Internal Revenue Service

Index Number: 1361.00-00

Department of the Treasury
Washington, DC 20224
Person to Contact:

Telephone Number:

199906044

Refer Reply To:
CC:DOM:P&SI:Br.1-PLR-111420-98
Date:
November 13, 1998

LEGEND

X =

ESOP =

A =

B =

C =

D =

E =

F =

G =

Plan =

256

CC:DOM:P&SI:Br.1-PLR-111420-98

This responds to a letter dated November 3, 1998, and prior correspondence submitted on behalf of X and requesting rulings under § 1361 of the Internal Revenue Code.

FACTS

You have represented the facts as follows. X is the common parent of a consolidated group that includes its seven domestic subsidiaries, A, B, C, D, E, F, and G. X is a domestic corporation that is not an ineligible corporation (as defined in § 1361(b)(2). X's shareholder has filed an election to treat X as an S corporation effective Date 1. In addition, X intends to file elections to treat all seven of its domestic subsidiaries as qualified subchapter S subsidiaries effective the same day.

All of X's issued and outstanding stock is and has been owned by ESOP for over 10 years. ESOP is an organization described in § 401(a) and is exempt from tax under § 501(a). ESOP's exemption from tax under § 501(a) is not denied under § 502 or § 503.

X has only one class of common stock issued and outstanding. Each share has identical distribution and liquidation rights. ESOP has the right to vote such shares, except on matters on which ESOP's participants must have the right to vote pursuant to § 409(e).

ESOP is administered by X pursuant to Plan. As Plan administrator, X has the discretion to require that any dividend distribution it makes to ESOP be distributed to the participants of ESOP in accordance with the number of shares held in the respective participant's account. X has exercised this discretion annually and has directed that dividends be passed through to participants in each of the preceding seven years. Pursuant to § 404(k), X has claimed a federal tax deduction for the amount of the dividends paid to the participants each year. X cannot continue this dividend pass-through arrangement after it elects S corporation treatment because the deduction for applicable dividends is only available to a subchapter C corporation.

X's employees have come to expect the cash flow received from the passthrough dividends each year. X's management believes that significant employee morale issues will develop if similar cash flows are not made available to its employees in the future. Accordingly, X proposes to amend Plan to provide that its participants may elect once each year to withdraw from ESOP the portion of cash distributions on X stock paid to ESOP during an S corporation year and allocated to participants' accounts

that have been designated by the board of directors of X as eligible for distribution to the participants (the In-Service Distribution Arrangement). We are expressing no opinion whether this proposed amendment is consistent with §§ 401(a) and 4975(e)(7) and the associated regulations, as applicable.

RULINGS REQUESTED

You have requested that we rule as follows:

(1) The ESOP, and not its participants, will be treated as the shareholder of X stock owned by the ESOP for purposes of the eligibility rules of §§ 1361(b)(1)(A), 1361(b)(1)(B), and 1361(b)(1)(C); and

(2) X will not be treated as having more than one class of stock because of ESOP's distribution provisions.

LAW AND ANALYSIS

Section 1361(a) provides that an "S corporation" is, with respect to a given year, a small business corporation for which an election under § 1362(a) is in effect. Section 1361(b)(1) defines "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not (A) have more than 75 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock. Under § 1362(a), a small business corporation generally may elect to be an S corporation.

Section 1361(c)(6), effective for taxable years beginning after December 31, 1997, provides that an organization that is described in section 401(a) or 501(c)(3) and exempt from taxation under § 501(a) may be an S corporation shareholder.

Section 401(a) generally defines pension, profit-sharing, and stock bonus plans of employers organized for the exclusive benefit of their employees as "qualified trusts" if certain requirements are met. Section 501(a) generally provides that any organization described in § 401(a) is exempt from taxation under subtitle A of the Code, unless the exemption is denied under § 502 or § 503.

Section 1361(c)(6) was added to the Code by section 1316 of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1755. The legislative history accompanying the provision provides that, "[f]or purposes of

determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will count as one shareholder. " See S. Rep. No. 281, 10th Cong., 2d Sess. 231 (19960.

Section 1361(b)(2) generally defines an "ineligible corporation," for purposes of § 1361(b)(1), as any corporation that is (A) a financial institution that uses the reserve method of accounting for bad debts; (B) an insurance company subject to tax under subchapter L; (C) a corporation to which an election under § 936 applies; or (d) a DISC or former DISC.

Section 1.1361-1(l)(1) states that, except as otherwise provided in § 1.1361-1(l)(4), 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. § 1.1361-1(l)(2) provides rules determining whether stock confers identical rights.

Under § 1.1361-1(l)(2)(i), 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 is thus not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement.

CONCLUSION

Based on the facts submitted and the representations made, we conclude as follows:

(1) The ESOP, and not its participants, will be treated as the shareholder of the X stock owned by the ESOP for purposes of the eligibility rules of §§ 1361(b)(1)(A), 1361(b)(1)(B), and 1361(b)(1)(C); and

(2) X will not be treated as having more than one class of stock because of the ESOP's distribution provisions.

Except as specifically ruled on above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provisions of the Code. In particular, no opinion is expressed as to whether ESOP, as amended, will constitute a qualified trust under § 401(a). This ruling is directed only to the taxpayer requesting it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Signed/Dianna K. Miosi

DIANNA K. MIOSI
Chief, Branch 1

Enclosures (2)