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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200317023

SEP 24 2002

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 representative on December 7, 2001, as modified by a letter dated March 1, 2002, concerning the application of section 401(a)(28) of the Internal Revenue Code ("Code") upon the spin-off of an employee stock ownership plan ("ESOP") from a profit sharing plan owning employer securities, and also concerning the allocation of shares of Company A's common stock upon the creation of the ESOP.

Company A was formed in 1959 and became a holding company for several subsidiary corporations in 1962. Company A maintains Plan X for the benefit of its employees and the employees of its subsidiaries. Plan X is a profit sharing plan that meets the qualification requirements of Code section 401(a). Plan X is the result of a merger in 1988 of several profit sharing plans ("Prior Plans") that were originally maintained by some of the corporations which became subsidiaries of Company A. Some of the Prior Plans held employer stock. No stock was acquired by the Prior Plans after the 1960's. When these plans were merged, the resulting Plan X owned stock in all of Company A's subsidiaries, and currently owns stock in six of the nine subsidiaries. The stock comprises approximately half of the total Plan X assets.

Five separate accounts are maintained for participants in Plan X. Four accounts are not participant-directed. Three of those four accounts are invested in Plan X's general fund, which includes the stock in the subsidiaries, while the fourth is invested in stock of Company A. The fifth account offers investment funds for participant self-direction.

Company A is proposing a corporate restructuring in which these six subsidiaries would each become a wholly-owned subsidiary of Company A. Plan X would exchange its stock in each subsidiary for shares of stock in Company A with an equal value. Company A will elect S corporation status prior to the reorganization.

Your authorized representative has represented that the exchange of shares between Plan X and Company A will qualify as a tax-free reorganization under Code section 368(a)(1)(B). As part of the restructuring, Company A will establish an ESOP as described in Code section 4975(e)(7), which will receive the Company A stock owned by Plan X in a transfer from Plan X. The ESOP will provide for an allocated company stock account for each participant to which shares of common stock of Company A transferred to the ESOP will be allocated immediately after the transfer. The remainder of Plan X assets will remain in Plan X. The total of each participant's accounts in the ESOP and in Plan X immediately after the spin-off will equal such account in Plan X immediately before the spin-off. The ESOP will have the same vesting schedule as Plan X, and will preserve the Plan X distribution options.

Your authorized representative has requested rulings to the effect of the following on your behalf:

1. For purposes of Code section 401(a)(28), Company A's stock will be treated as having been acquired on or before December 31, 1986;

2. The ten-year period of participation required to be a qualified participant under Code section 401(a)(28)(B)(iii) will begin upon the spin-off from Plan X to the ESOP, and years of participation in Plan X will not be taken into account for this purpose;

3. The allocation of shares of Company A's common stock to the allocated company stock accounts under the ESOP will not be considered annual additions within the meaning of Code section 415(c);

4. Shares of Company A's common stock allocated to the allocated company stock accounts under the ESOP will not violate Code section 4975(e)(7), will satisfy section 1.401-1(b)(ii) of the Income Tax Regulations, and will be considered allocated shares for purposes of determining if the ESOP meets the requirements of Code section 409(e);

5. A qualified election period within the meaning of Code section 401(a)(28)(B)(iv) will begin no earlier than the effective date of the employee stock ownership plan; and

6. The basis of Company A's common stock, determined in accordance with section 1.402(a)-1(b)(2)(ii) of the regulations, will not be affected by the transfer from Plan X to the ESOP.

With respect to your first, second, and fifth requested rulings, Code section 401(a)(28)(A) provides in general that in the case of a trust which is part of an ESOP (within the meaning of section 4975(e)(7)) or a plan which meets the requirements of section 409(a), such trust shall not

constitute a qualified trust under section 401(a) unless such plan meets the requirements of 401(a)(28)(B) and (C).

Code section 401(a)(28)(B) generally provides that each "qualified participant" must be given the opportunity to elect within 90 days after the close of each plan year in the qualified election period (as defined in section 401(a)(28)(iv)) to direct the plan as to the investment of certain designated percentages of the participant's account balance. Section 401(a)(28)(B)(iii) states that, for purposes of this subparagraph, the term "qualified participant" means any employee who has completed at least 10 years of participation under the plan and has attained age 55. Section 401(a)(28)(B)(iv) states in relevant part that, for purposes of this subparagraph, the term "qualified election period" means the 6-plan-year period beginning with the later of (I) the first plan year in which the individual first became a qualified participant, or (II) the first plan year beginning after December 31, 1986.

H. R. Rep. No. 100-795, 100th Cong., 2nd Session 1, 196 (1988), which was followed by the Conference Report, states that, for purposes of the 10-year rule, participation in a predecessor plan is taken into account.

Pursuant to section 1175(a)(1) of Public Law 99-514, Code section 401(a)(28) is effective for stock acquired after December 31, 1986.

Notice 88-56, 1988-1 C.B. 540, Q & A-1, states that employer securities acquired by or contributed to an ESOP or a tax credit ESOP after December 31, 1986, are subject to the diversification of investments requirement of Code section 401(a)(28). Q & A-1 further notes that employer securities acquired by or contributed to an ESOP on or before December 31, 1986, are not subject to the diversification requirements, with certain exceptions for de minimis amounts of employer securities. Q & A-3 describes several circumstances in which employer securities acquired by an ESOP or tax credit ESOP after December 31, 1986, are treated as acquired by or contributed to the ESOP or tax credit ESOP on or before December 31, 1986. In one of these circumstances, cash or other assets derived from the disposition of employer securities pursuant to a corporate reorganization or acquisition attempt (whether or not successful) which are used to purchase other employer securities will be treated as acquired by or contributed to the ESOP on or before December 31, 1986, if certain requirements concerning the period of time until reinvestment are met.

In the present case, the ESOP will be established after December 31, 1986. The ESOP will receive employer securities, which were acquired by other plans prior to December 31, 1986, but those plans were not employee stock ownership plans as described in Code section 4975(e)(7). The reorganization in the present case does not satisfy the requirements of Q & A-3 because the employer securities were not held by an ESOP on or before December 31, 1986.

Therefore, in accordance with Notice 88-56, Q & A-1 and Q & A-3, we conclude with respect to your first requested ruling that Company A's stock will not be treated as having been acquired on or before December 31, 1986, and thus will be subject to the diversification requirements of Code section 401(a)(28).

With respect to your second requested ruling, years of participation in a predecessor plan are considered in determining whether a participant in the ESOP meets the requirements of Code section 401(a)(28)(B)(iii). Therefore, we conclude that the ten-year period of participation required to be a qualified participant under Code section 401(a)(28)(B)(iii) will begin upon the date that an employee became a participant in Plan X or a Prior Plan, and years of participation in Plan X or a Prior Plan will be taken into account for this purpose.

With respect to your fifth requested ruling, in accordance with subparagraphs (A) and (B) of Code section 401(a)(28), a qualified election period in an ESOP with respect to a qualified participant cannot commence earlier than the qualified participant's date of participation in that ESOP. Therefore, we conclude that a qualified election period within the meaning of Code section 401(a)(28)(B)(iv) will begin no earlier than the effective date of the employee stock ownership plan.

With respect to your third requested ruling, Code section 415(c)(1) states that contributions and other additions with respect to a participant exceed the limitation of this subsection if, when expressed as an annual addition (within the meaning of paragraph (2)) to the participant's account, such annual addition is greater than the lesser of $40,000 or 100 percent of the participant's compensation.

Code section 415(c)(2) provides that for purposes of paragraph (1), the term "annual addition" means the sum for any year of employer contributions, employee contributions, and forfeitures, with certain modifications not relevant to the present case.

Section 1.415-6(b)(2) of the Income Tax Regulations states that the term "annual additions" includes employer contributions which are made under the plan. Furthermore, the Commissioner may in an appropriate case, considering all of the facts and circumstances treat transactions between the plan and the employer or certain allocations to participants' accounts as giving rise to annual additions.

Section 1.415-6(b)(2)(iv) of the regulations provides that the transfer of funds from one qualified plan to another will not be considered an annual addition for the limitation year in which the transfer occurs.

In the present case, Company A stock owned by Plan X will be transferred directly to an ESOP. Since the transfer is from one qualified plan to another, we conclude with respect to your third requested ruling that the allocation of shares of Company A's common stock to the allocated company stock accounts under the ESOP will not be considered annual additions within the meaning of Code section 415(c).

With respect to your fourth requested ruling, section 6.02(1) of Revenue Procedure 2001-4, 2001-1 I.R.B. 121, states that the Employee Plans Technical Office issues letter rulings involving the Code sections specified therein, which do not include Code section 401. Section 6.02(8) of Revenue Procedure 2001-4 states that the Employee Plans Technical Office issues letter rulings involving, with respect to employee stock ownership plans and tax credit employee stock ownership plans, sections 409(l), 409(m), and 4975(d)(3). Section 6.02(8) further states that

other subsections of sections 409 and 4975(e)(7) involve qualification issues within the jurisdiction of Employee Plans Determinations. Section 6.03 states that the Employee Plans Technical Office ordinarily will not issue letter rulings on matters involving a plan's qualified status under sections 401 through 420 and section 4975(e)(7). These matters are generally handled by the Employee Plans Determinations program as provided currently in Revenue Procedure 2002-6, 2002-1 I.R.B. 127 and in other revenue procedures listed in section 6.03.

Therefore, in accordance with sections 6.02(1), 6.02(8), and 6.03 of Revenue Procedure 2001-4, we are unable to respond to your fourth requested ruling.

With respect to your sixth requested ruling, 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 four rules set forth therein is applicable.

Revenue Ruling 67-213, 1967-2 C.B. 149, involves the transfer of funds directly from the trust forming part of a qualified pension plan to the trust forming part of a qualified stock bonus plan. The revenue ruling provides, in part, that if a participant's interest in a qualified plan is transferred from the trust forming part of that plan to the trust forming part of another qualified plan without being made available to the participant, no taxable income will be recognized by reason of such transfer.

In Revenue Ruling 80-138, the transfer of employer securities from a qualified plan maintained by a parent to a qualified plan maintained by a subsidiary did not change the basis in the securities for purposes of computing net unrealized appreciation, because the transfer, in which no amounts were distributed or made available to the subsidiary's employees, was not a taxable event. In the present case, the transfer of shares from Plan X to the ESOP is similar to the transfer of employer securities in Revenue Ruling 80-138 because no amounts are being distributed to participants. Since there is no taxable event the basis in the securities transferred remains unchanged.

Therefore, with respect to your sixth requested ruling, we conclude that the basis of Company A's common stock, determined in accordance with section 1.402(a)-1(b)(2)(ii) of the regulations, will not be affected by the transfer from Plan X to the ESOP.

This ruling is based on the assumption that Plan X and the ESOP are qualified under Code section 401(a) at all times relevant to the transaction described herein and that the ESOP is an

ESOP as described in section 4975(e)(7). This ruling is also based on the assumption that the proposed transfer of assets from Plan X to the ESOP will meet the requirements of section 414(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 letter has been sent to your authorized representative in accordance with a power of attorney on file with this office.

If you have any questions, please contact

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Branch 3
Tax Exempt and Government Entities Division

Enclosures
Notice 437
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cc: