Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

In Re:

Refer Reply To:
CC:PSI:B07 – PLR-112436-04
Date:
June 15, 2004

Legend

X =

Y =

Z =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

a =

Dear

This letter responds to your letter dated February 17, 2004, and subsequent correspondence, requesting relief under section 1362(f) of the Internal Revenue Code.

FACTS

According to the information submitted, X elected to be treated as an S corporation effective Date 1. On Date 2, X transferred a shares of X to each of Y and Z. On or about Date 4, X determined that due to its treatment of Y's and Z's shares and

the terms of shareholder agreements entered into with Y, X may have inadvertently created a second class of stock in violation of the one class of stock requirement in section 1361(b)(1)(D). On Date 3, X reacquired the shares transferred to Z.

X represents that it did not intend to create a second class of stock. As soon as X realized the problem, X amended its current shareholder agreement with Y and undertook other corrective measures. The amended shareholder agreement restricts the transferor of Y's shares and provides for a repurchase of the shares based upon the book value of the shares. The amended agreement does not restrict the shareholder's rights to distributions. X and its shareholders agree to make any adjustments, consistent with the treatment of X as an S corporation, as might be required by the Secretary.

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 section 1362(a) is in effect for the 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.

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"). 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. 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)(2)(iii)(A) provides that buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical rights unless a principal purpose of the agreement is to

circumvent the one class of stock requirement and the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and thus, are disregarded in determining whether the outstanding shares of stock confer identical rights.

Section 1.1361-1(l)(2)(iii)(B) provides that bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights.

Section 1362(d)(2)(A) provides that an election under section 1362(a) will 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(d)(2)(B) provides that the termination shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under section 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to section 1362(b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or (B) was terminated under section 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 such 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 in the corporation at any time during the period specified pursuant to section 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.

CONCLUSION

Based on the facts represented and the information submitted by X, we conclude that X's S corporation election may have terminated on Date 2 because X may have had more than one class of stock. However, we conclude that, if X's S election was terminated, the termination was inadvertent within the meaning of section 1362(f). Further, we conclude that the amended shareholder agreement does not create a second class of stock under section 1361(b)(1)(D). Consequently, we conclude that X will be treated as an S corporation from Date 2, and thereafter, unless X's S corporation election otherwise terminates under section 1362(d).

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

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed on whether X's original S corporation election was a valid election under section 1362(a).

Pursuant to the power of attorney on file with this office, we are sending a copy of this letter to X and X's second authorized representative.

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.

Sincerely,

/s/ David R. Haglund

David R. Haglund
Senior Technician Reviewer, Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)

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

cc: