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:01
PLR-131422-18

Date:
May 22, 2019

Legend

X =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

A =

B =

C =

D =

E =

Agreement 1 =

Agreement 2 =

Dear :

This letter responds to a letter dated October 15, 2018, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code (Code).

Facts

The information submitted states X was organized on Date 1 as a corporation under the laws of State. On Date 2, A, B, C, and D, each assigned one share of X to E, which was taxed as a partnership for U.S. federal tax purposes. Effective Date 3, X converted to a limited partnership, organized under the laws of State. On Date 4, X elected to be taxed as an association taxable as a corporation, effective Date 3. On Date 4, A, B, C, and D, and their spouses holding community property interests in the X shares, filed Form 2553, Election by a Small Business Corporation, for X to be treated as an S corporation, effective Date 3. E did not sign and submit Form 2553, although E was a shareholder as of Date 3. As of Date 3, E was an ineligible shareholder under § 1361(b)(1)(B).

Effective on Date 3, A, B, C, D, and E signed a partnership agreement, Agreement 1. Agreement 1 included provisions in contemplation of X 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 IX 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; (2) Article X. A. providing "for federal income tax purposes, each item of income, gain, loss and deduction will be allocated among the Partners in the same manner as its correlative item of 'book' income, gain, loss or deduction is allocated pursuant to this Article X"; (3) Article X. B. providing, in part, "[a]ll items of income, gain, loss, deduction, and credit of the Partnership as determined for federal income tax purposes shall be allocated among the Partners in accordance with their respective percentage Partnership Interests"; (4) Article XI. A. providing, in part, "Distributable Cash may be distributed at the sole discretion of the General Partner among the Partners pro rata in

accordance with their Sharing Ratios"; and (5) Article XVII. C. providing, in part, "after all allocations of income, gains, losses and deductions pursuant to Article X" liquidation distributions shall be made "to the Partners in payment of the positive balances in their Capital Accounts." These provisions applied during the period when X intended to be treated as an S corporation until Date 5, when Agreement 2 replaced Agreement 1.

Before Date 5, X redeemed all of D's shares. Effective on Date 5, A, B, C, and E signed a partnership agreement, Agreement 2. Agreement 2 included provisions in contemplation of X being treated as a partnership for federal income tax purposes; however, the applicability of those provisions was not limited to such a situation. Agreement 2 included the following partnership provisions: (1) Article VIII(b)(1) 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; (2) Article VIII(c)(1) providing "[e]xcept as otherwise provided, Profit and Loss for such fiscal year shall generally be allocated among the Partners in proportion to their respective Sharing Ratios at the time the allocation is made"; (3) Article V(l) defining, in part, "Sharing Ratio" to mean "the ratio of a Partner's Capital Account to the Capital Accounts of all Partners . . . . Each Partner's Sharing Ratio is subject to change over time as provided in this Agreement"; (4) Article VIII(d)(1) providing, in part, "Distributable Cash, if and when there is any, shall generally be distributed to the Partners pro rata to their Partnership Interests at the time the distribution is made"; (5) Article V(i) defining, in part, "Partnership Interest" to mean "the ownership interest . . . in the Partnership, including, without limitation, his right to a distributive share of the Profits and Losses, distributions, and the Property of the Partnership"; and (6) Article VIII(d)(3) providing "[u]pon liquidation of the Partnership (and after adjusting Capital Accounts to reflect unrealized gains or losses[])], the remaining Partnership property shall be distributed to the Partners in accordance with their Capital Account balances." These provisions applied from Date 5, during the period when X intended to be treated as an S corporation, until Date 6.

X represents that its S election on Date 3 may have been ineffective due to an ineligible shareholder and a second class of stock and, if not ineffective, that its S election may have terminated on Date 5 due to a second class of stock. X represents that the following corrective actions were taken: (1) on Date 6, A and B assigned their membership interests in E to C, the remaining member, causing E to be treated as an entity disregarded from C for U.S. federal income tax purposes; and (2) on Date 7, X converted to a corporation under the laws of State. X represents that the conversions on Date 2 and Date 7 each qualified as an F reorganization within the meaning of § 368(a)(1)(F).

X requests three rulings. First, the ineffectiveness of the X's S election caused by E being taxed as a partnership on Date 3, was inadvertent within the meaning of § 1362(f), and X will be treated as an S corporation from Date 3 and thereafter. Second, the ineffectiveness of the X's S election due to the provisions of Agreement 1 was

inadvertent within the meaning of § 1362(f), and X will be treated as an S corporation from Date 3 and thereafter. Third, the termination of the X's S election due to the provisions of Agreement 2 was inadvertent within the meaning of § 1362(f), and X will be treated as an S corporation from Date 3 and thereafter.

X represents that the possible ineffectiveness and termination of its S election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X also represents that X and its shareholders agree to make any adjustments required as a condition of obtaining relief under the inadvertent invalid election rule as provided under § 1362(f) of the Code that may be required by the Secretary. X and its shareholders represent that they have filed all returns consistent with X being an S corporation.

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 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 (i.e., treating the ineffective election as effective) or inadvertent termination of an S corporation election provided the following conditions are met:

a. The corporation made an election under § 1362(a) 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 within a reasonable period of time after discovery of the ineffectiveness or 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 4 and intended to be effective on Date 3 was ineffective. The S election for X was ineffective because, on Date 3, E held X shares, failed to sign and submit Form 2553 electing S status for X, and was an ineligible S corporation shareholder under § 1361(b)(1)(B). In addition, X's S election was ineffective because X had more than one class of stock due to the partnership provisions in Agreement 1. If X's S election had been effective, X's S election would have terminated on Date 5 because X had more than one class of stock due to partnership provisions in Agreement 2, which was effective on Date 5.

We conclude the ineffectiveness of the S election for X, due to E being an ineligible shareholder, was inadvertent within the meaning of § 1362(f). We also conclude that the ineffectiveness of X's S election, as a result of Agreement 1 creating a second class of stock, was inadvertent within the meaning of § 1362(f). We also conclude that the termination of X's S election, as a result of Agreement 2 creating a second class of stock, was inadvertent. Accordingly, under § 1362(f), X will be treated as an S corporation from Date 3, and thereafter, provided the S election for X is otherwise valid

and has not terminated under § 1362(d). Such relief is conditioned upon filing a completed Form 2553 to make an S election for X to be effective Date 3 with the appropriate service center within 120 days of the date of this letter. A copy of this letter should be attached to the submitted Form 2553.

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.

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,

By: *Joy Spies*
Joy Spies
Senior Technician Reviewer, Branch 1
(Passthroughs and Special Industries)

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