

Internal Revenue Service

Number: **200537010**

Release Date: 9/23/2005

Index Number: 1361.01-04

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:B01

PLR-107451-05

Date:

June 16, 2005

Legend:

X =

State =

D1 =

D2 =

a =

b =

Dear :

This letter responds to the letter dated February 4, 2005, and related correspondence, written on behalf of X, requesting a ruling that a proposed issuance of stock under an Incentive Stock Bonus Plan ("Plan") would not cause X to have more than one class of stock within the meaning of § 1361(b)(1)(D) of the Internal Revenue Code ("Code").

FACTS

The information submitted discloses that X was incorporated under the laws of State on D1. X elected to be taxed as an S corporation for federal tax purposes, effective D2. X has a single shareholder and issued two classes of common stock differentiating only in voting rights.

X intends to establish the Plan for the benefit of certain key employees ("Participants"), provided that, in accordance with a revised shareholder agreement, X acquires from the sole owner, upon the owner's death, the owner's stock to the extent of the proceeds of certain life insurance owned by X on the life of the owner to fund the Plan. The Plan provides that X may grant revocable options to the Participants to acquire the stock of X at its fair market value at the time of exercise. Reasonable bonuses may be made to such Participants, the net after tax proceeds of which will be used to exercise the options. The Plan also provides that, while any such options remain outstanding, the net after tax proceeds from distributions on account the stock of X acquired by the Participants shall likewise be used to exercise such options. The Plan further provides for options to acquire a controlling interest in X, upon the death or incapacity of the owner, to the extent any owner's stock remains outstanding after the life insurance funded redemption. The Participants may continue the acquisition of the owner's stock via the exercise of options on the remaining owner's stock, with the net after tax proceeds from bonuses and distributions. The Participants who purchase the stock of X, other than the controlling shares, will vest in such stock at a rate of a% for each year of service (including prior service); provided, however, no more than b years of service shall be counted. A Participant is fully vested in any controlling shares acquired.

The Plan provides that X has the right to purchase from a Participant all of the stock owned by the Participant within a 60-day time period following the date the Participant's employment is terminated for any reason. Upon such an event, X shall pay to the Participant an amount equal to the fair market value of the purchased stock that is vested at such time.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 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 100 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, 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 arrangement 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, in general, 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 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.

CONCLUSION

Based solely on the facts submitted and representations made, we conclude that the Plan will not cause X to have a second class of stock within the meaning of § 1361(b)(1)(D).

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code.

This ruling is directed only to the taxpayer 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 mailed to your authorized representative.

Sincerely,

/s/ David R. Haglund

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

Enclosures (2)

Copy of this letter
Copy for § 6110 purposes