

**Internal Revenue Service**

Department of the Treasury **199951052**

Index No: 402.07-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:  
OF:E:EP:T:3

Date:

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LEGEND:

Company M:

Company N:

• Plan X:

Fund D:

Fund E:

Fund F:

Date G:

Date H:

State Y:

State Z:

Ladies and Gentlemen:

This is in response to the letter dated , submitted by your authorized representative on your behalf, in which you request a letter ruling as to the proper methodology to use in determining the basis of employer securities distributed from a qualified retirement plan. The following facts and representations support your ruling request.

Company M is the parent company of a controlled group of trades or businesses within the meaning of section 414 of the Internal Revenue Code. Company M was founded in 1937 and was originally incorporated in State Y in 1947. Its successor was incorporated in State Z in 1986. Public trading of Company M's common stock commenced on June 19, 1980.

Company M maintains Plan X, a profit-sharing plan, that is intended to comply with the requirements of Code section

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401(a). Plan X's related trust is represented to be tax-exempt under Code section 501(a). Plan X permits participants to make both pre-tax and after-tax contributions and also provides for Company M matching and profit-sharing contributions. Plan X's most recent favorable determination letter is dated March 25, 1996.

Prior to Date G, all participant and Company M contributions to Plan X were initially invested in Fund D of Plan X's trust. On an annual basis, Plan X participants could transfer, within Plan X, a portion of their Fund D interests to one or more Company N mutual funds. Plan X participant account balances invested in Company N funds were valued, and could be transferred between such funds, on a daily basis. Earnings and losses on the Fund D's assets were allocated on a quarterly basis to participant accounts. Cash accounting was applied in valuing the Plan X participant accounts. All distributions from the pre-Date G Plan X were made in cash.

Fund D held a variety of different investments including Company M common stock that had been contributed to Plan X as profit-sharing contributions prior to Date H, 1977. As of Date H, 1977, Fund D had accumulated 8,660 shares of Company M common stock. The stock has split several times since 1977.

Except for the common stock referenced above, all other pre-Date G contributions to Plan X were in the form of cash. The Plan X's trustee never used Plan X assets to purchase Company M stock, and sold such stock on only three occasions. The shares of Company M stock held in Fund D were never earmarked or otherwise allocated to the individual accounts of Plan X participants. The Company M stock was not segregated from the other investments in Fund D.

Effective with Date G, Plan X was amended and restated in its entirety to, among several changes, change the eligibility rules for participant pre-tax and after tax contributions and Company M profit-sharing contributions. Additionally, the Plan X amendment was intended to give participants more flexibility in directing the investment of their accounts.

The amended and restated Plan X eliminates Fund D and gives Plan X participants more choices regarding the investment of their accounts. Participants may now choose from 13 investment funds, including Funds E and F which hold

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Company M stock. Fifty percent of a participant's annual profit-sharing allocation is automatically invested in Fund E or, if the participant is age 55 or older, in Fund F.

Plan X participants may make one transfer per calendar quarter into or out of Fund F. Assets in a participant's account held in Fund E may be transferred to the other Plan X funds after the participant attains age 55. Transfers between the other Plan X funds may be made on a daily basis. Plan X now permits participants to elect to receive distributions of their Company M stock as shares of Company M stock in lieu of cash.

Immediately prior to the initial allocation of shares of Company M stock on Date G, approximately 66 percent of Fund D was invested in Company M common stock. In connection with the elimination of Fund D, on Date G, Plan X made an initial allocation of shares of Company M common stock to the accounts of Plan X participants who had not attained age 55. These initial allocations of shares of Company M stock were in amounts equivalent to the smallest of (a) 30 percent of the value of a participant's aggregate account balance, (b) 100 percent of the value of his or her profit-sharing account, or (c) 66 percent of the participant's interest in Fund D, and were credited to Fund E. Affected Plan X participants then selected the funds in which their remaining account balances would be invested (including Fund F). Plan X participants age 55 and older directed the investment of 100 percent of their account balances.

After the shares of Company M common stock were credited, as described above, to either Fund E or Fund F, the unallocated shares remaining in the Plan X trust were sold and the sale proceeds were invested in the other funds as required by the initial investment elections of Plan X participants. Since Date G, Plan X's trust buys and sells shares of Company M stock only as required by participant investment elections and distribution requests. Company M contributes shares of its common stock representing 50 percent of its annual profit-sharing contribution. All shares of Company M stock held in Plan X's trust are allocated to individual Plan X participant accounts, and each Plan X participant's interest in either Fund E or Fund F is stated as a number of shares.

Based on the above facts and representations, you through your authorized representative, request the following letter ruling:

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That, under Plan X as amended and restated, the basis of previously unallocated shares of Company M common stock that were allocated to Plan X participant accounts on Date G may be determined under the moving average method described in section 1.402(a)-1(b)(2)(ii)(d), using Date G as the "time of distribution so that the basis assigned to any share of Company M stock allocated to a Plan X participant's account on said date will be Plan X's average original cost basis in all shares of Company M common stock held by Plan X on Date G.

With respect to your ruling request, Code section 402 provides that any amount actually distributed to any distributee by any employees' trust described in Code section 401(a) that is exempt from tax under Code section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under Code section 72.

Code section 402(d)(4)(D) provides, in pertinent part, that, with respect to a lump sum distribution, the taxable amount is the amount of the distribution which exceeds the net unrealized appreciation attributable to that part of the distribution consisting of employer securities.

Section 1.402(a)-1(b)(2)(i) of the Income Tax Regulations provides that the amount of net unrealized appreciation in employer securities which are distributed by a trust is the excess of the market value of such securities at the time of distribution over the trust's cost or other basis for such securities.

Section 1.402(a)-1(b)(2)(ii) of the regulations provides that the cost or other basis of a distributed employer security shall be computed in accordance with whichever of the following rules is applicable:

(a) 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;

(b) if as of the close of each taxable year of the trust (or other specified period of time not in excess of 12 consecutive calendar months) the trust allocates among the accounts of participating employees all securities acquired by the trust during the period (exclusive of securities

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unallocated under a plan providing for allocation in whole shares only), the cost or other basis to the trust of any securities allocated as of the close of a particular allocation period shall be the average cost or other basis to the trust of all securities of the same type which were purchased or otherwise acquired by the trust during such allocation period. For purposes of determining the average cost to the trust of securities included in a subsequent allocation period, the actual cost to the trust of the securities unallocated as of the close of a prior allocation period shall be deemed to be the average cost or other basis to the trust of securities of the same type allocated as of the close of such prior allocation period;

(c) In a case where neither (a) nor (b) of this subdivision is applicable, if the trust fund, or a specified portion thereof, is invested exclusively in one particular type of employer security of the employer corporation, and if during the period the distributee participated in the plan none of such securities has been sold except for the purpose of paying benefits under the trust or for the purpose of enabling the trustee to obtain funds with which to exercise rights which have accrued to the trust, the cost or other basis to the trust of all securities distributed to such distributee shall be the total amount credited to the account of such distributee (or such portion thereof as was available for investment in such securities) reduced by the amount available for investment but uninvested on the date of distribution. If at the time of distribution to a particular distributee a portion of the amount credited to his account is forfeited, appropriate adjustment shall be made with respect thereto in determining the cost or other basis to the trust of the securities distributed; and

(d) in all other cases, there shall be used the average cost (or other basis) to the trust of all securities of the employer corporation of the type distributed to the distributee which the trust has on hand at the time of the distribution, or which the trust had on hand on a specified inventory date which date does not precede the date of distribution by more than twelve calendar months. If a distribution includes securities of the employer corporation of more than one type, the average cost (or other basis) to the trust of each type of security distributed shall be determined. The average cost to the trust of securities of the employer corporation on hand on a specified inventory date (or on hand at the time of distribution) shall be computed on the basis of their actual cost, considering the securities most recently purchased to be those on hand, or

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by means of a moving average calculated by subtracting from the total cost of securities on hand immediately preceding a particular sale or distribution an amount computed by multiplying the number of securities sold or distributed by the average cost of all securities on hand preceding such sale or distribution.

As set forth in the analysis below, subparagraph (d) of Regulation Section 1.402(a)1(b)(2)(ii) is the appropriate method for determining Plan X's basis in the shares of Company M common stock allocated on Date G, as none of subparagraphs (a) through (c) applies.

To use the method under subparagraph (a) to determine basis, securities must have been earmarked for the account of a particular participant in Plan X at the time they were purchased or contributed to the plan. Prior to Date G, Plan X never earmarked or otherwise designated any number of shares of Company M common stock to specific Plan X participants. Instead, shares of stock were held in Fund D and earnings or losses on such stock and the other Fund D assets were allocated to participant accounts quarterly. Because the shares of Company M common stock were not earmarked at the time they were contributed to Plan X's trust, subparagraph (a) does not apply for purposes of determining the basis of shares allocated to Plan X participant accounts as of Date G.

Under the method set forth in subparagraph (b), shares of stock must have been allocated within 12 months from the acquisition of such shares by Plan X. Plan X, however, never allocated shares of Company M common stock to particular participant accounts until Date G, which was more than twelve months after the time the stock was acquired by Plan X. Therefore, subparagraph (b) does not apply for purposes of determining the basis of shares allocated to participant accounts as of Date G.

For subparagraph (c) to apply, Fund D or a specified portion thereof must have been invested in one particular type of security of Company M, and the securities must not have been sold except to pay for benefits or to provide liquidity necessary for the trustee to exercise rights under Plan X. The shares of Company M common stock were commingled with other plan assets in Fund D at all times prior to Date G. In addition, such shares were sold on three occasions not solely for the purpose of providing benefits or other rights under the plan. Therefore, subparagraph (c) does not apply for purposes of determining the basis of shares allocated to Participant accounts as of Date G.

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Because none of subparagraphs (a) through (c) applies, subparagraph (d) must apply regarding the initial allocation of shares to Plan X participant accounts as of Date G. Subparagraph (d) states, in pertinent part, that "[I]n all other cases, there shall be used the average cost (or other basis) to the trust" of employer securities owned by the trust at the time of distribution. The basis of previously unallocated shares of Company M common stock may be computed using Date G as if it were a time of distribution to participant accounts.

Thus, with respect to your ruling request, the Service concludes as follows:

That, under Plan X as amended and restated, the basis of previously unallocated shares of Company M common stock that were allocated to Plan X participant accounts on Date G may be determined under the moving average method described in section 1.402(a)-1(b)(2)(ii)(d), using Date G as the "time of distribution" so that the basis assigned to any share of Company M stock allocated to a Plan X participant's account on said date will be Plan X's average original cost basis in all shares of Company M common stock held by Plan X on Date G.

This ruling is directed solely to the taxpayer who requested it. Code section 6110(k)(3) provides that it may not be used or cited by others as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,



Frances V. Sloan  
Chief, Employee Plans  
Technical Branch 3

Enclosures:

Deleted copy of letter ruling  
Form 437

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