Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:2-PLR-102966-00
Date:
June 6, 2000

X =

A =

B =

C =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Month =

Dear :

This letter responds to your letter dated January 3, 2000, and subsequent correspondence, submitted on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that the Articles of Incorporation of X were executed on Date 1. The Articles of Incorporation were not filed until Date 2 and under the laws of State, X is treated as having been incorporated on Date 2. The shareholders of X are A, B, and C. X elected to be an S corporation effective Date 1.

The Articles of Incorporation executed on Date 1 and filed on Date 2 authorized X to issue 1,000,000 shares of common stock. Shortly after X's incorporation, X's tax advisor recommended to A, B, and C that the Articles of Incorporation be amended to provide for the issuance of preferred stock. The tax advisor told A, B, and C that the preferred stock would provide flexibility to the shareholders in the event that the shareholders wanted to restructure the corporation in the future. The tax advisor did not advise A, B, and C that the issuance of the preferred stock would result in the termination of X's S corporation election and A, B, and C were unaware of the consequences of issuing the preferred stock. Hence, A, B, and C executed, and filed with State, an amendment to X's Articles of Incorporation that authorized X to issue 9,500 shares of preferred stock in addition to the 1,000,000 shares of common stock already authorized. The amendment, however, failed to define the rights of the preferred stockholders as required by the laws of State in effect at the time.

On Date 3, X issued shares of preferred stock to A, B, and C. A, B, and C failed to contribute any money or property to X in exchange for the preferred stock even though such a contribution was required by the laws of State at the time. Further, the number of shares of preferred stock issued to A, B, and C far exceeded the number of shares authorized to be issued in the amendment.

In Month, X retained legal counsel for assistance in a proposed restructuring of X and for general corporate representation. Upon review of X's records, X's legal counsel discovered that X may have issued a second class of stock. In response, on Date 4, A, B, and C adopted an amendment to X's Articles of Incorporation that eliminated the preferred stock. Also on Date 4, A, B, and C surrendered their shares of preferred stock and the preferred stock was canceled on the records of X.

A, B, and C represent that since Date 1, X has made distributions on the basis of the ownership of X's common stock. No distributions have been made with respect to the preferred stock. Further all of X's income and expenses have been reported by A, B, and C in proportion to their ownership of the common stock of X. X, A, B, and C represent that neither X nor A, B, and C realized that issuance of preferred stock would result in termination of X's S corporation election, and that X, A, B, and C had no intention of terminating the election. X, A, B, and C represent that the terminating event was not motivated by tax avoidance nor was it the result of retroactive tax planning.

X's legal counsel represents that, as a result of A, B, and C's failure to comply with the laws of State, the effect of the issuance of the preferred stock on the rights of A, B, and C, under the laws of State, is uncertain. X's legal counsel believes that while the stock was outstanding that the stock was voidable but not void. Hence, A, B, and C possessed preferential rights to liquidation and distributions based on their ownership of preferred stock. The exact scope of any such preferences, however, could only have been determined through court action.

X, A, B, and C have agreed to make any adjustments that the Commissioner may require, consistent with the treatment of X as an S corporation.

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.

Under section 1361(b)(1)(D) of the Code, for purposes of subchapter S, the term "small business corporation" includes a domestic corporation which is not an ineligible corporation and which does not have more than 1 class of stock.

Section 1361-1(l)(1) provides that, subject to certain exceptions, 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 are disregarded in determining whether a corporation has more than one class of stock.

Section 1361-1(l)(2) 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).

Section 1362(d)(2)(A) provides that an election under § 1362(a) will 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 the termination shall be effective on and after the date of cessation.

Section 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 (determined without regard to § 1362(b)(2)) 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 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 (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 in the corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we hold that X's S corporation election terminated on Date 3, under §1362(d)(2) of the Code, because from Date 3 to Date 4 X had more than one class of stock. We hold also that the termination of X's S corporation election was an inadvertent termination within the meaning of § 1362(f) of the Code.

We further hold that under the provisions of § 1362(f), X will be treated as an S corporation during the period Date 3 to Date 4, and subsequent periods, provided that X's election to be an S corporation was valid and was not otherwise terminated under § 1362(d). If X or its shareholders fail to treat X as described above, this ruling will be null and void.

Except as specifically ruled above, we express no opinion concerning the federal income tax consequences of the transactions described above under any other provision of the Code. This ruling letter is directed only to the taxpayer who requested it and may not be used of cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely yours,

J. THOMAS HINES
Acting Branch Chief,
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of this letter
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