

**Internal Revenue Service**

Department of the Treasury

Number: **200314016**  
Release Date: 4/4/2003  
Index Number: 1361.01-04

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

**CC:PSI:B1-PLR-152868-02**

Date:

December, 19 2002

Legend:

X =

State =

D1 =

D2 =

Y =

D3 =

a =

b =

D4 =

D5 =

Dear :

This responds to a letter dated September 17, 2002, together with related documents, submitted on behalf of X, requesting a ruling under §1362(f) of the Internal Revenue Code.

**FACTS**

The information submitted discloses that X is a corporation organized under the laws of the State on D1. X elected to be treated as a subchapter S corporation effective

PLR-152868-02

D1. On D2, X obtained a commercially reasonable loan from Y, a lender actively and regularly engaged in the business of lending money and providing mezzanine financing to various types of business. The loan was to mature on D3. In consideration of the loan, X issued a stock purchase warrant to Y. The warrant allowed Y to acquire up to a% of X's fully diluted common stock at \$b per share. The warrant was exercisable at any time up to and including D4. The warrant also contained a put feature that enabled Y to sell the warrant to X, in the 30-day period prior to D4, for cash based upon the fair market value of the shares of common stock issuable to Y upon its exercising the warrant.

Prior to D3, X repaid the loan in full. Thereafter, X and Y twice agreed to extend the time period for Y to exercise the warrant. Eventually, on D5, X and Y reached an agreement on the fair market value of the warrant. Y executed the put feature of the warrant and X paid Y in full with cash.

X requests a ruling that the extensions of time on the warrant subsequent to the discharge of the underlying loan did not constitute issuance of a second class of stock, which terminated its S election.

## **LAW AND ANALYSIS**

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under section 1362(a) is in effect for such year.

Section 1361(b)(1) provides that 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 subsection (c)(2), or an organization described in subsection (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.

Section 1.1361-1(l)(4)(i) provides the general rule that, instruments, obligations, or arrangements are not treated as a second class of stock for purposes of this paragraph (l) unless they are described in paragraphs (l)(4)(ii) or (iii) of this section.

Section 1.1361-1(l)(4)(iii)(A) provides pertinently that, 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 paragraph (b)(1) of this section to a person who is not an eligible

PLR-152868-02

shareholder under paragraph (b)(1) of this section, or materially modified. For purposes of this paragraph (l)(4)(iii), if an option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the terms of the loan, the extension of the time period in which the option may be exercised is not considered a material modification.

Section 1.1361-1(l)(4)(iii)(B) provides exceptions to the general rule contained in §1.1361-1(l)(4)(iii)(A). In particular, it provides that a call option is not treated as a second class of stock for purposes of this paragraph (l) if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation. §1.1361-1(l)(4)(iii)(B)(1).

### CONCLUSIONS

Based solely on the facts submitted and the representations made, we conclude that X did not issue a second class of stock within the meaning of §1361(b)(1)(D) by agreeing to the extensions of time on the warrant and, therefore, X's subchapter S election was not terminated.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is a valid S corporation.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being mailed to your authorized representative.

Sincerely,

/s/ David R. Haglund

David R. Haglund  
Senior Technician Reviewer  
Branch 1  
Associate Chief Counsel  
(Passthroughs and Special Industries)

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