



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

200716027

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JAN 26 2007

T:EP:RA: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 April 6, 2006, as supplemented by letters dated November 3, 2006, December 15, 2006, and December 22, 2006, 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, is engaged in the manufacturing and importation of _____
Company A established Plan X effective _____ for the benefit of its
employees. Plan X is leveraged and is intended to be qualified under section 401(a) of the
Internal Revenue Code ("Code") and is intended to be an ESOP within the meaning of Code
section 4975(e)(7).

On _____ the trustee of Plan X's related trust ("Trustee") entered into an exempt loan
in the amount of approximately \$ _____ with a third-party lender ("the Loan"), which
enabled Plan X's related trust to purchase approximately _____ shares ("the Loan
Shares").

After the _____ Loan was repaid and all of the _____ Loan Shares were released and allocated,
Company A continued to make annual cash contributions from _____ through _____ to Plan X
which were generally used to repurchase shares which had been allocated to the accounts of Plan

X participants who became eligible for distributions of their account balances during the year. These repurchased shares remained in Plan X and were reallocated to other participants' accounts. As of February 2000, Plan X held % of the total shares of Company A stock then outstanding.

On _____ Company A made a second exempt loan to Plan X in the amount of \$ _____ ("the 2000 Loan"). The _____ Loan enabled Plan X to purchase, by a tender offer to all of Company A's shareholders ("the Tender Offer"), _____ shares of Company A stock ("the _____ Loan Shares") which were pledged as security for the _____ Loan. As a result of the Tender Offer, Plan X acquired an additional _____ % of the total shares of Company A stock then outstanding. The _____ Loan Shares are held in a suspense account under the terms of Plan X and have been released and allocated to eligible participants' accounts as Plan X makes scheduled payments of principal and interest on the _____ Loan. The _____ Loan is scheduled to be retired in _____ unless prepaid by Plan X.

Company A represents that, at the time it made the _____ Loan, it fully intended to make contributions to Plan X sufficient to permit Plan X to pay all installments of principal and interest as those installments became due, and that it fully intended to maintain Plan X at least through the scheduled retirement date for the _____ Loan.

As of _____ a total of _____ shares, or _____ % of the _____ Loan Shares had been released from Plan X's suspense account and _____ or _____ % of the _____ Loan Shares remained unallocated.

In late _____, Company A began experiencing a significant decline in demand for its domestically produced products, due primarily to increasing competition from _____ imports. Demand for domestically manufactured _____ continued to decline in subsequent years, causing Company A to close manufacturing facilities and resulting in a substantial decline in Company A's workforce since _____ and an approximate 50% reduction in the number of active participants in Plan X. Company A does not expect the size of its workforce to increase. In response to increasing competition from foreign _____ manufacturers, Company A has shifted its business strategy away from domestic _____ manufacturing and expects that, if the market for its domestically produced _____ does not improve, it will make additional workforce reductions.

Company A proposes to terminate Plan X because the reduction in the number of Plan X participants described above has made Plan X increasingly burdensome for Company A to continue to maintain, and because Company A and the trustee of Plan X have not been able to agree to a method of restructuring the _____ Loan that would allow Company A to effectively address the burdens associated with continuing to maintain Plan X in light of the significant change in economic circumstances and drastic decline in Plan X participation.

In accordance with the terms of Plan X, Company A proposes to redeem that number of the unallocated _____ Loan Shares held in Plan X's suspense account which have a total fair market value equal to the then outstanding balance (principal and accrued interest) of the _____ Loan. Company A will simultaneously direct the trustee of Plan X's related trust to use the redemption

proceeds to repay the then outstanding balance of the Loan. The Loan will then be retired. The number of shares to be redeemed will be determined based on the closing price per share of Company A stock as reported on the NASDAQ Capital Market on the day which the redemption occurs. The redeemed shares will be retired (i.e., become authorized but unissued shares).

The shares that remain in Plan X's suspense account after the repayment of the Loan ("Surplus ESOP Shares"), along with any unallocated interest-bearing cash, will then be allocated to the accounts of all participants in Plan X as earnings pro rata on the basis of their respective account balances in Plan X as of the termination date. Your authorized representatives have represented that this proposed allocation will be made in a manner that passes the general test for nondiscrimination under Code section 401(a)(4) for employer contributions. Your authorized representatives have further represented that, in the unlikely event that the total value of unallocated Loan Shares as of the redemption date is less than the then outstanding balance of the Loan, Company A will forgive the remaining balance of the Loan.

Immediately following the proposed repayment of the Loan, Plan X and its related trust will be terminated, and participants' accounts in Plan X (including any Surplus ESOP Shares that have been allocated to participants' accounts) will be transferred in a trustee-to-trustee transfer to another qualified retirement plan sponsored by Company A.

Your authorized representatives have requested rulings to the effect of the following on your behalf:

1. The repayment of the Loan in connection with the termination of Plan X with the proceeds of the proposed redemption by Company A of unallocated Loan Shares that have a fair market value equal to the outstanding balance (principal and accrued interest) of the Loan at the time of such redemption will not cause the Loan to fail to satisfy the requirements for exemption under Code section 4975(d)(3); and
2. The allocation of Surplus ESOP Shares to participants' Plan X accounts immediately following the proposed repayment of the Loan will be treated as an allocation of earnings and will not constitute annual additions to those participants' accounts under Code section 415(c).

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 Loan. Nearly 30 percent of the Loan Shares have been released from the Plan X suspense account and allocated to participants' accounts. At the time Plan X was established and at the time the Loan occurred, Company A intended that Plan X would continue until the 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 the financial and business reasons described above. Upon the termination of Plan X, Company A will redeem that number of the unallocated Loan Shares held in the Plan X suspense account which have a total fair market value equal to the then outstanding balance (principal and accrued interest) of the Loan. Company A will simultaneously direct the trustee of Plan X's related trust to use the redemption proceeds to repay the then outstanding balance of the

Loan. The Loan will then be retired. The number of shares redeemed will be determined based on the closing price per share of Company A stock as reported on the NASDAQ Capital Market on the day which the redemption occurs. The redeemed shares will be retired. The remaining shares in Plan X's suspense account will then be allocated as earnings to the Company A stock accounts of Plan X participants on the basis of their account balances as of Plan X's termination date.

Accordingly, with respect to your first requested ruling, we conclude that the repayment of the Loan in connection with the termination of Plan X, with the proceeds of the proposed redemption by Company A of unallocated Loan Shares that have a fair market value equal to the outstanding balance (principal and accrued interest) of the Loan at the time of such redemption, will not cause the Loan to fail to satisfy the requirements for exemption under Code section 4975(d)(3).

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 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 Income Tax 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 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 Income Tax Regulations upon their allocation to participants' accounts in this situation.

Accordingly, we conclude with respect to your second requested ruling that the allocation of Surplus ESOP Shares to participants' Plan X accounts immediately following the proposed

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repayment of the Loan will be treated as an allocation of earnings and will not constitute annual additions to those participants' accounts under Code section 415(c).

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 assumption 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.

Copies of this ruling letter have been sent to 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.

at

Sincerely yours,



Frances V. Sloan, Manager
Employee Plans Technical Group 3

Enclosures
Notice 437
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cc: