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Date:
March 25, 2013

Legend

Company	=	EIN:
State	=	
Year	=	
X	=	
n	=	
m	=	
o	=	
p	=	
q	=	
r	=	
s	=	
t	=	
u	=	
Date 1	=	
Date 2	=	

Date 3 =

Date 4 =

Date 5 =

Dear :

This responds to a letter dated December 12, 2012 submitted on behalf of Company by its authorized representative, requesting a ruling under § 1361(b)(1)(D) of the Internal Revenue Code.

FACTS

The information submitted states that Company was formed in State on Date 1. In Year, X joined Company. Company and X agreed that as part of X's employment with Company, X would provide financing of approximately $n. In addition, Company determined that it would require additional capital for business expansion. To that end, on Date 2, Company issued three mandatorily convertible debentures (collectively "Debentures"): one to X, and two to X's individual retirement account (IRA) in return for advances made by X and X's IRA. X made an election to be treated as an S corporation effective on Date 3, more than three years after Date 2.

Debenture 1, "Individual Debenture"

On Date 2, X transferred $m to Company in exchange for the Individual Debenture, mandatorily convertible into o shares of Company common stock on the earliest of (i) Date 4, (ii) the date that Company's board of directors adopts a resolution approving the transfer of a majority interest in the company or the liquidation or sale of substantially all of Company's assets, or (iii) X's death. The Individual Debenture did not bear interest. The number of shares convertible under the Individual Debenture was based on the per-share purchase price of Company's common stock established in a valuation report prepared in late Year.

On Date 4, the Individual Debenture matured and in accordance with its terms automatically converted into o shares of Company's common stock.

Debenture 2, "IRA Debenture 1"

On Date 2, X's IRA transferred $p to Company in exchange for IRA Debenture 1. It carried a market interest rate of q percent per annum payable by Company on a quarterly basis. Like the Individual Debenture, the number of shares convertible under IRA Debenture 1 was based on the per-share purchase price of Company's common stock established in the Year valuation report. It was convertible into r shares of

Company's common stock on the earliest of (i) Date 4, (ii) the date that Company's board of directors adopts a resolution approving the transfer of a majority interest in the company or the liquidation or sale of substantially all of Company's assets, or (iii) X's death.

On Date 4, IRA Debenture 1 was modified to extend the maturity date to Date 5, assuming neither of the other contingencies occurred.

Debenture 3, "IRA Debenture 2"

On Date 2, X's IRA Rollover transferred $s to Company in exchange for IRA Debenture 2. Its terms were identical to IRA Debenture 1.

On Date 4, IRA Debenture 2 was modified to provide that Company could cancel the IRA Debenture 2 by either issuing to X's IRA shares of Company's common stock, plus any accrued and unpaid interest, or by making a cash payment in an amount Company determines is reasonable based on the principal amount of the debenture and the value of the t shares of common stock that the IRA would otherwise be entitled to receive. On Date 4, Company exercised this cash-out right and paid $u in full satisfaction of IRA Debenture 2.

Representations

Company makes the following representations.

1. Company and its shareholders intended for Company to be treated as an S corporation for U.S. federal income tax purposes effective Date 3 and have filed their U.S. federal income tax returns consistent with having a valid S corporation election in effect since Date 3.

2. Company has only had common stock outstanding, and all shares of Company common stock have identical rights to Company's distribution and liquidation proceeds.

3. Company did not intend for the Debentures to create a "second class of stock" that would invalidate its S corporation election.

4. Company, X, and X's IRA intended that the Debentures be classified as indebtedness for U.S. federal income tax purposes.

5. Company, X, and X's IRA have treated the Debentures as indebtedness for U.S. federal income tax purposes since issuance.

6. When the Debentures were issued, Company had no plan or intention to elect to be treated as an S corporation for U.S. federal income tax purposes.

7. The Debentures were not issued with a principal purpose to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of common stock under § 1361(b)(1)(D) or to circumvent the limitation on eligible shareholders of §§ 1361(b)(1)(A), (B), and (C).

8. The Debentures were not issued with a principal purpose to circumvent the "one class of stock requirement" under § 1361(b)(1)(D).

9. Company constitutes a "depository institution holding company" as defined in § 3(w)(1) of the Federal Deposit Insurance Act.

10. The q percent interest rate provided under IRA Debenture 1 and IRA Debenture 2 was the market rate for similar debentures on Date 2.

LAW

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

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (b) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1362(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) 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. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

Section 1.1361-1(l)(2)(i) provides that 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, by laws, 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 thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of § 1361(b)(1)(D) and § 1.1361-1(l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1.1361-1(l)(3) provides that, except as provided in §§ 1.1361(b)(3), (4), and (5) (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account.

Section 1.1361-1(l)(4)(ii) provides that, except as provided in § 1.1361-1(l)(4)(i), any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock described in § 1.1361-1(l)(3)), regardless of whether designated as debt, is treated as a second class of stock of the corporation-- (1) If the instrument, obligation, or arrangement constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law; and (2) A principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders contained in § 1.1361-1(b)(1).

Section 1.1361-1(l)(4)(iii) provides that, except as otherwise provided in § 1.1361-1(l)(4), a call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder under § 1.1361-1(b)(1) to a person who is not an eligible shareholder under § 1.1361-1(b)(1), or materially modified. For purposes of 1.1361-1(l)(4), if an option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the terms of the loan, the extension of the time period in which the option may be exercised is not considered a material modification. In addition, a call option does not have a strike price substantially below fair market value if the price at the time of exercise cannot, pursuant to the terms of the instrument, be substantially below the fair market value of the underlying stock at the time of exercise.

Section 1.1361-1(l)(4)(iv) provides that a convertible debt instrument is considered a second class of stock if-- (A) It would be treated as a second class of stock under § 1.1361 1(l)(4)(ii) (relating to instruments, obligations, or arrangements

treated as equity under general principles); or (B) It embodies rights equivalent to those of a call option that would be treated as a second class of stock under § 1.1361 1(l)(4)(iii) (relating to certain call options, warrants, and similar instruments).

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that that the issuance of the Debentures did not cause Company to have more than one class of stock for purposes of § 1361(b)(1)(D).

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the above-described facts under any other provision of the Code. This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Bradford Poston
Senior Counsel, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: