Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **200045005**
Release Date: 11/9/2000
Index Number: 1361.01-04, 1362.00-00

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:7-PLR-100873-00
Date:
July 10, 2000

LEGEND:

a =

Company =

b =

Plan =

c =

d =

A =

e =

f =

g =

h =

i =

j =

k =

l =

m =

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Dear Sir or Madam:

In a letter, dated July 8, 1998, and a supplemental submission, dated December 1, 1999, you requested rulings under §§ 1361 and 1362 of the Internal Revenue Code.

The information submitted and the representations made are summarized as follows: Prior to the end of a, Company was an S corporation with a single class of common stock authorized. Effective b, Company became a C corporation.

Company adopted the Plan, effective c. The Trust established pursuant to the Plan purchased approximately d percent of the outstanding common stock of Company. The remaining outstanding stock of Company is held by A, an individual.

On e, the shareholders of Company approved an amendment to Company's Certificate of Incorporation, which provided for the division of the single class of common stock into two classes of common stock: (1) Class A Common Stock, and (2) Class B Common Stock.

Article 4 of the Certificate of Incorporation was amended to provide as follows:

> The total number of shares of capital stock which this corporation shall have authority to issue is f shares of which g shares shall be Class A Common Stock, par value h per share, and i shares shall be Class B Common Stock, par value h per share.
>
> The shares of Class A Common Stock and Class B Common Stock shall be identical in all respects, except that all dividends declared and paid on shares of Class A Common Stock shall be paid in additional shares of Class A Common and all dividends declared and paid on shares of Class B Common Stock shall be paid in cash. In the event that any dividend is declared on shares of Class B Common Stock, a corresponding dividend shall be declared on shares of Class A Common Stock in a per share amount equal to the per share amount of the cash

dividend declared on the shares of Class B Common Stock divided by the appraised value of the Class A Common Stock (as determined by the Board of Directors of the corporation). In the event that any dividend is declared on shares of Class A Common Stock, a corresponding cash dividend shall be declared on shares of Class B Common Stock in a per share amount equal to the appraised value of the shares of Class A Common Stock (as determined by the Board of Directors of the corporation) being paid as a dividend on each share of Class A Common Stock.

The Trust held all of the Class A Common Stock and most of the Class B Common Stock. A held the remaining outstanding shares of the Class B Common Stock.

On j, Company filed an election to be an S corporation, effective k.

Company was not aware that the e amendment to Article 4 of the Certificate of Incorporation created a second class of stock that would cause Company's S election to be ineffective. When company became aware that it had two classes of stock, to remedy the situation, on l , the Certificate of Incorporation was amended as follows:

1. Article Fourth of Company's Certificate of Incorporation is amended to read in its entirety as follows:

4. (a) The total number of shares of capital stock which this corporation shall have the authority to issue is m shares of common stock, par value n per share.

(b) In the event that the Board of Directors shall declare a dividend on the shares of common stock that is payable in cash, each shareholder of record at the time such dividend is declared may elect, with respect to some or all such shares held, that such dividend shall be payable in the form of additional shares of common stock, to be paid at the same time and in the same amount as cash dividends are paid. Such elections shall have no effect unless there are sufficient authorized but unissued common shares to allow all stock dividends so elected to be paid. No election under this subsection may be made after o.

2. Upon the above amendment to the Certificate of Incorporation becoming effective pursuant to p, each share of Company's Class A common stock and Class B common stock outstanding immediately prior to the effective time of the amendment shall, without any action on the part of the respective holders thereof, be reclassified into one share of

> common stock, par value n per share, and each stock certificate which, immediately prior to the effective time of such amendment, represented shares of Company's capital stock shall from and after such time and without the necessity of presenting the same for exchange, represent the number of shares of common stock equal to the number of shares of Class A common stock or Class B common stock formerly represented by such certificate. This amendment and the exchange effectuated hereby shall be effective at the date and time of the filing with g of this Certificate of Amendment to the Certificate of Incorporation.

Company and its shareholder represent that the failure to qualify as a small business corporation was not motivated by tax avoidance or hindsight. In addition, Company and its shareholders consent to adjustments that the Service may require.

You have requested the following rulings:

1. Company's election to be treated as an S corporation, effective on j, was inadvertently ineffective within the meaning of § 1362(f), and that Company will be treated as an S corporation from j, and thereafter, provided Company's S election is not otherwise terminated under the provisions of § 1362(d).

2. Article 4 of the Certificate of Incorporation, as amended on k, does not create a second class of stock under § 1361(b)(1)(D) and the regulations thereunder.

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 the year.

Section 1361(b)(1) 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—

(A) have more than 75 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 1 class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in § 1.1361-1(l)(4) (relating to instruments, obligations, or

arrangements treated as a second class of stock), a corporation is 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. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

Section 1.1361-1(l)(2) 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, by laws, 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 of § 1361(b)(1)(D) and § 1.1361-1(l). 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 1362(f) provides that if—

(1) an election under § 1362(a) by any corporation—

(A) 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

(B) was terminated under § 1362(d)(2) or (3),

(2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent,

(3) no later than a reasonable period of time after discovery of the circumstances resulting in the 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 § 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 the period,

then notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation is to be treated as an S corporation during the period specified by the Secretary.

Ruling No. 1:

Based solely on the information submitted and the representation made, we conclude that Company's election to be treated as an S corporation was invalid because on k, Company had more than one class of stock. We also conclude that the invalid election was inadvertent, within the meaning of § 1362(f). Pursuant to § 1362(f), Company will be treated as an S corporation for the period beginning k, and thereafter, provided Company's S election was otherwise valid and was not terminated under the provisions of § 1362(d).

Company and all its current and former shareholders must treat Company as having been an S corporation for the period beginning k, and thereafter. Accordingly, all current and former shareholders, in determining their respective income tax liabilities for the period beginning k, and thereafter, must include the pro rata share of the separately and nonseparately computed items of Company as provided in § 1366, make adjustments to stock basis as provided in § 1367, and take into account any distributions made by Company as provided by § 1368. If Company or any of its current or former shareholders fail to treat Company as having been an S corporation for the period beginning k, and thereafter, as described above, this ruling shall be null and void.

Ruling No. 2:

Based solely on the information submitted and the representation made, we conclude that the l amendment to the Article 4 of the Certificate of Incorporation does not create a second class of stock under of § 1361(b)(1)(D).

Except as specifically ruled in this letter, we express or imply no opinion concerning the federal tax consequences of this transaction under the cited provisions or any other provision of the Code. Specifically, we express or imply no opinion concerning whether Company is otherwise a valid S corporation for federal tax purposes.

This ruling is directed only to the taxpayer(s) 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 is being sent to your authorized representative.

Sincerely yours,

Joseph H. Makurath
Senior Technician Reviewer, Branch 7
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)