Internal Revenue Service

Number: **201246008**
Release Date: 11/16/2012

Index Number: 1362.00-00, 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:B01
PLR-109819-12
Date:
August 17, 2012

X =

State =

k =

$m =

$n =

$p =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

D8 =

D9 =

D10 =

D11 =

Dear :

This letter responds to a letter dated February 27, 2012, on behalf of X from X's authorized representative, requesting rulings regarding whether X's S corporation election terminated, and regarding inadvertent termination relief under §1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X was incorporated under the laws of State on D1. X timely filed a Form 2553, Election by a Small Business Corporation, effective D2.

On or about D3, X purchased a life insurance policy on the life of one of its shareholders, whose spouse was the sole beneficiary. X paid premiums on the policy totaling $m without treating the premiums as part of the shareholder's compensation or distributions, and without receiving reimbursement for the premium payments. The shareholder later reimbursed X for all the premiums that X paid, with interest, on D11.

From D4 through D5, X made small errors in its distribution calculations. As a result, X overpaid one of its shareholders by $n and underpaid another shareholder by the same amount. X corrected this discrepancy through an equalizing distribution in D10.

In D6, one of X's shareholders loaned X $p. Later in D6, pursuant to the advice of a proposed lender, X recharacterized the remaining unpaid balance of the arrangement as a capital contribution in its D6 financial statements. In D7, X reversed the characterization and treated the arrangement once again as a loan. X repaid the loan in D7. X erroneously reported the repayment as a distribution on its D7 tax return. However, X represents that X and the shareholder have otherwise consistently treated the transaction as a loan for tax purposes.

On or about D8, the shareholders of X entered into a Shareholder Agreement. The Shareholder Agreement contained a clause that, upon the sale of all the shares of X, an amount equal to k percent of the sales price would be specially allocated to one of the shareholders of X. On D9, the shareholders of X terminated the Shareholder Agreement. No payment was ever made pursuant to this clause.

X represents that X and its shareholders filed their tax returns, from D2 onward, as if X were an S corporation, except for the D7 loan repayment being reported as a distribution. In addition, X and its shareholders represent that, assuming that any of the actions described above caused a second class of stock in X, the termination of X's S corporation election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation that the Secretary may require.

LAW AND ANALYSIS

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)(D) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not, among other requirements, have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that 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) 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, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds.

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

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) provides that any termination under section 1362(d)(2)(A) shall be effective on and after the date of cessation.

Section 1362(f) provides, in part, that if (1) an election under §1362(a) by any corporation was terminated under § 1362(d)(2), (2) the Secretary determines that the circumstances resulting in such termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such 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 such corporation at any time during the period specified pursuant to §1362(f), agrees to make 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 termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely on the information submitted and representations made, we conclude that, with respect to the life insurance premium payments, X's S corporation election may have terminated on D3 due to the presence of a second class of stock. However, we also conclude that, if X's S corporation election was terminated, such a termination was "inadvertent" within the meaning of § 1362(f).

We also conclude that, with respect to the erroneous distribution calculations and the Shareholder Agreement, if X's S corporation election did not terminate on D3, then it may have terminated in D4 or on D8 due to the presence of a second class of stock. However, we also conclude that, if X's S corporation election was so terminated, such a termination was "inadvertent" within the meaning of § 1362(f).

We also conclude that, with respect to the D6 loan bookkeeping and tax reporting, no actual disproportionate distribution occurred. Accordingly, X's S corporation election did not terminate as a result of the D6 loan bookkeeping and tax reporting.

Under the provisions of §1362(f), X will be treated as an S corporation from D3, and thereafter, provided that, apart from the inadvertent termination rulings above, X's S corporation election was otherwise valid and has not otherwise terminated under §1362(d). Accordingly, from D3, the shareholders of X must include their pro rata share of the separately stated and non-separately stated computed items of X as provided in §1366, make any adjustments to basis as provided in §1367, and take into account any distributions made by X as provided in §1368. If X and its shareholders fail to treat X as described above, this ruling will be null and void.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion regarding whether X is otherwise eligible to be an S corporation.

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 a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Joy C. Spies
Joy C. Spies
Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: