Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:03
PLR-113034-19

Date:
November 29, 2019

Legend

Company =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Agreement 1 =

Agreement 2 =

Dear :

This letter responds to a letter dated May 20, 2019, 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. Company's operating agreement, 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 4.1 providing, "Allocation of Net Profits. For each taxable year of the Company, Net Profits are to be allocated to the Members as follows … First, if one … or more Members have a negative Capital Account balance, to those Members in proportion to their negative Capital Account balances until all negative Capital Accounts have zero balances; provided, however, that no such negative Capital Account is to be increased to an amount in excess of zero as a result of this Subsection"; and
>
> (2) Article 4.2 providing "Allocation of Net Losses. For each taxable year of the Company, Net Losses are to be allocated to the members as follows subject to the provisions of Section 4.3,..First if one or more Members have a positive capital account balance, to those members in proportion to their positive Capital Account balance until all positive Capital Accounts have zero balances"; and
>
> (2) Article 4.3 providing, "Distribution of Available Cash … to the Members in proportion to their respective positive Capital Account balances until each Member has received an amount equal to the balance of his Capital Account"; and
>
> (3) Article 10.2 requiring, in part, "Upon the dissolution of the Company, the Members shall proceed to liquidate the Company and the liquidation proceeds will be applied and distributed in the following order of priority … to the Members in proportion to their respective positive Capital Accounts."

Taxpayer represents that, on Date 4, Agreement 2 replaced Agreement 1 in order to eliminate the potential for a second class of stock under § 1361(b)(1)(D). On Date 5, this office contacted Company's representative to discuss concerns with the revisions in Agreement 2, and Company submitted a revised Agreement 2 on Date 6.

In addition, on Date 3, Company issued a membership interest to an individual retirement account (IRA), an ineligible S corporation shareholder. On Date 4, Company repurchased all outstanding shares held by the IRA.

Company represents that Company and its shareholders have filed tax returns consistent with Company having a valid S corporation election in effect as of Date 1. 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 1 through the date of the ruling request have consented to any adjustments as may be required by the Secretary.

Company requests two rulings. First, Company requests relief pursuant to § 1362(f) due to its governing provisions creating more than one class of stock. Second, Company requests relief pursuant to § 1362(f) because an ineligible shareholder held its shares from Date 2 to Date 3.

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 for purposes of subchapter S, the term "small business corporation" means a domestic corporation, which is not an ineligible corporation and does not have (A) 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 subsection § 1361(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 1.1361-1(h)(1)(vii) provides that IRAs (including Roth IRAs) are not eligible S corporation shareholders (except as provided in the limited circumstance in that section).

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(a)(1) 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 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) provides, in part, that if (1) an election under §1362(a) by any

corporation (i) 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 (ii) was terminated under §1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken so that the corporation for which the election was made or the termination occurred is a small business corporation; and (4) the corporation for which the election was made or the termination occurred, and each person who was a shareholder of the corporation at any time during the period specified pursuant to §1362(f), agree to make the adjustments (consistent with the treatment of the corporation as an S corporation as may be required by the Secretary with respect to this period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, the 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 on the facts submitted and representations made, we conclude that the S election was ineffective. Company had more than one class of stock due to the partnership provisions in Agreement 1. We further conclude that had Company's S corporation election otherwise been effective, Company's S election would have terminated on Date 2 when an IRA, an ineligible shareholder under § 1361(b)(1)(B), received shares in Company. We 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). We further conclude even if Company's S election were otherwise valid, the termination resulting from IRA holding Company shares constituted an inadvertent termination 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).

As a condition for this ruling, for any tax periods between Date 2 and Date 3 in which Company reported a net loss, the shareholder who was an IRA will be treated as the shareholder of the shares of stock held by them at that time. For any tax periods between Date 2 and Date 3 in which Company reported a net gain, the beneficiary of the IRA will be treated as the shareholders of the shares of stock held by the IRA. Additionally, Company and its shareholders agree to adopt the revisions to Agreement 2 as submitted to this office on Date 6 within 120 days of the date of this letter.

Except as specifically ruled above, we express or imply no opinion as to the federal income tax consequences of the facts described above under any other provision of the Code, including Company's eligibility to be a valid S corporation.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it 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.

Sincerely,

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Caroline E. Hay
Senior Counsel, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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