

**Internal Revenue Service**

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Department of the Treasury

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Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B1

PLR-134992-04

Date:

November 18, 2004

In Re:

Legend:

X =

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Dear :

This letter responds to your letter dated June 9, 2004, and subsequent correspondence, requesting relief under section 1362(f) of the Internal Revenue Code.

Facts:

You have represented that the facts are as follows. X is a corporation that made an S corporation election effective Date 1. On Date 2, X and A, an employee of X, entered into a restricted stock agreement that called for A to receive M shares of X stock in exchange for certain services, upon the lapse of restrictions dated Date 3. On Date 4, X and B, an employee of X, entered into a restricted stock agreement that called for B to receive N shares of X stock in exchange for certain services, upon the lapse of restrictions dated Date 5. On Date 6, X and C, an employee of X, entered into a restricted stock agreement that called for C to receive O shares of X stock in exchange for certain services, upon the lapse of restrictions dated Date 7. Neither A, B, nor C made an election pursuant to section 83(b) upon receipt of the restricted stock. X treated the restricted stock issued to A, B, and C as outstanding stock for federal income tax purposes.

X changed tax advisors and the new advisors notified X that X had erroneously treated A, B, and C as shareholders. See section 1.1361-1(b)(3). X, A, B, and C took corrective action that included filing amended returns, recharacterization of the distributions as loans to A, B, and C, and repayment of those loans. X has asked for a ruling that if the erroneous treatment of A, B, and C as shareholders and the corrective action caused X's S election to terminate, then the termination constituted an inadvertent termination within the meaning in section 1362(f).

Law and Analysis:

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 section 1362(a) is in effect for the year.

Section 1361(b)(1)(D) 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, among other things, have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides 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 law, and binding agreements relating to distribution and liquidation proceeds (collectively, the "governing provisions"). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement. Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1.1361-1(l)(2)(iii)(A) provides that buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical rights unless a principal purpose of the agreement is to circumvent the one class of stock requirement and the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and thus, are disregarded in determining whether the outstanding shares of stock confer identical rights.

Section 1.1361-1(l)(2)(iii)(B) provides that bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights.

Section 1.1361-1(l)(2)(iii)(C) provides that a determination of book value will be respected if the book value is determined in accordance with generally accepted accounting principles (including permitted adjustments) or if the book value is used for a substantial nontax purpose.

Section 1.1361-1(b)(3) provides that, for purposes of subchapter S, stock that is issued "in connection with the performance of services" (within the meaning of section 1.83-3(f)) and that is "substantially nonvested" (within the meaning of section 1.83-3(b)) is not treated as outstanding stock of the corporation, and the holder of that stock is not

treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under section 83(b).

Section 1362(d)(2)(A) provides that an election under section 1362(a) will 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(d)(2)(B) provides that the termination shall be effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under section 1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to section 1362(b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or (B) was terminated under section 1362(d)(2) or (3), (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 (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 in the corporation at any time during the period specified pursuant to section 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 or termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

#### Conclusion:

Based upon the information submitted and the representations set forth above, we conclude that if the erroneous treatment of A, B, and C as shareholders of X or if the corrective actions caused X's S election to terminate, the termination was inadvertent within the meaning of section 1362(f).

Pursuant to the provisions of section 1362(f), X will be treated as continuing to be an S corporation from Date 2 and thereafter, provided that X's subchapter S election is not otherwise terminated under section 1362(d).

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the above-described facts under any other provision of the Code. In particular, no opinion is expressed or implied concerning whether X's S election was valid under section 1362.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to the your authorized representative.

Sincerely,

/s/ David R. Haglund

David R. Haglund  
Senior Technician Reviewer, Branch 1  
Office of Associate Chief Counsel  
Passthroughs & Special Industries

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

cc: