

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact:  
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Telephone Number:

Refer Reply To:  
CC:PSI:B1  
PLR-128255-08  
Date:  
December 15, 2008

Legend

X =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year 1 =

Year 2 =

a =

b =

c =

d =

e =

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

This letter responds to a request, dated June 19, 2008, written on behalf of X, requesting relief under § 1362(f) for an inadvertent S corporation termination.

### FACTS

You have represented that the facts are as follows. X is a corporation organized under the laws of State on Date 1. X also made an S corporation election effective Date 1. Effective Date 2, X elected to revoke its status as an S corporation pursuant to § 1362(d)(1).

X has two classes of stock, Class A common stock (voting) and Class B common stock (non-voting), which are identical in all respects except for voting rights. Each share of Class A common stock and Class B common stock has equal rights to distributions, dividends, and liquidation proceeds.

As part of a stock incentive compensation program, X granted shares of restricted Class B common stock ("Restricted Stock") to certain key employees effective Date 3 ("Year 1 Restricted Stock") and Date 4 ("Year 2 Restricted Stock"). The Restricted Stock was subject to vesting in equal increments over a years, commencing on Date 4 and Date 5, respectively. The Year 1 Restricted Stock was granted to b key X employees, and the Year 2 Restricted Stock was granted to c key X employees. d of the b employees granted Year 1 Restricted Stock and e of the c employees granted Year 2 Restricted Stock (the "Electing Individuals") timely filed § 83(b) elections with respect to the Restricted Stock.

Notwithstanding these elections, during the taxable years Year 1 and Year 2 X did not treat the unvested Restricted Stock for which a § 83(b) election was made as outstanding stock of X. X was unaware that the Restricted Stock for which a § 83(b) election was made should have been treated as outstanding as of the date of the grants.

X now requests a ruling that if X's failure to treat the Restricted Stock for which a § 83(b) election was made as outstanding stock of X caused X's S election to terminate, then the termination of X constituted an inadvertent termination within the meaning of § 1362(f). X represents that it will take the following corrective actions: (1) for Year 1 and Year 2, X will treat all of the Restricted Stock for which a § 83(b) election was made as outstanding for all purposes; (2) X will make corrective distributions to the Electing Individuals, with respect to the Restricted Stock for which a § 83(b) election was made,

as would have been made had such Restricted Stock been treated as outstanding during Year 1 and Year 2, and (3) X will treat the portion of the distributions made to historical shareholders in Year 2 in excess of the pro rata amount as a loan from X to such shareholders, and the historic shareholders will repay the loan to X.

## LAW AND ANALYSIS

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 section 1362(a) is in effect for the year.

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, among other things, have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation is generally 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. 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(i)(2)(iii)(A) provides that buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical rights unless a principal purpose of the agreement is to circumvent the one class of stock requirement and the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and thus, are disregarded in determining whether the outstanding shares of stock confer identical rights.

Section 1.1361-1(l)(2)(iii)(B) provides that bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights.

Section 1.1361-1(l)(2)(iii)(C) provides that a determination of book value will be respected if the book value is determined in accordance with generally accepted accounting principles (including permitted adjustments) or if the book value is used for a substantial nontax purpose.

Section 1.1361-1(b)(3) provides that, for purposes of subchapter S, stock that is issued "in connection with the performance of services" (within the meaning of § 1.83-3(f)) and that is "substantially nonvested" (within the meaning of § 1.83-3(b)) is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under § 83(b).

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.

## CONCLUSION

Based upon the information submitted and the representations set forth above, we conclude that if the erroneous failure to treat the Restricted Stock of X as

outstanding stock of X caused X's S election to terminate, the termination was an inadvertent termination within the meaning of § 1362(f).

Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from Date 1 through Date 2, provided that X's subchapter S election is not otherwise terminated under § 1362(d).

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the above-described facts under any other provision of the Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Internal Revenue 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 will be sent to your authorized representative.

Sincerely,

*David R. Haglund*

David R. Haglund  
Senior Technician Reviewer  
Branch 1  
Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
Copy for section 6110 purposes

cc: