

## Internal Revenue Service

Number: **200533002**

Release Date: 8/19/2005

Index Number: 1362.00-00

Department of the Treasury  
Washington, DC 20224

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CC:PSI:2 – PLR-103413-05

Date:

April 28, 2005

### LEGEND

X =

A =

B =

C =

Trust 1 =

Trust 2 =

Fund =

LP1 =

LP2 =

LP3 =

d1 =

d2 =

d3 =

State =

n =

\$a =

Dear

This responds to a letter dated January 13, 2005, submitted on behalf of X by its authorized representative requesting a ruling on the status of X's S election.

The information submitted states that X was incorporated under the laws of State on d1 and made an S election effective d1. X's original shareholders were A, B, C, Trust 1 and Trust 2. Subsequently, X entered into discussions with Fund, a venture capital fund, for the sale of X stock to Fund. On d2, X sold n shares of newly issued convertible preferred X stock to LP1, LP2 and LP3 (the Partnerships), three limited partnerships controlled by Fund, for \$a. This terminated X's S election under § 1362(d)(2) of the Internal Revenue Code because X no longer met the definition of a small business corporation as defined by § 1361(b)(1).

In the months following the sale, disagreements arose between the original X shareholders and the Partnerships. These disagreements led X and the Partnerships to agree to unwind the original purchase. X and the Partnerships entered into a Stock Rescission Agreement which was consummated as of d3, which date was in the same taxable year as d2. The terms of the agreement provide that X remit \$a to the Partnerships. Upon the execution of the agreement and delivery of the \$a, the issuance of the convertible preferred stock would be deemed rescinded. The agreement requires that X promptly cancel the issuance of the convertible preferred stock. The agreement provides for the resignation of the Partnerships' representative from X's Board of Directors. The agreement also releases all parties from any liability or obligation that arose from the original Stock Purchase Agreement with the exception that the indemnification clauses for the Partnerships and their representative remain in effect. X represents that during the period from d2 to d3, X did not make any distributions to the Partnerships.

Section 1361(a) 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) 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 1 class of stock.

Section 1362(d)(2)(A) provides that an election under § 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.

The Service recognizes that a rescission may be given full effect in abrogating a transaction under certain conditions. When these conditions are met, the transaction is disregarded for federal income tax purposes. In this connection, Rev. Rul. 80-58, 1980-1 C.B. 181, states the general legal principles pertaining to the doctrine of rescission in the following terms:

The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.

The revenue ruling states that there are at least two conditions that must be satisfied for the remedy of rescission to apply to disregard a transaction for federal income tax purposes. First, the parties to the transaction must return to the status quo ante; that is, they must be restored to "the relative positions they would have occupied had no contract been made." Second, this restoration must be achieved within the taxable year of the transaction.

X, A, B, C, Trust 1, Trust 2, LP1, LP2 and LP3 were restored to the relative positions they would have occupied if the X stock had never been sold to the Partnerships. In addition, this restoration was achieved within the same taxable year. Therefore, the legal doctrine of rescission applies to (1) disregard the creation of convertible preferred stock and X's issuance of that stock to the Partnerships, and (2) prevent the termination of X's S corporation status.

Based solely on the facts submitted and representations made, we rule that X will be treated as continuing to be an S corporation during the period from d2 to d3, and thereafter, provided that X's S election was valid and was not otherwise terminated

under § 1362(d). We further rule that during the period from d2 to d3, A, B, C, Trust 1 and Trust 2 will be treated as the shareholders of X. Accordingly, A, B, C, Trust 1 and Trust 2 must include in income their pro rata shares of the separately and nonseparately stated items of X as provided in § 1366 and must make any adjustments to stock basis as provided in § 1367 and take into account any distributions made by X as provided in § 1368. This ruling is null and void if X, A, B, C, Trust 1 or Trust 2 fail to comply with these requirements.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code, including whether X was or is a small business corporation under § 1361(b).

The rulings contained in this letter are predicated upon facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by the appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the factual information, representations, and other data may be required as part of the audit process.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code 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 forwarded to X's authorized representative.

Sincerely yours,

J. Thomas Hines  
Chief, Branch 2  
Associate Chief Counsel  
(Passthroughs and Special Industries)

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