

Internal Revenue Service

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

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Date:

May 12, 2009

LEGEND

X =

A =

B =

C =

D =

State =

Date =

1

Date =

2

Date =

3

Year =

1

Year =

2

Year =

3

Dear :

We received your letter dated November 13, 2008, and subsequent correspondence, written on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code. This letter responds to your request.

FACTS

X was incorporated under the laws of State and filed an S corporation election effective for its taxable year beginning Date 1. Since Year 1, X has filed composite state income tax returns on behalf of its shareholders, A, B, C, and D. X has also paid the composite tax due on those returns on behalf of its shareholders. X did not have any written or oral agreement with its shareholders to make these payments, until X formalized this practice in a Stockholder Agreement on Date 2. X represents the composite tax payments should have been treated as constructive distributions, which caused the distributions X made to its shareholders be disproportionate from Year 1 through Year 2.

X represents it did not intend to create a second class of stock or to terminate X's S corporation election and that the circumstances resulting in the possible termination of the election were not motivated by tax avoidance or retroactive planning. X represents it has taken the following corrective actions: (1) On or about Date 3, X made remedial distributions to correct the effect of the potential disproportionate distributions X may have made; (2) Since Year 3, X has been treating state tax payments made on behalf of X's shareholders as constructive distributions and has taken these constructive distributions into account in determining the amount of other distributions and whether all distributions have been proportionate to stock ownership. X will continue this treatment in subsequent years. X represents X and each of its shareholders have filed all returns consistent with X's S election from Year 1 through the present.

X also represents that X informally agreed to make distributions proportionate to each shareholder's interest in X for the year, sufficient to cover each shareholder's tax liability, if X's shareholders owed any additional tax liability as a result of any adjustments required by the Secretary as a condition for granting relief pursuant to § 1362(f).

X and all of its shareholders have agreed to make such adjustments (consistent with the treatment of X as an S corporation) as may be required by the Secretary.

LAW AND ANALYSIS

Section 1361(a) 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, for purposes of subchapter S, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not, among other things, 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. Differences in voting stock among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.

Section 1.1361-1(l)(2)(i) provides, in part, 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). 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)(2)(ii) provides that state laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds,

within the meaning of § 1.1361-1(l)(1), provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

Except as provided in § 1362(g), § 1362(a)(1) provides that 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 first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

For S corporation elections made and terminations occurring before January 1, 2005, § 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 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 the ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the 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 of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to this period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner.

CONCLUSION

Based on the information submitted and representations made, we conclude that if X had more than one class of stock, X's election to be treated as an S corporation terminated on Year 1 when X first made the composite tax payments on behalf of X's shareholders, A, B, C, and D. However, we conclude that, if X's S election was terminated, such termination was inadvertent within the meaning of § 1362(f).

Therefore, X will be treated as continuing to be an S corporation from Year 1 and thereafter, provided X's S corporation election was valid and was not otherwise terminated under § 1362(d). For all relevant years, X's shareholders must include their pro rata share of the separately and nonseparately stated computed items of income or loss of X as provided in § 1366, make any adjustments to basis provided in § 1367, and take into account any distributions made by X as provided in § 1368.

In addition, we conclude that X's informal agreement to make distributions proportionate to each shareholder's interest in X to its current and former shareholders for each shareholder's share of tax liability for Year 1 through Year 2 as a result of any adjustments required by the Secretary as a condition for granting relief pursuant to § 1362(f) will not cause the termination of X's S election.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion concerning whether X is otherwise eligible to be treated as an S corporation for federal tax purposes.

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, we are sending a copy of this letter to your authorized representative.

Sincerely,

/s/

Christine Ellison
Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes

cc: