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:03
PLR-135511-09
Date:
January 07, 2010

LEGEND

Company =

State =

Date1 =

Year1 =

Agreement =

Plan1 =

Plan2 =

X =

Y =

Z =

Dear :

We received a letter dated July 22, 2009, and subsequent correspondence, written on behalf of Company, requesting a ruling under § 1361(b)(1)(D) of the Internal Revenue Code. This letter responds to that request.

FACTS

Company was organized in Year1. After several restructurings, Company incorporated in State. Company filed Form 2553, Election by a Small Business Corporation, effective Date1.

Company has issued and outstanding shares of stock, X, Y, and Z, comprised of voting and non-voting common stock. Company represents that all of the stock confers identical rights to distributions and liquidation proceeds.

Under an agreement among Company and its shareholders, the Agreement, shares of X and Y stock are transferable to third parties, subject to certain purchase rights of Company and certain non-selling shareholders. If a shareholder wants to transfer X or Y stock to a person other than a permitted transferee, as defined in the Agreement, the remaining shareholders of X and Y stock and Company are entitled to purchase or redeem the shares at a defined purchase price under rights of first refusal, in accordance with a prescribed set of priority rules and limitations. Company has the right to mandate the automatic redemption of Company stock in the event a shareholder ceases to qualify as a valid S corporation shareholder.

Company adopted a stock option plan, Plan1, with the intention that the plan not qualify as an incentive stock option plan under § 422. Plan1 provides that key employees and independent directors of the Company may be given stock options to purchase Z stock. These options vest over the prescribed term, and upon vesting, the employee may exercise the stock option at a price equal to the book value, as determined under Plan1, of the underlying shares of Z stock as of the date of the grant of the option. In addition, the stock options and the shares of Z stock issued upon the exercise are nontransferable. Pursuant to the provisions of Plan1, Company may be required to redeem the Z stock on specified dates for a redemption price equal to the book value on certain valuation dates, as determined under Plan1. For redemption purposes under Plan1, the book value per share for Z stock may not exceed the book value per share of X stock.

Company later adopted a restricted stock plan, Plan2. Plan2 is a restricted stock plan in which certain key employees and independent directors are granted restricted Z stock awards. The awards of restricted Z stock vest over a term of years, and the shares are nontransferable. Pursuant to the provisions of Plan2, Company may be required to redeem the Z stock on specified dates for a redemption price equal to the book value on certain valuation dates, as determined under Plan2. For redemption purposes under Plan2, the book value per share for Z stock may not exceed the book value per share of X stock.

Company represents that the Agreement, Plan1, and Plan2 were not created as a plan to circumvent the one class of stock requirement for S corporations. Company further represents that, for redemption purposes, book value is determined using Generally Accepted Accounting Principles ("GAAP").

LAW AND ANALYSIS

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 the year.

Section 1361(b)(1)(D) provides that the term "small business corporation" means a domestic corporation that, among other things, does not have more than one class of stock. Accordingly, S corporations may not have more than one class of stock.

Section 1.1361-1(b)(3) of the Income Tax Regulations provides that for purposes of subchapter S, stock that is issued in connection with the performance of services (within the meaning of § 1.83-3(f)) and that is substantially nonvested (within the meaning of § 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 § 83(b).

Section 1.1361-1(l)(1) provides that, 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)(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 of § 1361(b)(1)(D) and § 1.1361-1(l).

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 distribution and liquidation rights unless (1) 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), and (2) 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)(1) 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 optional adjustments).

Section 1.1361-1(l)(4)(iii)(A) provides that, except as otherwise provided in the paragraph, a call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder under § 1.1361-1(b)(1) to a person who is not an eligible shareholder under § 1.1361-1(b)(1), or materially modified.

Section 1.1361-1(l)(4)(iii)(B)(2) provides that a call option that is issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) is not treated as a second class of stock for purposes of § 1.1361-1(l) if the call option is nontransferable within the meaning of § 1.83-3(d) and the call option does not have a readily ascertainable fair market value as defined in § 1.83-7(b) at the time the option is issued.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that the Agreement, Plan1, and Plan2 do not cause Company to have more than one class of stock for purposes of § 1361(b)(1)(D).

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the above-described facts under any other provision of the Code. Specifically, no opinion is expressed or implied concerning whether Company's S corporation election was a valid election under § 1362.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) 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 Company's representative.

Sincerely,

/s/

Tara P. Volungis
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

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