Internal Revenue Service

Number: **201642021**
Release Date: 10/14/2016

Index Number: 1362.04-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01
PLR-118723-16
Date:
July 11, 2016

LEGEND

X =

Y =

State A =

State B =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Dear

This letter responds to a letter dated June 7, 2016, submitted on behalf of X and Y, requesting relief under § 1362(f) of the Internal Revenue Code (Code).

Facts

According to the information submitted, X was incorporated under the laws of State A on Date 1 and made an election to be treated as an S corporation effective Date 1. X's S election may have terminated effective Date 2 when X issued a warrant on its stock which may have constituted a second class of stock. X became aware of this problem on Date 3 and immediately took corrective action, voiding the warrant on Date 4.

On Date 5, incident to what was intended to qualify as a reorganization under § 368(a)(1)(F), X's shareholders contributed all of their stock in X to Y, a corporation organized under the laws of State A. Effective immediately afterwards, Y made an election to treat X as a qualified subchapter S subsidiary (QSub). Following the reorganization, and also on Date 5, X converted into a limited liability company organized under the laws of State B. On Date 6, Y sold X to an unrelated party.

X and Y represent that the potential termination was not motivated by tax avoidance or retroactive tax planning. X and Y and its shareholders have agreed to make any adjustments that the Commissioner may require, consistent with the treatment of X as an S corporation.

Law

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(1) defines a "small business corporation" as 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)(4)(iii) provides that, with certain exceptions, a call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking in account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued or at certain other times.

Section 1362(d)(2) 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 a corporation is an S corporation) such corporation ceases to be a small business

corporation. A termination of an S corporation election under § 1362(d)(2) is effective on and after the date of cessation.

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such termination were inadvertent, (3) no later than a reasonable period of time after discovery of the event resulting in the ineffectiveness, 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 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, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Conclusion

Based on the information submitted and the representations made, we conclude that the warrant issued on Date 2 may have caused X to have a second class of stock. However, we conclude that, if X's S election was terminated, such termination was inadvertent within the meaning of § 1362(f) of the Code. Consequently, we rule that X will be treated as continuing to be an S corporation from Date 2 through Date 5, when X became a QSub, provided that X's S election otherwise was not terminated under § 1362(d).

Except as specifically ruled upon above, no opinion is expressed as to the federal income tax consequences of the facts described above under any other provision of the code. In particular, no opinion is expressed or implied as to whether X otherwise qualifies as a subchapter S corporation under § 1361. In addition, we express or imply no opinion on whether the transactions on Date 5 qualified as an F reorganization within the meaning of § 368(a)(1)(F).

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter ruling will be sent to X and Y's authorized representatives.

Sincerely,

David R. Haglund
David R. Haglund
Branch Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: