Internal Revenue Service

Number: **201214001**
Release Date: 4/6/2012

Index Number: 1362.04-00, 1361.01-04

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:B01
PLR-124866-11
Date:
November 29, 2011

Legend:

X =

State =

D1 =

D2 =

Class A =

D3 =

Class B =

D4 =

Year =

Y =

D5 =

a =

D6 =

D7 =

D8 =

A =

b =

c =

D9 =

B =

d =

D10 =

e =

Dear :

This responds to the letter dated June 9, 2011, and related correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

FACTS

The information submitted states that X was incorporated under the laws of State on D1. X elected to be treated as an S corporation, effective D2. X has issued shares of the Class A stock. On D3, X authorized the Class B stock. On D4, X designated a portion of the authorized Class B stock as the Series A Convertible Class B stock ("Series A Class B stock"). X, however, has not issued any shares of the Class B stock and, therefore, does not have any outstanding shares of such stock.

In Year, X issued a secured convertible note ("original note") to Y. After D5, the original note was convertible into shares of the Class A stock, unless X had issued shares of any series of the Class B stock, in which case, the original note would be convertible into Class B stock at $*a* per share. On D6, X renewed the original note ("renewed note") on substantially the same terms as contained in the original note, except that the maturity date of the renewed note is D7. Both the original note and

renewed note (collectively, the "Convertible Note") contained an Anti-Dilution Provision that would adjust the number of shares into which the Convertible Note could be converted if X issued certain options or shares at a price less than $*a* per share.

On or about D8, X issued Series A Class B stock purchase warrant ("original warrant") to A, an individual, in consideration for services provided by an entity owned by A. The original warrant allowed A to purchase *b* shares of the Series A Class B stock, during a specified period, at $*c* per share. On D9, A assigned one-half of the original warrant to an entity owned by B, also an individual, for services B provided to the entity owned by A. As such, on D9, A and B each owned warrants which allowed them to purchase *d* shares of the Series A Class B stock, during a specified period, at $*c* per share (collectively, "Warrants"). The Warrants provided that they could not be exercised if such exercise would terminate X's S election.

On D10, X issued options (the "original options") to current or former employees and consultants to X ("optionees") in consideration for the services rendered or to be rendered to X. The original options allowed some optionees to purchase the Class A stock at $*c* and others at $*e* per share. The original options could only be exercised in connection with a defined "change of control" of X. Subsequently, X amended the original options with respect to the definition of "change of control" of X (collectively, "Options").

X makes the following representations:

(1) X has only ever had one class of stock outstanding (Class A) and did not intend to create a second class of stock or terminate its S election;

(2) X did not issue the Convertible Note, Warrants, or Options with a principal purpose to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock under § 1361(b)(1)(D) or to circumvent the limitation on eligible shareholders of §§ 1361(b)(1)(A), (B) and (C);

(3) Prior to the issuance of the Options, based on a good faith determination, the conversion price ($*a* per share) of the Convertible Note was at least 90% of the fair market value of the underlying stock on the issuance dates of the Convertible Note;

(4) The issuance of the Options may have triggered the Anti-Dilution Provision of the Convertible Note and, therefore, on D10, the conversion price ($*c* per share) of the Convertible Note would not have been at least 90% of the fair market value of the underlying stock;

(5) Because the Warrants are exercisable only for the Series A Class B stock, and the issuance of any shares of the Series A Class B stock would have terminated X's S election, the Warrants have never been exercisable, and thus they have never been substantially certain to be exercised within the meaning of § 1.1361-1(l)(4)(iii)(A); and

(6) As X has not had a defined change of control, the Options have never been exercisable, and thus they have never been substantially certain to be exercised within the meaning of § 1.1361-1(l)(4)(iii)(A).

Immediately after the discovery of the errors, X and its shareholders took the following corrective actions: (1) The Convertible Note was amended to provide that the principal may only be converted into stock if X's S election was terminated by actions not related to the Convertible Note and that the Anti-Dilution Provision does not apply to options, warrants, or other equity awards issued to current or former employees or consultants for services rendered or to be rendered to X; (2) The Warrants were amended to provide that they can only be exercised if (i) X's S election was terminated by actions not related to the Warrants or the holder of the Warrants, or (ii) X is acquired by merger, sale of substantially all of X's assets, or sale or exchange of more than 80% of X's outstanding voting securities within a 12 month period; and (3) X's Article of Incorporation was amended to provide that X is no longer authorized to issue any capital stock other than the Class A stock.

In addition, X and its shareholders agree to make any adjustments required by the Commissioner consistent with the treatment of X as an S corporation.

LAW AND ANALYSIS

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 the year.

Section 1361(b)(1)(D) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that, 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)(4)(i) provides that, in general, instruments, obligations, or arrangements are not treated as a second class of stock for purposes of § 1.1361-1(l) unless they are described in § 1.1361-1(l)(4)(ii) or (iii). However, in no event are instruments, obligations, or arrangements described in § 1.1361-1(l)(4)(iii)(B) and (C) (relating to the exceptions and safe harbor for options), § 1.1361-1(l)(4)(ii)(B) (relating to the safe harbors for certain short-term unwritten advances and proportionally-held debt), or § 1.1361-1(l)(5) (relating to the safe harbor for straight debt), treated as a second class of stock for purposes of § 1.1361-1(l).

Section 1.1361-1(l)(4)(ii)(A) 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)(A) provides, in part, 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.

Section 1.1361-1(l)(4)(iii)(C) provides that, a call option is not treated as a second class of stock if, on the date 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, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. Further, a good faith determination of fair market value by the corporation 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 to obtain a fair value.

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 arrangements).

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 (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consent, or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken - (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to this subsection, agrees to make such 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 such ineffectiveness or termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner.

CONCLUSION

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

Except as specifically ruled upon above, no opinion is expressed or implied concerning the tax consequences of any facts discussed or referenced in this letter. In particular, we express no opinion as to whether X is otherwise a valid S corporation.

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

In accordance with the Power of Attorney on file with this office, copies of this letter ruling will be sent to your authorized representatives.

Sincerely,

Joy C. Spies
Joy C. Spies
Acting Senior Technician Reviewer
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter
Copy for § 6110 purposes

cc: