Internal Revenue Service

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Date:
November 09, 2007

Company =

State =

A =

Business Trust =

B =

C =

Trust 1 =

Trust 2 =

Trust 3 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

Dear :

We received a letter dated May 7, 2007, and subsequent correspondence, submitted on behalf of Company requesting rulings under § 1361(f) of the Internal Revenue Code. This letter responds to that request.

FACTS

Company was incorporated on a, under the laws of State, and elected to be an S corporation effective on b. From taxable year f, through c, Company's shareholders were Business Trust, with A as the deemed owner, B, C, Trust 1, Trust 2, and Trust 3 ("Shareholders").

During taxable years d, e, and h, Company loaned certain amounts to A to facilitate purchases of Company stock from other shareholders. To enable A to repay those loans, Company provided A with additional bonus compensation for taxable years f through i, the first of which was approved by Company's directors on j. Subsequently, Company's business advisor informed Company that part or all of the additional bonus compensation was excessive and constituted constructive distributions by Company to A. Therefore, Company's S corporation election may have terminated due to Company having a second class of stock.

Company represents that it did not enter into the bonus compensation arrangement with A with a principal purpose of circumventing the single class of stock requirement. In addition, Company and its shareholders did not intend to terminate Company's S corporation election. To correct the possible terminating event, A will make partial repayments of the bonuses to Company. Company will then make corrective pro-rata distributions to the other shareholders as of the time the bonuses were paid to A as Company determines are necessary. Company and the shareholders will make appropriate adjustments to their returns for the taxable years of the bonuses to correct deductions taken for the bonus repayment amounts.

In addition, shares of Company stock were transferred to Trust 2 and Trust 3 on or about k. An election to be treated as a qualified subchapter S trust ("QSST") was made for Trust 2. However, while Trust 3 was intended to be treated as a QSST, no QSST election was made by the beneficiary of Trust 3. Notwithstanding the failure to make a QSST election for Trust 3, Company represents that Trust 3 was treated as though a QSST election had been made. Trust 2 and Trust 3 subsequently terminated on c, when their stock in Company was purchased by A.

Company represents that Company and its Shareholders did not intend to terminate Company's S corporation election and were not motivated by tax avoidance or retroactive tax planning. Finally, Company and the Shareholders have agreed to make any further adjustments (consistent with the treatment of Company as an S corporation) as may be required by the Secretary.

LAW

Section 1361(a)(1) provides that for purposes of title 26, the term "S corporation" means, with respect to the taxable year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that 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 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 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 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.

In § 1.1361-1(l)(2)(vi), Example 2, (Distributions that differ in timing), S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes $50,000 to A in the current year, but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds. The example concludes that under § 1.1361-1(l)(2)(i), the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, § 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

Section 1361(c)(2)(A)(i) provides that for purposes of § 1361(b)(1)(B), a trust all of which is treated (under subpart E of part I of subchapter J of chapter 1) as owned by an individual who is a citizen or resident of the Untied States may be a shareholder.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) the corporation ceases to be a small business corporation.

Section 1362(f) provides 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 consents, or (B) was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in the 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 the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to this period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation shall be 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 Company's S corporation election was terminated on k, when Company stock was transferred to Trust 3, an ineligible shareholder. We also conclude that the termination of Company's S corporation election was inadvertent within the meaning of § 1362(f).

Consequently, we rule that under § 1362(f) Company will be treated as an S corporation from k, and thereafter, provided Company's S corporation election is otherwise valid and is not, except as addressed below, otherwise terminated under § 1362(d). In addition, Trust 3 will be treated as a QSST described in § 1361(d)(3) from k, to c, when the trust terminated, provided Trust 3 satisfied the requirements to be a QSST. Accordingly, Company's shareholders must include their pro rata shares of the separately and nonseparately computed items in their income as provided in § 1366, make adjustments to the stock basis of those shares as provided in § 1367, and take into account any distributions with respect to those shares as provided in § 1368.

We further conclude that to the extent Company's S corporation election terminated due to the excessive additional bonus compensation paid by Company to A, first approved on j, any termination was inadvertent within the meaning of § 1362(f). Consequently, we rule that Company will continue to be treated as an S corporation from j, and thereafter, provided Company's S election is not otherwise terminated under § 1362(d). Accordingly, Company's shareholders must include their pro rata shares of the separately and nonseparately computed items in their income as provided in § 1366, make adjustments to the stock basis of those shares as provided in § 1367, and take into account any distributions with respect to those shares as provided in § 1368. As an additional condition to this letter, Company, A, and the other shareholders must take steps as indicated above to correct the possible terminating event. In addition, Company's disproportionate and corrective distributions must be given appropriate tax effect.

Except for the specific rulings above, we express or imply no opinion concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding Company's eligibility to be an S corporation or Trust 3's eligibility to be a QSST.

Under a power of attorney on file with this office, we are sending a copy of this letter to Company's authorized representative.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/

LESLIE H. FINLOW
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: copy of this letter for § 6110 purposes

cc: