**Internal Revenue Service**

Department of the Treasury

Washington, DC 20224

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LEGEND

Company =

State =

Practice =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

Shareholders =

Members =

Dear :

This letter responds to a letter dated October 15, 2001, submitted on behalf of Company requesting a ruling under § 1362(f) of the Internal Revenue Code.

According to the information submitted, Company was organized under the laws of State on a, and is engaged in Practice. Company filed an election under § 1362(a) to be treated as an S corporation effective as of b, by filing the required Form 2553, Election by a Small Business Corporation. Company's Form 2553 was correctly and accurately completed with three exceptions. On the form, Company inadvertently provided an inaccurate number of shares of issued and outstanding stock held by each of the Shareholders. In addition, the dates on which three of the Shareholders acquired their stock were inaccurately provided. Finally, three former shareholders whose interest in Company had been redeemed in c, consented to the election for Company in addition to all of the remaining Shareholders who consented to the election. Company's subchapter S election was accepted by the Internal Revenue Service Center.

In d, a law firm was engaged to review Company's entity structure and other matters. The firm informed Company that the following provisions in its e by-laws, still in place at the time, might provide for differing shareholder rights to distribution and liquidation proceeds. Article f of Company's by-laws provided:

> The Board of [Members], by a [g] vote, shall allocate the profits and losses of the Association at the end of each fiscal year. For these purposes, the following definitions apply: SCHEDULE A: That schedule established by the Board of [Members] listing the percentage allocation of profits or losses to each shareholder.

In addition, Article h of the by-laws provided:

> The Association may be dissolved by operation of law, as provided in [State] Code, or by the affirmative vote of [i] majority of the active shareholders. ... Upon dissolution, the assets shall be first used to pay debts and then distributed to shareholders: (a) To pay their capital accounts, and then (b) To be divided among them as a distribution of profits.

Company represents that the preceding provisions have never been interpreted or implemented to provide for unequal distribution rights or for disproportionate distribution on liquidation. Company further represents that the Shareholders never intended Company to be operated except as an S corporation since its S election. According to Company, its income has been paid as salary compensation to its shareholders and some non-shareholders, with any remaining profit or loss allocated equally among the shareholders. After being informed that its by-laws might violate the single class of stock requirement for S corporations, Company amended its by-laws to conform with the single class of stock rules as of j.

Company also represents that any invalidity of its S corporation election was not part of a plan to invalidate the election. Neither Company nor its Shareholders were aware that Company's e by-laws could invalidate its S election. Finally, Company and its Shareholders agree to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Service.

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)(D) provides that 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) (relating to instruments, obligations, or arrangements treated as a 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.

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 affect in accordance with the facts and circumstances.

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of the failure to meet the requirements of § 1361(b) or to obtain shareholder consents; (2) the Secretary determines that the circumstances resulting in the ineffectiveness were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness, steps were taken so that the corporation is a small business corporation, 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 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 the ineffectiveness, the corporation shall be treated as an S corporation during the period specified by the Secretary.

In Rev. Rul. 74-150, 1974-1 C.B. 241, a newly formed corporation timely filed a Form 2553 which erroneously reported the number of shares issued and outstanding. The ruling holds that because the purpose of Form 2553 is to provide a means by which a timely subchapter S election may be made by a corporation and to record the required consent of the shareholders to that election, a timely filed subchapter S election is not invalidated by the corporation's issuing a lesser number of shares of stock than was set forth in the election on Form 2553.

Based solely on the facts submitted and the representations made, we conclude that Company's subchapter S election will not be invalidated solely because of the errors discussed above that were made on Company's Form 2553.

In addition, based solely on the facts submitted and the representations made, we conclude that Company's S corporation election may have been invalid on b, because at that time Company may have had more than one class of stock. We further conclude that if Company's election was invalid, it was inadvertent within the meaning of § 1362(f). Thus, under the provisions of § 1362(f), Company will be treated as an S corporation from b, and thereafter, provided that Company's S corporation election is otherwise valid and is not otherwise terminated under § 1362(d).

This ruling is contingent on Company and its Shareholders treating Company as having been an S corporation from b, and thereafter. Accordingly, Company's Shareholders, in determining their income tax liabilities for the period beginning b and thereafter, must include their pro rata shares of the separately and nonseparately computed items of Company under § 1366, make any adjustments to stock basis under § 1367, and take into account any distributions made by Company to shareholders under § 1368. If Company or any of Company's Shareholders fail to treat Company as described above, this ruling will be null and void.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representative.

This ruling is directed only to the taxpayer requesting it. Under § 6110(k)(3), it may not be used or cited as precedent.

Sincerely yours,

/s/
JEANNE SULLIVAN
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

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