Internal Revenue Service

Number: **201201009**
Release Date: 1/6/2012

Index Number: 1362.04-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:03
PLR-120242-11
September 26, 2011

LEGEND

Company =

State =
D1 =
D2 =
D3 =
D4 =
Month =
Year =

Dear :

This letter responds to a letter dated May 4, 2011, submitted on behalf of Company, requesting a ruling under §1362(f) of the Internal Revenue Code (Code).

FACTS

According to the information submitted, Company was incorporated under the laws of State on D1 and elected to be an S corporation for federal tax purposes effective D1. Between D2 and D4, Company issued stock warrants in connection with the issuance of additional shares of Company's stock to its shareholders; on D3, Company issued additional stock warrants in connection with a debt financing transaction. The issuance of the stock warrants may have terminated Company's S corporation election. In Month of Year, Company discovered that the stock warrants might be deemed a second class of stock and immediately sought legal advice to rectify the situation.

Company represents that it was not aware that the issuance of the stock warrants could cause it to be treated as having a second class of stock and, thus, could have caused its S corporation election to terminate. Company represents that the potential

termination of its S corporation election was inadvertent and the circumstances resulting in the potential termination were not motivated by tax avoidance or retroactive tax planning.

LAW

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation that is not an ineligible corporation and that 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 § 1361(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)(4)(iii)(A) of the Income Tax Regulations provides that except as otherwise provided in § 1.1361-1(l)(4)(iii), 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)(iii), 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)(iii)(B) provides in part that (1) a call option is not treated as a second class of stock for purposes of § 1.1361-1(l) if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation. Section 1.1361-1(l)(4)(iii)(B)(1) continues to apply if the call option is transferred with the loan (or if a portion of the call option is transferred with a corresponding portion of the loan).

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(f) provides in part that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in the termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation for which the termination occurred is a small business corporation; and (4) the corporation for which the termination occurred, and each person who was a shareholder in 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 may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely on the representations made and the information submitted, we conclude that Company's S corporation election may have terminated because Company may have had more than one class of stock. However, we conclude that, if Company's S corporation election was terminated, such a termination was inadvertent within the meaning of § 1362(f). Consequently, we rule that Company will be treated as continuing to be an S corporation from D2 to D4 and thereafter, provided that Company's S corporation election is not otherwise terminated under § 1362(d).

Except for the specific ruling above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code.

This ruling is directed only to the taxpayer requesting it. 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, we are sending a copy of this letter to Company's authorized representative.

Sincerely,

Mary Beth Carchia
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes