Internal Revenue Service

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August 13, 1999

Company =

State X =

Subsidiary =

Seller A =

Seller B =

Seller C =

X =

Y =

Z =

M =

N =

P =

Q =

R =

We reply to your letter dated March 26, 1999, requesting rulings as to the income tax consequences of a proposed transaction. Additional information was submitted in a letter dated June 25, 1999. The facts submitted for our consideration are summarized below.

Company is a State X corporation that owns all of the outstanding stock of Subsidiary, which is also a State X corporation. Company and Subsidiary file a consolidated tax return using a calendar year and accrual method of accounting. Company has X shares of voting common and Y shares of nonvoting common stock outstanding. Company stock is not publicly traded. Seller A, Seller B, and Seller C are shareholders of Company and executive employees of Subsidiary. Seller A owns M percent of Company voting common stock and N percent of Company nonvoting common stock. Seller B owns M percent of Company voting common stock and P percent of Company nonvoting common stock. Seller C owns Q percent of Company voting common stock and R percent of Company nonvoting common stock.

Seller A, Seller B, and Seller C each proposes to sell some of his Company stock to an Employee Stock Option Plan (the ESOP) to be adopted by Subsidiary. The ESOP will finance the purchase of the stock with proceeds received from an unaffiliated bank loan. Prior to each seller's sale of Company stock to the ESOP, nonvoting shares will be converted to voting shares. Thereafter, each seller will sell Z shares of Company stock to the ESOP.

In connection with the proposed transaction, the taxpayers have made the following representations:

(a) Subsidiary will adopt the ESOP and request a determination letter from the appropriate District Director that the ESOP meets the applicable requirements of § 401(a) of the Internal Revenue Code.

(b) The purchase price of Company stock to be sold to the ESOP will equal the fair market value of the stock.

(c) There is no plan, intention, or understanding by the Company to redeem from the ESOP any of the purchased stock.

(d) The combined beneficial interest in the ESOP of the selling shareholders and all related persons will not exceed 20 percent, based on the following:

(i) The combined covered compensation of the selling shareholders and related persons will not exceed 20 percent of the total covered compensation under the ESOP;

(ii) The total of the account balances (vested and nonvested) of the selling shareholders and related persons will not exceed 20 percent of the total of all employee account balances (vested and nonvested)) in the ESOP; and

(iii) The combined interest (vested and nonvested) of the selling shareholders and related persons in any separately managed fund or account within the ESOP (not taking into account a separately managed fund or account within the ESOP that at no time may be credited with stock of the employer) will not exceed 20 percent of the total net assets in that fund or account.

(e) The restrictions on disposition of the shares of stock to be distributed to employee-participants from the ESOP (other than restrictions imposed by federal or state laws) will be no more onerous than the disposition restrictions on at least a majority of the shares of stock held by other shareholders of the employer. Company stock to be held by the ESOP will be subject to a right of first refusal. For purposes of this representation, any right of first refusal with respect to the stock to be distributed from the ESOP will not be considered a restriction on disposition, if the right of first refusal will:

(i) apply to shares of stock that are not publicly traded (within the meaning of § 54.4975(b)(1)(iv) of the Pension Excise Taxes Regulations) at the time the right is exercised (all of the employer's stock in this case are such non-publicly traded shares);

(ii) be in favor of the ESOP, the employer, or both, in any order of priority;

(iii) not provide for a selling price and other terms that will be less favorable to the seller than the greater of (1) the fair market value of the stock, or (2) the purchase price and other terms offered by a purchaser (other than the employer or the ESOP) making a good faith offer to purchase the stock of the employer; and

(iv) lapse no later than 14 days after the shareholder gives written notice to the holder or holders of the right that an offer by a third party to purchase the stock has been received.

Based solely on the information submitted and on the representations made, we rule as follows:

(1) The sale of shares of Company stock to the ESOP will be treated as a sale of that stock and not as a distribution of property to Seller A, Seller B, or Seller C to which § 301 applies (Rev. Proc. 87-22, 1987-1 C.B. 720).

(2) As provided by § 1001, gain will be realized and recognized by Seller A, Seller B, and Seller C and measured by the difference between the sales price and the adjusted basis of the stock sold as determined under § 1011. Provided § 341 (relating to collapsible corporations) is not applicable and the Company stock is a capital asset in the hands of each of Seller A, Seller B, and Seller C, the gain, if any, will constitute capital gain subject to the provisions and limitations of Subchapter P of Chapter 1 of the Code.

This ruling is predicated on Subsidiary's adoption of the ESOP and receipt of a favorable determination letter from the District Director. We express no opinion regarding the qualification of the ESOP under § 401(a). Further, we express no opinion regarding the tax treatment of the transaction 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 transaction that are not specifically addressed by the above rulings.

The rulings contained in this letter are based upon information and representations submitted by the taxpayers and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Each affected taxpayer must attach a copy of this letter to the federal income tax return for the taxable year in which the transaction covered by this ruling letter is consummated.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayers.

Sincerely yours,
Assistant Chief Counsel (Corporate)
By: Filiz A Serbes
Filiz A. Serbes
Assistant to Chief, Branch 5