**Internal Revenue Service**

Department of the Treasury
Washington, DC 20224

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Date:
December 14, 2007

Company =

A =

B =

C =

D =

E =

F =

State =

LLC =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

o =

Dear :

We received a letter dated April 11, 2007, and subsequent correspondence, submitted on behalf of Company, requesting a ruling under § 1361(f) of the Internal Revenue Code. This letter responds to that request.

FACTS

Company incorporated under the laws of State on a, and elected to be an S corporation effective on that date. Company's current shareholders are individuals A, B, C, D, and E.

On b, Company issued a convertible note to D in the amount of c in order to raise capital for business operations ("Note 1"). Note 1 matured on d, and was converted to e shares of Company common stock issued to D. On f, Company issued another convertible note to E in the amount of g in order to raise capital for business operations

("Note 2"). After the maturity date for Note 2 was extended, Note 2 matured on h, and was converted to i shares of Company common stock of issued to E. Company represents that it was not aware that Note 1 and Note 2 (together the "Notes") might constitute a second class of stock that would terminate Company's S corporation election.

In addition, in j, Company hired C for certain services in exchange for k shares of Company common stock. However, rather than issue the stock directly to C, Company issued the stock to LLC, of which C was an employee, on l. LLC was a disregarded entity owned by F, an ineligible shareholder. The following year, Company's accountants became aware of the transfer of stock to LLC and advised Company that it had an ineligible shareholder. Consequently, on m, all shares of Company stock held by LLC were transferred to C. Company represents that it was not aware that LLC was an ineligible shareholder or that the transfer of Company stock to LLC would terminate Company's S corporation election.

Company also represents that the terminating events (actual and potential) were not intended to terminate Company's S corporation election and that Company was not motivated by tax avoidance. Company and its shareholders agree to make any necessary adjustments consistent with the treatment of Company as an S corporation.

LAW

Section 1361(b)(1) 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-- (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)(4)(ii)(A) provides that except as provided in § 1.1361-1(l)(4)(i), any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock described in § 1.1361-1(l)(3)), regardless of whether designated as debt, is treated as a second class of stock of the corporation—(1) If the instrument, obligation, or arrangement constitutes equity or otherwise results in the

holder being treated as the owner of stock under general principles of federal tax law; and (2) A principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders contained in § 1.1361-1(b)(1).

Section 1.1361-1(l)(4)(iv) provides that a convertible debt instrument is considered a second class of stock if—(A) It would be treated as a second class of stock under § 1.1361-1(l)(4)(ii) (relating to instruments, obligations, or arrangements treated as equity under general principles); or (B) It embodies rights equivalent to those of a call option that would be treated as a second class of stock under § 1.1361-1(l)(4)(iii) (relating to certain call options, warrants, and similar instruments).

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.

For S corporation elections made and terminations occurring before January 1, 2005, § 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 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 to the extent Company's S corporation election terminated due to the issuance of the Notes on b and f, any termination was inadvertent within the meaning of § 1362(f). We further conclude that Company's S corporation election was terminated on l, when Company issued its stock to an ineligible shareholder, and that the termination of Company's S corporation election was inadvertent within the meaning of § 1362(f).

Consequently, we rule that Company will continue to be treated as an S corporation from b, and thereafter, provided Company's S election is not otherwise terminated under § 1362(d), except as addressed below. Accordingly, the shareholders of Company 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. However, no adjustments are required by C and F for taxable years n and o.

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.

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

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/

CHRISTINE ELLISON
Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosures: copy of this letter
copy for § 6110 purposes

cc: