

Internal Revenue Service

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LEGEND

X =

State =

A =

B =

C =

D =

Date =

1
Date =

2
Date =

3
Date =

4

Dear :

We received a letter dated October 1, 2008, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting a ruling under §§ 1361 and 1362 of the Internal Revenue Code. This letter responds to your request.

FACTS

X was incorporated in State on Date 1. X elected to be an S corporation effective Date 2. X has had four shareholders, A, B, C, and D, during the period at issue in this request. Beginning in the year ending Date 3, X made disproportionate distributions.

X represents that each share in X has identical rights to liquidation proceeds and distributions, and that no provision exists in the governing documents, regulations, or by-laws that vary these rights. X also represents that no other binding agreements exist that vary these rights. In addition, X represents that a corrective distribution was made on Date 4. X further represents that this corrective distribution resulted in distributions proportionate to A, B, C and D's respective interests in X since its inception as an S corporation. Finally, X represents that it has intended to be an S corporation since its election effective Date 2.

A, B, C and D each represent they have not received a distribution in excess of their stock basis. A, B, C, and D each further represent that no distributions have been made that were dividends of accumulated earnings and profits of X (prior C corporation earnings and profits) or capital gains. Finally, A, B, C, and D each consent to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

LAW

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) defines a "small business corporation" as 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(l)(1) of the Income Tax Regulations provides 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 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. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

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 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 of § 1361(b)(1)(D) and § 1.1361-1(l). 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 1.1361-1(l)(3) provides that, except as provided in §§ 1.1361-1(b)(3), (4), and (5) (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account.

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(d)(2)(B) provides that any termination under § 1362(d)(2) shall be effective on and after the date of cessation.

CONCLUSION

Based solely on the information submitted and the representations made, we conclude that if X has more than one class of stock due to the disproportionate distributions X made to A, B, C, and D, X's election to be treated as an S corporation terminated in the year ending on Date 3. We also conclude that the termination was

inadvertent under § 1362(f). Consequently, we conclude that X will continue to be treated as an S corporation beginning on Date 2 and thereafter, provided X's S corporation election was valid and was not otherwise terminated under § 1362(d). This ruling is contingent on X making corrective distributions to A, B, C, and D so that each shareholder has received distributions proportionate to their interests in X from Date 2 and thereafter.

This ruling also is contingent on X and A, B, C, and D treating X as having been an S corporation for the period beginning on Date 2 and thereafter. A, B, C, and D also must, in determining their respective income tax liabilities, include their pro rata share of the separately stated and nonseparately computed items of income or loss of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions that X made as provided in § 1368.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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,

/s/

Christine E. Ellison
Branch Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

Copy for § 6110 purposes

cc: