Internal Revenue Service

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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:03
PLR-119888-19

Date:
February 20, 2019

Legend

Company =

Purchaser =

A =

B =

Agreement 1 =

Agreement 2 =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

n =

Dear :

This letter responds to a letter dated August 14, 2019 submitted on behalf of Company by its authorized representative requesting a ruling under §1362(f) of the Internal Revenue Code (Code).

Facts

The information submitted states Company was organized on Date 1 as a limited liability company under the laws of State. Company timely filed Form 2553, Election by a Small Business Corporation, for Company to be an association treated as an S corporation effective Date 2. From Date 1 to Date 5, A and B were the sole owners of the Company. On Date 5, A and B sold all the outstanding Company shares to Purchaser.

Effective on Date 3, the Company Shareholders signed an operating agreement, Agreement 1. Agreement 1 included provisions in contemplation of Company being treated as a partnership for federal income tax purposes; however, the applicability of those provisions was not limited to such a situation. Agreement 1 included the following partnership provisions:

(1) Section 4.4 providing, in part, "A Capital Account … shall be established and maintained for each Member … If a Member validly transfers his or her Ownership Interest, the Capital Account of the transferring Member shall carry over to the transferee Member in accordance with the Code."

(2) Section 4.5 providing, "Each Member's Capital Account shall be adjusted as follows:

a. Increases. Each Member's Capital Account shall be increased by:
   i. Capital contribution of cash and/or property at its agreed upon fair market value;
   ii. All items of LLC income and gain (including income and gain exempt from tax).
b. Decreases. Each Member's Capital Account shall be decreased by:
   i. Distributions of cash and/or property at its agreed upon fair market value;
   ii. All items of LLC deduction and loss (including deductions and loss exempt from tax)."

(3) Section 5.3 providing, in part, "if a Member unexpectedly receives any adjustment, allocations, or distributions described in Treasury Regulations §1.704-1(b)(2)(ii)(d)(4), (5) or (6) or any amendment thereto, or receives an

allocation of loss which produces a negative capital account for any Member while any other Member has a positive capital account, then items of LLC income shall be specifically allocated to such Member until the deficit Capital Account is eliminated. This paragraph is intended to constitute a 'qualified income offset' within the meaning of Treasury Regulation §1.704-1(b)(2)(ii)(d)."

(4) Section 5.4 providing, in part, "if there is a net decrease in LLC 'minimum gain' during a taxable year, each Member shall be specially allocated, before any other allocation, items of income and gain for such taxable year (and, if necessary, subsequent years) in proportion to each Member's share of the net decrease in LLC 'minimum gain' as determined in accordance with Treasury Regulation §1.704-2(g)(2). This paragraph is intended to comply with the 'minimum gain chargeback' provisions of Treasury Regulation §1.704-2(f)."

(5) Section 5.5 providing, in part, "to the extent that Code §704(c) is applicable to any item of income, gain, loss, and deduction with respect to any property (other than cash) that has been contributed by a Member and which is required to be allocated to such Member for income tax purposes, the item shall be allocated to such Member in accordance with Code §704(c)."

(6) Section 5.6 providing, in part, "Distribution of LLC assets and property shall be made at such times and in such amounts as the Members determine subject to any restrictions in this Agreement. Distributions shall be made among the Members in proportion to the Member's Ownership Interests."

(7) Section 12.4 providing, in part, "[u]pon the occurrence of any of the events specified above and the completion of winding up all LLC business and affairs, the assets of the LLC shall be promptly liquidated and distributed in the following order… (c) to the Members in proportion to their Capital Accounts after adjustments for all allocations of net profits and net loss."

These provisions applied from Date 3 until Date 4, a period when Company intended to be treated as an S corporation.

Effective on Date 4, A and B signed an operating agreement, Agreement 2. Agreement 2 superseded Agreement 1. Agreement 2 included provisions in contemplation of Company being treated as a partnership for federal income tax purposes; however, the applicability of those provisions was not limited to such a situation. Agreement 2 also provided for three types of stock, Class A (common units), Class B (incentive units), and Class C (preferred units). The Class A stock was voting common stock with a pro-rata right to distribution and liquidation proceeds. The Class B stock was intended to provide a holder with a liquidating distribution only to the extent the holders of other Company shares first received distributions equal to a previously established fair market value of Company. The Class C stock was intended to provide a holder with a first priority distribution to the extent of a holder's capital contribution to

the extent it was not previously returned. On Date 4, Company issued n shares of Class A stock to each A and B. No agreement was entered into obligating the issuance of Class B or C stock, and Company never issued Class B or C stock.

Agreement 2 also included the following partnership provisions:

(1) Section 5.3 providing, in part, “if a Member unexpectedly receives any adjustments, allocations, or distributions described in Treasury Regulations §1.704-1(b)(2)(ii)(d)(4), (5) or (6) or any amendment thereto, or receives an allocation of loss which produces a negative capital account for any Member while any other Member has a positive capital account, then items of LLC income shall be specially allocated to such Member such that the deficit Capital Account is eliminated. This paragraph is intended to constitute a ‘qualified income offset’ within the meaning of Treasury Regulation §1.704-1(b)(2)(ii)(d).”

(2) Section 5.4 providing, in part, “if there is a net decrease in LLC minimum gain during a taxable year, each Member shall be specially allocated, before any other allocation, items of income and gain for such taxable year (and, if necessary, subsequent years) in proportion to each Member's share of the net decrease in LLC minimum gain as determined in accordance with Treasury Regulation §1.704-2(g)(2). This paragraph is intended to comply with the ‘minimum gain chargeback’ provisions of Treasury Regulation §1.704-2(t).”

(3) Section 5.5 providing in part, “A capital account for each Member (the ‘Capital Accounts’) will be established on the Company’s books and records. The Capital Accounts will be maintained in accordance with the following provisions:

5.5.1 To each Member’s Capital Account there shall be added (a) such Member’s Capital Contributions, (b) such Member’s allocable share of income, gain and profit and any items in the nature of income or gain that are specially allocated to such Member pursuant to this Agreement, and (c) the amount of any Company liabilities assumed by such Member or which are secured by any property distributed to such Member.

5.5.2 From each Member’s Capital Account there shall be subtracted (a) the amount of cash and the fair market value of any Company assets (other than cash) distributed to such Member (other than any payment of principal and/or interest to such Member pursuant to the terms of a loan made by the Member to the Company) pursuant to any provision of this Agreement, (b) such Member’s allocable share of losses, deduction and expense and any other items in the nature of expenses or losses that are specially allocated to such Member pursuant to this Agreement, and (c) liabilities of such Member assumed by the Company or which are secured by any property contributed by such Member to the Company.

5.5.3 In the event any interest in the Company is transferred in accordance with the terms of this Agreement, the transferee shall succeed to the Capital Account of the transferor to the extent it relates to the transferred interest.

5.5.4 The foregoing provisions and the other provisions of this Agreement relating to the maintenance of Capital Accounts are intended to comply with Regulations Sections §1.704-1(b) and §1.704-2 and shall be interpreted and applied in a manner consistent with such Regulations. In the event that the Managers shall determine that it is prudent to modify the manner in which the Capital Accounts, or any additions or subtractions thereto, are computed in order to comply with such Regulations, the Managers may make such modification, provided that it is not likely to have a material effect on the amounts distributable to any Member upon the dissolution of the Company."

(4) Section 5.7 providing, "Tax Distributions. For so long as the Company has elected to be treated as a partnership for tax purposes, the Managers shall cause the Company to make distributions of Available Amounts as soon as is practicable following the close of any tax period, to each of the Members in amounts up to and in proportion to each such Member's Presumed Tax Liability (as defined below) with respect to such period (in necessary [sic], as estimated by the Managers based on the results of such period). Any amounts distributed to a Member pursuant to this Section 5.7 shall be treated as a dollar-for-dollar advance against the first amounts otherwise attributable to such Member pursuant to Section 5.6, above. 'Presumed Tax Liability' shall mean, with respect to any Member, the amount determined by multiplying the highest marginal U.S. federal income tax rate (applicable to the character of the income in question) applicable to corporations or individuals, as applicable, for such fiscal year, not to exceed forty percent (40%) by the excess of the taxable income or gain for such period which is allocable to such Member under this Article 5, over deductions allocated to such Member under this Article 5 for the same period."

(5) Section 8.3 providing, in part, "[e]ach Member shall look solely to the assets of the Company for all distributions with respect to the Company, its Capital Contribution thereto, its Capital Account and its share of income, gain, profits, losses, deduction, expense and credit of the Company, and shall have no recourse therefor (upon dissolution or otherwise) against any other Member. Accordingly, if any Member has a deficit balance in its Capital Account (after giving effect to all contributions, distributions and allocations for all taxable years, including the year during which the liquidation occurs), then such Member shall have no obligation to make any Capital Contribution with respect to such deficit, and such deficit shall not be considered a debt owed to the Company or to any other person for any purpose whatsoever."

(6) Section 8.4 providing, in part, "Upon the occurrence of a dissolution event described in Section 8.1 above, the Company shall terminate. In the event of the

dissolution and termination of the Company, the Managers shall proceed with an orderly liquidation of the Company and the proceeds of such liquidation shall be applied and distributed in the following order of priority:

8.4.1 To creditors of the Company, whether they are or are not Members, for payment of the debts and liabilities of the Company and the expenses of liquidation;

8.4.2 To the setting up of any reserves that the Managers may deem reasonably necessary for any contingent or unforeseen liabilities or obligations of the Company. Such reserves shall be paid over by the Managers to a bank or other institutional escrow agent to be held for the purpose of disbursing such reserves in payment of the aforementioned contingencies, and at the expiration of such period as the Managers may deem advisable, to distribute the balance in the manner provided in this Section 8.4; and

8.4.3 To the Class C Members to the extent of any Unreturned Capital Amount with respect to each such Class C Member;

8.4.4 To the Class A Members and the Class B Members to the extent of any Unreturned Capital Amount to each such Member;

8.4.5 To the Members in accordance with Section 5.6, above; and,

8.4.6 Notwithstanding the provisions of 8.4.3, 8.4.4. and 8.4.5, priority shall be given to the Additional Units consistent with the terms upon which such units are granted."

Company requests two rulings. First, the termination of Company's S corporation election on Date 3 was inadvertent within the meaning of section 1362(f). Second, pursuant to the provisions of section 1362(f), the Taxpayer will be treated as an S corporation at all times since Date 3 until Date 5, provided that Company's S corporation election did not otherwise terminate.

Company represents that the circumstances resulting in the termination of its S election under §1362(a) were inadvertent and not motivated by tax avoidance or retroactive tax planning. Company states that Company and its shareholders have filed their federal income tax returns consistent with having a valid S corporation election in effect for Company. Company and its shareholders have agreed to make such adjustments (consistent with the treatment of Company as an S corporation) as may be required by the Secretary.

Law and Analysis

Section 1362(a) 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) 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) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which 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) provides, in part, 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 laws, and binding agreements relating to distribution and liquidation proceeds (collectively, governing provisions).

Section 1.1361-1(l)(3) provides that, except as provided in §1.1361-1(b)(3), (4), and (5) (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account.

Section 1362(d)(2)(A) provides that an election under §1362(a) shall 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(f) and the regulations thereunder provide relief for an inadvertent termination of an S corporation election provided the following conditions are met:

a. The corporation made an election under §1362(a) or §1361(b)(3)(B)(ii) that was ineffective or was terminated;

b. The Service determines that circumstances resulting in the ineffectiveness or termination were inadvertent;

c. Steps were taken by the corporation to qualify it as a small business corporation

or qualified subchapter S subsidiary (QSub) within a reasonable period of time after discovery of the termination event; and

d. The corporation and all shareholders agree to any adjustments that the Service may require for the period.

Conclusion

Based on the facts submitted and representations made, the S election effective on Date 2 was terminated on Date 3 because Company had more than one class of stock due to the partnership provisions in Agreement 1, which was effective on Date 3. If Company's S election had not terminated on Date 3, Company's S election would have terminated on Date 4 because Company had more than one class of stock due to partnership provisions in Agreement 2, which was effective on Date 4.

We conclude the termination of the S election for Company, as a result of Agreement 1 creating a second class of stock was inadvertent within the meaning of §1362(f). We also conclude that the termination of Company's S election, as a result of Agreement 2, creating a second class of stock, was inadvertent. Accordingly, under §1362(f), Company will be treated as an S corporation from Date 3 to Date 5 provided the S election for Company was otherwise valid and has not terminated. Because the Company states it was never obligated to issue and never did issued Class B or Class C stock, such stock was not outstanding and, thus, did not create a second class of stock for purposes of §1.1361-1(l)(1).

Except as specifically ruled upon above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. In particular, we express or imply no opinion regarding the validity of Company's S election between Date 2 and Date 3.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

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

Pursuant to a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely,

____

Richard T. Probst
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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

cc: