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Person to Contact:

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Date:
May 18, 1999

Holding =

Bank =

State X =

ESOP =

Plan =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

a =

b =

c =

d =

e =

f =

g =

Dear :

This is in response to a letter dated January 20, 1999, requesting rulings as to the federal income tax consequences of a proposed transaction. Additional information was submitted in a letter dated May 10, 1999. The facts submitted for consideration are substantially as set forth below.

Holding was incorporated in Date 1 as a stock corporation for the sole purpose of acquiring all the capital stock issued by Bank upon its conversion from a federally chartered mutual savings association to a federally chartered stock savings bank. In connection with the conversion, Holding sold shares of common stock in a public offering.

The offering of stock in Holding was closed on Date 2, and net cash proceeds of $a were raised. At the closing of the offering, Holding purchased all of the outstanding capital stock of Bank for $b. Holding retained $c for use in Holding's future operations. Bank has never joined in the filing of a consolidated return with Holdings.

Earnings and profits (as calculated under § 312 of the Internal Revenue Code) for Holding and Bank equal $d and $e, respectfully.

On Date 3, Holding's Board of Directors approved the ESOP effective Date 4. On Date 4 Holding loaned the ESOP $g (the "ESOP Loan") in order to enable the ESOP to purchase shares of Holding common stock in its initial public offering. The ESOP Loan was structured as an "exempt Loan" within the meaning of § 54.4975-7(b)(1)(iii) of the Excise Tax Regulations, with shares of common stock to be released from collateral based on principal and interest payments in accordance with § 54.4975-7(b)(1)(ii). According to the stock pledge agreement, earnings attributable to the

240

pledged stock must be used solely for the purpose of repayment of the ESOP Loan.

The Board of Directors of Holding has determined that the initial public offering raised approximately $f in excess of Holdings current operating needs. Holding, therefore, proposes to distribute a portion of this amount (the "Distribution") pro rata to Holding's shareholders. The Distribution represents a return of capital (i.e., is not being paid from earnings and profits).

As a stockholder of Holding, the ESOP would receive a pro rata portion of the Distribution. In accordance with the provisions of the ESOP, the ESOP would differentiate, with respect to the Distribution, between shares allocated to the accounts of ESOP participants ("Allocated Shares") and shares held unallocated as security for the ESOP Loan ("Unallocated Shares"). The portion of the Distribution that is attributable to Allocated Shares would be immediately allocated to the accounts of ESOP participants. With respect to Unallocated Shares, the Distribution would be held in the suspense account as collateral for the ESOP Loan. The distribution in the suspense account, including earnings while held in such account, would be reinvested in employer securities, within the meaning of § 4975(e)(7), as soon as administratively feasible without materially affecting the value of the securities based on applicable market conditions.

On Date 5, Holding's board of directors approved Holding's Plan. On Date 6, the effective date of the Plan, certain Holding and Bank employees were automatically granted stock options pursuant to the Plan. The Plan provides that the exercise price of an outstanding stock option will be proportionately adjusted for any increase, decrease, change or exchange of shares for a different number or kind of shares or other securities of Holding that results from a merger, consolidation, recapitalization, reorganization, reclassification, stock dividend, split-up, combination of shares, or similar event in which the number or kind of shares is changed with the receipt of payment of consideration by Holding.

Because the fair market value of the common stock is expected to decrease by an amount equal to the capital distribution, each outstanding stock option would be adjusted as follows (hereinafter referred to as the "proportionate option adjustment"):

(i) the exercise price of each outstanding option would be proportionately reduced so that the ratio or the exercise price over the fair market value is the same both before and after the capital distribution; and

(ii) the number of shares subject to each stock option would be increased by a number equal to 100 percent of the number that would otherwise be required as an adjustment in order to avoid any decrease in the money

value of the stock option, due to the reduction in their exercise price that is made pursuant to the preceding clause.

The following representations are made in connection with the proposed transaction:

(a) Holding (i) is not required to file consolidated federal income tax returns with its subsidiaries, (ii) has not elected to file a consolidated Federal income tax return, and (iii) will not file a consolidated Federal income tax return for the year of the Distribution.

(b) There is no plan or intention to liquidate Holding.

(c) Holding is not a personal holding company as defined in § 542.

(d) Holding has only one class of stock outstanding, that being common stock.

(e) All dealings between Holding and Bank are at arm's length.

(f) No stock will be redeemed in connection with the Distribution.

(g) Holding has not acquired any assets in a transaction to which § 381 applies.

(h) There was no plan or intention to make the Distribution at the time of the organization of Holding.

Section 4975(c)(1)(B) 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. However, under §§ 4975(d)(3)(A) and (B) a loan to a leveraged ESOP generally is exempt from the prohibitions provided in § 4975(c) and the excise taxes imposed by §§ 4975(a) and (b) 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 of qualifying employer securities.

Section 54.4975-7(b)(1)(iii) provides that an exempt loan must satisfy the requirements of § 54.4975-7(b).

Section 54.4975-7(b)(4) provides, in pertinent part, that the proceeds of an exempt loan must be used within a reasonable time after their receipt by the borrowing ESOP to acquire qualifying employer securities.

242

Section 54.4975-7(b)(5) provides, in pertinent part, that an exempt loan must be without recourse against the ESOP. Furthermore, qualifying employer securities acquired with the proceeds of the exempt loan are assets of the ESOP that may be given as collateral on an exempt loan.

In the case at hand, the portion of the return of capital distribution received by the ESOP that is attributable to shares held in the ESOP suspense account will be added to the suspense account and used to purchase additional employer securities. The return of capital distribution received by the ESOP on account of the unallocated shares in the ESOP suspense account is attributable to the proceeds of the loan from the Company to the ESOP since it represents the diminution in value of those shares.

Section 415 provides limitations on the amount of benefits provided and contributions made with respect to a participant under a qualified plan. Section 415(c) limits the "annual addition" by which a participant's account under a defined contribution plan (including a stock bonus plan) may be increased. Section 415(c)(2) defines "annual addition" for any year as the sum of employer contributions, employee contributions and forfeitures allocated for that year.

Section 404(a) provides limitations on the amount of deductions with respect to employer contributions paid to a qualified plan.

In the case at hand, the portion of the return of capital distribution received in the ESOP that is attributable to shares allocated to the ESOP participants' accounts will be added to the participants' accounts. The return of capital distribution received by the ESOP that is added to the accounts of ESOP participants who have allocated shares is not an annual addition for purposes of § 415 because it is not an employer contribution, employee contribution or forfeiture. It is a return of a portion of the value of shares previously allocated to the participants' accounts and previously taken into account for purposes of § 415. The return of capital distribution will result in a decrease in value of the employer securities.

Also, the return of capital distribution received by the ESOP that is attributable both to the shares allocated to the accounts of the ESOP participants and to the shares allocated to the ESOP suspense account is not an employer contribution for purposes of § 404 and is therefore not deductible under § 404. This amount received by the ESOP is a return of a portion of the value of shares previously allocated to the participants' accounts and to the ESOP suspense account.

The return of capital distribution received by the ESOP that is allocated to the suspense account is attributable to the proceeds of the exempt loan and must be invested in qualifying employer securities. This investment must be made within a

reasonable time after receipt of the return of capital distribution by the ESOP, pursuant to § 54.4975-7(b)(4). The taxpayer has estimated that the purchase of employer stock with the return of capital distribution will be made within a period of 120 days. The Company is subject to Rule 10b-18 of the Securities Act of 1934, which restricts daily open market repurchases of stock by a public company to 25 percent of the average daily trading volume over a four week period. This rule will limit the amount of Company stock the ESOP can repurchase per day.

Section 424(h)(1) (previously, § 425(h)(1)) provides the general rule that, if the terms of any option to purchase stock are modified, extended, or renewed, such modification, extension, or renewal is considered as the granting of a new option. With certain exceptions, § 424(h)(3) defines the term "modification" to mean any change in the terms of the option that gives the employee additional benefits under the option.

Section 1.425-1(e)(5)(ii)(b) of the Income Tax Regulations provides that a change in the number or price of the shares of stock subject to an option to reflect a corporate transaction (as defined in § 1.425-1(a)(ii) is not a modification of the option, provided that the excess of the aggregate fair market value (determined immediately after such corporate transaction) of the shares subject to the option immediately after such change over the aggregate new option price of such shares is not more than the excess of the aggregate fair market value of the shares subject to the option immediately before the transaction over the aggregate former option price of such shares, and provided that the option after such change does not give the employee additional benefits which he did not have before such change. The ratio of the option price immediately after the change to the fair market value of the stock subject to the option immediately after the corporate transaction must not be more favorable to the optionee on a share by share comparison than the ratio of the old option price to the fair market value of the stock subject to the option immediately before such transaction. Whether these "spread" and "ratio" tests have been met are factual determinations within the jurisdiction of the District Director.

Under § 1.425-1(a)(1)(ii),the term "corporate transaction" is defined to mean any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any purchase or acquisition of property or stock by any corporation, any separation of a corporation (including a spin-off or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in § 368), or any partial or complete liquidation by a corporation, if such action by such corporation results in a significant number of employees being transferred to a new employer or discharged, or in the creation or severance of a parent-subsidiary relationship.

In Revenue Ruling 71-385, 1971-2 C.B. 215, the Service concluded that a change in the price of outstanding stock options to reflect a decline in the value of a corporation's stock resulting from a spin-off was a change to reflect a "corporate transaction" under then § 425(a). Therefore, the change was not a modification under then § 425(h)(3).

The present case is similar to Rev. Rul. 71-385 in that the proposed return of capital distribution, like a corporate spin-off, will cause a reduction in the market value of Company shares. Thus, as in Rev. Rul. 71-385, we conclude that the proposed adjustment will reflect a "corporate transaction."

Based solely on the information submitted and the representations set forth above, it is held as follows:

(1) The portion of the Distribution from Holding to a shareholder of Holding that is made from the current or accumulated earnings and profits of Holding for the taxable year of the Distribution is a dividend (as defined in § 316) and will be includible in the gross income of the shareholder of Holding (§ 301(c)(1) and 316).

(2) The portion of the Distribution that exceeds the amount of the current or accumulated earnings and profits of Holding for the taxable year of the Distribution is not a dividend, and will be applied against and reduce a shareholder's adjusted basis in the stock of Holding (§§ 301(c)(2)) and 316).

(3) The portion of the Distribution that is not a dividend shall, to the extent that it exceeds a shareholder's adjusted basis in the stock of Holding, be treated as gain to the shareholder from the sale or exchange of property (§ 301(c)(3)).

(4) Because Holding and Bank will not file a consolidated income tax return for the tax year of the Distribution, the earnings and profits of Holding for that tax year will be computed without reference to the operations of Bank, and will not be subject to the provisions of § 1.1502-33.

(5) The portion of the capital distribution received by the ESOP attributable to unallocated shares held by the ESOP may be held as collateral for the ESOP loan and must be used to acquire qualifying employer securities without adversely affecting the status of the ESOP loan as an "exempt loan" within the meaning of § 54.4975-7(b)(1)(iii).

245

(6) To the extent treated as a distribution other than a dividend within the meaning of § 316(a), the capital distribution received by the ESOP will not constitute an employer contribution for the purposes of § 404(a) and therefore will neither be deductible by the Company nor result in an annual addition for purposes of § 415(c)(2).

(7) The ESOP loan will not fail to meet the requirements of § 4975(d)(3) if amounts received by the ESOP in the form of a capital distribution on account of unallocated shares are reinvested in qualifying employer securities (within the meaning of § 4975(e)(7)) within 120 days.

(8) Provided that the "spread" and "ratio" tests are met (with regard to which we express no opinion) we rule that the proposed proportionate option adjustment made to each outstanding ISO to reflect the proposal return of capital to its shareholders will not constitute a "modification, extension, or renewal" of those options, within the meaning of § 424(h)(3), and will not affect their status as ISOs within the meaning of § 422.

No opinion was requested and none is expressed as to the correct amount of the earnings and profits of Holding or Bank. Additionally, we express no opinion about the tax treatment of the Distribution under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the Distribution that are not specifically covered by the above rulings.

This ruling is directed only to the taxpayers on whose behalf it was requested. Section 6110(k)(3) provides that this ruling may not be cited or used as precedent.

Pursuant to a power of attorney on file in this office a copy of this letter is being sent to the taxpayer.

Each affected taxpayer must attach a copy of this letter to that taxpayer's federal income tax returns for the tax year in which the Distribution is consummated.

Sincerely,

Assistant Chief Counsel (Corporate)

By _____
Debra Carlisle
Chief, Branch 5

246