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:01
PLR-114908-21

Date:
January 14, 2022

Legend:

X =

A =

B =

C =

Agreement 1 =

Agreement 2 =

Agreement 3 =

Agreement 4 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

State =

n% =

Dear :

This letter responds to a letter dated June 29, 2021, submitted on behalf of X by its authorized representative, requesting a ruling under § 1362(f) of the Internal Revenue Code (Code).

FACTS

The information submitted states that X was organized on Date 1 as a limited liability company under the laws of State. A, B, and C were the sole members of X.

Effective Date 2, X filed Form 2553, Election by a Small Business Corporation, for X to be treated as an S corporation. At the time of the election, A, B, and C had an oral operating agreement, Agreement 1.

The provisions of Agreement 1 applied until Date 3, when Agreement 2, Agreement 3 and Agreement 4 replaced Agreement 1. The provisions of Agreement 2, Agreement 3, and Agreement 4 entitled A, B, and C to different rights concerning distributions and liquidation proceeds, and thus created a second class of stock. Specifically, Section 6.2 of Agreement 2 required X to maintain capital accounts and provided that capital accounts would control the division of assets on liquidation. Section 11.2 of Agreement 2 provided that distributions would be made first to each person owning a transferable interest that reflects contributions made and not previously returned in an amount equal to the unreturned contributions, and thereafter to members in the proportions in which they shared in distributions before dissolution.

The provisions of Agreement 2 applied from Date 3, and Agreement 3 and Agreement 4 applied from Date 4, during the period when X intended to be treated as an S corporation, until Date 5. Pursuant to Agreement 3 and Agreement 4, C gave up his ownership interest in X for a “transaction bonus” equal to n% of the net cash proceeds from a subsequent sale of X, plus a payment of $1,000 per month for occasional consulting services. X represents that, in substance, Agreement 3 and Agreement 4 are appropriately characterized as an exchange of C’s ownership interest in X for a continuing ownership interest that conferred rights to distribution and liquidation proceeds different from those held by A and B. Thus, Agreement 3 and Agreement 4 created a second class of stock.

X represents that the following corrective action was taken: on Date 5, A, B, and C executed an amended and restated operating agreement for X, X filed an amended return to reflect the amended and restated operating agreement, and X made “true-up” distributions to A, B, and C. The amended and restated operating agreement did not include capital account maintenance provisions and required that all distribution and liquidation proceeds be shared in accordance with the shareholders’ ownership interests. Additionally, Agreement 3 and Agreement 4 were terminated as of Date 5.

X requests two rulings. First, due to the provisions of Agreement 2, X's S election was inadvertently terminated within the meaning of § 1362(f), and X will be treated as an S corporation from Date 3 and thereafter. Second, the termination of X's S election due to the provisions of Agreement 3 and Agreement 4 was inadvertent within the meaning of § 1362(f), and X will be treated as an S corporation from Date 4 and thereafter.

X represents that the termination of its S election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X also represents that X and its shareholders agree to make any adjustments required as a condition of obtaining relief under the inadvertent invalid election rule as provided under § 1362(f) of the Code that may be required by the Secretary. X and its shareholders represent that they have filed all returns consistent with X being an S corporation.

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 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 ineffective S corporation election (i.e., treating the ineffective election as effective) or inadvertent termination of an S corporation election provided the following conditions are met: (A) The corporation made an election under § 1362(a) that was ineffective or was terminated; (B) The Service determines that the circumstances resulting in the ineffectiveness or termination were inadvertent; (C) Steps were taken by the corporation to qualify it as a small business corporation within a reasonable period of time after discovery of the ineffectiveness or 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, we conclude that X's S election terminated on Date 3 because Agreement 2 created a second class of stock. We further conclude that the termination was inadvertent within the meaning of § 1362(f). We also conclude that, if X's S election had not terminated on Date 3, it would have terminated on Date 4 as a result of Agreement 3 and Agreement 4 creating a second class of stock. We further conclude that this termination would have been inadvertent. Accordingly, under § 1362(f), X will be treated as an S corporation from Date 3, and thereafter, provided the S election for X otherwise is valid and has not terminated under § 1362(d).

Except as specifically ruled above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provisions of the Code. Specifically, we express or imply no opinion as to whether X was otherwise eligible to be treated an S corporation.

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.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precIn accordance with a power of attorney on file with this office, we are sending a copy of this letter to X's authorized representatives.

Sincerely,

/s/

Joy C. Spies
Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
Copy of this letter for § 6110 purposes

cc: