Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
March 26, 2003

LEGEND

X	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
State	=
Post-Conversion Year 2xxx	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
Client 1	=
Client 2	=
Client 3	=

Dear . :

This letter responds to your request dated November 5, 2002, for rulings on certain federal income tax consequences under Sections 1361 and 1374 of the Code with regard to your Date 5 conversion from a "C corporation" pursuant to Section 1361(a)(2) to an "S corporation" pursuant to Section 1361(a)(1). On March 13, 2003 and on March 25, 2003, you submitted additional information. The information submitted for consideration is summarized below.

Corporate Structure, Compensation Arrangements and Shareholder Agreements

X is a personal injury law firm providing legal services as a professional association organized under the laws of the State on Date 1. X computes its federal income tax liability on the cash receipts and disbursements method of accounting. X reported its taxable income as a calendar year C corporation for all taxable years ending on or before Date 5. X elected to be taxed as an S corporation within the meaning of Section 1361 of the Code effective for tax years beginning after Date 5 (the conversion date). As an S Corporation, X has continued to compute its federal income tax liability and file its returns as a calendar year, cash-basis taxpayer.

X has *a* issued and outstanding shares of common stock, which is its sole class of stock, and they are held by *b* individuals. In addition to the salaries, X has in place an historical "Bonus Compensation Arrangement," which compensates its attorney employees in accordance with formulas designed to reflect the employee's contribution to the firm's profitability for the year.

X also has in place two types of stock redemption agreements. The first type is called an "Incentive Shareholder Agreement." Under the agreement, each contracting shareholder acquires "Purchased Shares" and "Option Shares," and is required to sell his or her shares upon death, disability, retirement, or termination of employment. The redemption prices for "Purchased Shares" and "Option Shares" are set according to complex formulas designed to be incentives to retain newer attorneys for longer periods of employment.

The other type is the historical "Old Redemption Agreement" between X and its two senior attorneys. Under the agreement, upon death, permanent disability, or termination of employment, X is required to purchase the stock of the two senior attorneys at the book value, determined as of the last day of X's prior taxable year as such amount is reflected on the balance sheet. Further, the two senior attorneys are entitled to receive in recognition of their years of service to X payments of deferred compensation. The amount of the deferred compensation is calculated as such: (1) *c* % of all of the firm's accounts receivable, when collected; plus (2) *c* % of all fees (contingent fees) collected, less referral fees, on all open files as of the terminating event; plus (3) *d* % of all amounts collected on litigation costs.

X represents that the principal purposes of either the "Bonus Compensation Arrangement" or the stock redemption agreements are not to circumvent the one class of stock requirement.

Contingent Fee Agreements and Litigation Costs

X is retained by clients for legal representation against parties alleged to be responsible for damages sustained by the clients. X normally enters into contingent fee agreements ("CFAs") with its clients for a fee that is contingent upon the outcome of the matter.

Each CFA expresses the client's obligation to pay to X legal fees based on a percentage of the particular recovery with reference to the gross amount recovered and the particular stage in the litigation process in which the recovery was realized. The client also agrees to reimburse X from any recovery for any litigation costs X incurs on behalf of the client. For its part, X agrees to pay all necessary litigation costs and expenses of investigating the claim, including expert witness fees, court costs, etc. (collectively referred to as "Litigation Costs"). In the event of a judgment or settlement in favor of the client, the client pays X a legal fee which is first deducted from the gross proceeds awarded the client. Any Litigation Costs incurred by X on the client's behalf are then applied against the client's portion so that the client's only recovery is the net amount. In the event the case is lost, there is no recovery, or X withdraws, the client does not reimburse X for any fees or costs.

X had approximately *e* unresolved CFAs outstanding on Date 5. X also had approximately $ *f* of outstanding Litigation Costs, which X incurred prior to Date 5. These Litigation Costs relate to X's *e* unresolved CFAs.

X requests that the Service rule on 3 specific outstanding CFAs (CFA 1, CFA 2 and CFA 3) and other CFAs substantially identical to CFAs 1, 2 and 3 that it had entered into prior to Date 5, the day it converted from a C corporation to an S corporation. CFA 1 and CFA 3 were settled and withdrawn (respectively) in *Post-Conversion Year 2xxx*, the calendar year beginning on the first day immediately following Date 5. X received its fee and recovered the Litigation Costs it incurred in pursuing CFA 1 in *Post-Conversion Year 2xxx*, when CFA 1 was settled. CFA 2 was settled prior to Date 5, but the client received its entire recovery (pursuant to which X received its fees and recovered its expenses) all in *Post-Conversion Year 2xxx*. X received neither a fee nor the repayment of Litigation Costs as to CFA 3 because X withdrew from the case in *Post-Conversion Year 2xxx*, prior to any settlement or final adjudication. The specific facts of the 3 CFAs are set forth below.

CFA 1. On date 2, Client 1 entered into CFA 1 with X to pursue claims for damages for personal injuries Client 1 sustained. This case was unresolved as of Date 5. During *Post-Conversion Year 2xxx*, CFA 1 was settled and Client 1 was awarded $ *g*. Taxpayer recovered Litigation Costs of $ *h*, of which $ *i* were incurred as of Date 5.

CFA 2. On date 3, Client 2 entered into CFA 2 with X to pursue claims for damages for

personal injuries Client 2 sustained. CFA 2 was settled prior to Date 5 and resulted in Client 2 being awarded $ *j*. Client 2 was paid the entire award in *Post-Conversion Year 2xxx*. X recovered Litigation Costs of $ *k*, of which it incurred $ *l* in the years prior to its conversion.

CFA 3. On date 4, Client 3 entered into the Contingency Fee Agreement with X to pursue claims for damages for personal injuries Client 3 sustained. This case was unresolved as of Date 5. The case was closed by the firm's withdrawal from the case in *Post-Conversion Year 2xxx*. X recovered neither a fee nor the Litigation Costs of $ *m* it incurred prior to Date 5, because Client 3 was not liable to pay the fee or repay those costs.

X requests the following rulings:

1. X's legal fees received in *Post-Conversion Year 2xxx* which were attributable to CFA 1 and other substantially identical CFAs are not subject to the tax imposed by Section 1374 of the Code.

2. X's legal fees received in Post-Conversion Year 2xxx which were attributable to CFA 2 and other substantially identical CFAs constitute recognized built-in gains under Sections 1374(d)(3) and 1374(d)(5)(A) of the Code.

3. X's recovery in Post-Conversion Year 2xxx of Litigation Costs (i.e., the direct costs of investigating and prosecuting the litigation) it incurred prior to Date 5 in connection with CFAs 1 and 2 and other substantially identical CFAs is not subject to the tax imposed by Section 1374 of the Code.

4. Unrecovered Litigation Costs (i.e., the direct costs of investigating and prosecuting the litigation) it incurred in connection with CFA 3 and other substantially identical CFAs from which X withdrew in Post-Conversion Year 2xxx constitute recognized built-in losses for that tax year under Sections 1374(d)(4) and 1374(d)(5)(B) of the Code.

5. Quantum Meruit as permitted under State X law is a proper theory of valuation for determining the fair market value of assets in order to calculate X's NUBIG under Section 1374(d)(1) of the Code with respect to CFAs 1, 2 and 3 and other substantially identical CFAs.

6. Estimated future costs (i.e., Litigating Costs X estimates it will incur after Date 5 in pursuing all CFAs that were outstanding on Date 5) are included in computing X's NUBIG limitation under Section 1374(d)(1) of the Code with respect to CFAs 1, 2 and 3 and other substantially identical CFAs.

7. The Bonus Compensation Arrangement established and used by X for the past ten years in paying bonus compensation to its attorneys, including attorney shareholders, does not violate the one class of stock limitation under Subchapter S as prescribed in Section 1361(b)(1)(D) of the Code.

8. The presence of the Incentive Shareholders Agreement and/or Old Redemption Agreement and Professional Employment Agreement does not violate, either alone or integrated as a single set of agreements, the one class of stock requirement under Section 1361(b)(1)(D) of the Code.

LAW AND ANALYSIS:

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

Section 1361(b)(1)(B) of the Code defines the term “small business corporation” as a domestic corporation that is not an ineligible corporation and that, among other things, does not have more than one class of stock.

Section 1.1361-1(b)(4) of the Income Tax Regulations provides for the treatment of deferred compensation plans. Specifically, it provides that, for purposes of Subchapter S, an instrument, obligation, or arrangement is not outstanding stock if it: (i) does not convey the right to vote; (ii) is an unfunded and unsecured promise to pay money or property in the future; (iii) is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and (iv) is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income.

Section 1.1361-1(l)(2)(iii)(A) of the Income Tax Regulations provides that, in general, 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 -- (a) a principal purpose of the agreement is to circumvent the one class of stock requirement of Section 1361(b)(1)(D) of the Code and this paragraph (1), and (b) 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. For purposes of § 1.1361-1(l)(2)(iii)(A) of the Income Tax Regulations, a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence.

Section 1374 (a) of the Code imposes a corporate level tax on an S corporation's net recognized built-in gain (“NRBIG”) during the recognition period (generally 10 years) following either a C corporation's conversion to S corporation status, or an S corporation's acquisition of assets in a transaction in which the S corporation's basis in the acquired assets is determined by reference to the basis of such assets in the hands of a C corporation.

Section 1374 (d)(2) of the Code provides that an S corporation's NRBIG for any tax

year is generally computed as if it was a C corporation, but taking into account only those items treated as recognized built-in gain or recognized built-in loss (“RBIL”).

Section 1374 (d)(3) of the Code provides that recognized built-in gain includes any gain recognized on the disposition of an asset during the recognition period, except to the extent the S corporation shows that (a) it did not hold the asset on the Conversion Date, or (b) the gain recognized was greater than the excess of the asset's fair market value over its adjusted basis on the Conversion Date.

Section 1.1374-4(a) of the Income Tax Regulations provides that Section 1374(d)(3) of the Code applies to any gain or loss recognized during the recognition period in a transaction that is treated as a sale or exchange for federal tax purposes.

Section 1.1374-4(b)(1) of the Income Tax Regulations includes as recognized built-in gain any item of income "properly taken into account" during the recognition period if the item would have been properly included in gross income prior to the recognition period by an accrual-method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

Section 1.1374-4(b)(2) of the Income Tax Regulations provides, in relevant part, that "any item of deduction properly taken into account during the recognition period is [a] recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual-method taxpayer."

In Example 1 of § 1.1374-4(b)(3) of the Income Tax Regulations, X is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, X has $ 50,000 of accounts receivable for services rendered before that date. The market value of the accounts receivable on the date of conversion is $40,000 and an adjusted basis of $ 0. In 1996, X collects $50,000 on the accounts receivable and includes that amount in gross income. Under § 1.1374-4(b)(1), the $50,000 included in gross income in 1996 is recognized built-in gain because it would have been included in gross income before the beginning of the recognition period if it had been an accrual-method taxpayer.

Section 1.1374-4(b) (2) of the Income Tax Regulations provides, in relevant part, that "any item of deduction properly taken into account during the recognition period is [a] recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual-method taxpayer."

In Example 2 of § 1.1374-4(b)(3) of the Income Tax Regulations, Y is a cash-method C corporation that elects to become an S corporation effective January 1, 1996. In 1995, a lawsuit was filed against Y claiming $1 million in damages. In 1996, Y loses the lawsuit, pays a $500,000 judgment, and properly claims a deduction for that amount. Under § 1.1374-4(b)(2), the $500,000 deduction allowed in 1996 is not recognized built-in loss because it would not have been allowed as a deduction against gross income before the beginning of the recognition period if Y had been an accrual-method

taxpayer.

In Example 3 of § 1.1374-4(b)(3) of the Income Tax Regulations, X is a cash-method C corporation that elects to become an S corporation effective January 1, 1996. In 1995, X lost a lawsuit and became obligated to pay $150,000 in damages. Under Section 461(h)(2)(C) of the Code, this amount is not allowed as a deduction until X makes payment. In 1996, X makes payment and properly claims a deduction for the amount of the payment. Under § 1.1374-4(b)(2) of the Income Tax Regulations, the $150,000 deduction allowed in 1996 is recognized built-in loss because it would have been allowed as a deduction against gross income before the beginning of the recognition period if X had been an accrual-method taxpayer (disregarding Sections 461(h)(2)(C) and 1.461-4(g) of the Code).

Based solely on the information submitted in this ruling request, we rule:

1. X's legal fees received in Post-Conversion Year 2xxx which were attributable to CFA 1 and other substantially identical CFAs are not subject to the tax imposed by Section 1374 of the Code.

2. X's legal fees received in Post-Conversion Year 2xxx which were attributable to CFA 2 and other substantially identical CFAs constitute recognized built-in gain under Sections 1374(d)(3) and 1374(d)(5)(A) of the Code.

3. X's subsequent recovery in Post-Conversion Year 2xxx of Litigation Costs (i.e., the direct costs of investigating and prosecuting the litigation) it incurred prior to Date 5 in connection with CFAs 1 and 2 and other substantially identical CFAs is not subject to the tax imposed by Section 1374 of the Code.

4. Unrecovered Litigation Costs (i.e., the direct costs of investigating and prosecuting the litigation) X incurred in connection with CFA 3 and other substantially identical CFAs from which X withdrew in Post-Conversion Year 2xxx do not constitute recognized built-in losses under Sections 1374(d)(4) and 1374(d)(5)(B).

5 and 6. Under section 7.01 of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 19, there are certain areas where because of the inherently factual nature of the problem involved, or for other reasons, the Service will not issue advance ruling letters. Accordingly, we will not rule on whether quantum meruit is a proper theory of valuation for determining the fair market value of assets in order to calculate X's NUBIG under Section 1374(d)(1) of the Code with respect to CFAs 1, 2 and 3 and other substantially identical CFAs. For the same reason, we will not rule on whether future Litigating Costs are includable in determining the fair market value of assets in order to calculate X's NUBIG under Section 1374(d)(1) with respect to CFAs 1, 2 and 3 and other substantially identical CFAs.

7. The Bonus Compensation Arrangement established and used by X for the past ten years in paying bonus compensation to its attorneys, including attorney-shareholders, does not violate the one class of stock limitation under Subchapter S as prescribed in Section 1361(b)(1)(D) of the Code.

8. The presence of the Incentive Shareholders Agreement and/or Old Redemption Agreement and Professional Employment Agreement does not violate, either alone or integrated as a single set of agreements, the one class of stock requirement under Section 1361(b)(1)(D) of the Code.

Except as expressly provided herein, we express no opinion about the tax consequences of the above facts under other provisions of the Internal Revenue Code and regulations. Specifically, we express or imply no opinion concerning whether: (a) X is a valid S corporation; (b) the Litigation Costs constitute loans or capitalizable expenses; (c) X has recognized losses under other sections of the Code; (d) the Litigation Costs are deductible in *Post-Conversion Year 2xxx*; and (e) CFAs 1, 2 and 3 constitute an interest in choses in action.

This ruling is directed only to X. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

Steven J. Hankin

Senior Technician Reviewer, Branch 6
Office of Office of Associate Chief Counsel
(Corporate)

cc: