

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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January 25, 2008

Legend

X =

Y =

A =

B =

C =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

D8 =

D9 =

Dear \_\_\_\_\_ :

This letter responds to a letter dated December 13, 2006, and subsequent correspondence, written on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

#### Facts

The information submitted states that X was incorporated under the laws of State on D1. X elected to be an S corporation effective D2. On D3, X purchased all of the stock of Y and elected to treat Y as a qualified subchapter S subsidiary (QSub) effective D3.

Under X's Articles of Incorporation, X was authorized to issue common stock. As of D2, X's common stock was held by A, B, and C. On D4, X's Articles of Incorporation were amended to authorize the issuance of preferred stock, which provided for preferential distribution rights over the common stock. X issued shares of preferred stock to A on D5, D6, and D7 in exchange for A's contribution of money to X.

Around D8, X's Board of Directors discovered that X may have inadvertently terminated its S corporation election on D5 by issuing a second class of stock. On D9, X took corrective action by issuing additional shares of common stock to A in exchange for, and upon cancellation of, the preferred stock, and by amending X's Articles of Incorporation to eliminate the preferred stock.

X represents that no distributions of cash or other property have ever been made by X with respect to the preferred stock. X further represents that X and its shareholders did not intend to create more than one class of stock, and, as soon as X's Board of Directors realized the potential problem caused by the preferred stock, X eliminated the preferred stock. X and its shareholders agree to make any adjustments, consistent with the treatment of X as an S corporation, as might be required by the Secretary.

### Law and Analysis

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any tax year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(1) provides that the term "small business corporation" means 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, in part, that 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, in part, that in general, 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 1361(b)(3)(B) provides that the term "qualified subchapter S subsidiary" means any domestic corporation which is not an ineligible corporation (as defined in § 1361(b)(2)), if 100 percent of the stock of the corporation is held by the S corporation, and the S corporation elects to treat the corporation as a QSub.

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) will be terminated whenever (at anytime on or after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(f) provides that if (1) an election under § 1362(a) or § 1361(b)(3)(B)(ii) by any corporation was terminated under § 1362(d)(2) or § 1361(b)(3)(C), (2) the Secretary determines that the circumstances resulting in such termination were inadvertent, (3) no later than a reasonable period of time after

discovery of the circumstances resulting in such termination, steps were taken so that the corporation for which the termination occurred is a small business corporation or a QSub, as the case may be, and (4) the corporation for which the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of such corporation as an S corporation or a QSub, as the case may be) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such termination, such corporation shall be treated as an S corporation or a QSub, as the case may be, during the period specified by the Secretary.

### Conclusion

Based solely on the facts submitted and representations made, we conclude that the issuance of the preferred stock was a second class of stock that terminated X's S corporation election and Y's QSub election on D5. We also conclude that the termination of X's S corporation election and Y's QSub election was inadvertent within the meaning of § 1362(f).

Under the provisions of § 1362(f), X will be treated as an S corporation from D5 and thereafter, provided X's S corporation election is otherwise valid and is not otherwise terminated under § 1362(d). In addition, Y will be treated as a QSub of X from D5 and thereafter, provided that Y satisfies the requirements to be a QSub under § 1361(b)(3)(B) and that X's S corporation election is not otherwise terminated under § 1362(d).

This ruling is contingent on X and its shareholders treating X as an S corporation for the period beginning D5 and thereafter, and on X treating Y as a QSub for the period beginning D5 and thereafter. X and its shareholders must make any adjustments that are necessary to comply with this ruling. Accordingly, the shareholders of X must include their pro rata shares of the separately and nonseparately computed items of X in their income as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion regarding whether X is otherwise eligible to be an S corporation, or whether Y is otherwise eligible to be a QSub.

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

Sincerely,

/s/

Tara P. Volungis  
Senior Technician Reviewer, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

Copy for section 6110 purposes

cc: