Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B03
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Date:
July 18, 2024

LEGEND

Company =

A =

B =

X =

Y =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Agreement =

State =

Year 1 =

Year 2 =

Year 3 =

Dear :

This letter responds to a letter dated December 21, 2023, and subsequent correspondence, submitted on behalf of Company by its authorized representatives, requesting a ruling under § 1362(f) of the Internal Revenue Code (Code).

FACTS

The information submitted states that Company was formed as a limited partnership under the laws of State on Date 1. At formation Company was wholly owned by A, directly and indirectly through X, a State limited liability company wholly owned solely by A which was treated as a disregarded entity for federal tax purposes. Under the laws of State, interests in Company and X were owned as community property by A and B.

Also on Date 1, A and X signed a limited partnership agreement for Company, Agreement, which included provisions in contemplation of Company being treated as a partnership for federal income tax purposes.
Specifically, Agreement included the establishment and maintenance of capital accounts as provided in Treasury regulations, referenced defined terms under subchapter K of the Code, and provided for liquidation proceeds to be distributed in accordance with positive capital account balances. However, it also provided that distributions and all items of income, gain, loss, and deduction were to be made pro rata. Agreement also conferred on X as the general partner broad authority, including the power to alter the owners' rights to distributions. On Date 3, Company filed Form 8832, Entity Classification Election, electing to be treated as a corporation for federal income tax purposes, effective Date 2. On Date 4, Company filed Form 2553, Election by a Small Business Corporation, electing to be treated as an S corporation, effective Date 2. However, on Date 2 and Date 4, Agreement was still in effect and Company remained a limited partnership under the laws of State.

Beginning in Year 1 and in subsequent years, A transferred to B certain limited partnership interests in Company, which were then held by B as separate property under the laws of State. From Year 1 to Year 2, Company made distributions solely to A, notwithstanding B's partial ownership of Company as separate property. Company also had in place a senior credit facility, which permitted Company to borrow money to make non-identical distributions for the purpose of paying salary, life insurance premiums, and accrued interest. In Year 3, X, as Company's general partner, approved distributions pursuant to the senior credit facility. However, all actual distributions in Year 3 were made pro rata.

Company was subsequently advised that the provisions of Agreement, the disproportionate distributions to A and B, its formation under state law as a limited partnership, and the approval of distributions under the senior credit facility rendered Company's S Corporation election invalid or otherwise terminated. Company then took the following remedial actions. On Date 5, Company engaged in a reorganization, which resulted in Company being wholly owned for federal income tax purposes by Y, a newly formed State limited liability company that elected to be treated as a corporation for federal tax purposes (the "Reorganization"). Y purported to succeed to Company's S corporation election, which then filed an election to treat Company as a qualified subchapter S corporation, effective Date 5. Y's limited liability company agreement confers identical distribution and liquidation rights on its owners and does not reference any provisions of subchapter K of the Code.

To further remediate the issues that caused the ineffectiveness (or termination) of Company's S election, Company amended Agreement to eliminate all references to subchapter K of the Code and to confer identical distribution and liquidation rights on its owners. The terms of the senior credit facility were also amended to eliminate any rights to non-identical distributions. Finally, on Date 6, A made certain true-up payments to B in amounts designed to correct the disproportionate distributions to A that occurred between Year 1 to Year 2.

The information provided states that on and after Date 2, the owners of Company were all eligible S Corporation shareholders, all income and expense items were allocated on a pro rata basis, and other than described above, all distributions were made on a pro-rata basis based on ownership, and all shareholders were treated equally in corporate matters. Company represents that the ineffectiveness or termination of Company's S corporation election was inadvertent and not motivated by tax avoidance or retroactive tax planning. Company and its shareholders agree to make any adjustments (consistent with the treatment of Company as an S corporation) as may be required by the Secretary.

LAW AND ANALYSIS

Section 1361(a)(1) of the Code 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(a)(1) 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 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) provides, in relevant part, that if (1) an election under § 1362(a) by any corporation 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 was terminated under § 1362(d)(2), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken so that the corporation for which the election was made or the termination occurred is a small business corporation or to acquire the required shareholder consents, and (4) the corporation for which the election was made or the termination occurred, and each person who was a shareholder in such corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments (consistent with the treatment of such 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 or termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based solely on the facts submitted and representations made, we conclude that Company's S corporation election was ineffective on Date 2 as a result of Agreement creating a second class of stock. We also conclude that the ineffectiveness of Company's S election, due to Agreement creating a second class of stock, was inadvertent within the meaning of § 1362(f). We further conclude that if Company's S election was ineffective due to Company's status as a State limited partnership on Date 2 creating a second class of stock, such ineffectiveness was inadvertent within the meaning of § 1362(f). Finally, we conclude that if the approval of distributions under the senior credit facility caused a termination of Company's S election in Year 3, due to creating a second class of stock, such termination was inadvertent within the meaning of § 1362(f).

Accordingly, under § 1362(f), Company will be treated as continuing to be an S corporation on and after Date 2, provided that Company's S corporation election was valid and not otherwise terminated under § 1362(d).

Except as specifically ruled above, we express or imply no opinion as to the federal income tax consequences of the facts described above under any other provision of the Code, including Company's eligibility to be a valid S corporation or the Reorganization.

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.

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

Sincerely,

/s/

Robert D. Alinsky
Branch Chief, Branch 3
Office of the Associate Chief
Counsel (Passthroughs & Special
Industries)

Enclosure:
Copy of this letter for § 6110 purposes

cc: