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Person To Contact:
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Telephone Number:

Refer Reply To:
CC:TEGE:EB:QP3
PLR-131938-17

Date: April 17, 2018

Company A =
Company B =
ESOP A =
State C =

Dear :

This letter is in response to a request for a ruling, submitted on your behalf by your authorized representative on October 6, 2017, and subsequent correspondence dated February 15, 2018 and March 23, 2018, concerning the consequences of a subsidiary corporation's adoption of a parent corporation's employee stock ownership plan (ESOP).

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

Company A is incorporated under the laws of State C and has elected to be taxed as a subchapter S corporation under section 1361 of the Internal Revenue Code (Code).

In , Company A established ESOP A, and it continues to maintain ESOP A for its employees. ESOP A is qualified plan under section 401(a) and an ESOP under section 4975(e)(7). ESOP A holds stock in Company A. To participate in ESOP A, an individual must be an employee of Company A or an employee of an affiliated company that has adopted ESOP A with the consent of Company A's Board of Directors. To date, no affiliated company has been approved for participation in ESOP A. Therefore, the only participants in ESOP A are employees of Company A.

ESOP A is not leveraged. ESOP A requires a participant's benefit to be distributed in the form of cash. As of the date of the ruling request, ESOP A owned approximately % of the stock of Company A.

Company A established Company B as its subsidiary in . Company A is the sole shareholder of Company B. Company B has not submitted an election to be taxed as an S corporation under section 1361, nor has Company A made an election to treat Company B as a qualified subchapter S subsidiary under section 1361(b)(3)(B). Therefore, Company B is taxed as a C corporation.

Company B's operations have been limited and it does not have its own employees. Company B plans to expand its operations and employ its own employees. Company A intends to make the employees of Company B eligible to participate in ESOP A as employees of an affiliated company.

You have represented that neither Company A nor any other member of its controlled group of corporations (as defined in section 409(l)(4)) has any stock that is readily tradable on an established securities market, as defined in § 1.401(a)(35)-1(f)(5)(ii) of the Income Tax Regulations. Company A represents that it has issued only one class of common stock. Company A represents that its common stock has a combination of voting power and dividend rights equal to or in excess of (a) that class of common stock of any member of Company A's controlled group of corporations (under section 409(l)(4)) having the greatest voting power, and (b) that class of common stock of any member of Company A's controlled group of corporations (under section 409(l)(4)) having the greatest dividend rights.

Based on the above facts and representations, Company A requests the following rulings:

1. As to Company B and its employees, Company A stock held by ESOP A will constitute qualifying employer securities within the meaning of sections 4975(e)(8) and 409(l);
2. If Company B adopts ESOP A, ESOP A will continue to satisfy the requirements of section 409(h) if it continues to provide only cash distributions and to preclude participants from electing to receive distributions in Company A stock, because Company A stock will continue to be stock of an S corporation and, as a result, section 409(h)(2)(B) will continue to apply;
3. Company B's adoption of ESOP A will not affect the application of allocation restrictions of section 409(p) because the stock held by ESOP A will continue to be S corporation stock of Company A and the restrictions of section 409(p) apply to S corporation stock held by an ESOP;
4. Company B's adoption of ESOP A, for the benefit of its employees, will not jeopardize the status of ESOP A as an ESOP under section 4975(e)(7); and
5. The exception to the unrelated business taxable income (UBTI) rules of section 512(e)(1) set forth in section 512(e)(3) will continue to apply to ESOP A following Company B's adoption of ESOP A.

Section 4975(e)(7) defines an ESOP as a defined contribution plan which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and which is otherwise defined in regulations prescribed by the Secretary. Section 4975(e)(7) says that a plan shall not be treated as an ESOP unless it meets the requirements of section 409(h), section 409(o), and, if applicable, section 409(n), section 409(p), and section 664(g), and, if the employer has a registration-type class of securities (as defined in section 409(e)(4)), it meets the requirements of section 409(e).

Section 4975(e)(8) defines the term "qualifying employer security" as any employer security within the meaning of section 409(l).

Section 409(h)(1)(A) states that a participant who is entitled to a distribution from the plan has a right to demand that his benefits be distributed in the form of employer securities. For purposes of section 409(h), the term "employer securities" is defined in section 409(l).

Section 409(h)(2)(A) states that a plan which otherwise meets the requirements of this subsection or of section 4975(e)(7) shall not be considered to have failed to meet the requirements of section 401(a) merely because under the plan the benefits may be distributed in cash or in the form of employer securities.

Section 409(h)(2)(B)(i) provides in pertinent part that an "applicable plan" shall not be treated as failing to meet the requirements of this subsection or section 401(a) merely because it does not permit a participant to exercise the right described in paragraph (1)(A) if such plan provides that the participant entitled to a distribution has a right to receive the distribution in cash. Under section 409(h)(2)(B)(ii)(II), an applicable plan includes a plan that is established and maintained by an S corporation.

Section 409(l)(1) generally defines "employer securities" as common stock issued by the employer (or by a corporation which is a member of the same controlled group) which is readily tradable on an established securities market. If there is no readily tradable common stock within the meaning of section 409(l)(1), section 409(l)(2) states that the term "employer securities" means common stock issued by the employer (or by a corporation which is a member of the same controlled group) having a combination of voting power and dividend rights equal to or in excess of (A) that class of common stock of the employer (or of any other such corporation) having the greatest voting power, and (B) that class of common stock of the employer (or of any other such corporation) having the greatest dividend rights.

Section 409(l)(4) defines the term "controlled group of corporations" as having the same meaning as under section 1563(a) (determined without regard to subsections (a)(4) and (e)(3)(C) of section 1563).

Under section 1563(a)(1), one or more corporations will constitute a parent-subsidiary controlled group if stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation is owned by one or more of the other corporations, and the common parent owns at least 80 percent of the total value of shares of all classes of the stock of at least one of the other corporations.

Under section 1361(b)(1)(D), an S corporation may not have more than one class of stock.

Section 409(p) generally states that an ESOP holding employer securities consisting of stock in an S corporation shall provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year (as defined in section 409(p)(3)(A)), accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of section 401(a)) for the benefit of any disqualified person (as defined in section 409(p)(4)(A)).

Section 512(e)(1)(A) and (B) provides that if an organization described in section 1361(c)(2)(A)(vi) or 1361(c)(6) holds stock in an S corporation, such interest shall be treated as an interest in an unrelated trade or business, and notwithstanding any other provision of Part I (General Rule) of Subchapter F (Exempt Organizations), all items of income, loss, or deduction taken into account under section 1366(a), and any gain or loss on the disposition of the stock in the S corporation, shall be taken into account in computing the UBTI of such organization.

Section 1361(c)(6) refers to a qualified trust described in section 401(a) and exempt from taxation under section 501(a) as one of the types of exempt organizations permitted to be a shareholder of an S corporation. Section 1366(a) provides rules for determining the tax of a shareholder of an S corporation.

Section 512(e)(3) provides that section 512(e) does not apply to employer securities (as defined under section 409(l)) held by an ESOP described under section 4975(e)(7).

Company A has represented that neither Company A nor any corporation in its controlled group of corporations as defined in section 409(l)(4) has securities that are readily tradable on an established securities market, as defined in § 1.401(a)(35)-1(f)(5)(ii). Company A, further, has represented that it has issued only one class of common stock. Company A also represents that its common stock has a combination of voting power and dividend rights equal to or in excess of (a) that class of common stock of any member of Company A's controlled group of corporations (under section 409(l)(4)) having the greatest voting power, and (b) that class of common stock of any member of Company A's controlled group of corporations (under section 409(l)(4)) having the greatest dividend rights.

ESOP A holds Company A stock. Company A, as the sole shareholder of Company B, is in the same controlled group of corporations with Company B under section 409(l)(4). Accordingly, with respect to ruling request (1), we conclude that as to Company B and its employees, Company A stock held by ESOP A will constitute employer securities within the meaning of section 409(l)(2) and qualifying employer securities within the meaning of section 4975(e)(8).

With regard to your remaining ruling requests, we have determined that Company A's establishment of Company B, as a wholly owned C corporation subsidiary, does not affect Company A's continued status as an S corporation and the continued status of Company A's stock as stock of an S corporation for purposes of sections 409(h), 409(p), 512(e)(3) and 4975(e)(7).

Accordingly, we conclude that upon Company B's adoption of ESOP A:

2. ESOP A will continue to be an applicable plan under section 409(h)(2)(B)(ii) and not subject to section 409(h)(1)(A);
3. ESOP A will continue to be an ESOP holding employer securities consisting of stock in an S corporation and thus subject to section 409(p);
4. ESOP A will not fail to be an ESOP under section 4975(e)(7) merely because Company B adopts ESOP A; and
5. Section 512(e)(3) will not cease to apply to ESOP A.

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

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the proposed transaction under any other provision of the Code or regulations.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party, as specified in Rev. Proc. 2018-1, § 7.01(16)(b). This office has not verified any of the material submitted in support of the request for ruling, and such material is subject to verification on examination. The Associate office will revoke or modify a letter ruling and apply the revocation retroactively if there has been a misstatement or omission of controlling facts; the facts at the time of the transaction are materially different from the controlling facts on which the ruling was based; or, in the case of a transaction involving a continuing action or series of actions, the controlling facts change during the course of the transaction. See Rev. Proc. 2018-1, § 11.05.

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,

John T. Ricotta
Branch Chief
Qualified Plans Branch 3
(Tax Exempt & Government Entities)