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The information submitted states that X is a corporation formed in State on Date 1. X made an election to be treated as an association taxable as an S corporation under § 1362 effective Date 2. The members of X executed a buy-sell agreement effective Date 3 that imposed certain restrictions on the transfer of shares, created obligations and options with respect to the shares on the occurrence of certain events, provided for certain permitted transfers of shares, and made certain other relevant agreements. Except for sales of stock made pursuant to a right of first refusal provision, all purchases under the buy-sell agreement were to take place at the “sales price” as defined by the agreement. The agreement contained two methods for determining sales price – (1) agreement of the parties within 90 days of the end of each fiscal year, or (2) formula contained in the agreement to approximate fair market value.

The members of X executed an amended and restated buy-sell agreement effective Date 4. The amended and restated agreement adds a provision to the original agreement to address a potential future settlement or award from a legal dispute with a third party. Under the amended and restated agreement, if any of A, B, or C (the original members of X) sells their shares prior to resolution of the third-party claim that shareholder retains a right to receive a portion of any future recovery. X represents that the third-party claim created uncertainty in determining the sale price under the buy-sell agreement, as any potential recovery could significantly affect X's balance sheet. X represents that the clause allows the value of the third party claim to accrue to the original members if any recovery is made and allows a person to purchase X's stock without requiring the selling original shareholder and purchaser to come to an agreement on the value of the claim. X represents that the amended-buy sell agreement was entered into prior to X making an S election, and did not enter into the agreement with the purpose of circumventing the single class of stock requirement.

On Date 5, X also adopted a bonus plan to be funded by a portion of any future recovery from the third-party claim. The plan awards certain of its employees for their work on a particular matter. Payment under the plan, however, is contingent upon X receiving a recovery from the third-party claim.

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

Section 1361(b) provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (b) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1362(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)(1) 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. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

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, equipment 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).

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 purposes of the agreement is to circumvent the one class of stock requirements 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 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)(C)(1) provides that a determination of book value will be respected if the book value is determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments).

Section 1.1361-1(l)(3) provides that, except as provided in §§ 1.1361-1(b)(3), (4), and (5) (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account.

Section 1362(a) provides, in part, that a small business corporation may elect to be an S corporation. Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation such corporation ceases to be a small business corporation.

Conclusion

Based solely on the facts submitted and representations made, we conclude that neither the amended buy-sell agreement nor bonus plan X entered into created a second class of stock for purposes of § 1361(b)(1)(D). Thus, we conclude that X's S

corporation election was not invalid under § 1362(a) and that X will be treated as an S corporation beginning on D2 and thereafter, provided X's S corporation election was otherwise valid and was not otherwise terminated under § 1362(d).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. 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. Pursuant to a power of attorney on file, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 2
(Passthroughs & Special Industries)

Enclosures (2)