Internal Revenue Service

Number: **201505008**
Release Date: 1/30/2015

Index Number: 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:B3
PLR-116433-14

Date:
October 14, 2014

X =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Year 1 =

Year 2 =

Dear :

This letter responds to a letter dated April 7, 2014, and subsequent correspondence, written on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

Facts

The information submitted states that X was formed as a State limited liability company pursuant to an operating agreement dated as of Date 1, and made an election to be treated as an S corporation effective Date 2. X's operating agreement was amended and restated as of Date 3, to authorize the issuance of new classes of membership interests in X: Preferred Units, Class B Common Units, and Class C Common Units. The shares held by the original members were classified as Class A Common Units. The amended operating agreement provided that a holder of the Preferred Units would receive preferential distribution rights over the other members. Class A and Class B Common Unit holders would share in the distributions, income, and losses of X on a pro rata basis, though the Class A Common Unit holders would also receive preferential liquidation rights. The Class C Common Units holder would only receive a distribution upon the liquidation of X.

Beginning on Date 3 through Date 4, X issued interests in some of the new classes of membership, including Preferred Units to individual retirement accounts (IRAs). On Date 5 and Date 6, X redeemed all outstanding Preferred Units. On Date 7, X redeemed all outstanding Class C Common Units, exchanged all Class B Common Units for Class A common Units, and amended its operating agreement to eliminate all references to any second classes of stock. As of Date 7, X only had one class of stock held by eligible shareholders.

X timely filed its tax returns as an S corporation for all years. X reported all items of income, loss, deduction, and credit on a pro rata basis for Class A and B Common Units, and made distributions only to Class A and B Common Units. No allocations or distributions were made to Preferred Units or Class C Common Units.

X represents that it was not aware that issuing new classes of stock to shareholders and issuing stock to ineligible shareholders could terminate X's S corporation election. X represents that any termination of its S corporation election 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, as might be required by the Secretary.

X requests a ruling that termination of X's S corporation election due to the issuance of multiple classes of stock or having ineligible shareholders was inadvertent within the meaning of section 1362(f). Furthermore, notwithstanding the termination of its S corporation election, X requests that it will be treated as an S corporation from Date 3 and thereafter.

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 such year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1.1361-1(f) of the Income Tax Regulations provides that, except as otherwise provided in § 1.1361-1(e) (relating to nominees), § 1.1361-1(h) (relating to certain trusts), or § 1361(c)(6) (relating to certain exempt organizations), a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

Rev. Rul. 92-73, 1992-2 C.B. 224, holds that a trust that qualifies as an individual retirement account under § 408(a) is not a permitted S corporation shareholder under § 1361.

Section 1.1361-1(l)(1) 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 rights 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). 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 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) 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(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 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) 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.

Section 1.1362-4(d) provides, in part, that in the case of stock held by an ineligible shareholder that causes an inadvertent termination for an S corporation under § 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation during the period the ineligible shareholder actually held stock in the corporation.

Conclusion

Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on Date 3 as a result of X issuing units in more than one class of stock between Date 3 and Date 4, some of which were issued to ineligible shareholders. We further conclude that the termination constituted an inadvertent termination within the meaning of § 1362(f).

X has taken corrective action so that it once again meets the requirements of a small business corporation under § 1361(b). In addition, X and its shareholders agree to make the adjustments discussed below. Therefore, we determine that pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from Date 3 and thereafter, provided that X's S corporation election was otherwise valid and,

apart from the inadvertent termination ruling described above, has not otherwise terminated under § 1362(d).

As a condition for this ruling, for any tax periods between Date 3 and Date 7 in which X reported a net loss, shareholders who were IRAs will be treated as the shareholders of the shares of stock held by them at that time. For any tax periods between Date 3 and Date 7 in which X reported a net gain, the beneficiaries of the IRAs will be treated as the shareholders of the shares of stock held by IRAs.

Furthermore, this ruling is contingent on X making corrective distributions so that the shareholders of the Preferred Units, Class A Common Units, and Class B Common Units receive distributions proportionate to their interests in X from Date 3 through Date 7, within 120 days of the date of this letter if X has not already done so. Under these facts and circumstances, we are not requiring X to make corrective distributions to the holder of the Class C Common Units. For taxable years ending Year 1 and Year 2, X and the shareholders of the Preferred Units, Class A Common Units, and Class B Common Units agree to amend their tax returns consistent with the treatment described above. If X fails to make the corrective distributions or if X or these shareholders fail to treat themselves as described above, this ruling shall be null and void.

Except as specifically set forth above, we express or imply no opinion 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 otherwise eligible to be an S corporation.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. Pursuant to a power of attorney on file with this office, we will send a copy of this letter ruling to X's authorized representative.

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

Sincerely,

Holly Porter
Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2):

A copy of this letter
A copy for § 6110 purposes