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:02
PLR-117002-07
Date:
February 14, 2008

Legend

Company =

State =

ESOP =

b =

c =

d =

Dear :

This letter responds to a letter dated April 4, 2007, submitted on behalf of Company by its authorized representatives, requesting a ruling under § 1361(b)(1)(D) of the Internal Revenue Code.

The information submitted states that Company is a corporation incorporated in State. Company was taxed as a C corporation from its incorporation until Date 2. Company elected to be treated as an S corporation effective Date 2.

While it was still taxed as a C corporation, Company adopted an employee stock ownership plan, ESOP. Prior to Date 1, ESOP owned a% of the shares of Company's common stock (the "Pre-Transaction ESOP Shares"). Company has one class of common stock outstanding, and all shares of Company stock have identical rights to operating and liquidating distributions.

On Date 1, Company undertook a series of transactions that resulted in ESOP becoming the sole owner of Company's outstanding stock. (1) Company obtained a line of credit in the amount of $b; (2) Company then made a loan, to be secured by Company stock, of $c to ESOP (the "ESOP Loan"); (3) ESOP used the ESOP Loan proceeds to purchase all of the remaining outstanding stock of Company, pursuant to stock purchase agreements (the "Stock Purchase Agreements"). As a result of these transactions, ESOP became the owner of 100 percent of the outstanding stock of Company.

Among its provisions, ESOP provides that it shall distribute benefits to participants at stated periods of time following their termination of employment due to retirement, disability, death, or other reason. ESOP further provides that the distribution of a participant's benefit may be made in cash, in Company stock, or in both. As a result of the transactions described above, and in particular the loan made by Company to ESOP (the "ESOP Loan Debt"), the net worth, under generally accepted accounting principles ("GAAP") of Company, immediately after the transactions was $d less than the net worth, under GAAP, of the Company immediately before the transactions. The value of Company's stock has similarly declined to reflect the reduction in the Company's net worth under GAAP.

Consequently, Company entered into a Floor Price Agreement (the "Floor Price Agreement") on Date 2. This Floor Price Agreement provides that Company, under certain conditions, will repurchase, for a minimum price (the "Floor Price"), the Pre-Transaction ESOP Shares that are, or have been, distributed to ESOP participants. Thus, all valuations of the Pre-Transaction ESOP Shares are to reflect the value of shares, as determined by an independent appraiser, without taking into account the ESOP Loan Debt.

Company represents that the purpose of the Floor Price Agreement is to protect the value of the Pre-Transaction ESOP Shares that have already been allocated to employee accounts from a steep decline in value that is normally associated with a highly leveraged ESOP transaction. According to Company, the decline in value of the stock will result solely from the effects of the ESOP Loan Debt, and as the debt is paid

down, the value will recover. A serious employee relations problem will occur if a voluntary corporate action has the effect of reducing the value, under GAAP, of the Pre-Transaction ESOP Shares already owned by ESOP. This impacts employees who are close to retirement or who have previously terminated employment and are waiting for distributions of their shares. According to Company, the Pre-Transaction ESOP Shares will continue to fluctuate in value with the fortunes of Company and general market conditions, as would occur in the absence of a leveraged ESOP transaction.

Company requested the following ruling: Company will not be considered to have a second class of stock in violation of § 1361(b)(1)(D) solely as a result of the existence of the Floor Price Agreement.

Section 1361(b)(1) 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 these regulations, 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 stock is activated by the termination of a participant's employment due to death, disability, or retirement. 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 stock is to be redeemed are employee shareholders or their trust, 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 an agreement is not to avoid the one class of stock requirement or the agreement sets a purchase price that does not greatly vary from the fair market value of the stock.

Based on the facts submitted and representations made, we conclude that the Floor Price Agreement 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 adopting the Floor Price Agreement.

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's S corporation election is valid under § 1362(a). In addition, we express or imply no opinion on whether ESOP is qualified under § 401(a) or whether the redemption of Pre-Transaction ESOP Shares under the Floor Price Agreement 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 first and second 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.

Sincerely,

J. Thomas Hines
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

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

cc: