

The information submitted states that X was incorporated under the laws of State on Date 1. X elected to be treated as an S corporation for Federal tax purposes effective Date 2. At the time of the S election, all of the shares of X stock were held by Trust A, Trust B, and Individual.

X made disproportionate distributions to its shareholders in taxable years Year 1, Year 2, and Year 3, which may have created a second class of stock in violation of the one class of stock requirement under § 1361(b)(1)(D). After the discovery of the errors, X took remedial action and made corrective distributions to the shareholders, thus eliminating the cumulative amount of the disproportionate distributions.

X represents that under its governing provisions, all of X's shares of stock possess identical rights to distribution and liquidation proceeds and that no provision exists in the governing documents, regulations, or by-laws that vary these rights and X represents that no other binding agreement exists that varies these rights. X further represents that neither X nor its shareholders knew that disproportionate distributions could terminate X's S corporation election.

X represents that the possible termination was not motivated by tax avoidance or retroactive tax planning. X and its shareholders have agreed to make any further adjustments the Commissioner may require consistent with the treatment of X as an S corporation.

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 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. Differences in voting rights 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 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, by-laws, 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 effect in accordance with the facts and circumstances.

Section 1.1361-1(l)(3) provides that, except as provided in §§ 1.1361-1(b)(3), (4), and (5) (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account.

Section 1362(a) provides, in part, that a small business corporation may elect 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 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(f) provides, in part, 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 consent, 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 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 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.

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 solely on the facts submitted and representations made, we conclude that because X made disproportionate distributions to its shareholders, X may have had more than one class of stock beginning in Year 1. We conclude, however, that if X's S election was terminated, such termination was inadvertent within the meaning of § 1362(f). Further, we conclude that the corrective actions taken by X and its

shareholders do not create a second class of stock under § 1361. Consequently, we rule that X will be treated as an S corporation for Year 1, and thereafter, provided X's S corporation election was valid and was not otherwise terminated under § 1362(d).

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. 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. Pursuant to a power of attorney on file, a copy of this letter is being sent to X's authorized representatives.

Sincerely,

Joy C. Spies

Joy C. Spies
Senior Technician Reviewer, Branch 1
(Passthroughs & Special Industries)

Enclosures (2)
Copy of Letter
Copy for 6110 purposes

cc: