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Third Party Communication: None

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PLR-132285-05

Date:

January 10, 2006

Legend:

X =

Y =

State =

Date 1 =

Date 2 =

Dear

This letter is in response to your request, on behalf of X, dated June 1, 2005, and subsequent correspondence dated, January 3, 2006, for a letter ruling that X's proposed stock option plan will not cause X to have more than one class of stock within the meaning of section 1361(b)(1)(D) of the Internal Revenue Code.

Facts

Based on the materials submitted and representations contained within subsequent correspondence, we understand the relevant facts to be as follows. X is a corporation formed on Date 1 in accordance with the laws of State. On Date 2, X elected to be treated as an S corporation for federal income tax purposes. Y has also elected to be treated as an S corporation for federal tax purposes. Both X and Y have identical shareholders and percentage ownership. Y has several foreign affiliates. X

has determined that it would like to issue options to the employees of these affiliates for the right to purchase X's stock. Each option strike price per share will be equal to or greater than the fair market value of X's stock on the grant date.

### 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 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 one class of stock.

Section 1.1361-1(l)(2)(1) of the Income Tax Regulations provides that, except as provided in section 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 the stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(iii)(B) of the regulations 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)(4)(i) provides 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 (l)(4)(iii) of this section. However, in no event are instruments, obligations, or arrangements described in paragraph (b)(4) of this section (relating to deferred compensation plans), paragraphs (l)(4)(iii)(B) and (C) of this section (relating to the exceptions and safe harbor for options), paragraph (l)(4)(ii)(B) of this section (relating to the safe harbors for certain short-term unwritten advances and proportionally-held debt), or paragraph (l)(5) of this section (relating to the safe harbor for straight debt), treated as a second class of stock for purposes of this paragraph (l).

Section 1.1361-1(l)(4)(iii)(C) of the regulations provides that a call option is not treated as a second class of stock, if, on the date the call option is issued, transferred by a person who is an eligible shareholder to a person who is not an eligible shareholder under section 1.1361-1(b)(1) of this section, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. For purposes of section 1.1361-1(l)(4)(iii)(C), a good faith determination of fair market value by the corporation will be respected unless it can be

shown that the value was substantially in error and the determination of the value was not performed with reasonable due diligence to obtain a fair value.

Based on the facts as presented, the proposed stock option plan satisfies the safe harbor for options in section 1.1361-1(l)(4)(iii)(C).

Conclusion

Based solely on the facts submitted and representations made, we conclude that the issuance of options to purchase X's stock to its employees will not result in X be found to have a second class of stock within the meaning of section 1361(b)(1)(D).

Sincerely,

David R. Haglund

David R. Haglund  
Senior Technician Reviewer, Branch 1  
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

Copy of this letter for section 6110 purposes

cc: