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Date:
December 20, 2013

LEGEND

Company =

Sub 1 =

Sub 2 =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Year 1 =

Year 2 =

Year 3 =

Dear :

This letter is in response to your request, dated November 25, 2013, on behalf of Company, seeking relief under § 1362(f) of the Internal Revenue Code.

FACTS

Based on the materials submitted and representations within, we understand the relevant facts to be as follows: Company is a domestic corporation organized under the laws of State on Date 1. Three individuals collectively owned all of Company's outstanding common stock.

Sub 1 is a domestic corporation organized under the laws of State on Date 2. Sub 1's charter authorized 100 shares of common stock. Effective Date 3, Sub 1's articles were amended to authorize two classes of common stock: 8,000 shares of voting Class A common stock and 2,000 shares of Class B common stock, with the Class B stock being identical to the Class A stock except for the fact that the Class B stock was nonvoting. The same three individuals that owned Company owned all of Sub 1's outstanding Class A shares. Company has been unable to locate the stock record book for Sub 1 following the death of one of the founding shareholders who served as primary record keeper, but Company believes no Class B common shares were issued.

Effective on Date 4, the Company's articles of incorporation were amended to create two classes of common stock, identified as "Class A Common Stock" and "Class B Common Stock," and all outstanding shares of the Original Common Stock were converted into an equal number of shares of Class A Common Stock. On Date 4, or shortly thereafter, the owners of Sub 1 contributed all of their respective shares of Sub 1 to Company in exchange for a total of 1,000 newly issued shares of Class B Common Stock with the intention of having Company own all of the equity interests in Sub 1. Following the Date 4 contribution, Company believes that it acquired, and continues to own as of the date of this letter, 100% of Sub 1's outstanding shares.

On Date 5, subsequent to the contribution of Sub 1 to Company, compensatory options to acquire shares of Class B Common Stock of Sub 1 were granted to an employee, exercisable only upon a change in control of Sub 1. The provision of the employee's Employment Agreement which provided for the issuance of the options states that the options were "for the purchase of shares of Class B Non-Voting Common Stock …equal to, as of the date hereof, eight percent (8%) of the outstanding Class B Common Stock of [Sub 1]." Company represents that those options were never exercised and were

later exchanged by the employee for options to acquire shares of Company. Company represents that, as of the date of this letter, that no persons have ever come forward and asserted rights as a holder of outstanding Class B shares of Sub 1.

In the months leading up to Date 6, Company engaged outside tax advisors to consider an S corporation election for Company and a QSub election for Sub 1. In order to satisfy the single class of stock requirement, the Company determined that it would redeem all of the outstanding shares of Class A Common Stock in exchange for a distribution, to be made by Company to the shareholders on a pro rata basis (the Redemption Transaction), of Sub 2 described below. In addition, Company's tax advisors recommended amending Company's articles of incorporation to convert the Class B Common Stock, the only remaining class of stock that would be outstanding following the Redemption Transaction, to a single class of ordinary common stock.

Company filed a timely election under § 1362(a) to be treated as an S corporation effective beginning on Date 6. Company timely filed Form 8869, Qualified Subchapter S Subsidiary Election, for Sub 1, also effective Date 6. Company, however, has no record of executing the Redemption Transaction or subsequent recapitalization before Date 6. Several months after Date 6, the shareholders signed the documents relating to the Redemption Transaction and recapitalization and the recapitalization became effective on the date it was filed with State's Secretary of State, however the documents provided that the transaction's effective date related back to the date immediately prior to Date 6.

At the same time Company elected to be treated as an S corporation, Sub 2 filed a timely election under § 1362(a) to be treated as an S corporation effective beginning on Date 6. However, due to an oversight by Company's tax preparers, beginning in the first year of the S corporation election and the following three taxable years, Sub 2 reported all income, gain, loss, deduction, and credits as if it was a QSub of Company. Beginning with the fifth taxable year after Date 6, Sub 2 began filing tax returns as a separate S corporation.

In the years following Date 6, Company would make pro rata cash distributions to its stockholders. Company recorded the distributions as debits to separate Distribution Accounts maintained for each shareholder. The Distribution Accounts were similar to draw accounts or a contra account to stockholder's equity, and they were closed out annually to stockholder's equity. Periodically, however, Company would make payments on behalf of a shareholder that were also charged to the shareholder's Distribution Account. As a result of the non pro rata debits to the Distribution Accounts, at year-end the shareholders' respective account balances were not in proportion to their respective percentage ownership of Company. Accordingly, to bring each shareholder's Distribution Account balances into alignment with their percentage interests in Company, Company would determine a target balance for each shareholder's Distribution Account. Company then made adjusting entries on their

books so as to cause each shareholder's Distribution Account balance to equal that target balance. Company reported the final post-adjustment Distribution Account balances as distributions for all relevant tax purposes. The shareholder receivables and payables were evidenced only by book entries. Company did not charge or receive interest on the loan balances. The loan balances were not required to be settled up by a specified time following year-end, but instead were allowed to remain outstanding, with the balances fluctuating from year to year.

In Year 1, one of the shareholders died. In December of Year 2, the other two founding shareholders purchased all of the shares of Company then owned by that shareholder's estate and his surviving spouse pursuant to a Purchase Agreement. Section 3(a) of the Purchase Agreement provided for a pre-closing distribution by Company. Specifically, it recited that Company will make a pro rata tax free distribution in the same number of dollars per share. Section 3(a) also provided that Company would pay a specified dollar amount of the aggregate distribution to the estate and surviving spouse at the closing. Company made a distribution in December of Year 2 to the two acquiring shareholders which they used to finance a portion of the buyout purchase price. An additional distribution was made to each of acquiring shareholders on the closing date of the buyout, which were also applied by them to finance the buyout. Between amounts paid by the two shareholders at closing and the amounts distributed by Company, the estate and surviving spouse received the purchase price contemplated by the Purchase Agreement. Although the cash distribution records indicate disproportionate distributions, Company tax return reporting for Year 2 show aggregate distributions to shareholders allocated among them in proportion to their respective stockholdings during the year. Thus, Company believes that a portion of the amounts distributed to the two acquiring shareholders represented distributions to the estate and surviving spouse, and the estate and surviving spouse ended up receiving such amounts, so that the Year 2 tax reporting accurately reflects the ultimate economics of the Purchase Agreement. Following the buyout, Company determined that it was only necessary to equalize the distributions of the two remaining, and now equal, shareholders because the estate and surviving spouse were bought out at year-end. Thus, when the books were closed, Company made adjusting entries to the two remaining shareholders Distribution Account balances, while the surviving spouse's Distribution Account balance was left unadjusted.

In Year 3, Company agreed to sell the stock of Sub 1 to an unrelated third-party. As part of the buyer's due diligence, the buyer notified company that the QSub election may have been ineffective because (i) the Company may have had an invalid S election as a result of having two classes of stock outstanding if the Redemption Transaction was not effective retroactively or as a result of the distributions described above, and (ii) if any outstanding Class B Non-Voting Common Stock had been issued as a result of the exercise of the employee stock option or otherwise, the Company may not have been the sole shareholder of Sub 1. To correct any potential issue in this regard, Sub 1 completed a recapitalization in which Sub 1 issued 1,000 Class B shares to Company.

Following the issuance of the Class B Shares, Sub 1 completed a reverse stock split of both the Class A shares (7500:1) and Class B shares (2000:1). The amendment to the articles memorializing the reverse stock split also provided that any fractional shares of Class B stock resulting from the reverse stock split were converted into a right to receive cash. Thus, the recapitalization eliminated any possibility that any person other than the Company owns shares of Sub 1 stock, and any unknown holder would simply have a right to assert a claim for damages but not the rights of a stockholder.

Also in Year 3, the Distribution Account loan balances were paid in full, with cash payments being made by Company or by the shareholders, as applicable, to discharge the then outstanding due to/due from balances.

RULINGS REQUESTED

Company request rulings to the effect that:

(1) If Company's S election was invalid, it was an inadvertent invalid election within the meaning of § 1362(f) and, therefore, Company will be treated as an S corporation commencing with its taxable year beginning Date 6 and continuing thereafter, provided that the Company's S corporation election is otherwise valid and is not otherwise terminated under § 1362(d). In addition, to the extent the manner in which Company made distributions and advances to its shareholders created a second class of stock, the termination of Company's S election was inadvertent under § 1362(f) and, therefore, the Company will be treated as an S corporation commencing with its taxable year beginning Date 6 and continuing thereafter, provided that the Company's S corporation election is otherwise valid and is not otherwise terminated under § 1362(d).

(2) Sub 1's QSub election, to the extent it was otherwise invalid or terminated because Company's S election was invalid or subsequently terminated, or because of the possibility that Sub 1 may have had unidentified shareholders other than Company on or after Date 6, should likewise be treated as an inadvertent invalid election or an inadvertent termination of such election within the meaning of § 1362(f) and, therefore, Sub 1 will be treated as a QSub of Company effective as of Date 6 and continuing thereafter, provided that Sub 1's QSub election is otherwise valid and is not otherwise terminated under § 1361(b)(3)(C).

In accordance with § 1362(f) and § 1.1362-4, Company and each person who has been a shareholder of Company at any time after Date 6 through the date of the ruling request have consented to any adjustments as may be required by the Secretary. Company, Sub 1, and Company's shareholders represents that the tax returns for all of the relevant tax years since Date 6 are not inconsistent with the tax treatment of Company as an S corporation, and Sub 1 as a QSub.

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 a corporation is generally 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)(i) 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 (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.

Section 1.1361-1(l)(2)(iii)(B) provides that bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation’s shares of stock confer identical rights.

Section 1361(b)(3)(B) defines a QSub as a domestic corporation which is not an ineligible corporation, if 100 percent of the stock of the corporation is owned by the S corporation, and the S corporation elects to treat the corporation as a qualified subchapter S subsidiary.

Section 1.1361-3(a) of the Income Tax Regulations prescribes the time and manner for making an election to be classified a qualified subchapter S subsidiary.

Section 1.1361-3(a)(4) provides that an election to treat an eligible subsidiary as a qualified subchapter S subsidiary may be effective up to two months and 15 days prior to the date the election is filed or not more than 12 months after the election is filed.

The proper form for making the election is Form 8869, Qualified Subchapter S Subsidiary.

Section 1362(d)(2)(A) provides that an election under § 1362(a) will 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 the termination shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under §§ 1362(a) or 1361(b)(3)(B)(ii) 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 consents or (B) was terminated under § 1362(d)(2) or (3) or § 1361(b)(3)(C), (2) the Secretary determines that the circumstances resulting in the 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 a QSub, as the case may be, or (B) to acquire the 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 § 1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation or a QSub, as the case may be) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation will be treated as an S corporation or a QSub, as the case may be, during the period specified by the Secretary.

CONCLUSION

Based on the information submitted and the representations made, we conclude that Company's S corporation election may have been ineffective or subsequently terminated because Company may have had more than one class of stock. However, we conclude that, if Company's S election was ineffective or subsequently terminated, such ineffectiveness or termination was inadvertent within the meaning of § 1362(f) of the Code. Further, we conclude that the corrective actions taken by Company and its shareholders and by Sub 1 eliminated any potential second class of stock of the Company under § 1361 and eliminated any potential failure of Sub 1 to meet the requirement of § 1361(b)(3)(B)(i), and any potential failures were inadvertent under § 1362(f). Consequently, we rule that Company will be treated as continuing to be an S corporation from Date 6, and thereafter, provided that Company's S election otherwise is not terminated under § 1362(d). Pursuant to the provisions of § 1362(f), Sub 1 will be treated as a QSub from Date 6 and thereafter, provided that its election is not otherwise terminated.

Except as specifically ruled upon above, no opinion is expressed as to the federal income tax consequences of the facts described above under any other provision of the code. In particular, no opinion is expressed or implied as to whether Company or Sub 1 otherwise qualifies as a subchapter S corporation, or QSub, respectively, under § 1361. Furthermore, no opinion is expressed or implied as to the shareholders' basis in Company or Sub 2, the accumulated adjustments account or other tax attributes of Company or Sub 2 as a result of the erroneous income tax reporting of Sub 2 as a QSub of Company during the four taxable years following Date 6.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and are accompanied by a perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of this request, it is subject to verification on examination.

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 the Power of Attorney on file with this office, a copy of this letter ruling will be sent to the taxpayer's representatives.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 2
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosure (1)
Copy of Letter for § 6110 purposes