Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:3-PLR-146450-01
Date:
January 24, 2002

LEGEND

Company =

Subsidiary =

Shareholders =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Y =

X =

Dear

We received your letter, dated August 27, 2001, submitted on behalf of Company, requesting rulings under sections 1361 and 1362 of the Internal Revenue Code. This responds to your request.

FACTS

Company represents the following facts. Company, a bank holding company, was incorporated on Date 1 under the laws of State. Company, along with other minority shareholders, owned the stock of Subsidiary, a bank. On Date 2, Subsidiary effected a reverse stock split so that Company became the sole shareholder of Subsidiary. In compliance with Federal law, Company then sold X of capital stock of Company to each of Subsidiary's directors on Date 3 for $Y. The directors signed an Agreement regarding their shares of Company stock.

In part, the Agreement restricted the transfer of the shares by the directors to anyone other than Company. The Agreement also provided for the sale back of each director's shares to Company in consideration for $Y upon the director's ceasing to hold the office of director. Finally, the Agreement provided that each director assigned to Company any and all dividends or distributions of whatsoever kind or nature.

On Date 5, Company filed a timely election under section 1362(a) to be treated as an S corporation effective Date 4 and a timely election under section 1361(b)(3)(B) to treat Subsidiary as a qualified subchapter S subsidiary (QSSS) effective Date 4.

In Date 6, Company and its representatives determined that due to the Agreement, Company may have inadvertently created a second class of stock. As a result, Company possibly was not in compliance with section 1361(b)(1)(D). On Date 7, the Agreement was amended and restated to remove the limitation on dividends and

distributions, and to provide for the payment of fair market value to the directors upon their sale of the stock back to Company. The Amended Agreement is now in effect.

Company represents that it did not intend to create more than one class of stock. As soon as Company realized the potential problem caused by the Agreement, it acted to correct the Agreement by creating the Amended Agreement. Company and its Shareholders agree to make any adjustments, consistent with the treatment of Company as an S corporation, as might be required by the Secretary.

Company requests the following rulings: (1) under section 1361(b)(1)(D) of the Internal Revenue Code, the Amended Agreement does not create a second class of stock, (2) under section 1362(f), Company's S corporation election was inadvertently invalid, therefore Company will be treated as an S corporation effective Date 4, and (3) Subsidiary's status as a QSSS is effective Date 4.

LAW AND ANALYSIS

Section 1361(a)(1) provides that, for purposes of the Code, the term "S corporation" means, with respect to any tax year, a small business corporation for which an election under section 1362(a) is in effect for the year.

Section 1361(b)(1)(D) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, have more than one class of stock.

Section 1.1361-1(l)(1) provides that, a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the "governing provisions"). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement. Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1.1361-1(l)(2)(iii)(A) provides that buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer

identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and section 1.1361-1(l), and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights.

Section 1.1361-1(l)(2)(iii)(B) provides that bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights.

Section 1362(f) provides that if (1) an election under section 1362(a) by any corporation was not effective for the tax year for which made by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, (2) the Secretary determines that the circumstances resulting in the ineffectiveness were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness, steps were taken so that the corporation is a small business corporation or to acquire the required shareholder consents, and (4) the corporation and each person who was a shareholder of the corporation at any time during the period specified pursuant to section 1362(f) agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to that period, then, notwithstanding the circumstances resulting in the ineffectiveness, the corporation shall be treated as an S corporation during the period specified by the Secretary.

The conference report on the Small Business Job Protection Act of 1996, P. L. 104-188, provides that the Service should be reasonable in exercising this authority and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations. H. R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 222 (1996), 1996-3 C.B. 741, 962.

According to the legislative history of section 1362(f)--

> If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.
>
> The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a

> termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenue without undue hardship to taxpayers. For example, . . . it may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

S. Rep. No. 640, 97th Cong., 2d Sess. 12-13 (1982), 1982-2 C.B. 718, 723-24.

Section 1.1362-4(b) of the Income Tax Regulations provides that, for purposes of section 1.1362-4(a), the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

Section 1361(b)(3)(B) defines the term "qualified subchapter S subsidiary" as a domestic corporation that is not an ineligible corporation, if 100 percent of the stock of the corporation is owned by the S corporation, and the S corporation elects to treat the corporation as a QSSS.

CONCLUSION

Based on the facts represented and the information submitted by Company, we conclude that Company's election to be treated as an S corporation was inadvertently invalid within the meaning of section 1362(f) because it had more than one class of stock. We also conclude that the Amended Agreement does not create a second class of stock under section 1361(b)(1)(D). Consequently, we conclude that Company will be treated as an S corporation beginning Date 4 and thereafter, unless Company's S election otherwise terminates under section 1362(d). Moreover, we conclude that because Company's S corporation election is effective as of Date 4, Subsidiary will be treated as a QSSS beginning Date 4 and thereafter, unless Company's S corporation election otherwise terminates under section 1362(d) or Subsidiary fails to meet the requirements of a QSSS under section 1361(b)(3)(B).

This ruling is contingent on Company and its Shareholders treating Company as an S corporation for the period beginning Date 4 and thereafter and on Company treating Subsidiary as a QSSS for the period beginning Date 4 and thereafter. Company and its Shareholders must make any adjustments that are necessary to comply with this ruling.

Except for the specific ruling above, we express or imply no opinion concerning the

federal income tax consequences of the facts of this case under any other provision of the Code, including whether Company or Subsidiary is otherwise eligible to be an S corporation or a QSSS, respectively.

Under power of attorney on file with this office, we are sending a copy of this letter to Company and Company's second authorized representative.

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.

Sincerely,

/s/

Christine Ellison
Branch Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes.

cc: