

X's S election on Date 2 may have been ineffective due to an ineligible shareholder and a second class of stock. X represents that it took the following corrective actions: (1) on Date 3 the X shares were transferred from the ineligible shareholder to an eligible shareholder; and (2) on Date 4 converting to a limited liability company under the laws of State, and by making conforming amendments to certain loans so that they qualify as straight debt under § 1361(c)(5). X represents that the conversion on Date 4 qualified as an F reorganization within the meaning of § 368(a)(1)(F). X represents that other than the possible ineffectiveness of its S corporation election, X has continuously qualified as an S corporation since Date 2.

X represents that the possible ineffectiveness of its S election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X also represents that X and its shareholders agree to make any adjustments required as a condition of obtaining relief under the inadvertent invalid election rule as provided under § 1362(f) of the Code that may be required by the Secretary. X and its shareholders represent that they have filed all returns consistent with X being an S corporation.

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) defines a "small business corporation" as 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 1 class of stock.

Section 1361(c)(5)(A) provides, in general, that for purposes of § 1361(b)(1)(D), straight debt shall not be treated as a second class of stock.

Section 1361(c)(5)(B) provides that for purposes of § 1361(c)(5), the term "straight debt" means any written unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors, (ii) there is no convertibility (directly or indirectly) into stock, and (iii) the creditor is an individual (other than a nonresident alien), an estate, a trust described in § 1361(c)(2), or a person which is actively and regularly engaged in the business of lending money.

Section 1361(c)(5)(C) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to provide for the proper treatment of straight debt under Subchapter S and for the coordination of such treatment with other provisions of this title.

Treas. Reg. § 1.1361-1(l)(1) 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 laws, and binding agreements relating to distribution and liquidation proceeds (collectively, governing provisions).

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation was not effective for the taxable year for which made by reason of a failure to meet the requirements of § 1361(b), (2) the Secretary determines that the circumstances resulting in the ineffectiveness were inadvertent, (3) no later than a reasonable period of time after the discovery of the circumstances resulting in the ineffectiveness, steps were taken so that the corporation for which the election was made is a small business corporation, and (4) the corporation for which the election was made, and each person who was a shareholder in such corporation at any time during the period specified by § 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 the ineffectiveness, the corporation is treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that X's S corporation election may have been ineffective. We further conclude that, if the election was ineffective, the ineffectiveness was inadvertent within the meaning of § 1362(f). Therefore, X will be treated as an S corporation effective Date 2 and thereafter, provided X's S corporation election is not otherwise terminated under § 1362(d).

Except as specifically ruled upon above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply 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.

Pursuant to the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely,

Laura C. Fields

Laura C. Fields

Senior Technician Reviewer

Office of the Associate Chief Counsel

(Passthroughs & Special Industries)

Enclosures (2)

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cc: