Internal Revenue Service

Department of the Treasury

Washington, DC 20224

UIL: 512.00-00
401.00-00
409.00-00
4975.00-00

Contact Person:

Telephone Number:

In Reference to: T:EP:RA:T1

Date:

APR 24 2000

Legend:

Company A =

Plan X =

Plan Y =

Dear :

This is in response to a letter dated November 5, 1999, as supplemented by correspondence dated February 1, 2000, submitted on your behalf by your authorized representative requesting rulings under section 512(e)(1) and (e)(3) of the Internal Revenue Code (the "Code"). The following facts and representations were submitted in connection with your request.

Effective January 1, 1975, Company A established an employee stock ownership plan ("ESOP") qualified under sections 401(a), 409 and 4975(e)(7) of the Code (Plan Y). Plan Y has a favorable determination letter issued on April 20, 1995. Effective January 1, 1985, Company A established Plan X, a profit-sharing plan which includes a qualified cash or deferred arrangement under section 401(k) of the Code. Plan X also has a determination letter, issued on June 30, 1995. During the 1999 plan year, Plan X and Plan Y (collectively, the "Plans") were amended and restated to comply with federal tax legislation affecting qualified plans.

Plan X permits employees to choose among six options for the investment of elective deferrals, including a Company A stock fund. Effective January 1, 1999, Plan X was also amended to provide that the portion of a participant's account that is invested in Company A stock ("Company A Stock Fund") constitutes an ESOP account under sections 409 and 4975(e)(7) of the Code. Specifically, each ESOP account consists of: (1) the portion of each participant's account that was invested in the Company A Stock Fund as of January 1, 1999; (2) any additional elective deferrals that are invested in the Company A Stock Fund on or after the amendment's effective date; (3) any amounts that were invested at any time in the Company A Stock Fund on or after the effective date, with adjustments for income, withdrawals, contributions and expenses; and (4) any matching contributions made in Company A stock on or after the effective date.

Effective December 15, 1999, any participant with an investment in the Company A Stock Fund will be restricted from transferring amounts held in the fund to any of the other investment funds offered under Plan X except as may be necessary to satisfy the diversification requirements. Following these and other amendments, the ESOP component of Plan X is intended to be a stock bonus plan which will comply with the ESOP requirements. Favorable determination letters will again be requested for Plan X, including the ESOP component, and for Plan Y.

As of the date of your ruling request, Company A had a total of 48,679 shares of common stock issued and outstanding, 6,864 of which are owned by the ESOP component of Plan X and 41,815 shares owned by Plan Y. Thus, all of the outstanding common stock of Company A is owned by Plans X and Y. A total of 38,952 shares are allocated to participants' and former employees' accounts under the Plans, with stock ownership per account ranging from .06 percent to 15 percent of the total number of shares outstanding. Each share of Company A stock has identical voting and dividend rights, and you represent that all of the authorized, issued and outstanding shares of stock of Company A qualify as employer securities under section 409(l) of the Code. On or before March 15, 2000, Company A will file an S election with the Internal Revenue Service with an effective date of January 1, 2000.

Based on the above facts and representations, you request the following rulings:

(1) The Company A stock held by the ESOP component of Plan X and by Plan Y will not be treated as an interest in an unrelated trade or business under section 512(e)(1)(A) of the Code, or any corresponding successor provision, following Company A's S election effective for the tax year beginning on January 1, 2000.

(2) All of the income of Company A and gain realized from the disposition of Company A stock passed through to the ESOP component of Plan X and to Plan Y will be exempt from the unrelated business income tax (UBIT) under section 512(e)(1) of the Code, or any corresponding successor provision, based on the exemption under section 512(e)(3), or any corresponding successor provision, following the effective date of Company A's S election.

Section 512(e)(1)(A) and (B) of the Code provides that if an organization described in section 1361(c)(6) holds stock in an S corporation, such interest shall be treated as interest in an unrelated trade or business, and notwithstanding any other provision of Part I (General Rule) of Subchapter F (Exempt Organizations), all items of income, loss, or deduction taken into account under section 1366(a), and any gain or loss on the disposition of the stock in the S corporation, shall be taken into account in computing the UBIT of such organization.

Section 1361(c)(6) of the Code refers to a qualified trust described in section 401(a) and exempt from taxation under section 501(a) as one of the types of exempt organizations permitted to be a shareholder of an S corporation. Section 1366(a) provides rules for determining the tax of a shareholder of an S corporation.

Section 512(e)(3) of the Code provides that section 512(e) does not apply to employer securities (as defined under section 409(1)) held by an ESOP described under section 4975(e)(7).

Section 409(l) of the Code generally defines employer securities to mean common stock issued by the employer which is readily tradeable on an established securities market, or if there is no such stock, common stock issued by the employer which has a combination of voting power and dividend rights at least equal to that class of common stock of the employer having the greatest voting power and that class of common stock having the greatest dividend power.

Regarding ruling request (1), we conclude that based on current law, the S corporation stock held by the ESOP component of Plan X and by Plan Y is not treated as an interest in an unrelated trade or business under sections 512(e)(1)(A) and 512(e)(3) of the Code following the effective date of Company A's S election. Regarding ruling request (2), we further conclude that, because you represent that Company A stock qualifies as employer securities within the meaning of section 409(l), the exemption provided under section 512(e)(1)(B) applies with respect to the Company A stock held by Plans X and Y beginning on the effective date of the S election. However, section 6.09 of Rev. Proc. 2000-4, 2000-1 I.R.B. 115 provides that the Service will not rule on the tax effects of proposed legislation. Thus, the above rulings are limited to the exemption provided by current law.

The above rulings are based on the assumption that Plan X and Plan Y are qualified under sections 401(a) and 4975(e)(7) of the Code, and that their related trusts are exempt under section 501(a), at all relevant times. In addition, these rulings also assume that the stock of Company A held by the Plans qualifies as employer securities within the meaning of section 409(l).

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 has been sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,

John Swieca, Manager
Employee Plans Technical Group 1
Tax Exempt and Government Entities Division

Enclosure:
Deleted copy of the ruling
Notice 437

cc:

337