Internal Revenue Service

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Legend

X =

Sub 1 =

Sub 2 =

Sub 3 =

A =

State =

d1 =

d2 =
d3 =

d4 =

d5 =

d6 =

d7 =

$n =

Dear

This letter responds to a letter dated January 31, 2007, and subsequent correspondence, submitted on behalf of X requesting a ruling under § 1361(b)(1)(D) or § 1362(f) of the Internal Revenue Code.

The facts submitted state that X was incorporated on d1 under the laws of State to be a bank holding company. X acquired Sub 1 on d2. X acquired Sub 2 on d3. X caused Sub 1 to form Sub 3 in d4. X filed an election to be an S corporation, effective d5. X also elected to treat its subsidiaries as qualified subchapter S subsidiaries (QSubs) effective d5. Sub 3 merged into Sub 1 on d6 and Sub 2 merged into Sub 1 on d7.

To comply with banking law that requires bank directors to own stock in either the bank or the bank's holding company, A, the majority shareholder sold a share of X's outstanding stock to each director of Sub 1, Sub 2 and Sub 3 for $n (Director's Share). As a condition of sale, each director had to sign an agreement (Director's Agreement) stating that if the director ceased being a director, that director had to resell the share to A for the purchase price of $n. The Director's Agreement further stipulated that the director had to assign dividends to A, the director could not pledge or encumber the share in any manner and could not sell or otherwise transfer the stock to anyone other than A. A had a unilateral right to buy back the stock for $n at any time and for any reason.

X subsequently discovered that the Director's Agreement may have created a second class of stock and submitted this request for a ruling that the Director's Agreement does not create a second class of stock or that X's S corporation election was inadvertently invalid. X represents that there was no intention to knowingly terminate the S election and that the events that resulted in the termination were not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to amend or rescind the Director's Agreement so that a Director's Share confers identical rights in distribution proceeds, liquidation proceeds and provides for the payment of fair market value on the sale of a Director's Share back to A. X and its shareholders agree to make any adjustments required by the Secretary consistent with the treatment of X as an S corporation.

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

Section 1361(b)(1)(D) provides that the term "small business corporation" means a domestic corporation that does not have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in § 1.1361-1(l)(4) (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is 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 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 governing distribution and liquidation proceeds (collectively, the governing agreements).

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 § 1361(b)(1)(D), 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 of 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 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 QSub.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made by reason of a failure to meet the requirements of § 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 (A) so that the corporation is a small business corporation, or (B) 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 § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as might be required by the Secretary regarding this 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.

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election may have been ineffective for the taxable year beginning d5, or subsequently terminated, with the issuance of Directors Shares because it may have had more than one class of stock. We conclude that if X's S corporation election was ineffective or if it terminated because the Director's Agreement created a second class of stock, then it was inadvertent within the meaning of § 1362(f).

In addition, we conclude that under § 1362(f), X will be treated as an S corporation from d5, and thereafter, provided that X's S corporation election is otherwise valid and that the Directors' Agreements are amended so that a Director's Share confers identical rights in distribution proceeds, liquidation proceeds and provides for the payment of fair market value on the sale of a Director's Share back to A. In addition, because X's S corporation election is effective as of d5, Sub 1, Sub 2 and Sub 3 will be treated as QSubs from d5 and thereafter, provided that they satisfy the requirements to be QSubs under § 1361(b)(3)(B) and that X's S corporation election is not otherwise terminated under § 1362(d).

This ruling is contingent on X and its shareholders treating X as an S corporation for the period beginning d5 and thereafter, and on X treating Sub 1, Sub 2 and Sub 3 as QSubs for the period beginning d5 and thereafter. X and its shareholders must make any adjustments that are necessary to comply with this ruling. Accordingly, the shareholders of Company must include their pro rata shares of the separately and nonseparately computed items attributable to those shares in their income as provided in § 1366, make adjustments to the stock basis of those shares as provided in § 1367, and take into account any distributions with respect to those shares as provided in § 1368.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the above described transaction under any other provision of the Code. Specifically, no opinion is expressed on whether X is otherwise eligible to be treated as an S corporation and whether Sub 1, Sub 2 and Sub 3 are otherwise eligible to be treated as QSubs.

This 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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representatives.

Sincerely,

J. Thomas Hines
Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

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