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Date: September 17, 2015

LEGEND

X =

A =

State =

Date 1 =

Date 2 =

Period =

Dear :

This letter responds to a letter dated March 18, 2015, and subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1361(b)(1)(D) of the Internal Revenue Code (Code).

FACTS

The information submitted states that X was incorporated in State on Date 1 and elected to be treated as an S corporation effective Date 2. From Period, X employed A, who was also a shareholder of X. During that time, X may have paid excessive compensation to A. A was an at will employee without a written compensation agreement. X's board reviewed and approved the compensation of all of X's employees annually. X represents that its governing provisions, including its Articles of Association, its Bylaws and its Shareholder Agreements, confer identical rights to

distribution and liquidation proceeds with respect to X's outstanding shares of stock. X also represents that it was not a principal purpose to circumvent the one class of stock requirement through compensation paid to A.

LAW

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(a)(1) 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, among other prohibitions, does not have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides, in part, 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, in part, 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, 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 related 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.

In § 1.1361-1(l)(2)(vi), Example 3 (treatment of excessive compensation), S, a corporation, has two equal shareholders, C and D, who are each employed by S and have binding employment agreements with S. The compensation paid by S to C under C's employment agreement is reasonable. The compensation paid by S to D under D's employment agreement, however, is found to be excessive. The facts and

circumstances do not reflect that a principal purpose of D's employment agreement is to circumvent the one class of stock requirement of section § 1361(b)(1)(D) and § 1.1361-1(l). Under § 1.1361-1(l)(2)(i), the employment agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the employment agreements, even though S is not allowed a deduction for the excessive compensation paid to D.

CONCLUSION

Based solely on the facts submitted and representations made, we conclude that because X's governing provisions provide for identical distribution and liquidation rights and because X represents that it was not a principal purpose to circumvent the one class of stock requirement through compensation paid to A, any excessive compensation paid to A does not cause X to be treated as having more than one class of stock for purposes of § 1361(b)(1)(D). Under these circumstances, we conclude that X's S corporation election did not terminate as a result of the compensation paid to A.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provisions of the Code. Specifically, we express or imply no opinion regarding X's eligibility to be an S corporation or whether X paid excessive compensation to A.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

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

In accordance with a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely,

Holly Porter
Branch Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

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