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X was incorporated under the laws of State in Year. X elected to be treated as an S corporation effective Date. X's Stockholder's Agreement requires X to make payments to its shareholders, as distributions with respect to X's stock, in an amount based on each shareholder's pro rata share of X's taxable income for a given taxable period. These payments are intended to ensure that X's shareholders have sufficient funds to

pay their federal and state income taxes on their respective shares of X's income. These distributions are required to be made no later than December 31<sup>st</sup> of the calendar year succeeding the calendar year to which the distributions relate.

If X's taxable income is increased or its creditable foreign taxes are decreased after X's original return for a particular taxable year is filed, the Stockholder's Agreement allows X to make a distribution to its shareholders, in accordance with their respective interests in X's taxable income or loss for that period, with respect to the deficiency resulting from such increase or decrease within a reasonable time after the amount of the increase or decrease becomes final (the Discretionary Payment Provision). The Discretionary Payment Provision is intended to allow X to assist its shareholders in paying their additional tax liability resulting from adjustments to X's originally filed tax returns.

X believes it is more efficient and equitable to base distributions under the Discretionary Payment Provision on the shareholders' interests during the taxable period to which the adjustment relates, rather than the shareholders' interests at the time the distributions are made.

X's current Discretionary Payment Provision only applies if X's taxable income is increased or its creditable foreign taxes are decreased after X's original tax return for a taxable year has been filed. X proposes to amend the Discretionary Payment Provision to cover other post-filing adjustments to X's tax returns. The new provision will permit X to make a distribution to each person or entity that was a shareholder during the relevant taxable year if any item of X's taxable income, gain, loss, deduction, or credit, or the like, is adjusted or amended after X's original return for that taxable year is filed. Any such distributions: (1) must be made in accordance with the shareholders' respective interests in X's taxable income or loss for that taxable year; (2) may take into account any interest, penalties, or the like attributable to the post-filing adjustment; and (3) will be made at a time selected by X, but in any event, at a reasonable time after the relevant post-filing adjustment is finally determined.

X represents that, in all cases, the amount of any distribution pursuant to the amended Discretionary Payment Provision is required to be allocated proportionately among shareholders by reference to their respective interests in X's taxable income or loss for the relevant period.

X requests a ruling that the Discretionary Payment Provision (including the proposed amendments) does not cause X to have more than one class of stock for purposes of § 1361(b)(1)(D), and that distributions made pursuant to the Discretionary Payment Provision will not cause X to have more than one class of stock for purposes of § 1361(b)(1)(D).

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 § 1362(a) is in effect for the year.

Section 1361(b)(1) provides that the term “small business corporation” means a domestic corporation that is not an ineligible corporation and meets the requirements of § 1361(b)(1)(A) through (D).

Section 1361(b)(1)(D) provides that an S corporation may not have more than one class of stock. Section 1.1361-1(l)(1) of the Income Tax Regulations provides that, except as provided in § 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).

Section 1.1361-1(l)(2)(iv) provides that a governing provision does not, within the meaning of § 1.1361-1(l)(2)(i), alter the rights to liquidation and distribution proceeds conferred by an S corporation’s stock merely because the governing provision provides that, as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders’ varying interests in the S corporation’s income in the current or immediately preceding taxable year. If distributions pursuant to the provisions are not made within a reasonable time after the close of the taxable year in which the varying interests occur, the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock.

## CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that the Discretionary Payment Provision (including the proposed amendments) does not cause X to have more than one class of stock for purposes of § 1361(b)(1)(D), and that distributions made pursuant to the Discretionary Payment Provision (as amended) will not cause X to have more than one class of stock for purposes of § 1361(b)(1)(D).

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express no opinion regarding X’s eligibility to be an S corporation.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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 is being sent to your authorized representative.

Sincerely,

David R. Haglund

David R. Haglund

Chief, Branch 1

Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

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