

Internal Revenue Service 200634059

Uniform Issue List: 402.07-00

MAY 19 2006

Legend:

Company A =  
Company B =  
Plan X =  
Plan Y =  
Plan Z =

SE:TEP:RA:T3

Dear :

This is in response to correspondence dated June 3, 2004, as supplemented by correspondence and communications dated August 27 and December 9, 2004, and November 4, 2005, in which you requested a letter ruling regarding the taxability of certain distributions from Plan X. A conference was held on November 30, 2004.

The following facts and representations have been submitted under penalty of perjury in support of the ruling requested:

Company A is a wholly-owned subsidiary of Company B. On October 1, 1980, Company A adopted the predecessor of Plan Y and amended and restated it as Plan Y, a profit-sharing plan, effective October 1, 1987. Plan Y was amended and restated February 15, 1996. A salary deferral feature, as described in section 401(k) of the Internal Revenue Code (Code), was added to Plan Y effective October 1, 1991. In addition, Company A also adopted Plan Z, an employee stock ownership plan (ESOP) effective October 1, 1990. Plan Z was amended and restated effective February 15, 1996.

On July 16, 1997, Plan Y was merged into Plan Z, which was the surviving plan. The combined plan was renamed Plan X. At the time of the merger, an employer matching contribution feature was added to the salary deferral/profit-sharing portion of Plan X. Since 1997, Plan X has been amended for both plan design changes and changes in the law.

Plan X is a combined ESOP and cash or deferred arrangement plan described in section 401(k) of the Code. Plan X satisfies the ESOP requirements of sections 409 and 4975(e), the cash or deferred arrangement provisions of section 401(k), and the

matching contribution requirements of section 401(m) of the Code. Plan X is a qualified plan under section 401(a) of the Code.

Although Plan Y and Plan Z were merged to become a combined plan, Plan X continues to separately account for benefits in an ESOP component (ESOP Accounts) and a 401(k) component (401(k) Accounts). Participants in Plan X can have as many as seven sub-accounts within Plan X; there is a maximum of three sub-accounts permitted within the ESOP Accounts and a maximum of four sub-accounts permitted within the 401(k) Accounts.

A participant's interest in the ESOP Accounts of Plan X is accounted for entirely within the "Participant's ESOP Account", which is a defined account in Plan X. A Participant's ESOP Account may be composed of the following: 1) "Participant's Company Stock Account", 2) "Participant's ESOP Investment Account", and 3) "Participant's Qualified Directed Investment Account". The Participant's Company Stock Account is composed solely of shares of Company B stock. The assets of the Participant's ESOP Investment Account represent the proceeds of two underwritten stock offerings, one by Plan Z on July 1, 1997, just prior to its merger with Plan Y, and the other by Plan X and Company A on January 25, 2000, whereby Plan X and Plan Z participants, as the case may be, were permitted to direct the Plan X and Plan Z trustee, as the case may be, to sell a portion of their vested employer securities (Company A stock at the time) and then self-direct the investment of the proceeds among a diversified selection of mutual funds. The Participant's Qualified Directed Investment Account exists only for a participant who has attained age 55 and who has completed ten or more years of participation in Plan X. This account holds the diversification proceeds that would result if a qualified participant elected to diversify 25 or 50 percent of the employer securities in such Participant's Company Stock Account.

A participant's interest in the 401(k) Accounts of Plan X could include the following: 1) "Participant's Profit Sharing Account", 2) "Participant's Deferral Account", 3) "Participant's Matching Account", and 4) "Participant's Rollover Account". The Participant's Profit Sharing Account includes discretionary, profit-sharing contributions made by Company A and Company B. A Participant's Deferral Account includes only elective deferral contributions made by the participant. A Participant's Matching Account includes matching contributions made in cash pursuant to a matching formula. A Participant's Rollover Account includes amounts rolled over into Plan X by a participant from his or her former employer's qualified retirement plans. All of these accounts are participant self-directed and invested among a diversified group of mutual funds made available to all participants.

The distribution provisions of Plan Y and Plan Z prior to their merger and the distribution provisions of the sub-accounts under the ESOP Accounts and the 401(k) Accounts under Plan X were and are different and have been different since 1996. The sub-accounts under the 401(k) Accounts are distributable on account of retirement, death, disability, or termination of employment as soon as administratively practicable after the event giving rise to the distribution. In addition, a participant may take an in-service distribution of the vested portion of these sub-accounts upon attainment of age 59 ½.

With respect to the sub-accounts under the ESOP Accounts, in the event a participant meets the definition of "normal retirement" in Plan X (defined as the attainment of age 65 with five or more years of participation, the attainment of age 55 with seven or more

years of service, or the date the combination of the participant's age plus years of service equals or exceeds 70), dies, or becomes disabled, the participant or his beneficiary is entitled to a distribution as soon as administratively practicable after the event giving rise to the distribution. The distribution of amounts in the sub-accounts under the ESOP Accounts may be taken in a single sum or in installments.

In the event a participant incurs an ordinary termination of employment, Plan X previously provided that the distribution of the participant's sub-accounts under the ESOP Accounts generally would be delayed until the last day (September 30) of the fifth plan year after the employee's separation from service, and then paid either in a single sum or installments. However, if the value of the vested portion of the participant's sub-accounts under the ESOP Accounts is less than \$50,000 as of the date of separation from service, a participant may request a lump sum distribution immediately after the separation from service.

Effective September 30, 2003, the distribution provisions for a participant's sub-accounts under the ESOP Accounts pertaining to an ordinary termination of employment were amended and now 1) a participant who terminated employment with Company A on or before September 30, 1998 could receive a distribution of the participant's sub-accounts under the ESOP Accounts, including employer securities, on or after September 30, 2003, 2) a participant who terminated employment with Company A from October 1, 1998 to September 30, 2003 may receive a distribution of the participant's sub-accounts under the ESOP Accounts on or after September 30, 2004, and 3) a participant who terminated employment with Company A on or after October 1, 2003, may receive a distribution of the participant's sub-accounts under the ESOP Accounts on or after the one-year anniversary of his or her date of termination of employment.

One final distribution option is available only for the employer securities in the Participant's Company Stock Account. Plan X provides that a participant (but not a former or terminated participant) with at least five years of service may request once each plan year an in-service distribution of up to ten percent of the shares of Company B stock in the Participant's Company Stock Account. For participants with less than five years of service, the percentage is five percent, and the shares of employer securities to be distributed must have been actually allocated to the Participant's Company Stock Account at least two years prior to the distribution. These in-service distribution provisions also are available to an alternate payee.

There is one current employee, two former employees, and an alternate payee who are currently eligible, or soon will be eligible, for distributions of Company B stock from Plan X's Participant's Company Stock Account. The rulings which are being requested concern the tax treatment of net unrealized appreciation under section 402(e)(4)(B) of the Code.

The current employee (Employee A) was hired by Company A on July 10, 1995 and terminated employment on June 7, 2001 as part of a reduction in force. In 2001, Employee A elected to take a distribution of his sub-accounts under the 401(k) Accounts, which included his Participant's Deferral Account and Participant's Matching Account. Due to the delayed distribution provisions of Plan X, Employee A was not permitted in June 2001 to also take a distribution of the shares of Company B stock in his Participant's Company Stock Account and the mutual funds in his Participant's ESOP Investment Account. On July 8, 2002, Employee A was rehired by Company A. His

Participant's Company Stock Account and Participant's ESOP Investment Account were, and still are, in Plan X and now are subject to a new distribution restriction that the sub-accounts under the ESOP Accounts cannot be distributed until one year after an ordinary termination of employment. Employee A will terminate employment with Company A by December 31, 2006, and will be eligible to withdraw the entirety of his Participant's ESOP Account (including the employer securities in his Participant's Company Stock Account) on or after the one-year anniversary of his date of termination. Employee A intends to withdraw the entirety of his Participant's ESOP Account on or within three months after the one-year anniversary of his date of termination.

The first former employee (Employee B) was hired by Company A on April 27, 1992 and terminated employment on May 3, 1999. On January 22, 2002, Employee B elected to take a distribution of his Participant's Deferral Account, Participant's Matching Account, and Participant's Profit Sharing Account. Due to the delayed distribution provisions of Plan X, Employee B was not permitted to take a distribution of the shares of Company B stock in his Participant's Company Stock Account and the mutual funds in his Participant's ESOP Investment Account. With the modification of the distribution rules for the sub-accounts under the ESOP Accounts, Employee B is now eligible to withdraw the entire amount from his Participant's ESOP Account, including the employer securities in his Participant's Company Stock Account.

The other former employee (Employee C) was hired on August 28, 1995 and terminated employment on December 30, 2001. On September 30, 1999, Employee C took a plan loan from Plan X. The loan amount exceeded the amount of the Participant's Deferral Account, Participant's Matching Account, and Participant's Profit Sharing Account at the time of the plan loan. Under the terms of Plan X, the loan became due and payable on Employee C's effective date of termination of employment and a Form 1099R was issued in 2002. Since Employee C was unable to repay the loan, the loan went into default, her Participant's ESOP Investment Account was offset by the amount of the loan, and she incurred a distribution in 2002 equal to the amount of the defaulted loan. With the modification of the distribution rules for the sub-accounts under the ESOP Accounts, Employee C is now eligible to withdraw the entire amount remaining in her Participant's ESOP Account, including the employer securities in her Participant's Company Stock Account.

The alternate payee (Alternate Payee D) was divorced from a current employee (Employee E) on September 4, 2001 and pursuant to a Qualified Domestic Relations Order (QDRO) was allocated 50 percent of Employee E's total account in Plan X. That allocation included a 50 percent allocation from each Plan X sub-account, including Employee E's Participant's Company Stock Account. Plan X does not permit an alternate payee to take an early distribution, but the QDRO required a distribution on or after the date on which Employee E attained his earliest retirement age, as defined in section 414(p)(4)(B) of the Code. Employee E remains employed by Company A and Company B, but he attained the defined earliest retirement age on March 27, 2004, so Alternate Payee D is entitled to a distribution. However, Employee E is currently not entitled to a lump sum distribution of his total account balance in Plan X because he remains employed by Companies A and B and is under age 59 ½.

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

1. With respect to a Plan X distribution to Employee A on or within three months after the one-year anniversary of his date of termination of employment with Company A, provided Employee A receives a lump sum distribution of his Participant's ESOP Account (which is comprised of his Participant's Company Stock Account and Participant's ESOP Investment Account) within one taxable year on account of his second separation from service with Company A, Employee A will be entitled to net unrealized appreciation treatment under section 402(e)(4)(B) of the Code with respect to the distribution of Company B securities. Net unrealized appreciation treatment is available to Employee A despite the fact that Employee A received a distribution of his Plan X Participant's Deferral Account and Participant's Matching Account after his first separation from service with Company A.
2. With respect to a distribution to Employee B no later than March 31, 2007, provided Employee B receives a lump sum distribution of his Participant's ESOP Account (which is comprised of his Participant's Company Stock Account and Participant's ESOP Investment Account) within one taxable year on account of his separation from service with Company A, Employee B will be entitled to net unrealized appreciation treatment under section 402(e)(4)(B) of the Code with respect to the distribution of Company B securities. Net unrealized appreciation treatment is available to Employee B despite the fact that Employee B received a distribution of his Participant's Deferral Account, Participant's Matching Account, and Participant's Profit Sharing Account in 2002, and will not receive a distribution of his Participant's ESOP Account until a date that is after September 30, 2004, due to the delayed distribution provisions of Plan X regarding the sub-accounts under the ESOP Accounts.
3. With respect to a distribution to Employee C no later than March 31, 2007, provided Employee C receives a lump sum distribution of her Participant's ESOP Account (which is comprised of her Participant's Company Stock Account and Participant's ESOP Investment Account) within one taxable year on account of her separation from service with Company A, Employee C will be entitled to net unrealized appreciation treatment under section 402(e)(4)(B) of the Code with respect to the distribution of Company B securities. Net unrealized appreciation treatment is available to Employee C on account of her separation from service despite the fact that Employee C received a distribution from her Participant's ESOP Investment Account in a prior taxable year because her plan loan, which was due and payable upon termination of employment, was not repaid and was therefore defaulted and offset from her Participant's ESOP Investment Account.
4. With respect to a distribution to Alternate Payee D no later than March 31, 2007, provided Alternate Payee D receives a lump sum distribution within one taxable year of her portion of Employee E's Participant's ESOP Account, including his Participant's Company Stock Account, that was allocated and assigned to her pursuant to a QDRO, Alternate Payee D will be entitled to net unrealized appreciation treatment under section 402(e)(4)(B) and (D)(vii) of the Code. Net unrealized appreciation treatment is available to Alternate Payee D despite the fact that her former spouse remains employed by Company A and Company B and currently is not eligible for a lump sum distribution on account of death, attainment of age 59 ½, separation from service, or disability (within the meaning of section 72(m)(7) of the Code).

Section 402(a) of the Code provides that, except as otherwise provided in this section, any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72.

Section 402(e)(4)(A) of the Code provides that in the case of a distribution other than a lump sum distribution, the amount actually distributed to any distributee from a trust described in section 401(a) shall not include any net unrealized appreciation in employer securities attributable to amounts contributed by the employee.

Section 402(e)(4)(B) of the Code provides that in the case of any lump sum distribution which includes employer securities, there shall be excluded from gross income the net unrealized appreciation attributable to that part of the distribution which consists of employer securities.

Section 1.402(a)-1(b)(1)(ii) of the Income Tax Regulations provides that securities of the employer corporation include securities of a parent or subsidiary corporation of the employer corporation.

Section 402(e)(4)(D)(i) of the Code defines the term "lump sum distribution", in part, as a distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient on account of the employee's death, after the employee attains age 59  $\frac{1}{2}$ , on account of the employee's separation from service, or after the employee has become disabled, from a trust which forms a part of a plan described in section 401(a) and which is exempt from tax under section 501.

Section 402(e)(4)(D)(ii) of the Code provides for the aggregation of certain trusts and plans in determining the amount of a lump sum distribution. That section provides, in pertinent part, that for purposes of determining the balance to the credit of an employee all trusts which are part of a plan shall be treated as a single trust, all pension plans maintained by the employer shall be treated as a single plan, all profit-sharing plans maintained by the employer shall be treated as a single plan, and all stock bonus plans maintained by the employer shall be treated as a single plan.

With respect to ruling request one, a specific triggering event, such as separation from service, must occur before a distribution may be considered to be a lump sum distribution as described in section 402(e)(4)(D) of the Code. A separate triggering event may occur subsequent to a prior lump sum distribution which could permit a subsequent payment to be a lump sum distribution as described in section 402(e)(4)(D) of the Code. In this instance, Employee A's second separation from service would be considered a separate triggering event for purposes of section 402(e)(4)(D). Therefore, such subsequent distribution of the balance to Employee A's credit on account of his second separation from service could be considered to be a lump sum distribution, and the portion of this distribution attributable to the net unrealized appreciation of employer securities could be excluded from gross income.

Accordingly we conclude, with regard to your first ruling request, that with respect to a Plan X distribution to Employee A on or within three months after the one-year anniversary of his date of termination of employment with Company A, provided Employee A receives a lump sum distribution of his Participant's ESOP Account (which

is comprised of his Participant's Company Stock Account and Participant's ESOP Investment Account) within one taxable year on account of his second separation from service with Company A, which will be no later than December 31, 2006, Employee A will be entitled to net unrealized appreciation treatment under section 402(e)(4)(B) of the Code with respect to the distribution of Company B securities. Net unrealized appreciation treatment is available to Employee A despite the fact that Employee A received a distribution of his Plan X Participant's Deferral Account and Participant's Matching Account after his first separation from service with Company A.

With respect to ruling request two, section 402(e)(4)(D)(i) of the Code provides the definition of a lump sum distribution, in part, as a distribution within one taxable year of the recipient of the balance to the credit of an employee. Section 402(e)(4)(D)(ii) provides for the aggregation of certain trusts and plans to determine the balance to the credit of an employee. Benefit payments from the ESOP sub-accounts of Plan X constitute distributions from Plan X which must be aggregated with distributions from the 401(k) sub-accounts of Plan X (including amounts transferred from the separate accounts in Plan Y) for purposes of determining the balance to the credit of an employee.

In the case of Employee B, due to the delayed distribution provisions of Plan X, he was ineligible to take a distribution from his ESOP Accounts at the time he elected to take a distribution from his 401(k) Accounts. Since the Plan X distribution provisions pertaining to termination of employment were amended, Employee B is now eligible to withdraw the entire balance to his credit from his ESOP Accounts, including the employer securities in his Participant's Company Stock Account, on account of his separation from service.

In this instance, Employee B's separation from service on May 3, 1999 was the triggering event for purposes of section 402(e)(4)(D) of the Code. In 2002, Employee B received a distribution from Plan X on account of separation from service. Any future subsequent distribution of the remaining balance to the credit of Employee B in his Participant's ESOP Account is not distributed within one taxable year of the 2002 payment. Therefore, such distribution will not be a lump sum distribution and, therefore, the portion of this distribution attributable to the net unrealized appreciation of employer securities cannot be excluded from gross income.

Accordingly we conclude, with regard to your second ruling request, that with respect to a distribution to Employee B of his Participant's ESOP Account (which is comprised of his Participant's Company Stock Account and Participant's ESOP Investment Account) within one taxable year, Employee B will not be entitled to net unrealized appreciation treatment under section 402(e)(4)(B) of the Code with respect to the distribution of Company B securities. Net unrealized appreciation treatment is not available to Employee B since Employee B received a distribution of his Participant's Deferral Account, Participant's Matching Account, and Participant's Profit Sharing Account in 2002, and will not receive a distribution of his Participant's ESOP Account until a date that is after September 30, 2004, due to the delayed distribution provisions of Plan X regarding the sub-accounts under the ESOP Accounts.

With respect to ruling request three, section 402(e)(4)(D) of the Code provides the definition of a lump sum distribution. Specifically, section 402(e)(4)(D)(i) states, in pertinent part, that the term "lump sum distribution" means the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient on account of the employee's separation from service.

Section 1.72(p)-1, Q & A-13(b) of the Income Tax Regulations provides that in the event of a plan loan offset, the amount of the account balance that is offset against the loan is an actual distribution for purposes of the Code, not a deemed distribution under section 72(p) of the Code.

A distribution of a plan loan offset amount is a distribution that occurs when, under the plan terms governing a plan loan, the participant's accrued benefit is reduced (offset) in order to repay the loan. A distribution of a plan loan offset amount can occur in a variety of circumstances, for example, where the terms governing a plan loan require that, in the event of the employee's termination of employment, the loan be repaid immediately or treated as in default.

In the case of Employee C, separation from service occurred on December 30, 2001. It was at that point that the balance to the credit which became payable on account of her separation from service was determined. Under the terms of Plan X, the plan loan became due and payable on the termination date and her Plan X accrued benefits were reduced to repay the loan. Since the loan went into default and Employee C's Participant's ESOP Investment Account was used to pay off the loan, the use of a portion of Employee C's balance to the credit in her Plan X Participant's ESOP Investment Account is a distribution in 2002, which negates her ability to receive a lump sum distribution from Plan X on account of her December 30, 2001 separation from service in a subsequent tax year. Since she did not receive the balance to her credit from Plan X within one taxable year, she did not receive a lump sum distribution as described in section 402(e)(4)(D) of the Code. Since she did not receive a lump sum distribution, the rules of section 402(e)(4)(B) of the Code, which provide that in the case of any lump sum distribution which includes employer securities, there shall be excluded from gross income the net unrealized appreciation attributable to that part of the distribution which consists of employer securities, do not apply.

Accordingly we conclude, with regard to your third ruling request, that with respect to a Plan X distribution to Employee C, any distribution from her Participant's ESOP Account (which is comprised of her Participant's Company Stock Account and Participant's ESOP Investment Account) will not be entitled to net unrealized appreciation treatment under section 402(e)(4)(B) of the Code with respect to the distribution of Company B securities. Net unrealized appreciation treatment is not available to Employee C on account of her separation from service since Employee C received a distribution from her Participant's ESOP Investment Account in a prior taxable year because her plan loan, which was due and payable upon termination of employment, was not repaid and was therefore defaulted and offset by accrued benefits from her Participant's ESOP Investment Account.

With respect to ruling request four, section 3.02 of Revenue Procedure 2006-4, 2006-1 I.R.B. 132, provides that a "letter ruling" is a written statement issued to a taxpayer by the Service that interprets and applies the tax laws applicable to employee benefits plans to the taxpayer's specific set of facts. Section 6.02 of Rev. Proc. 2006-4 provides



that in employee plans matters, the Service issues letter rulings involving certain specific issues. Section 8.01 of Rev. Proc. 2006-4 provides that the Service ordinarily will not issue a ruling in certain areas because of the actual nature of the problem involved or because of other reasons. The Service may decline to issue a ruling when appropriate in the interest of sound tax administration or on other grounds whenever warranted by the facts of circumstances of a particular case.

Section 6047(d) of the Code provides that the employer maintaining the plan, or the plan administrator, is required to make returns and reports regarding such plan to the Service, to the participants and beneficiaries of such plan, and to such other persons as the Service may by regulations prescribe.

With regard to your fourth ruling request, Company A's reason in requesting this ruling concerns its reporting obligations to Alternate Payee D. Specifically, the ruling was requested to resolve tax issues of Alternate Payee D, not for reasons which would affect Plan X. Since this ruling affects the alternate payee and not Company A, we cannot issue this ruling to Company A since it is not within the jurisdiction of Rev. Proc. 2006-4 to do so. However, the following general information may be helpful.

Section 402(e)(1) of the Code provides that alternate payees are treated as distributees for purposes of sections 402(a) and 72 of the Code. An alternate payee who is the spouse or former spouse of the participant shall be treated as the distributee of any distribution or payment made to the alternate payee under a qualified domestic relations order, as defined in section 414(p).

Section 402(e)(4)(B) of the Code provides that in the case of any lump sum distribution which includes employer securities, there shall be excluded from gross income the net unrealized appreciation attributable to that part of the distribution which consists of employer securities.

Section 402(e)(4)(D)(i) of the Code states, in pertinent part, that the term "lump sum distribution" means the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient on account of the employee's separation from service.

Section 402(e)(4)(D)(vii) of the Code provides the rules pertaining to lump sum distributions to alternate payees. If any distribution or payment of the balance to the credit of an employee would be treated as a lump sum distribution, then, for purposes of this paragraph, the payment under a qualified domestic relations order (within the meaning of section 414(p)) of the balance to the credit of an alternate payee who is the spouse or former spouse of the employee shall be treated as a lump-sum distribution. For purposes of this clause, the balance to the credit of the alternate payee shall not include any amount payable to the employee.

No opinion is expressed as to the tax treatment of the transaction described herein under the provisions of any other section of either the Code or regulations which may be applicable thereto.

This letter expresses no opinion as to whether Plan X, Plan Y, or Plan Z satisfies the requirements for qualification under section 401(a) of the Code.

This letter 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 as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter ruling has been sent to your authorized representative. If you wish to inquire about this ruling, please contact . Please address all correspondence to  
SE:T:EP:RA:T3.

Sincerely yours,



, Manager

Employee Plans Technical Group 3

Enclosures:

Deleted copy of letter ruling  
Notice of Intention to Disclose