

## Internal Revenue Service

Department of the Treasury

Number: **200122034**  
Release Date: 6/1/2001  
Index Number: 1362.02-02

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:Br.1-PLR-109213-00

Date:

February 28, 2001

### Legend:

Company =

ESOP =

Trust =

State =

Year1 =

Year2 =

D1 =

This letter responds to your representative's letter, dated April 24, 2000, together with subsequent correspondence, submitted on behalf of Company, requesting a ruling that Company's subchapter S election will not terminate under the circumstances described below.

### FACTS

According to the information submitted, Company, a State corporation, established the ESOP, an employee stock ownership plan, in Year1. Pursuant to the terms of the ESOP, Company established Trust to hold Company stock. By the end of Year2, Trust had acquired all of the outstanding stock of Company. On D1, Company elected to be treated as a subchapter S corporation.

The terms of the ESOP provide that distributions can be made to plan participants in the form of cash or Company stock, but that as long as Company has a subchapter S election in effect, Company must immediately repurchase any distributed

PLR-109213-00

stock. The terms of the ESOP also provide that every participant who receives a distribution can direct that the distribution be paid directly to an Individual Retirement Account (IRA), or to another qualified retirement plan as required under section 401(a)(31) (a “direct rollover”). Alternatively, a participant who receives and sells Company stock to Company generally may, within 60 days, roll the proceeds over to an IRA or qualified retirement plan (an “indirect rollover”).

In either a direct or an indirect rollover, in the case of a stock distribution, a participant or the participant’s IRA or plan custodian or trustee will complete an irrevocable stock transfer form. The irrevocable stock transfer form is prepared specifically for each distributee and identifies the number of shares and the dollar value of these shares to be sold to Company immediately following the distribution from the ESOP. Company prepares a stock certificate and a check for each distributee; the stock certificate is retired once the check is mailed. Because the stock distribution and the repurchase of the stock occur on the same day, the stock certificate never leaves Company’s premises. Company represents that by monitoring the timing of stock distributions from the ESOP, Company can ensure that Company will never have more than 75 shareholders.

Company has requested a ruling that Company’s status as an S corporation will not terminate if the ESOP makes distributions of Company stock, and one or more participants elects to make a direct rollover of the distribution to an IRA, provided that the stock is immediately repurchased by Company using the procedure described above.

## LAW AND ANALYSIS

For tax years beginning after December 31, 1997, section 1361(b)(1)(B) provides that an S corporation may not have as a shareholder a person that is not an estate, a trust described in section 1361(c)(2), an organization described in section 1361(c)(6), or an individual. Rev. Rul. 92-73, 1992-2 C.B. 224, holds that an IRA is not permitted to hold stock in an S corporation.

Section 1361(c)(6) provides that for purposes of section 1361(b)(1)(B), an organization which is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a), may be a shareholder in an S corporation. Under section 1361(c)(6), an employee stock ownership plan is an eligible shareholder of S corporation stock provided that the employee stock ownership plan is described in section 401(a) and is exempt from tax under section 501(a).

Section 401(a)(31) requires a section 401(a) plan to permit participants to elect to have an eligible rollover distribution paid directly to an eligible retirement plan specified by the participant. Section 402(c)(4) provides that the term “eligible rollover distribution” is defined as any distribution to an employee of all or any portion of the

PLR-109213-00

balance credited to his or her account in a qualified trust, except for distributions made in the form of an annuity or in installments over a period of ten years or more. Section 402(c)(8)(B) provides that the term “eligible retirement plan” is defined to include IRAs.

Under section 409(h)(1)(A), an employee stock ownership plan generally is required to make distributions available in the form of employer securities. However, section 409(h)(2) provides, in pertinent part, that an employee stock ownership plan maintained by an S corporation may provide that benefits will be distributed in the form of cash. Alternatively, section 409(h)(2) provides, in pertinent part, that benefits from an S corporation employee stock ownership plan may be distributed in the form of employer securities subject to the requirement that the securities may be sold back to the sponsoring employer under a fair valuation formula.

Employee stock ownership plans, IRAs, and S corporations are all subject to significant qualification rules. As described above, the terms of the ESOP provide that distributions can be made to plan participants in the form of cash or Company stock, but that as long as Company has a subchapter S election in effect, Company must immediately purchase any distributed stock. Distributions of cash and stock both may constitute eligible rollover distributions that qualify for direct and indirect rollovers. Whenever a distribution of stock (subject to immediate repurchase by Company) is rolled over to an IRA, the custodian of the IRA receives the proceeds of the repurchase. Thus, every direct or indirect rollover (whether of stock or of cash) to an IRA results in the custodian of the IRA receiving cash for benefit of the plan participant. In the case of a direct rollover of stock, the momentary designation of the custodian of the IRA as the owner of the stock under the particular facts described above will not cause Company's S election to terminate.

## CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that Company's status as an S corporation will not terminate if the ESOP makes distributions of Company stock, and one or more participants elects to make a direct rollover to an IRA, provided that the stock is immediately repurchased by Company using the procedure described above.

Except as specifically ruled on above, we express no opinion about the Federal tax consequences of any aspect of the above described transaction. Specifically, no opinion is expressed concerning whether the original election made by Company to be treated as an S corporation was a valid election under section 1362, or whether the ESOP constitutes a qualified plan under section 401(a).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

PLR-109213-00

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

Sincerely,  
Matthew Lay  
Assistant to the Branch Chief, Branch 1  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
Copy for section 6110 purposes