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Department of the Treasury

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Date:

April 29, 1999

X =

A =

B =

C =

D1 =

D2 =

Dear :

This letter responds to a letter dated December 16, 1998, and subsequent correspondence, submitted on behalf of X, concerning certain stock arising from a recapitalization.

The information submitted states that X has been an S corporation since D1. Currently A and B are the sole shareholders of X. Prior to D2, X's only authorized stock was 10,000 shares of voting common of which 100 shares were owned by each of A and B, the sole shareholders. Effective D2, X reorganized its capital structure to include a class of nonvoting common stock. The purpose of the reorganization is to provide incentive compensation to C by issuing shares of the newly created nonvoting common stock to C, subject to the stockholder's agreement described below. A, as X's president, represents that the nonvoting shares do not differ from the voting shares with respect to any rights of distribution and that these shares are entitled to the same allocation of earnings as the voting shares.

A proposed stockholder's agreement between A, B, C, and X (Agreement) provides for the terms under which stock that will be issued to C may be transferred or redeemed.

Section 1.1 of Agreement provides that the parties do not want shares of the Stock to be made generally available to Persons other than A and B. Therefore, the parties agree that C will not Encumber, Transfer, or permit to be Encumbered or Transferred all or any portion of C's stock, whether now or hereafter acquired, except in accordance with the Agreement. No attempted Encumbrance or Transfer of any shares of C's stock not in accordance with Agreement shall be reflected on X's books.

Section 1.2 of Agreement provides that C may not Encumber any or all of C's stock in connection with any debt.

Section 1.3 of Agreement provides that if C ceases to be an employee of X as a result of voluntary termination of employment, termination of employment by the mutual consent of C and X, termination of employment by X for any reason, whether such termination is voluntary or involuntary, with or without cause or with or without notice, or because C is a Disabled Stockholder (defined in § 8.7 of Agreement), C shall be deemed to have offered to sell all of C's stock to X and to A and B for the Agreement Price. Such offer shall be deemed made on the date on which C ceases to be an employee of X.

Item 1.3.1 of Agreement provides that X shall have sixty (60) days from such offer to elect to buy all or any of the Offered Stock.

Item 1.3.2 of Agreement provides that A and B shall have sixty (60) days from expiration of the option period in Item 1.3.1 in which to elect to buy all or any of the Offered Stock as to which X did not exercise its option. A and B may elect to buy such remaining shares of the Offered Stock in proportion to their respective ownership of the Stock (excluding the Offered Stock), or in such other proportion as they shall agree upon.

Item 1.3.3 of Agreement provides that if X and A and B shall not, in the aggregate, elect to buy all of the Offered Stock within such two (2) periods under items 1.3.1 and 1.3.2, X shall buy all of the Offered Stock as to which no election to purchase was made under items 1.3.1 or 1.3.2.

Provisions similar to § 1.3 are included in Agreement for (1) C's receipt of any Bona Fide offer (as defined in § 8.4) to purchase C's stock (§ 1.4), (2) any Involuntary Lifetime Transfer

by C (§ 1.5), and (3) C's death (§ 1.6).

Section 2 of Agreement provides that the Agreement Price shall be the book value of the Offered Stock.

Item 2.1.1 of Agreement provides that the book value of the Offered Stock shall be determined in accordance with generally accepted accounting principles consistently applied.

Section 1361(b)(1)(D) of the Code provides that 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 1361(c)(4) of the Code provides that for purposes of § 1361(b)(1)(D), a corporation will not be treated as having more than one class of stock solely because there are differences in voting rights among the shares of common stock.

Section 1.1361-1(1)(1) of the Income Tax Regulations provides that, except as provided in § 1.1361-1(1)(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(1)(2)(i) of the regulations 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. 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(1)(2)(iii)(A) of the regulations 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 § 1.1361-1(1), 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(1)(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(1)(2)(iii)(C)(1) of the regulations 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 adjustments).

Based solely on the facts submitted and the representations made, we conclude that the creation of the nonvoting common stock and the issuance of nonvoting common stock to C, subject to Agreement, do not create a second class of stock for purposes of § 1361(b)(1)(D).

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the facts described above under any other provision of the Code. In particular, no opinion is expressed or implied concerning whether the transaction effective D2 constituted a corporate recapitalization within the meaning of § 368(a)(1)(E). In addition, no opinion is expressed or implied regarding the application of § 83. Finally, no opinion is expressed or implied concerning whether X's S corporation election under § 1362 was valid.

This ruling is directed only to the taxpayer who requested 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 with this office, a copy of this letter is being sent to X.

Sincerely yours,

H. GRACE KIM  
Assistant to the Chief  
Branch 2  
Office of the Assistant  
Chief Counsel  
(Passthroughs and  
Special Industries)

Enclosures: 2  
Copy of this letter  
Copy for § 6110 purposes