

## Internal Revenue Service

Department of the Treasury

Number: **200205044**

Washington, DC 20224

Release Date: 2/1/2002

Index Number: U.I.L. No.: 1361.01-00

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Refer Reply To:

CC:PSI:3 PLR-127372-01

Date:

November 7, 2001

### Legend

Company =

Business =

ESOP =

Trust =

a =

b =

c =

d =

Dear

This letter responds to a letter received May 16, 2001, submitted on behalf of Company, requesting a ruling under § 1361(b)(1)(D) of the Internal Revenue Code.

The information submitted discloses that Company is an S corporation engaged in the Business. Prior to a, Company was taxed as a C corporation. While taxed as a C corporation, Company adopted an employee stock ownership plan, the ESOP, and established an employee stock ownership trust, the Trust. The Trust held 4.4 percent of the outstanding stock of Company ("Pre-Transaction ESOP Shares"), all of which were allocated to employees' accounts. Company has one class of common stock outstanding, and all shares of Company stock have identical rights to operating and liquidating distributions.

On b, in anticipation of Company's S election, a number of related events transpired: 1) The ESOP governing documents were amended and restated in their entirety; 2) An independent appraiser established the fair market value of the stock as of b; 3) Certain shareholders of Company loaned \$c to Company ("Transaction Debt"); 4) The Trust borrowed \$d from Company; 5) The Trust used the loan proceeds to

purchase all of the remaining outstanding stock of Company, other than the Pre-Transaction ESOP Shares, pursuant to a stock purchase agreement ("Stock Purchase Agreement"). As a result of the transactions, the Trust became the owner of 100 percent of the outstanding stock of Company.

Among its amended and restated provisions, the ESOP provides that the Trust shall distribute benefits to participants at stated periods of time following their termination of employment due to retirement, disability, death, or other reason. Distributions are made in annual installments over a period of up to five years. The ESOP also provides for in-service distributions to participants (in anticipation of retirement) in two instances. In one, participants aged 55 with ten years of service may receive a distribution of 25 percent (50 percent in some cases) of their account balances under the rules of § 401(a)(28)(B). In the other, participants aged 70 and one-half may elect to receive a distribution of an actuarially determined portion of their accounts, under the rules of § 401(a)(9). Distributions may be in cash, equal in value to the Company stock in which the participant's account is invested, or in Company stock, subject to a put option right of the distributee to sell the stock back to Company for its fair market value.

The Stock Purchase Agreement also contains a floor put right regarding future purchases of the Pre-Transaction ESOP Shares by Company. Under Section 6.09 of the Stock Purchase Agreement, Company will purchase any Pre-Transaction ESOP Shares that are distributed by the Trust to plan participants or that are sold by the Trust to Company at a price per share that is computed without regard to the Transaction Debt of Company incurred in connection with financing the Trust's acquisition of the shares (Floor Put Right). Thus, all valuations of Pre-Transaction ESOP Shares are to reflect the value of Company's commitment under section 6.09 of the Stock Purchase Agreement, as determined by an independent appraiser, without taking into account the Transaction Debt.

Company represents that the purpose of the Floor Put Right is to protect the Pre-Transaction ESOP Shares that have already been allocated to employee accounts from a steep decline in value that is normally associated with a highly leveraged ESOP transaction. According to Company, the decline in value of the stock will result solely from the effects of the Transaction Debt, and as the debt is paid down, the value will recover. A serious employee relations problem will occur if a voluntary corporate action has the effect of dramatically reducing the value of the Pre-Transaction ESOP Shares already owned by employees. The effect is most severe for employees who are close to retirement or who have previously terminated employment and are waiting for distributions of their shares. According to Company, the Pre-Transaction ESOP Shares will continue to fluctuate in value with the fortunes of the corporation and the general market conditions, as would occur in the absence of a leveraged ESOP transaction.

Company requested the following ruling: Company will not be considered to have a second class of stock in violation of § 1361(b)(1)(D) solely as a result of the existence of the Floor Put Right.

Section 1361(b)(1) provides that for purposes of subchapter S, the term "small

business corporation” means, in part, a domestic corporation which is not an ineligible corporation and which does not have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides, in part, 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.

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). 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, in part, that 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 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. In addition, if stock that is substantially nonvested (within the meaning of § 1.83-3(b) ) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Furthermore, the Commissioner may provide by Revenue Ruling or other published guidance that other types of bona fide agreements to redeem or purchase stock are disregarded.

Under the ESOP distribution provisions, Company’s agreement to redeem stock is activated by the termination of a participant’s employment due to death, disability, or retirement . Under § 1.1361-1(l)(iii)(B), agreements to redeem stock upon termination of employment are disregarded. In disregarding agreements that provide for

redemptions upon termination of employment, § 1.1361-1(l)(iii)(B) , in effect, distinguishes between redemption agreements for stock of employee shareholders and redemption agreements for stock of investor shareholders. In this case, the shareholders whose stock is to be redeemed are employee shareholders or their trust, rather than investor shareholders. Though specifically referencing redemptions upon termination of employment, as well as death, divorce, and disability, § 1.1361-1(l)(iii)(B) also anticipates that other types of bona fide agreements to redeem stock may be disregarded by the Service. In addition, a redemption agreement is disregarded under § 1.1361-1(l)(2)(iii)(A) where the principal purpose of an agreement is not to avoid the one class of stock requirement or the agreement sets a purchase price that does not greatly vary from the fair market value of the stock.

Based on the facts submitted and representations made, we conclude that the Stock Purchase Agreement containing the Floor Put Right will be disregarded in determining whether the outstanding shares of Company stock confer identical rights. Therefore, for purposes of § 1361(b)(1)(D) Company will not be considered as having more than one class of stock.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the foregoing facts. Specifically, we express or imply no opinion on whether Company's S corporation election is valid under § 1362(a). In addition, we express or imply no opinion on whether the ESOP is qualified under § 401(a) or whether the redemption of Pre-Transaction ESOP Shares under the Floor Put Right contained in the Stock Purchase Agreement may violate the nondiscrimination requirements of § 401(a)(4).

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Company.

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.

Sincerely yours,  
CHRISTINE ELLISON  
Chief, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure:

Copy for section 6110 purposes