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Department of the Treasury
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Person To Contact:
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Telephone Number:

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CC:PSI:03
PLR-104493-12
Date:
April 17, 2012

LEGEND

Company =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

Month =

Year =

Dear :

This letter responds to a letter dated January 16, 2012, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code (Code).

FACTS

According to the information submitted, Company incorporated under the laws of State on D1 and elected to be an S corporation for federal tax purposes effective D2. On or about D3, Company issued stock warrants in connection with the provision of professional consulting services. The issuance of the stock warrants may have terminated Company's S corporation election. Between the dates of D4 and D5, Company issued two series of convertible debt instruments in order to fund Company's expansion and operations. The issuance of the convertible debt instruments may have terminated Company's S corporation election. In Month of Year, Company discovered that the stock warrants and convertible debt might be deemed a second class of stock.

Company represents that the potential termination of its S corporation election was inadvertent. Company represents that it did not believe that the issuance of the stock warrants would cause it to be treated as having a second class of stock and, thus, would have caused its S corporation election to terminate. It also represents that it was unaware that the issuance of the convertible debt could cause it to be treated as having a second class of stock and, thus, could have caused its S corporation election to terminate.

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 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 § 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 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).

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 D3 to D5 and thereafter, provided that Company's S corporation election is not otherwise terminated under § 1362(d).

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion as to whether Company is otherwise eligible to be an S corporation for federal tax purposes.

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

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.

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

Sincerely,

Richard T. Probst
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: