Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Refer Reply To:
CC:PSI:3 PLR-104766-06
Date: May 3, 2006

Company =

State =

Sub1 =

Sub2 =

Sub3 =

Sub4 =

Sub5 =

a =

b =

c =

X =

Dear :

This letter responds to a letter dated January 20, 2006, and subsequent correspondence, submitted on behalf of Company requesting a ruling under § 1361(b)(1)(D) or § 1362(f) of the Internal Revenue Code.

FACTS

The facts submitted indicate that Company was incorporated on a under the laws of State. Company is a bank holding company that wholly owns five subsidiary banks (one as a second-tier subsidiary), Sub1, Sub2, Sub3, Sub4, and Sub5 (Subsidiary Banks). In compliance with federal banking law, Company sold shares of its outstanding capital stock to the directors of Sub1, Sub3, and Sub4 for $X (Directors' Shares). Those directors signed agreements with Company (Agreements) regarding their Directors' Shares of stock in Company. The other two subsidiary banks, Sub2 and Sub 5, are chartered in states that have no minimum stock ownership requirement for directors.

Under the Agreements, transfers of Directors' Shares by the directors are restricted to anyone but Company. In addition, upon ceasing to hold office as director, the directors are required to sell back to Company their Directors' Shares for the original purchase price of $X. Company represents that, except for these provisions, the Directors' Shares held by the directors have the same distribution and liquidation rights as other shares of Company stock.

Intending an effective date of b, Company filed timely an election to be treated as an S corporation. Company also filed timely elections for its subsidiary banks to be treated as qualified subchapter S subsidiaries (QSubs) with the same effective date.

In c, Company's majority shareholder died. The estate of the deceased shareholder and another major shareholder of Company decided to sell the subsidiary banks and liquidate Company. Upon the sale of the subsidiary banks, Company is obligated under the Agreements to purchase the Directors' Shares from the directors holding them for $X. To assist in the sales, Company engaged the services of an accountant who specializes in S corporation banks. The accountant determined that due to the Agreements, Company may have inadvertently created a second class of stock in violation of § 1361(b)(1)(D). Shortly thereafter, Company submitted its request for a ruling that the Agreements do not create a second class of stock or that Company's S corporation election was inadvertently invalid.

Company represents that it was not aware of any issue regarding its being a party to the Agreements as an S corporation. In addition, Company and its

shareholders have agreed to make any adjustments consistent with the treatment of Company as an S corporation as might be required by the Service.

LAW

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, among other things, does not have more than one class of stock. Accordingly, S corporations may 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.

For S corporation elections made before January 1, 2005, § 1362(f) provides, in part, 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.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that Company's S corporation election was ineffective for the taxable year beginning b, because it had more than one class of stock. We also conclude that the ineffectiveness of Company's S corporation election was inadvertent within the meaning of § 1362(f).

In addition, we conclude that under § 1362(f), Company will be treated as an S corporation from b and thereafter, provided that Company amends the Agreements to provide payment of fair market value to the directors upon their sale of Directors' Shares back to Company and that Company's S corporation election is otherwise valid. In addition, because Company's S corporation election is effective as of b, the Subsidiary Banks will be treated as QSubs from b and thereafter, provided that the Subsidiary Banks satisfy the requirements to be QSubs under § 1361(b)(3)(B) and that Company's S corporation election is not otherwise terminated under § 1362(d).

This ruling is contingent on Company and its shareholders treating Company as an S corporation for the period beginning b and thereafter, and on Company treating the Subsidiary Banks as QSubs for the period beginning b and thereafter. Company 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 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. Specifically, we express or imply no opinion regarding Company's eligibility to be an S corporation or the Subsidiary Banks' eligibility to be QSubs.

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

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/

CHRISTINE ELLISON
Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: copy of this letter for § 6110 purposes

cc: