

**Internal Revenue Service**

Number: **200708018**

Release Date: 2/23/2007

Index Number: 1361.01-04

Department of the Treasury  
Washington, DC 20224

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:3 PLR-164453-05

Date: November 9, 2006

Company =

Plan =

Agreement =

a =

Dear :

This letter responds to a letter dated December 16, 2005, submitted on behalf of Company requesting a ruling under § 1361(b)(1)(D) of the Internal Revenue Code that Company's stock option plan does not cause Company to have more than one class of stock.

**FACTS**

Company adopted a nonqualified stock option plan, the Plan, effective a, with the intention that the plan not qualify under § 422. Company's stated goal is to create a broader shareholder base of the top management who will remain with Company for the long-term. The Plan allows the corporation's shareholders and board of directors to grant stock options to officers of the company. The stock options may be granted only as of April 30<sup>th</sup> of a given year and will expire three years later, unless terminated earlier due to sale of the company or termination of the option holder's employment.

Company represents that the stock options have no readily ascertainable value at the time of issuance and are nontransferable. The exercise price on the options is equal to the Company's prorated net book value as of December 31<sup>st</sup> of the year preceding the year in which the option was granted, as adjusted for any interim equity distributions paid by Company through April 30<sup>th</sup> of the year in which the option was issued.

Under an agreement among Company and its shareholders, the Agreement, shares of Company stock are transferable to third parties, subject to certain purchase rights of Company and the non-selling shareholders. If Company shares are transferred to third parties within one year of their purchase, then Company has the right to purchase the shares at the purchase price under the Plan. Company has the right to redeem a shareholder's stock shares and a shareholder has a right to sell its shares of stock to Company upon the shareholder's death, disability, termination of employment, and voluntary or involuntary transfer of stock. If one of the preceding events occurs within one year of the shareholder's stock purchase, Company may redeem any stock issued under the Plan at the purchase price paid by the shareholder. In addition, Company has a continuing and discretionary right to redeem all of a shareholder's shares of stock as Company so elects.

## LAW

Section 1361(a)(1) provides that for purposes of tile 1, the term "S corporation" means, with respect to the taxable year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(1) 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 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

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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).

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 (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)(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 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 the same section, or materially modified.

Section 1.1361-1(l)(4)(iii)(B)(2) provides that if 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 services performed) is not treated as a second class of stock if—(i) The call option is nontransferable within the meaning of § 1.83-3(d); and (ii) The call option does not have a readily ascertainable fair market value as defined under

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§ 1.83-7(b) at the time the option is issued.

### CONCLUSION

Based on the facts and representations submitted by Company, we conclude that the implementation of Company's Plan, and the accompanying Agreement, under which stock options and shares are issued as described above does not cause Company to have more than one class of stock for purposes of § 1361.

Except for the specific ruling above, we express or imply no opinion concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding Company's eligibility to be an S corporation. In addition, we express or imply no opinion in this ruling regarding the tax consequences for individuals participating in the Plan, Company's deduction under § 83(h), or the associated withholding and reporting requirements relating to Plan participation. In particular, no opinion is expressed or implied regarding the application of § 409A to the Plan or to participation in the Plan.

Under a power of attorney on file with this office, we are sending a copy of this letter to Company's authorized representative.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

/s/

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

Enclosure: copy of this letter for § 6110 purposes