**Internal Revenue Service**

Department of the Treasury
Washington, DC 20224

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LEGEND

Company =

X =

Y =

State =

Revenue =

a =

b =

c =

d =

Dear :

We received a letter dated November 20, 2006, and subsequent correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code. This letter responds to that request.

## FACTS

Company was incorporated on a under the laws of State. Company's shareholders are X, with a b percent interest, and Y, with a c percent interest. Company elected under § 1362(a) to be treated as an S corporation effective on a. However, a shareholder agreement ("Agreement") by and among Company, and X and Y provided that certain Revenue of Company be distributed to X and Y other than in accordance with their percentage ownership interests in Company.

On approximately d, Company's corporate counsel became aware that Company may have more than one class of stock due to the distribution plan in the Agreement. Corporate counsel notified Company that its S corporation election may have been invalid as a result of the Agreement. Subsequently, the Agreement was amended to provide that Company's Revenue would be distributed to X and Y in accordance with their percentage ownership interests. Company represents that, since its incorporation, Company has had no taxable income and has made no distributions to its shareholders.

Company also represents that the possible issuance of more than one class of stock was not motivated by tax avoidance or retroactive tax planning, and that the invalid S corporation election was inadvertent. In addition, Company, X, and Y agree to make any necessary adjustments consistent with the treatment of Company as an S corporation.

## LAW

Section 1361(b)(1)(D) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations 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), 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.

Section 1362(d)(2)(A) provides that an election under § 1362(a) terminates whenever (at any time on or after the 1st day of the 1st taxable year for which the

corporation is an S corporation) the corporation ceases to be a small business corporation.

For inadvertent invalid S corporation elections or terminations before January 1, 2005, § 1362(f) provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which made by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or (B) was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents; and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees 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 the 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 that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner.

## CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that Company's S corporation election was not effective for the taxable year for which made because the distribution plan in the Agreement by and among Company and X and Y established more than one class of stock. However, we also conclude that Company's S corporation election was inadvertently invalid within the meaning of § 1362(f). Consequently, we rule that Company will be treated as an S corporation from a, and thereafter, provided Company's S election is not otherwise terminated under § 1362(d). Accordingly, Company's shareholders must include their pro rata shares of the separately and nonseparately computed items in their income as provided in § 1366, make adjustments to the stock basis of those shares as provided in § 1367, and take into account any distributions with respect to those shares as provided in § 1368.

Except for the specific ruling above, we express or imply no opinion concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding Company's eligibility to be an S corporation.

Under a power of attorney on file with this office, we are sending a copy of this letter to Company's authorized representatives.

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.

Sincerely,

/s/

CHRISTINE ELLISON
Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosures: copy of this letter
copy for § 6110 purposes