Internal Revenue Service

Number: **201815003**
Release Date: 4/13/2018

Index Number: 1361.00-00, 1361.01-02, 1361.01-04, 1361.05-00, 1362.00-00, 1362.01-00, 1362.01-01

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:03
PLR-121635-17

Date:
December 29, 2017

Legend

Company =

A =

B =

C =

D =

E =

Agreement 1 =

Agreement 2 =

Sub =

HoldCo Sub =

State 1 =

State 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Dear :

This letter responds to a letter dated July 12, 2017, and subsequent correspondence, submitted on behalf of Company by its authorized representative requesting a ruling under § 1362(f) of the Internal Revenue Code (Code).

Facts

The information submitted states Company was organized on Date 1 as a limited liability company under the laws of State 1. On Date 2, A, B, C, and D (the Company Shareholders) filed Form 2553, Election by a Small Business Corporation, for Company to be an association treated as an S corporation effective Date 3. As of Date 3, B was an ineligible shareholder under § 1361(b)(1)(B). It was the intent of the Company Shareholders that before Date 3 the Company shares held by B would be transferred to

E, an eligible S corporation shareholder.

Effective on Date 1, the Company Shareholders signed an operating agreement, Agreement 1. Agreement 1 included provisions in contemplation of Company being treated as a partnership for federal income tax purposes; however, the applicability of those provisions was not limited to such a situation. Agreement 1 included the following partnership provisions: (1) Article 2.3 providing, in part, "[t]he Managers shall provide to the Members, in the time, manner, and form that the Managers determine, reports concerning the financial condition and results of operation of the Company and the Members' Capital Accounts;" (2) Article 3.5 providing for the increase, decrease, maintenance and transfer of capital accounts in accordance with § 1.704-1(b)(2)(iv) of the Income Tax Regulations; (3) Article 4.1 providing "the Company's net profits, net losses, and other items of income, gain, loss, deduction and credit shall be allocated among the Members first, so their Capital Account balances are, as nearly as possible, in the same ratios as their respective Shares, and then, pro rata, in accordance with the Shares held by each member," and requiring certain adjustments under § 704(b) to ensure that the allocation of profits and losses have substantial economic effect; (4) Article 4.2 providing the terms and conditions for the Company to make distributions to its members, including that "[n]o distribution can be made until all debts to any member is paid in full with all accrued interest;" and (5) Article 9.3, in part, required "liquidating distributions to Members who have positive Capital Accounts, in accordance with such positive Capital Account balances, but only after the Capital Accounts have been adjusted for all prior contributions and distributions and allocations … for all periods." These provisions applied during the period when Company intended to be treated as an S corporation until Date 4, when Agreement 2 replaced Agreement 1 in order to eliminate the potential for a second class of stock under § 1361(b)(1)(D).

Sub was organized on Date 5 as a corporation under the laws of State 2. On Date 6 Company purchased all of the shares of Sub in a qualifying stock purchase for which a § 338(h)(10) election was made. Company then made an election on Form 8869, Qualified Subchapter S Subsidiary Election, to treat Sub as a QSub pursuant to § 1361(b)(3)(B)(ii) effective Date 6. On Date 8 Company transferred the stock of Sub to HoldCo Sub, a wholly owned disregarded entity owned by Company.

Company requests four rulings. First, the ineffectiveness of the Company's S election caused by B being a member on Date 3, was inadvertent within the meaning of § 1362(f) and Company will be treated as an S corporation from Date 2 and thereafter. Second, the ineffectiveness or termination of the Company's S election due to the provisions of Agreement 1 was inadvertent within the meaning of § 1362(f), and Company will be treated as an S corporation from Date 2 and thereafter. Third, the ineffectiveness or termination of Sub's QSub election caused by the ineffectiveness or termination of the Company's S election was inadvertent within the meaning of § 1362(f). Fourth, Company's request for an effective date for Sub's QSub election of Date 6, rather than Date 7, was inadvertent within the meaning of § 1362(f), and

Company's QSub election for Sub will be treated as effective Date 7.

In accordance with §§ 1362(f) and 1.1362-4, Company and each person who has been a shareholder of Company at any time on or after Date 3 through the date of the ruling request have consented to any adjustments as may be required by the Secretary.

Law and Analysis

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

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.

An S corporation election is not effective if there is an ineligible shareholder at any time during the taxable year for which the election is to be effective. See § 1.1362-6(a)(2)(iii), Example 3.

A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of the disposition. See § 1.1377-1(a)(2)(ii).

Section 1.1361-1(l)(1) provides, in part, 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).

Section 1361(b)(3)(A) provides that, except as provided in regulations prescribed by the Secretary, for purposes of the Code (i) a corporation that is a QSub shall not be treated as a separate corporation, and (ii) all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and such items (as the case

may be) of the S corporation.

Section 1361(b)(3)(B) provides that the term "QSub" means any domestic corporation which is not an ineligible corporation (as defined in § 1361(b)(2)), if (i) 100 percent of the stock of such corporation is held by the S corporation, and (ii) the S corporation elects to treat such corporation as a QSub.

Section 1.1361-3(a)(1) provides that the corporation for which a QSub election is made must meet all the requirements of § 1361(b)(3)(B) at the time the election is made and for all periods for which the election is to be effective.

When an S corporation that acquires another S corporation in a qualified stock purchase for which a § 338(h)(10) election is made and then makes a QSub election, the QSub election for the acquired subsidiary may not be effective until the day after the acquisition date. See § 1.1361-4(d), Example (3).

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 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(f) and the regulations thereunder provide relief for an ineffective S corporation election or ineffective QSub election (i.e., treating the ineffective election as effective) or inadvertent termination of an S corporation election or QSub election provided the following conditions are met:

a. The corporation made an election under § 1362(a) or § 1361(b)(3)(B)(ii) that was ineffective or was terminated;

b. The Service determines that circumstances resulting in the ineffectiveness or termination were inadvertent;

c. Steps were taken by the corporation to qualify it as a small business corporation or QSub within a reasonable period of time after discovery of the termination event; and

d. The corporation and all shareholders agree to any adjustments that the Service may require for the period.

Conclusion

Based on the facts submitted and representations made, we conclude that the S election filed on Date 3 and the QSub election intended to be effective on Date 6 were ineffective. The S election for Company was ineffective because on Date 3 B held

Company shares, signed and submitted Form 2553 electing S status for Company, and was an ineligible S corporation shareholder under § 1361(b)(1)(B). In addition, Company's S election was ineffective because Company had more than one class of stock due to the partnership provisions in Agreement 1. The QSub election for Sub was ineffective because it was effective on Date 6 and Company was not an S corporation at the time of the election.

We conclude the ineffectiveness of the S election for Company and of Company's QSub election for Sub were inadvertent within the meaning of § 1362(f). We also conclude that the ineffectiveness of Company's S election, as a result of Agreement 1 creating a second class of stock, was inadvertent within the meaning of § 1362(f). Accordingly, under § 1362(f), Company will be treated as an S corporation from Date 3, and thereafter, provided the S election for Company is otherwise valid and has not terminated under § 1362(d). Furthermore, under § 1362(f), Sub will be treated as a QSub from Date 7, and thereafter, provided the QSub election for Sub is otherwise valid and has not otherwise terminated under § 1361(b)(3)(B). Such relief is conditioned upon filing a completed Form 2553 and Form 8869 to make an S election for Company and QSub election for Sub, respectively, with the appropriate service centers within 120 days of the date of this letter to be effective Date 3 for the S election and Date 7 for the QSub election. A copy of this letter should be attached to the submitted Form 2553 and Form 8869.

Except as specifically ruled upon above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. In particular, we express or imply no opinion regarding whether Agreement 2 creates a second class of stock.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

The ruling contained in this letter is 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 ruling request, it is subject to verification on examination.

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

Sincerely,

_____
Bradford R. Poston
Special Counsel to the Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: