

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

Number: **201633017**  
Release Date: 8/12/2016  
Index Number: 1361.01-04

Third Party Communication: None  
Date of Communication: Not Applicable

Person To Contact:  
, ID No.

Telephone Number:

Refer Reply To:  
CC:PSI:B3  
PLR-132401-15

Date:  
April 01, 2016

Legend

X =

State =

D1 =

Year 1 =

Year 2 =

Dear :

This letter responds to a letter dated September 30, 2015, and subsequent correspondence, submitted on behalf of X by its authorized representative, requesting a ruling related to X's status as an S corporation under §§ 1361 and 1362 of the Internal Revenue Code.

FACTS

The information submitted states that X was incorporated under the laws of State on D1 and made an election to be treated as an S corporation effective the same day. From Year 1 to Year 2, X made disproportionate distributions to its shareholders due to an error in the ownership percentage information used for calculating shareholder distributions. Also during those same years, X made composite state tax payments on behalf of its shareholders, later determining the precise amount of state tax liability allocable to each shareholder. X treated the state tax payments as interest-free, no-term loans to the shareholders, some of which have not yet been repaid.

Near the end of Year 2, X engaged an accounting firm to audit its books. X learned that it was making disproportionate distributions and shortly thereafter made corrective distributions. X also changed its policy regarding the state tax payments such that it no longer treats the payments as loans. X represents that it corrected the disparate distributions due to the erroneous ownership percentage information and the composite state tax payments.

X represents that its governing provisions, including its Articles of Incorporation, Bylaws, and Shareholder Agreements, confer identical rights to distribution and liquidation proceeds with respect to X's outstanding shares of stock. X also represents that there was not a principal purpose to circumvent the one class of stock requirement. Finally, X represents that it always intended to be an S corporation since D1.

#### LAW

Section 1362(a) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

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 such year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which, among other prohibitions, does not 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.

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). A commercial contractual agreement such as a lease, employment agreement or loan agreement, is not a binding agreement related 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, and 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.

#### CONCLUSION

Based solely on the facts submitted and representations made, we conclude that because X's governing provisions provide for identical distribution and liquidation rights and because X represents that it was not a principal purpose to circumvent the one class of stock requirement, the disproportionate and corrective distributions X made to its shareholders and loans for the state tax payments did not create a second class of stock for purposes of § 1361(b)(1)(D). However, such disproportionate and corrective distributions must be given appropriate tax effect. Under these circumstances, we conclude that X's S corporation election did not terminate as a result of the distributions or loans.

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provisions of the Code. Specifically, we express or imply no opinion regarding X's eligibility to be an S corporation or the appropriate tax effects to be given as a result of the disproportionate distributions, loans, or the corrective distributions.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

This ruling is directed only to the taxpayer that requested 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 representatives.

Sincerely,

Holly Porter  
Branch Chief, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

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