use of the proceeds from the proposed redemption by Company A of Company A stock (equal in value to the then outstanding balance of the 1998 Loan) from the Plan X suspense account immediately followed by Plan X's full payment of the 1998 Loan balance with redemption proceeds will not violate the exempt loan requirements under Code section 4975(d)(3) or section 54.4975-7(b) of the regulations, and therefore will not constitute a prohibited transaction under Code section 4975.

2. The allocation to Plan X participants' Company Stock Accounts of surplus shares of Company A common stock remaining in the Plan X suspense account following the repayment of the 1998 Loan may be treated as earnings and not as annual additions for purposes of Code section 415(c).

3. Section 1.401(k)-1(d) of the regulations will not be violated when Plan X participants immediately participate in the 401(k) Profit Sharing Plan, nor will it be violated by the transfer of the elective deferrals and matching contributions contained in Plan X participants' accounts as described above.

4. The distribution to Plan X participants of their Company Stock Accounts in Plan X does not violate section 1.401(k)-1(d) of the regulations.

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 for repayment of the 1998 Loan. More than one-half the shares purchased with the proceeds of the 1998 Loan have been allocated to participants' accounts. At the time Plan X was established and at the time the 1998 Loan occurred, Company A intended that Plan X would continue until the 1998 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. Business competition has caused Company A to substantially reduce the number of its employees and close many of its stores. Company A anticipates further reductions and closings. Upon the termination of Plan X, Company A will redeem the number of Company A shares held in the Plan X suspense account that are equal in value (as determined by Plan X's independent appraiser on the date of such redemption) to the then outstanding balance of the 1998 Loan. The trustees of Plan X will simultaneously use the redemption proceeds to repay the then outstanding balance of the 1998 Loan.

Accordingly, with respect to your first requested ruling, we conclude that the use of the proceeds from the proposed redemption by Company A of Company A stock (equal in value to the then outstanding balance of the 1998 Loan) from the Plan X suspense account immediately followed by Plan X's full payment of the 1998 Loan balance with redemption proceeds will not violate the exempt loan requirements under Code section 4975(d)(3) or section 54.4975-7(b) of the regulations, and therefore will not constitute a prohibited transaction under Code section 4975.

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 ("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 regulations to an ESOP to which an exempt 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 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, the shares remaining in Plan X's suspense account following the prepayment of the 1998 Loan remain there because it was not necessary to redeem them to prepay the Loan. Thus, they reflect the extent of the appreciation in the value of the shares held in the suspense account and are, in effect, earnings, and are properly treated as such as part of the termination of Plan X. Since the shares remaining in Plan X's suspense account are treated as earnings, they do not constitute annual additions under section 1.415-6(b)(2)(i) of the regulations upon their allocation to participants' accounts in this situation.

Accordingly, we conclude with respect to your second requested ruling that the allocation to Plan X participants' Company Stock Accounts of surplus shares of Company A common stock remaining in the Plan X suspense account following the repayment of the 1998 Loan may be treated as earnings and not as annual additions for purposes of Code section 415(c).

With respect to your third and fourth requested rulings, Code section 401(k) provides that profit-sharing and certain other types of plans will not violate section 401(a) merely because they include a qualified cash or deferred arrangement as defined in section 401(k)(2).

Code section 401(k)(2) provides in pertinent part that amounts held by the trust which are attributable to employer contributions made pursuant to the employee's election may not be distributable to participants or other beneficiaries earlier than an event described in paragraph (10) or other stated events.

Code section 401(k)(10) states in pertinent part that an event described in this subparagraph is the termination of the plan without establishment or maintenance of another defined contribution plan.

Section 1.401(k)-1(d)(1) of the regulations provides that a cash or deferred arrangement satisfies this paragraph (d) only if amounts attributable to elective contributions may not be distributed before certain events, and any distributions so permitted also satisfy the requirements of paragraphs (d)(2) through (6) of this section (to the extent applicable). Section 1.401(k)-1(d)(1)(iii) provides that one of such events is, for years beginning after December 31, 1984, the termination of the plan.

Section 1.401(k)-1(d)(3) of the regulations states in pertinent part that a distribution may not be made under section 1.401(k)-1(d)(1)(iii) if the employer establishes or maintains a successor plan. It generally provides that a successor plan is any other defined contribution plan maintained by the same employer.

With respect to your third requested ruling, amounts attributable to elective contributions are not being distributed to Plan X participants. Such amounts are being transferred to the 401(k) Profit Sharing Plan. Accordingly, we conclude that section 1.401(k)-1(d) of the regulations will not be violated when Plan X participants immediately participate in the 401(k) Profit Sharing Plan, nor will it be violated by the transfer of the elective deferrals and matching contributions contained in Plan X participants' accounts as described above.

With respect to your fourth requested ruling, Company Stock Accounts in Plan X do not contain amounts attributable to elective contributions. Accordingly, we conclude that the distribution to Plan X participants of their Company Stock Accounts in Plan X does not violate section 1.401(k)-1(d) of the regulations.

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 also based on the assumptions that the cash or deferred arrangement contained in Plan X is a cash or deferred arrangement as described in section 401(k) of the Code, and that no section 404(k) deduction will be taken with regard to this transaction.

We note that the Department of Labor has jurisdiction with respect to the provisions of Part 4 of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), including the requirement in section 404(a)(1)(A) and section 404(a)(1)(B) of ERISA that fiduciaries discharge their duties for the exclusive purpose of providing benefits to participants and their beneficiaries and in a prudent manner. Therefore, we express no opinion as to whether the subject transactions are consistent with such provisions.

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.

A copy of this ruling letter has been sent to each of your authorized representatives 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

Frances V. Sloan, Manager
Employee Plans Technical Group 3

Enclosures
Notice 437
Deleted copy of ruling letter

cc: