

Office of Chief Counsel
Internal Revenue Service
memorandum

date: November 17, 2004

to: PAUL SHULTZ, Director
EP Rulings and Agreements T:EP:RA

from: ALAN TAWSHUNSKY *Alan Tawshunsky*
Assistant Chief Counsel (Employee Benefits) CC:TEGE:EB

subject: [REDACTED] - Section 402(j)

This is in response to your request for technical assistance regarding whether Code § 402(j) applies to participant-directed purchases of employer securities (Ruling request (3)). [REDACTED] D.

We have reviewed the following documents in responding to your request: (1) ruling request, dated December 27, 2002; (2) post-conference submission dated May 1, 2003; (3) letter from taxpayer's representative dated October 21, 2003; and (4) letter from taxpayer's representative dated June 30, 2003.

BACKGROUND

The [REDACTED] (or the Company) has requested a ruling regarding the application of Code § 402(j) to the transactions described below.

On [REDACTED] the Company¹ was incorporated as a wholly-owned subsidiary of the [REDACTED]. Effective [REDACTED] [REDACTED] merged with [REDACTED] in a triangular merger, effectuated through the merger of a wholly owned subsidiary of [REDACTED] (merger sub) with and into [REDACTED]. Following the merger, merger sub ceased to exist as a separate corporate entity and [REDACTED] continued as a wholly owned subsidiary of [REDACTED]. As part of the merger transaction, [REDACTED] changed its name to [REDACTED] effective [REDACTED].

The [REDACTED] (the [REDACTED]) succeeded the employee investment plan established [REDACTED] by [REDACTED]. Employer contributions to the [REDACTED] were invested in [REDACTED] common stock through [REDACTED].

¹ Upon its inception, the wholly owned subsidiary was called [REDACTED]. It was renamed the [REDACTED] on [REDACTED].

a leveraged ESOP component, and employee contributions could also be invested in [REDACTED] common stock at the direction of the participants.

On [REDACTED] the assets, liabilities and employees of the [REDACTED] products division of [REDACTED] (the Transferred Employees²) were transferred to the Company.

The [REDACTED] (The Plan) was established by the Company effective [REDACTED]. The Plan, like the [REDACTED] is described as a defined contribution plan with a leveraged ESOP component. On [REDACTED] the assets of the [REDACTED] allocated to the Transferred Employees were transferred to the Plan making it a successor to a portion of the [REDACTED].

[REDACTED] effectuated a spin-off of the Company on [REDACTED] (the spin-off transaction). Prior to this date, employer-matching contributions were automatically invested in the employer portion of the [REDACTED] Fund³. Participants could elect to invest their elective deferrals in the employee portion of the [REDACTED] Fund. Accordingly, prior to the spin-off transaction, all matching contributions made on behalf of the Transferred Employees were invested in parent-company [REDACTED] stock, and employee's elective deferrals were invested in parent-company stock at the discretion of the Transferred Employees.

As part of the spin-off transaction, shares of outstanding [REDACTED] common stock were converted into newly issued shares of [REDACTED] common stock and Company common stock received as dividends. The Company common stock received as a dividend was transferred to the employer portion of the newly created Company Stock Fund or the employee portion of the Company Stock Fund, as appropriate.

After the spin-off transaction, employer-matching contributions to the Plan were automatically invested in the employer portion of the Company Stock Fund,⁴ and participants could elect to invest their elective deferrals in the employee portion of the Company Stock Fund. Additionally, although the Plan's participants (including Transferred Employees) could continue to keep their accounts invested in the [REDACTED] Fund, after the spin-off transaction, they could not add to their investments in the [REDACTED] Fund and no amount could be transferred into the [REDACTED] Fund. Dividends paid on [REDACTED] common stock were allocated to the employee portion of the Company Stock Fund. Accordingly, after the spin-off transaction, the Transferred Employees could have accounts in both stock funds: the

² The term "Transferred Employees" includes the employees that transferred from [REDACTED] to the Company on [REDACTED] as well as, certain terminated [REDACTED] participants and [REDACTED] employees hired after [REDACTED] and before [REDACTED] (i.e., the spin-off transaction date).

³ Some vested participants who were at least age 50 had the right to reallocate some of these amounts to other investments available under the Plan.

⁴ These amounts were subject to vested participant diversification elections.

██████████ Fund, to which no more could be added, and the Company Stock Fund to which future amounts would be added.

On ██████████ and ██████████ entered into a merger agreement (the ██████████ merger). To effectuate the ██████████ merger, ██████████ formed a wholly owned subsidiary which was merged with and into ██████████ resulting in ██████████ becoming a subsidiary of ██████████

As a result of the ██████████ merger, ██████████ common stock was exchanged for ██████████ common stock. After the ██████████ merger, the Plan held ██████████ shares instead of ██████████ shares in the ██████████ Fund. Initially, post-merger ██████████ shares were to be treated as the pre-merger ██████████ shares were treated. Accordingly, the Plan's participants could continue to hold ██████████ shares, or could reallocate all or some part of their ██████████ shares into the employee portion of the Company Stock Fund or other investments available under the Plan. After the merger, the Plan's participants could not invest additional amounts in ██████████ shares, and ██████████ dividends were invested in the employee portion of the Company Stock Fund.

The Plan was subsequently amended to replace the ██████████ Fund with the ██████████ Fund and to discontinue the ██████████ Fund as of ██████████. Further, any amounts that are invested in the ██████████ Fund as of that date, for which no election has been made, will be transferred to Plan-approved investment funds other than Company common stock.

REQUESTED RULING

The Plan requests a ruling that under Code § 402(j), a transaction will be disregarded for purposes of determining net unrealized appreciation (NUA), where, at the direction of the participant, the plan trustee disposes of all or a portion of the participant's investment in ██████████ common stock and uses the proceeds to purchase Company common stock, provided that the reinvestment in Company common stock occurs within ninety days of the disposition of ██████████ common stock.

LAW AND ANALYSIS

Tax Treatment of Net Unrealized Appreciation

Code § 402(a) provides that the amount actually distributed to any distributee by any employees' trust described in Code § 401(a) which is exempt from tax under Code § 501(a) shall be taxable to him in the year in which so distributed under Code § 72 (relating to annuities). Code §§ 402(e)(4)(A) and (B) provide generally that the amount actually distributed to any distributee shall not include net unrealized appreciation in securities of the employer corporation.

Code § 402(e)(4)(E) provides in pertinent part that, for purposes of § 402(e), the term

"securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in subsections (e) and (f) of Code § 424) of the employer corporation.

Regulations § 1.402(a)-1(b)(2)(i) states that the amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust.

Regulation § 1.402(a)-1(b)(2)(ii) sets forth the manner in which the cost or other basis to the trust of a distributed security of the employer corporation is calculated for the purpose of determining the net unrealized appreciation on such security. Regulation § 1.402(a)-1(b)(2)(ii)(a) provides that if a security was earmarked for the account of a particular employee at the time it was purchased by or contributed to the trust so that the cost or other basis of such security to the trust is reflected in the account of such employee, such cost or other basis shall be used.

Code § 402(j) provides a special rule for certain transactions. Code § 402(j) states, that for Code § 402(e)(4) purposes, the determinations of net unrealized appreciation will not apply to transactions where a plan trustee disposes of securities of the employer corporation and uses the proceeds of such disposition to acquire securities of the employer corporation within 90 days.

Analysis

The issue analyzed below is whether Code § 402(j) applies to participant-directed transactions or is limited to trustee-initiated transactions. For the purposes of this analysis, we assume that shares of █████ stock are "securities of the employer corporation" for purposes of Code § 402(e)(4). This assumption reflects the fact that your technical assistance request states that you issued a favorable ruling with regard to ruling request number one.

1. Code § 402(j) and the Legislative History

Code § 402(j) provides:

Effect of disposition of stock by plan on net unrealized appreciation.

(1) In general.--For purposes of subsection (e)(4), in the case of any transaction to which this subsection applies, the determination of net unrealized appreciation shall be made without regard to such transaction.

(2) Transaction to which subsection applies. - This subsection shall apply to any transaction in which –

(A) the plan trustee exchanges the plan's securities of the employer corporation for other such securities, or

(B) the plan trustee disposes of securities of the employer corporation and uses the proceeds of such disposition to acquire securities of the employer corporation within 90 days (or such longer period as the Secretary may prescribe), except that this subparagraph shall not apply to any employee with respect to whom a distribution of money was made during the period after such disposition and before such acquisition.

The statutory language of Code § 402(j) does not explicitly cover a participant's election to dispose of, exchange or reinvest employer shares for purposes of Code § 402(e)(4).⁵

[REDACTED]

[REDACTED]

[REDACTED]

⁵ There are no regulations promulgated pursuant to Code § 402(j).

[REDACTED]

Pages 6-8
Withheld in full
Deliberative process




CONCLUSION

The taxpayer has requested a ruling that the plan's participants (including Transferred Employees) can continue to enjoy the favorable NUA treatment if they dispose of stock in an unrelated entity [REDACTED] and acquire stock of their current employer [REDACTED]. In effect, not providing the favorable NUA treatment for the Transferred Employees would create a tax incentive for the Transferred Employees to remain invested in non-employer stock instead of investing in the stock of the company for which they work.

The statutory language chosen by Congress does not prohibit the application of Code § 402(j) where the transaction to dispose of employer securities and reinvest in employer securities is directed by the participant. [REDACTED]



Based on the foregoing, we conclude that Code § 402(j) applies to participant-directed transactions. Subject to the assumptions stated above, we conclude in this case that to the extent the Transferred Employees elect to dispose of [REDACTED] stock and the proceeds of the disposition are invested in [REDACTED] stock within ninety days (or longer if an extension is granted), the transaction will be disregarded for purposes of determining net unrealized appreciation. This conclusion does not apply to any employee with respect to whom a distribution of money was made during the period after such disposition and before such acquisition. Further, for the purposes of the conclusions made here, the term "securities" is limited to those instruments described in Code § 402(e)(4)(E)(i) and Income Tax Regulation § 1.402(a)-1(b)(1)(ii) and expressly does not apply to contracts providing an employee the option to purchase employer securities.

If you have any further questions, please contact Lisa Mojiri-Azad or Dan E. Boeskin at (202) 622-6060.