

## Internal Revenue Service

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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:B03

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Date:

June 21, 2010

### LEGEND

Company =

ESOP =

Provision A =

Provision B =

State =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

Dear :

This letter responds to a letter dated December 28, 2009, and subsequent correspondence, submitted on behalf of Company by its authorized representative, requesting a ruling under § 1361(b)(1)(D) of the Internal Revenue Code.

FACTS

Company was incorporated in State on Date1. Company was taxed as a C corporation from its incorporation until Date5. Company elected to be treated as an S corporation effective Date5.

On Date2, while it was still taxed as a C corporation, Company adopted an employee stock ownership plan, ESOP. On Date3, ESOP purchased a minority interest in Company's stock (First Purchase Shares). Company has one class of common stock outstanding and all shares have identical rights to distribution and liquidation proceeds.

On Date4, Company undertook a series of transactions that resulted in ESOP becoming the sole owner of Company's outstanding stock. First, Company made a loan, secured by Company stock, to ESOP (ESOP Loan). Next, ESOP used the ESOP Loan proceeds to purchase all of the remaining outstanding shares of Company stock (Second Purchase Shares).

Among its provisions, ESOP provides generally that benefits are distributed to participants at stated periods of time following their termination of employment due to retirement, disability, death, or other reason. Provision A of ESOP provides generally that for purposes of distributions under the plan, the value of the shares held by ESOP is determined by an independent appraiser. The independent appraiser calculates the fair market value of ESOP's assets and reduces that value by any liabilities of ESOP, including the outstanding balance of the ESOP Loan.

Provision B of ESOP provides a special valuation rule with respect to First Purchase Shares for purposes of distributions under the plan. Provision B provides that the value of Company shares purchased in connection with the First Purchase Shares will not be decreased or otherwise affected by the outstanding balance of the ESOP Loan proceeds used to purchase the Second Purchase Shares.

Company represents that the purpose of Provision B is to protect the value of the First Purchase Shares from a steep decline in value that is normally associated with a highly leveraged employee stock ownership plan transaction. Company further represents that a serious employee relations problem would have occurred if a voluntary corporate action had the effect of reducing the value of First Purchase Shares already owned by ESOP. This would have negatively impacted employees who were close to retirement or who had previously terminated employment and were waiting for distributions. According to Company, First Purchase Shares continue to fluctuate in value with the fortunes of Company and general market conditions, as would occur in the absence of a leveraged employee stock ownership plan transaction.

Company requests a ruling that Company will not be considered to have a second class of stock in violation of § 1361(b)(1)(D) solely as a result of Provision B.

### LAW & ANALYSIS

Section 1361(b)(1)(D) provides that for purposes of subchapter S, the term "small business corporation" means 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 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 § 1.1361-1, 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 ESOP's distribution provisions, Company's agreement to redeem First Purchase Shares pursuant to the special valuation rule in Provision B is activated by a distribution from ESOP. Under ESOP's distribution provisions, plan participants are generally entitled to receive a distribution of the participant's vested balance attributable to Company's shares upon retirement, death, disability, or other reason for separation. Under § 1.1361-1(l)(2)(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)(2)(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 First Purchase Shares are redeemed through the special valuation rule in Provision B are employee shareholders, rather than investor shareholders. Though specifically referencing redemptions upon termination of employment, as well as death, divorce, and disability, § 1.1361-1(l)(2)(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 the agreement is not to avoid the one class of stock requirement or when the agreement sets a purchase price that does not greatly vary from the fair market value of the stock.

### CONCLUSIONS

Based on the facts submitted and representations made, we conclude that Provision B 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 as a result of ESOP's adopting Provision B.

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 otherwise qualifies as an S corporation under § 1361. In addition, we express or imply no opinion on whether ESOP is qualified under § 401(a) or whether the redemption of First Purchase Shares under Provision B 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's authorized representatives.

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.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

/s/

Leslie H. Finlow  
Senior Technician Reviewer, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

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

cc: