



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Uniform Issue List: 401.00-00
402.00-00

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OCT 31 2005

Attention:

Company A =

Company B =

Company C =

Company D =

Case M =

Trust P =

Trustee R =

Trustee S =

Plan X =

Dear:

This is in response to a letter dated September 28, 2004 in which you requested rulings concerning the proper treatment under sections 401(a), 411 and 415 of the Internal Revenue Code of 1986, as amended ("Code"), of litigation settlement proceeds and a damage award when transferred to Plan X, and distributions under sections 402 and 3405(c) of the Code to ESOP participants of amounts attributable to the litigation settlement proceeds and the damage award. Letters dated February 17, 2005, June 9,

2005, July 15, 2005, August 31, 2005, September 7, 2005, and October 5, 2005, supplemented the request.

You have submitted the following facts and representations:

Company B established Plan X, effective January 1, 1993. Plan X is qualified under section 401(a) of the Code and is an Employee Stock Ownership Plan ("ESOP") as described in section 4975(e)(7) of the Code. Plan X was amended and restated effective January 1, [REDACTED]. Trustee R and Trustee S were the original trustees of Plan X ("Individual Trustees"). Trustee R and Trustee S were shareholders, officers and directors of Company B. In a leveraged transaction which closed in March, 1994, Plan X acquired [REDACTED]% of the issued and outstanding shares of Company B stock for \$ [REDACTED] and also purchased additional shares of newly issued Company B stock for \$ [REDACTED]. After these purchases, Plan X owned approximately [REDACTED]% of the outstanding shares of Company B stock for which it had paid \$ [REDACTED].

In [REDACTED], Plan X was terminated. Some participants chose to receive distributions of their account balances in cash either directly or in the form of eligible rollover distributions. All other participants chose to receive distributions of their account balances in Company B stock either directly or in the form of eligible rollover distributions. A final Form 5500, *Annual Return/Report of Employee Benefit Plan*, was filed on October 7, [REDACTED] for [REDACTED]. Also, it is represented that the consent requirements of section 411(a)(11) of the Code were observed with respect to the [REDACTED] liquidation distribution.

In [REDACTED] Company C acquired all the issued and outstanding shares of Company B.

On December 29, [REDACTED] certain named participants sued Trustee R and Trustee S derivatively on behalf of Plan X and its participants. Company C was also named as a defendant in its own right and as successor in interest to Company B (Case M).

The plaintiffs in Case M are all persons, other than Trustee R and Trustee S, who have ever been participants in or beneficiaries of Plan X and who have received a distribution from Plan X at any time, including all such persons who were not active employees of Company B upon the termination of Plan X but who had not had a "one-year break in service" (as defined in Plan X).

The complaint in Case M was filed under Sections 409 and 502(a) of the Employee Retirement Income Security Act of 1974 ("ERISA") and alleges that Trustee R and Trustee S breached their fiduciary duties under section 404 of ERISA by failing to prudently investigate Plan X's initial acquisition of Company B stock and by causing Plan X to engage in a prohibited transaction under ERISA Section 406(a) by paying more than adequate consideration for such stock, resulting in losses to Plan X. The complaint alleges that Company B breached its fiduciary duty by engaging in a

prohibited transaction, and that Company C is liable for Company B's breach, as successor in interest to Company B.

Prior to trial, Company C and the plaintiffs entered into a settlement agreement ("Company C Settlement") pursuant to which Company C, in settlement of all claims against it and Company B, agreed to pay a lump sum amount ("Company C Settlement Damages") into a "Settlement Fund" in the form of a constructive trust. Company A was the successor trustee of the Settlement Fund, and, as noted below, became trustee of Plan X's trust.

In [REDACTED] a bench trial was conducted with respect to the claims not settled in the Company C Settlement. The judge found that Trustee S and Trustee R were liable for breach of their fiduciary duties by causing Plan X to engage in a prohibited transaction by paying more than adequate consideration for the Company B stock. Calculation of the actual value of the Company B stock at the time it was purchased by Plan X was submitted to a Special Master.

The Special Master returned a Report in January [REDACTED] finding that the value of Company B stock purchased by Plan X was \$ [REDACTED]. The amount paid by Plan X for the Company B stock (\$ [REDACTED]) was \$ [REDACTED] in excess of the value determined by the Special Master to be its actual value ("Excess Amount"). It is asserted that, to the extent approved by the Court, the Excess Amount, plus appropriate interest, constituted the presumptive amount of damages suffered by affected Plan X participants/beneficiaries attributable to the breach of fiduciary claims against Trustee R and Trustee S ("Trustee R, Trustee S Damages") and all other named defendants (Hereinafter, the Company C Settlement Damages and the Trustee R, Trustee S Damages are referred to as collectively as "Damages".) In this regard, it is also asserted that the amount of Damages awarded was solely in response to the breach of fiduciary claims against Trustee R, Trustee S, and against Company C (both in its own right and as successor in interest to Company B).

With respect to the damage awards, it was originally contemplated that the Damages would be paid into a Settlement Fund. After payment of costs and legal fees, the Settlement Fund would be transferred to a trust associated with Plan X and then distributed to the plaintiffs in the class in accordance with the terms of Plan X as hereinafter set forth.

On December 1, [REDACTED] a judgment of \$ [REDACTED] was awarded to the plaintiffs, representing the amount paid by Plan X in excess of the fair market value of the shares. Additionally, the court awarded prejudgment interest, in the amount of \$ [REDACTED]. In determining the prejudgment interest on the damage award, the court used the return that would have been earned had the amount awarded been invested in a balanced portfolio consisting of 60 percent stocks and 40 percent bonds using returns available under the Company D Stock Index, and the Company D Bond Index respectively, as measured from the date of purchase of the ESOP shares. It has been represented that

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the \$ [REDACTED] judgment and the \$ [REDACTED] interest represents the full amount of damages and interest received, or to be received, from all defendants.

The above-referenced settlement amount, including interest, has been paid to Company A. Said settlement sum is currently being held for disbursement in Trust P, which is being treated by Company A, as trustee, as a qualified trust associated with Plan X.

Company A, as surrogate for Company B, readopted Plan X for the limited purpose of receiving the Settlement amounts and disbursing to affected participants/beneficiaries amounts attributable to the Damages. The purpose of paying the Settlement Fund into a Trust associated with Plan X is to enable distributions from Plan X to qualify as eligible rollover distributions. The readopted Plan X provides that its participants will be all of the class of plaintiffs in Case M. Plan X, as readopted will be submitted to the Internal Revenue Service for a letter of determination that it meets the requirements of sections 401(a), 409 and 501(a) of the Code.

The Settlement Fund was transferred in cash to Company A as trustee of Plan X to be held under the terms thereof. The assets of Plan X are invested in a security the investment objective of which is the production of income and preservation of principal. Plan X, as readopted, provides that its assets (i.e., the Damages paid into the Settlement Fund and transferred to Plan X's Trust) will be allocated to the accounts of each participant in the ratio that each such participant's respective account balance bears to the total of the account balances of all participants. For purposes of such allocation a participant's account is defined as the vested account balance of such participant on the later of the date such participant terminated employment or on the date of the termination of Plan X. The account balances will not actually be distributed until appropriate notices (such as the Special Tax Notice) have been distributed and election forms have been completed and returned to Company A. Then, Plan X will be terminated and distributions of account balances made to participants. During the period of liquidation, account balances will be adjusted monthly for investment experience.

Based on the forgoing, you request the following rulings:

1. That transfer of the Damages from the Settlement Fund to Plan X's Trust will not adversely affect the qualified status of Plan X under section 401 (a). of the Code.
2. That the proposed manner of allocation of the Settlement Fund, when made, will not adversely affect the qualified status of Plan X under section 401(a) of the Code.
3. That the proposed manner of allocation of the Settlement Fund, when made, will not result in taxable income to ESOP participants under section 402(a) of the Code.

4. That the allocation of the Settlement Fund will be treated as earnings and not annual additions to participant accounts under section 415(c)(2) of the Code.
5. That distributions by Company A of the Settlement Fund will not be subject to the consent requirements of section 411(a)(11) of the Code.
6. That distributions from Plan X of amounts attributable to the Settlement Fund will be eligible rollover distributions within the meaning of sections 402(c)(4) and 3405(c) of the Code.

With respect to your ruling requests, section 401(a) of the Code sets down certain rules governing the qualification of employer sponsored retirement plans. Section 501(a) provides, in relevant part, that an organization described in section 401(a) shall be exempt from taxation under Subtitle A unless such exemption is denied under sections 502 or 503.

Revenue Ruling 2002-45, I. R. B. 2002-29, 116 holds that a "restorative payment" to a defined contribution plan is not a contribution to the plan, and is not taken into account for purposes sections 401(a)(4) or 415(c) of the Code. The Rev. Rul. defines a restorative payment as a payment to a qualified defined contribution plan if the payment is made to restore losses to the plan resulting from actions by a fiduciary for which there is reasonable risk of liability for breach of a fiduciary duty under Title I of the Employee Retirement Income Security Act of 1974, as amended, and plan participants who are similarly situated are treated similarly with respect to the payment.

Section 402(a)(1) of the Code provides that, except as otherwise provided in this section, any amount actually distributed to any distributee by an 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 (relating to annuities).

Section 402(c)(1) of the Code provides that, if an employee transfers any portion of an eligible rollover distribution into an eligible retirement plan, the amount so transferred shall not be includible in income for the taxable year in which paid.

Section 402(c)(4) of the Code provides that an "eligible rollover distribution" is a distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust; except that such term shall not include (A) any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made --- (i) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (ii) for a specified period of 10 years or more; B) any distribution to the extent such distribution is required under section 401(a)(9), and (C) any distribution which is made upon hardship of the employee.

Section 402(c)(8)(B) of the Code defines an eligible retirement plan to include, an individual retirement account described in section 408(a), an individual retirement annuity described in section 408(b); a qualified trust, and an annuity plan described in section 403(a).

Section 402(c)(3) of the Code provides, generally, that section 402(c)(1) shall not apply to any transfer of a distribution made after the 60th day following the day on which the distributee received the property distributed.

Section 402(c) of the Code, by its terms, refers to distributions made from a section 401(a) retirement plan.

Section 3405(c) of the Code provides for the withholding from an eligible rollover distribution an amount equal to 20 percent of such distribution, except in the case of any distribution if the distributee elects under section 401(a)(31) of the Code to have such distribution paid directly to an eligible retirement plan.

Section 411(a)(11) of the Code states that a plan is qualified only if the plan provides that benefits exceeding \$5,000 may not be immediately distributed without the consent of the participant.

The facts of this case indicate that the settlement proceeds, referenced herein, represent amounts that Plan X's trust would have held if the Company B stock purchased during 1994 had been purchased at fair market value. In effect, the settlement proceeds replace funds that were misused in purchasing said stock, and Plan X's obtaining said proceeds places it in the position in which it would have been in the absence of misconduct referenced in Case M and its related settlement. Thus, under the facts of this case, we believe that it is appropriated to treat the settlement proceeds as replacement payments due former Plan X participants.

In this case, in conjunction with Company B's termination of Plan X during calendar year 1997, affected plan participants, referenced above, were entitled to receive amounts due them from Plan X. In this regard, during 1997, Company B was unable to either distribute to affected Plan X participants or transfer, on their behalf, to other tax-favored arrangements (e.g. individual retirement arrangements) the portion of Plan X's assets that consisted of the amounts represented by the settlement proceeds since said amounts were not available to be distributed or transferred until the court action and settlement referenced above.

As a result, affected Plan X participants received, in conjunction with the purported [REDACTED] termination of Plan X, either as distributions or as transferred amounts, less than they were entitled to receive under the provisions of Plan X.

Also, it has been represented that the consent requirements of section 411(a)(11) of the Code were observed with respect to the 1997 liquidation.

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Thus, with respect to your ruling requests, we conclude that the Company A settlement proceeds referred herein to be contributed to the accounts of affected current or former Plan X participants shall be deemed a restorative payment to Plan X. Therefore, with respect to those proceeds, we conclude:


1. That transfer of the damages from the Settlement Fund to Plan X's Trust did not adversely affect the qualified status of Plan X under section 401 (a) of the Code.
2. That the allocation of the Settlement Fund, when made, will not adversely affect the qualified status of Plan X under section 401(a) of the Code.
3. That the allocation of the Settlement Fund to the accounts of affected Plan X participants, when made, will not result in taxable income to ESOP participants under section 402(a) of the Code.
4. That the allocation of the Settlement Fund, currently held in Trust P, to the accounts of affected Plan X participants will not result in annual additions, within the meaning of section 415(c)(2) of the Code, to the accounts of affected Plan X participants.
5. That distributions by Company A of the Settlement Fund will not be subject to the consent requirements of section 411(a)(11) of the Code.
6. That distributions from Plan X to affected participants/beneficiaries; of amounts attributable to the Settlement Fund will be eligible rollover distributions within the meaning of sections 402(c)(4) and 3405(c) of the Code.

No opinion is expressed as to the federal tax consequences of the transaction described above under any other provisions of the Code. Furthermore, no opinion is expressed as to whether the transaction described herein resulted in a failure to comply with any other provision of the Internal Revenue Code or of Title I of ERISA.

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.

If you have any questions concerning this ruling, please contact ***** (ID: **-*****) at (***) ***-**** (not a toll-free number).

Sincerely Yours,


Frances V. Sloan, Manager
Employee Plans Technical Group 3

Enclosures:
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