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INTERNAL REVENUE SERVICE
EMPLOYEE PLANS
TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name: ***** **

Taxpayer's Address: ***** **

Taxpayer's EIN: *****

Date of Conference: ***** **

Years Involved: *****

Plan: *****

ISSUES:

1. Whether § 54.4975-7(b)(8)(i) of the Income Tax Regulations ("Regulations") is an operational requirement or a documentary requirement.
 - i. Does the fact that the Employee Stock Ownership Plan, in operation, did not use the principal and interest method cause the loan to be in violation of § 54.4975-7(b)(8)(i) of the Regulations?
 - ii. Or does the fact that the provisions of the loan document required pledged shares to be released using the principal and interest method cause § 54.4975-7(b)(8)(i) of the Regulations to be met?
2. Whether the disqualified person is liable for the initial taxes under section 4975 of the Internal Revenue Code ("Code") for the taxable years ended 2003, 2004, 2005 and 2006.
3. Whether the prime rate or the actual interest should be used to determine the amount involved and the excise taxes under section 4975(a) of the Code.

FACTS:

On June 9, 1999, in order to effectuate the establishment of an ESOP, *****
***** ("Company") and ***** (a major provider of financial services
including commercial lending) ("the Financial Service Provider") entered into a
loan and security agreement ("the Back-to-Back Loan"). Effective July 1, 1999,

the Company established the ***** ("Plan"). The Plan is designed to be an ESOP as described in section 4975(e)(7) of the Code. On July 1, 1999, the Plan borrowed _____ from the Company to purchase _____ shares of Class A Common Stock ("the Loan"). The terms of the Loan were identical to the terms of the Back-to-Back Loan including the interest charged, as provided for below.

The note for the Loan ("Note") stated in relevant part:

This Note shall be payable in 59 equal monthly installments of principal of _____ on the last business day of each month, commencing July 30, 1999, and a 60th and final payment of all then unpaid principal (and accrued and unpaid interest) on the last business day of June, 2004. The principal amount of this Note may be prepaid in whole or in part from time to time without prepayment penalty. In the event of partial payments, the required monthly principal payment will remain the same.

The principal amount of this Note shall bear interest at a per annum rate equal to the sum of (a) _____ and (b) the "30-Day Commercial Paper Rate," as published in the Wall Street Journal, based on actual days elapsed over a 360-day year (and in the event such rate is no longer so published, such rate will be reasonably determined by the Company). Interest will be payable in arrears on the last business day of each month, commencing July 30, 1999.

On June 30, 2004, the maturity date of the Note was extended to October 31, 2004, and on October 29, 2004, it was further extended to June 30, 2009. Prior to January, 2005, the Plan made monthly payments of _____ in addition to several prepayments. Beginning in January, 2005, the Plan limited its monthly payments to _____ per month.

The interest rate on the Loan was below the prime rate at all times during the years at issue.

The Plan's pledge agreement ("Pledge Agreement"), dated July 1, 1999, pledged the Plan's _____ shares of Class A Common Stock as collateral for the Loan. The Pledge Agreement also stated that the pledged shares would be released from the suspense account using the principal and interest method. The Plan also requires shares to be released using the principal and interest method, or "if the requirements of Treas. Reg. § 54.4975-7(b)(ii) are met, principal payments only." In addition, Article IV, section 4.2 of the Plan provides that "[a]ny pledge of Financed Shares must provide for the release of shares so pledged on a basis equal to the principal and interest paid by the Trustee on the Acquisition Loan."

The Plan received a favorable determination letter dated June 1, 2001, and filed an additional application for a determination letter on January 31, 2007. The 2007 application is pending.

In 2005, the Department of Labor (DOL) conducted a review of the Plan and found that in operation, the principal-only method, not the principal and interest method, was used to calculate the release of shares from 1999 through 2004. In a letter to the Company dated March 14, 2006, the DOL stated that "in [its] opinion, the failure to use the method required by the ESOP Pledge Agreement for releasing shares from suspense violated [ERISA] Act Sections 404(a)(1)(A), 404(a)(1)(B), [and] 404(a)(1)(D) . . ." and constituted a prohibited transaction under section 406(a)(1)(B) of ERISA. The DOL also noted, in a letter dated April 25, 2006, that even if the principal-only method had been permitted by the Plan and pledge agreement, the Loan did not follow the statutory requirements needed to permit such principal-only payments.

In that letter, the DOL also noted that the Company agreed to recalculate the release of shares from 1999 through 2004 using the principal and interest method instead of the principal-only method. The recalculation resulted in a net release of additional shares to correct the Plan's failure. The Company agreed to credit the additional shares to the participant accounts as of December 31, 2005, and to use the principal and interest method to calculate the release of shares from 2005 until the loan is repaid in full. The DOL stated that because the taxpayer had taken these corrective actions, its office would take no further action on the matter. On October 10, 2006, the Company allocated the additional shares to the participant accounts based on the participant's pro-rata share of the stock credited to his or her account for each respective year.

LAW and ANALYSIS:

ISSUE 1

Section 4975(a) of the Code imposes a tax on each prohibited transaction (as defined in section 4975(c)) at a rate equal to 15 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period. The tax imposed by section 4975 shall be paid by any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such).

Section 4975(b) of the Code provides that in any case in which an initial tax is imposed by section 4975(a) on a prohibited transaction and the transaction is not corrected within the taxable period, there is imposed a tax equal to 100 percent of the amount involved.

Section 4975(c)(1)(B) of the Code provides that any direct or indirect lending of money or other extension of credit between a plan and a disqualified person generally is a prohibited transaction.

Section 4975(e)(2)(C) of the Code provides that an employer, any of whose employees are covered by the plan, is a disqualified person with respect to the plan.

Section 4975(d)(3) of the Code provides an exemption from the prohibited transaction rules for any loan to a leveraged employee stock ownership plan (as defined in section 4975(e)(7)) if (i) the loan is primarily for the benefit of the participants and beneficiaries of the plan and (ii) the loan is at a reasonable rate of interest and any collateral which is given to a disqualified person by the plan consists only of qualifying employer securities.

Section 4975(e)(7) of the Code stated that the term "employee stock ownership plan" means a defined contribution plan – (A) which is a stock bonus plan which is qualified, or a stock bonus plan 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; and (B) which is otherwise defined in regulations prescribed by the Secretary.

Section 54.4975-7(b)(8)(i) of the Regulations provides in pertinent part that for each plan year during the duration of a loan described in section 4975(d)(3) of the Code, the number of securities released must equal the number of encumbered securities held immediately before the release for the current plan year multiplied by a fraction. The numerator of the fraction is the amount of principal and interest paid for the year. The denominator of the fraction is the sum of the numerator plus the principal and interest to be paid for all future years. The number of future years under the loan must be definitely ascertainable and must be determined without taking into account any possible extensions or renewal periods. If the interest rate under the loan is variable, the interest to be paid in future years must be computed by using the interest rate applicable as of the end of the plan year. If collateral includes more than one class of securities, the number of securities of each class to be released for a plan year must be determined by applying the same fraction to each class.

Section 54.4975-7(b)(8)(ii) of the Regulations describes the special rule: A loan will not fail to be exempt merely because the number of securities to be released from encumbrance is determined solely with reference to principal payments. However, if release is determined with reference to principal payments only, the following three additional rules apply. The first rule is that the loan must provide for annual payments of principal and interest at a cumulative rate that is not less

rapid at any time than level annual payments of such amounts for 10 years. The second rule is that interest included in any payment is disregarded only to the extent that it would be determined to be interest under standard loan amortization tables. The third rule is that this subdivision (ii) is not applicable from the time that, by reason of a renewal, extension, or refinancing, the sum of the expired duration of the exempt loan, the renewal period, the extension period, and the duration of a new exempt loan exceeds 10 years.

Cornell-Young Co. v. U.S., 469 F.2d 1318, 1324 (5th Cir. 1972) held that "the law looks not only to the form of the plan but also to its operation."

In re Blais, 2004 WL 1067577, at *3 (S.D. Fla., March 16, 2004) held that, although the requirements of section 401(a) of the Code "speak to the form of the plan," they nevertheless "also extend to the manner in which the plan is operated."

With regard to Issue 1, the DOL determined that the Loan between the Company and the Plan constituted a prohibited transaction under ERISA section 406(a)(1)(B), for failing to follow the release method provided in § 2550.408b-3h of the DOL regulations. The Loan is also a prohibited transaction under Code section 4975(c)(1)(B) of the Code if it fails the exemption requirements under section 4975(d)(3). Section 54.4975-7(b)(8) of the Regulations provides that the release method of a loan described in section 4975(d)(3) must follow either the general rule of § 54.4975-7(b)(8)(i) or the special rule of § 54.4975-7(b)(8)(ii). This requirement includes both an operational and a documentary component. See, e.g., Cornell-Young Co. v. U.S., at 1324 (5th Cir. 1972). To conclude otherwise would strip the regulation of its meaning.

The Loan failed to meet the requirements of either the general rule or the special rule under section 54.4975-7(b)(8) of the Regulations. The general rule requires a release of shares using a principal and interest method, but the DOL found that the principal-only method was used to calculate the release of shares from 1999 to 2004. The special rule allows shares to be released solely with reference to principal payments, but the loan must provide for annual payments of principal and interest at a cumulative rate not less rapid at any time than level annual payments of such amounts for ten years. Here the Loan, in the amount of _____ required monthly principal payments of only _____ which either would have required 15 years, not 10, to pay off in its entirety, or would have resulted in a balloon payment thus violating the special rule's level annual payment requirement. Consequently, even if the language in the Plan and pledge agreement met the documentary requirement of Section 54.4975-7(b)(8) of the Regulations, the Loan violates the regulation in operation and fails to be exempt.

Therefore, the Loan violated section 54.4975-7(b)(8) of the Regulations and does not qualify for the exemption from the prohibited transaction rules under section 4975(d)(3) of the Code. The Loan constitutes a prohibited transaction under Code section 4975(c)(1)(B) of the Code.

ISSUE 2

Section 4975(f)(2) of the Code defines the term "taxable period" as the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of (1) the date of the mailing of a statutory notice of deficiency, (2) the date on which the first tier excise tax is assessed, or (3) the date on which correction of the prohibited transaction is completed.

Section 4975(f)(5) of the Code defines a correction as undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than that in which it would be if the disqualified person were acting under the highest fiduciary standards.

Section 141.4975-13 of the Temporary Pension Excise Tax Regulations provides that, under paragraphs (2), (4), (5), and (6) of section 4975(f), section 53.4941(e)-1 of the Foundation Excise Tax Regulations is controlling to the extent those regulations describe terms appearing both in section 4941(e) and section 4975(f) of the Code. The terms "taxable period" and "correction" appear in both section 4941(e) and section 4975(f).

Section 53.4941(e)-1(c) of the Regulations provides, in general, that the correction shall be accomplished by undoing the transaction which constituted the act of self-dealing to the extent possible, but in no case shall the resulting financial position of the private foundation be worse than that which it would be if the disqualified person were dealing under the highest fiduciary standards. For example, where a disqualified person sells property to a private foundation for cash, correction may be accomplished by recasting the transaction in the form of a gift by returning the cash to the foundation.

Section 53.4941(e)-1(c)(4)(i) of the Regulations provides that in the case of the use by a disqualified person of property owned by a private foundation, undoing the transaction includes, but is not limited to, terminating the use of such property. In addition to termination, the disqualified person must pay the foundation— (a) the excess (if any) of the fair market value of the use of the property over the amount paid by the disqualified person for such use until such termination, and (b) the excess (if any) of the amount which would have been paid by the disqualified person for the use of the property on or after the date of such termination, for the period such disqualified person would have used the

property (without regard to any further extensions or renewals of such period) if such termination had not occurred, over the fair market value of such use for such period. In applying (b) of this subdivision, the fair market value of the use of property shall be the rate at the time of correction.

Section 53.4941(e)-1(e)(1) of the Regulations provides that, in the instance of a prohibited transaction that is a loan, an additional prohibited transaction is deemed to occur on the first day of each taxable year in the taxable period after the taxable year in which the use occurred.

Rev. Rul. 2002-43, 2002-2 C.B. 85, addresses a prohibited transaction that spans multiple taxable years in a taxable period where the first tier excise tax rate changes and illustrates that where interest is not repaid in a given year, that interest is added to the principal amount in the subsequent year.

Rutland v. Commissioner, 89 T.C. 1137, 1151 (1987), held that the taxpayers were liable for excise taxes on one prohibited transaction entered into on the date the loans were executed plus an additional prohibited transaction on the first day of each taxable year or portion of a taxable year until such transactions were corrected.

Medina v. Commissioner, 112 T.C. 51, 55 (1999), held that a prohibited transaction that consists of a loan may only be corrected by the repayment of principal plus reasonable interest.

With regard to Issue 2, we concluded in Issue 1 that the Loan constitutes a prohibited transaction under section 4975(c)(1)(B) of the Code. Therefore, the Company—as the disqualified person who participated in the transaction—must pay the excise tax of 15% of the amount involved imposed under section 4975(a).

The taxable period for the prohibited transaction began on the date of the Loan, July 1, 1999, and ended on the earliest of (a) the date a notice of deficiency was mailed, (b) the date the excise tax was assessed, or (c) the date of correction. Because our first open year is 2003, we will consider the first date of the taxable period to be January 1, 2003. As for the ending date, the Service has not mailed a notice of deficiency, but assessed the excise tax for the prohibited transactions beginning in taxable years 2003 through 2006 on August 17, 2009. Regarding the correction date, the taxpayer notes that on October 10, 2006, per its agreement with the DOL, it allocated as of December 31, 2005, the additional shares that should have been allocated to participant accounts under the terms of the Loan.

Section 4975(f)(5) of the Code and section 53.4941(e)-1(c)(1) of the Regulations define correction as undoing the transaction to the extent possible, but in no case placing the plan in a worse financial position than that in which it would be if the disqualified person were acting under the highest fiduciary standards. Here, the Loan would have been exempt from the prohibited transaction rules had it followed the share release method described in section 54.4975-7(b)(8) of the Regulations. The DOL found that the taxpayer corrected the Loan by allocating the shares to participants that should have been allocated under the proper release method.

Although the Temporary section 4975 regulations look to the section 4941 regulations for the definition of "correction" under section 4975, we think it is important to interpret the regulations in light of the facts of the existing case involving an ESOP exempt loan transaction. While the regulations under section 4941 contemplate "undoing the transaction which constituted the act of self-dealing to the extent possible," they also provide that in no case is the foundation to be put in a worse position financially than if the disqualified person were dealing with the plan under the highest fiduciary standards. Correction of a prohibited transaction involving a loan typically involves terminating a loan. However, to require termination of the Loan in this case would put the Plan and its participants in a worse financial position than if the Plan had not entered the loan transaction. Thus, under these particular facts and circumstances, we believe it is reasonable to consider the taxpayer as having corrected the prohibited transaction by allocating the additional shares to participant accounts on October 10, 2006.

The taxpayer argues that it corrected the Loan on December 31, 2005, since the shares were credited as of that date. We disagree. The taxpayer did not undo the transaction until October 10, 2006, when it actually allocated the additional shares to the participant accounts and the participants were made whole.

Accordingly, with respect to Issue 2, the disqualified person is liable for the initial taxes under section 4975(a) of the Code for the prohibited transactions beginning in taxable years 2003 through 2006, for the period beginning January 1, 2003 and ending October 10, 2006.

ISSUE 3

Section 4975(f)(4) of the Code defines the term "amount involved," generally, as the greater of (1) the amount of money and the fair market value of the other property given or (2) the amount of money and the fair market value of the other property received. For purposes of the first tier excise tax, the fair market value is determined as of the date on which the prohibited transaction occurs,

whereas, for purposes of the second tier excise tax, the fair market value is the highest fair market value during the taxable period described in section 4975(f)(2).

Section 141.4975-13 of the Temporary Pension Excise Tax Regulations provides that, under paragraphs (4) and (5) of section 4975(f), § 53.4941(e)-1 of the Foundation Excise Tax Regulations is controlling to the extent those regulations describe terms appearing both in section 4941(e) and section 4975(f). The term "amount involved" appears in both section 4941(e) and section 4975(f).

Section 53.4941(e)-1(b)(2)(ii) of the Regulations provides that, where the transaction involves the use of money or other property, the amount involved is the greater of the amount paid for such use or the fair market value of such use for the period for which the money or other property is used and the amount involved is determined for the entire period that the money or other property is used.

Section 53.4941(e)-1(b)(3) of the Regulations provides that the fair market value of the use of property shall be determined as of the date on which the act of self-dealing occurred in the case of the initial taxes imposed by section 4941(a) (or section 4975(a)) and shall be the highest fair market value during the taxable period in the case of the additional taxes imposed by section 4941(b) (or section 4975(b)).

Section 1.170A-1(c)(2) of the Regulations provides that, in the case of contributions of property, the fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. See also, section 20.2031-1(b) of the Regulations (applying the same definition of fair market value to an estate) and section 25.2512-1 of the Regulations (applying the same definition of fair market value to a gift of property).

Rev. Rul. 2002-43, 2002-2 C.B. 85, provides that where a loan is a prohibited transaction, the excise tax is determined using the interest rate that was the greater of the interest on the loan or the fair market rate of interest for such loan at that time.

Where a loan is the prohibited transaction, the excise tax is determined using the interest rate that is the greater of the interest on the loan, or the fair market rate of interest. See Rev. Rul. 2002-43; Medina v. Commissioner, 112 T.C. 51 at 56-57 (1999) (holding that the fair market interest rate applied when determining the amount involved in a prohibited transaction case involving a loan unless

petitioners could show that the fair market interest rate was erroneous). When determining a fair market interest rate, courts have looked to the prime interest rate for purposes of setting an appropriate benchmark rate. See Till v. SCS Credit Corp., 541 U.S. 465, 479 (2004); Goldstein v. Commissioner, 89 T.C. 535, 548 (1987); Gorenstein Enterprises, Inc. v. Quality Care-USA, Inc., 874 F.2d 431, 436 (7th Cir. 1989).

With respect to Issue 3, the threshold question is whether the interest rate charged by the Loan is a fair market interest rate. We believe that the Company has offered sufficient documentation to support the use of its proposed interest rate as a fair market interest rate. The agreement, with regards to the Back-to-Back Loan, between the Company and the Financial Service Provider substantiates the interest rate used with respect to the Loan. Although the interest rate in this case is set slightly below the prime rate, we recognize that fair market interest rates can differ among local markets and believe that the loan agreement with the Financial Service Provider is sufficient to support the Company's claim that it was able to obtain such a favorable interest rate. Because we believe the Company has demonstrated that the interest rate on the Loan represents a fair market interest rate, it is that interest rate that should be used to calculate the amount involved for determining the excise tax on the Loan.

CONCLUSIONS:

1. Section 54.4975-7(b)(8) of the Regulations imposes both an operational and a documentary requirement. The Loan violated this section of the Regulations when it failed to release shares in accordance with either the general or the special rule of section 54.4975-7(b)(8)(i) and (ii). Therefore, the Loan failed the exemption requirements of section 4975(d)(3) of the Code, and constitutes a prohibited transaction under section 4975(c).
2. The Company is liable for excise taxes under section 4975(a) of the Code for the prohibited transactions beginning in the years 2003 through 2006 for the taxable period from January 1, 2003 to October 10, 2006.
3. The actual interest should be used to determine the amount involved and the excise taxes under section 4975(a) of the Code.