Internal Revenue Service

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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-144246-12

Date:
November 30, 2012

LEGEND

X =

State =

Corporation =

Shareholder A =

Shareholder B =

D1 =

D2 =

D3 =

D4 =

D5 =

Dear :

This responds to a letter dated October 10, 2012, and subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1361(b)(1)(D) of the Internal Revenue Code.

Facts

According to the information submitted, X was formed on D2 under State. X timely filed Form 2553 to make an election to be treated as an S corporation after D2 and on or before the 15th day of the third month of its first taxable year beginning D2. X intended to make its S election effective D2, but a recent review of its books and records has indicated that X's Form 2553 may have instead listed a desired effective date of D1, which precedes the date of X's formation on D2 by several days. X has always treated itself as having been an S corporation since its formation on D2.

X represents that X was formed to effect a split-off under § 355 (a divisive reorganization under § 368(a)(1)(D)). For a transitory period from D2 to D3, X was wholly owned by Corporation. The split-off occurred on D3, at which time X became wholly owned by Shareholder A. X, Corporation, and Shareholder A all treated Shareholder A as the sole owner of X for its entire first taxable year beginning D2.

As part of a recent internal investigation, X has just discovered several instances in which its share register and general ledger were not properly maintained or followed. These errors resulted in several discrepancies, including disproportionate distributions. X represents that these discrepancies and disproportionate distributions were not intentional, and X represents it will make remedial distributions to correct the effect of the disproportionate distributions. As a result of the remedial distributions, each shareholder of X will have received aggregate distributions that are pro rata and in accordance with share ownership.

X represents that under State law, all of X's stock have identical rights to distribution and liquidation proceeds. No provision in X's articles of incorporation, bylaws, or any other governing instruments altered those rights. X further represents that there is no agreement, written or oral, that any shareholder would be entitled to a preference regarding X's distribution or liquidation proceeds.

On D4, X redeemed stock owned by Shareholder B. Under the terms of the redemption agreement, Shareholder B's shares were redeemed in exchange for cash

and a promissory note from X secured by a security interest in stock of X. If X defaulted on its promissory note, Shareholder B would have had the right to cause X to issue shares of stock to Shareholder B. X made final payment under the promissory note on D5. X did not intend for the shares subject to the security interest to be treated as issued or outstanding for federal tax purposes. Shareholder B received no distributions or allocations of income, gain, loss, deduction, or credit with respect to the stock in which Shareholder B held a security interest. X represents that, in entering into the arrangement with Shareholder B, it did not have a principal purpose of circumventing the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or of circumventing the limitation on eligible shareholders.

X represents it did not intend to create a second class of stock or to terminate X's S corporation election and that the circumstances resulting in the possible termination of the election were not motivated by tax avoidance or retroactive planning.

X seeks a ruling that if its S corporation election on Form 2553 listed a desired effective date of D1, it will nonetheless be treated as having made its S election effective D2. Additionally, X seeks a ruling that Corporation's transitory ownership of X from D2 to D3, as part of the reorganization under § 368(a)(1)(D), will not cause X to have an ineligible shareholder for any portion of its first taxable year under § 1361(b)(1)(B) and will not, in itself, render X ineligible to elect to be an S corporation for its first taxable year. X also seeks a ruling that the discrepancies and disproportionate distributions resulting from the inadvertent failure to properly maintain and follow its share register and general ledger will not constitute issuance of a second class of stock, which would jeopardize X's S corporation status under § 1361(b)(1)(D). Additionally, X seeks a ruling that Shareholder B's security interest in stock of X will not constitute a second class of stock.

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. Section 1362(b)(1) provides that an S corporation election may be made by a small business corporation for any taxable year at any time during the preceding taxable year, or at any time during the taxable year and on or before the 15th day of the third month of the taxable year. Section 1.1362-6(a)(2)(i) of the Income Tax Regulations provides that a small business corporation makes an election to be an S corporation by filing a completed Form 2553.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more

than 1 class of stock. Section 1362(b)(2) provides in part that if an S corporation election is made for any taxable year during such year and on or before the 15th day of the third month of such year, but on one or more days in such taxable year before the day on which the election was made the corporation did not meet the requirements of § 1361(b), then such election shall be treated as made for the following taxable year.

Treas. Reg. § 1.1361-1(l)(1) 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. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.

Treas. Reg. § 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to liquidation and distribution proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating 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. 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 Treas. Reg. § 1.1361-1(l)(2)(vi), Example 2 (Distributions that differ in timing), S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes $50,000 to A in the current year, but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by a binding agreement relating to distribution or liquidation proceeds. The example concludes that under Treas. Reg. § 1.1361-1(l)(2)(i), the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, § 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

Treas. Reg. § 1.1361-1(l)(4)(i) provides that, subject to certain exceptions not relevant here, instruments, obligations, or arrangements are not treated as a second class of stock unless they are described in Treas. Reg. §§ 1.1361-1(l)(4)(ii) or (iii). Treas. Reg. § 1.1361-1(l)(4)(ii) provides, subject to certain exceptions not relevant here, that any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock described in Treas. Reg. § 1.1361-1(l)(3)), regardless of whether designated as debt, is treated as a second class of stock of the corporation if (1) 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 Treas. Reg. § 1.1361-1(b)(1). Treas. Reg. § 1.1361-1(l)(4)(iii) provides rules for when a call option, warrant, or similar instrument issued by a corporation is treated as a second class of stock.

Conclusion

Based solely on the facts submitted and representation made, we conclude that X's S corporation election is effective D2. Furthermore, we conclude that Corporation's transitory ownership of X from D2 to D3, as part of the reorganization under § 368(a)(1)(D), will not cause X to have an ineligible shareholder for any portion of its first taxable year under § 1361(b)(1)(B) and will not, in itself, render X ineligible to elect to be an S corporation for its first taxable year. If X otherwise meets the requirements of a small business corporation under § 1361, X is eligible to elect to be an S corporation under § 1362(a) for its first taxable year.

Additionally, we conclude that because X has identical distribution and liquidation rights under its governing provisions, the disproportionate distributions made by X, and the difference in timing between X's disproportionate distributions and the corrective distributions to its shareholders, do not cause X to be treated as having more than one class of stock for purposes of § 1361(b)(1)(D). However, X's disproportionate and corrective distributions to its shareholders must be given appropriate tax effect. Under these circumstances, we conclude that X's S corporation election did not terminate because of the disproportionate and corrective distributions. This ruling is contingent upon X making corrective distributions so that each shareholder has received distributions proportionate to their interests in X from D2 and thereafter, within 120 days of the date of this letter. Failure to make such corrective distributions will render this ruling void.

Furthermore, we conclude that Shareholder B's security interest in stock of X from D4 to D5 does not cause X to be treated as having more than one class of stock for purposes of § 1361(b)(1)(D), and X's S corporation election did not terminate because of the security interest.

Therefore, X will be treated as continuing to be an S corporation from D2, provided that X's S corporation election was otherwise valid and that X's S corporation election is not otherwise terminated under § 1362(d).

Except as expressly provided herein, no opinion is expressed or implied as to the federal tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed as to whether X is an S corporation for

federal tax purposes.

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.

Pursuant to the power of attorney on file with this office, a copy of this letter will be sent to X's authorized representative.

Sincerely,

David R. Haglund
David R. Haglund
Chief, Branch 1
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter,
Copy for § 6110 purposes

cc: