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-151432-13
Date:
June 24, 2014

LEGEND

X =

A =

B =

C =

D =

E =

Agreement 1 =

Date 1=

Date 2=

Date 3=

Date 4=

State =

Dear :

This responds to a letter signed December 23, 2013, submitted on behalf of X by X's authorized representative, requesting relief under § 1362(f) of the Internal Revenue Code (the Code).

FACTS

According to the information submitted and representations within, X was incorporated on Date 1, under the laws of State. Effective Date 2, X elected to be taxed as an S corporation.

On Date 3, A, the owner of 100% of the then outstanding shares of X, and B, C, D, and E, all of whom were, and continue to be, employees of X, entered into an interconnected series of agreements with X and each other. As part of these agreements B, C, D, and E were permitted to purchase nonvoting shares of X. These nonvoting shares were, and continue to be, subject to various restrictions. At no time did B, C, D, and E make an election pursuant to § 83(b) upon receipt of the restricted nonvoting shares. X treated the restricted nonvoting shares issued to B, C, D, and E as outstanding stock for federal income tax purposes, including by allocating a portion of X's items of income, loss, deduction, and credit to such shares and by distributing dividends to B, C, D, and E as a result of their ownership of such shares.

In addition, Agreement 1, entered into by X, A, B, C, D, and E provided two redemption provisions that could potentially be interpreted as providing different liquidation rights, for the nonvoting shares. X represents that the redemption provisions have never been implemented.

X represents that it has taken the following corrective action: (1) treating B, C, D, & E as employees and not as shareholders of X; (2) amending all of the affected returns for all open years; (3) treating any distributions made with respect to the restricted stock as compensation income to B, C, D, & E until there is no longer a substantial risk of forfeiture; and (4) amending Agreement 1 ,on Date 4, to remove the two redemption provisions that could potentially be interpreted as providing for a second class of stock.

X represents that neither X nor its shareholder intended to terminate X's Subchapter S election. In addition, X represents that, other than the potential termination due to a second class of stock and erroneous treatment of B, C, D, & E as shareholders, X has qualified as a small business corporation at all times since its election on Date 2. Lastly, X represents that X and its shareholder agree to make any adjustments required

as a condition of obtaining relief under the inadvertent termination rule as provided under § 1362(f) of the Code that may be required by the Secretary.

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) 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, and 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(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 taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) further provides that the termination shall be effective on and after the date of cessation.

Treas. Reg. § 1.1361-1(l)(1) 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 laws, and binding agreements relating to distribution and liquidation proceeds (collectively, governing provisions).

Treas. Reg. § 1.1361-1(l)(1)(2)(iii)(A) provides that buy-sell agreements among shareholders, agreements restricting the transferability of stock and redemption agreements are disregarded in determining whether a corporation’s outstanding shares of stock confer identical distribution and liquidation rights unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and Treas. Reg. § 1.1361-1(1), and the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

Treas. Reg. § 1.1361-1(b)(3) provides that, for purposes of subchapter S, stock that is issued “in connection with the performance of services” (within the meaning of Treas. Reg. § 1.83-3(f)) and that is “substantially nonvested” (within the meaning of Treas. Reg. § 1.83-3(b)) is not treated as outstanding stock of the corporation, and the holder

of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under § 83(b) of the Code.

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

CONCLUSION

Based on the facts submitted and the representations made, we conclude that if (1) the erroneous treatment of B, C, D, & E as shareholders, (2) the inclusion of the redemption provisions, or (3) if the corrective actions undertaken by X caused X's S corporation election to terminate, the termination was inadvertent within the meaning of § 1362(f). Therefore, X will be treated as an S corporation effective Date 2 and thereafter, provided X's S corporation election is not otherwise terminated under § 1362(d).

Except as specifically ruled upon above, we express or imply no opinion concerning the federal 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.

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

Sincerely,

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

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