Internal Revenue Service

Department of the Treasury

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X =

Y =

A =

x =

y =

z =

D1 =

D2 =

D3 =

D4 =

D5 =

Dear :

This letter responds to a letter dated December 29, 1998, and subsequent correspondence submitted by X's authorized representative on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on D1. A, the president and current sole shareholder of X, represents that from D1, X was a C corporation, wholly owned by Y, and that X filed consolidated returns as part of an affiliated group with Y.

On D2, A acquired all outstanding stock of X, then consisting of x shares of common stock and y shares of preferred stock. On the following day, D3, A, intending for X to elect to

be an S corporation, consulted with A's legal advisor, who informed A that the existence of two classes of stock prevented X from making a valid election to be an S corporation under § 1362 of the Code. A's legal advisor immediately attempted to cancel the preferred stock. Shortly after D4, A and X executed a redemption agreement, in which X agreed to redeem all the shares of X's preferred stock in return for a nominal payment of $z. On D5, X timely filed a Form 2553, Election by a Small Business Corporation, effective for X's taxable year beginning D3.

X and A have agreed to make any adjustments that the Commissioner may require due to X's inadvertent ineffective S election.

Section 1362(a) of the Code 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) of the Code 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) of the Code defines the term "small business corporation" as a domestic corporation that is not an ineligible corporation and that does not have more than one class of stock.

Effective with respect to elections for taxable years beginning after December 31, 1982, § 1362(f) of the Code provides, in part, that, if (1) an election under § 1362(a) by any corporation 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 consents, (2) the Secretary determines that the circumstances resulting in such ineffectiveness were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness, steps were taken so that the corporation is a "small business corporation," 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 the ineffectiveness, the corporation will be treated as an S corporation during the period specified by the Secretary.

Based solely on the facts submitted and the representations made, we hold that X's election to be an S corporation was

ineffective because, prior to the filing of the election, X had more than one class of stock. We also hold that the ineffectiveness of X's S corporation election was inadvertent within the meaning of § 1362(f) of the Code.

We further hold that under the provisions of § 1362(f) of the Code, X will be treated as an S corporation as of D3, provided X's S corporation election was not otherwise invalid and provided that the election was not terminated under § 1362(d). X and A must file all required returns consistent with X having no preferred stock as of D3.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code, including whether any of the actions undertaken to remove the second class of stock was a taxable event.

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.

Pursuant to a power of attorney on file with this office, a copy of this letter is being forwarded to X's authorized representative.

Sincerely yours,

J. THOMAS HINES
Senior Technician Reviewer
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
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