

## Internal Revenue Service

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Person To Contact:  
, ID No.

Telephone Number:

Refer Reply To:  
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### LEGEND

X =

State A =

State B =

State C =

State D =

Date 1 =

Date 2 =

A =

B =

C =

D =

E =

F =

G =

H =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Dear :

This responds to a letter dated November 26, 2012, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting a ruling under § 1361 of the Internal Revenue Code.

The information submitted states that X was incorporated in State A on Date 1. X made an election to be treated as an S corporation effective Date 2. Pursuant to the laws of State A, all shareholders have equal rights to distributions and liquidation proceeds, unless modified by the articles of incorporation. Neither X's articles of incorporation or bylaws modify such rights to distributions and liquidation proceeds.

Prior to Year 1, X did not make any distributions to cover the state tax liabilities of the shareholders nor did it file any composite state income tax returns on behalf of its shareholders.

Prior to Year 1, shareholders A and B moved from State A to State B. In Year 1, A and B received distributions to pay their State B income tax liability for that year (the "Yr1 Distributions"). X did not take the Yr1 Distributions into account when subsequent distributions were made to all shareholders, which resulted in disproportionate distributions for that year. Shortly after the Yr1 Distributions had been made, X realized the error and created a payable to shareholders A, C, D, E, F, and G (the "Distribution Accrual"). With respect to the Yr1 Distributions, there is no written or oral agreement between X and the shareholders to compensate shareholders for differing state tax burdens.

In Year 2, X filed composite state income tax returns in State C on behalf of all shareholders and in State B on behalf of shareholders C, D, E, and F (but not A, B or G, who were State B residents) and paid the balance due. X did not make additional distributions to each shareholder so that the distributions were pro rata when taking into account the tax paid in connection with the State B composite state income tax return, but X adjusted the Distribution Accrual to account for the state tax distributions, increasing the amount due to some shareholders and decreasing the amount due to others.

In Year 3, X filed composite state income tax returns in State C and State D on behalf of all shareholders, but no tax was due. X filed a composite state income tax return in State B on behalf of shareholders C, D, E, and F (but not A, B or G) and paid the balance due. In addition, early in Year 3, X issued additional shares to certain shareholders which caused the ownership percentages of all shareholders to change. Following the share issuance, X made a distribution to the shareholders based on pre-issuance ownership percentages because the distribution related to earnings attributable to Year 2. For the remainder of Year 3, X's distribution to shareholders were made according to post-issuance ownership percentages. At the conclusion of Year 3, the Distribution Accrual remained unchanged from Year 2.

In Year 4, X paid out the remaining balance in the Distribution Accrual to the appropriate shareholders. In addition, X paid additional amounts to certain shareholders to account for the fact that the Distribution Accrual account was not appropriately adjusted for the Year 3 composite income tax return payment to State B. Also in Year 4, H became a shareholder of X, which caused the ownership percentages of all shareholders to change. X subsequently made several distributions that were not pro rata because X made the distributions based on the ownership percentages of the shareholders prior to the admittance of H as a shareholder. However, once the disproportionate distributions were discovered in Year 4, X made additional distributions such that all distributions in Year 4 were pro rata.

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, for purposes of subchapter S, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not, among other things, have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides, in part, that a corporation that has more than one class of stock does not qualify as a small business corporation. 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 stock

among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.

Section 1.1361-1(l)(2)(i) provides, in part, 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 (collectively, the governing provisions). 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.

Based on the facts and representations submitted by X, we conclude that because X's stock has identical distribution and liquidation rights under its governing provisions, the difference in timing between X's disproportionate distributions to some of the shareholders and X's corrective distributions to certain shareholders do not cause X to have more than one class of stock for purposes of § 1361(b)(1)(D). However, such disproportionate and corrective distributions 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 to the shareholders.

Except for the specific ruling above, we express or imply no opinion concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding X's eligibility to be an S corporation.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent. Under a power of attorney on file with this office, we are sending a copy of this letter to X's authorized representative.

Sincerely,

Bradford R. Poston  
Senior Counsel, Branch 2  
(Passthroughs & Special Industries)

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