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Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:1-PLR-116558-00

Date:

February 5, 2001

Legend:

X =

A =

B =

D1 =

D2 =

Dear

This responds to your letter dated December 5, 2000, and prior correspondence, submitted on behalf of X requesting that we render several rulings with respect to the incentive stock compensation arrangement proposed by X and its two shareholders.

FACTS

X is a corporation which has a valid subchapter S election in effect. X has two shareholders, A and B (collectively "the Founders"). The Founders are unrelated to each other and unrelated to any of the key employees discussed below. The Founders have different retirement goals, however, they both intend to ultimately transfer all of their stock in X to certain key employees.

As part of their long-range plan to transfer ownership of X, the Founders have agreed to transfer equal amounts of "Incentive Stock" to key employees. In addition, each Founder intends to transfer the balance of their respective stock to the key employees over time, on each's own terms, and to such transferees as each Founder deems appropriate, subject only to the provisions of a buy-sell agreement dated D1. The Founders have agreed that they would like to put in a place a structure whereby each is able to effectively transfer ownership of Incentive Stock of X to certain key employees.

The Founders and X propose the following transactions to accomplish their objective of creating a structure whereby the Founders can transfer ownership of X to key employees.

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First, the Founders will cause X to amend its articles of incorporation to authorize the issuance of nonvoting common stock that differs from the other outstanding stock of X only with respect to voting rights. Second, X will issue equal quantities of the nonvoting stock to A and B. Part of the nonvoting shares received by the Founders will be used by the Founders as Incentive Stock to encourage the continued employment of certain key employees. The remaining nonvoting stock (non-incentive stock), and the Founders voting shares, will be used by the Founders to transfer ownership of X to certain key employees and other transferees. At the same time as the issuance of the nonvoting common stock, the Founders and X intend to amend the current buy-sell agreement that is in place to exempt the Founders transfer of Incentive Stock from the buy-sell agreement dated D1.

The Founders will then grant to the key employees the conditional, unsecured right to receive Incentive Stock. The Incentive Stock will consist of a portion of X's nonvoting stock. Each key employee's right to receive his specified Incentive Stock vests, in the event certain conditions are met, on D2. The period of time from the grant of the stock to D2 is referred to as the vesting period. At the time the grants of the Incentive Stock are given by the Founders, several agreements will be entered into between the Founders, X, and the key employees. These agreements are summarized below.

At Will Employment Agreement

X and the key employees will enter into an At Will Employment Agreement which provides that X will pay the key employees, annually and in arrears, bonuses equal in amount to a percentage of the distributions paid to the Founders with respect to their stock. The percentage is determined by reference to the number of shares of Incentive Stock that the key employee will receive at the close of the vesting period. X intends to treat the bonuses as wages subject to withholding. X's promise to pay the bonuses will be unfunded and unsecured. If a key employee's employment ends for any reason during the vesting period, the key employee will be entitled to receive a payment equal to certain book appreciation in their respective Incentive Stock during the vesting period, however, the key employee's right to receive unpaid bonuses ends with the employment relationship.

Stock Transfer Agreement

Under the Stock Transfer Agreement entered into between the Founders, and the key employees, the Founders' transfer of Incentive Stock to a key employee on D2 occurs without payment of any consideration by the key employee, but is subject to the key employee's fulfillment of certain conditions. First, the key employee must be employed by the taxpayer on D2. Second, the key employee must agree to execute an Agreement Among the Shareholders Regarding the Book Value of Stock (Agreement Regarding Book Value).

The Agreement Regarding Book Value

The Agreement Regarding Book Value is to be executed by A, B, X, and the key

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employees upon the transfer of the Incentive Stock. This agreement provides that upon the transfer of the Incentive Stock to the key employees, the fair market value of the stock is agreed to be its book value. The agreement further requires that a key employee offer his Incentive Stock to X and the other shareholders when (for any reason, including death) the key employee's employment with X ends or there is an attempted voluntary or involuntary transfer of the Incentive Stock. The book value of the stock is to be determined by reference to the audited financial statements for the fiscal year concluded immediately prior to the transfer, with one exception. In the case of an attempted voluntary sale of the Incentive Stock, the key employee is deemed to offer such stock at the proposed sale price if that is lower than book value.

LAW AND ANALYSIS

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

Section 1361(b)(1) of the Code provides that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and meets the requirements specified in sections 1361(b)(1)(A) through (D). Section 1361(b)(1)(D) provides that S corporations may not possess more than one class of stock.

Section 1361(c)(4) provides that for purposes of section 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(l)(1), provides that, except as provided in section 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.

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. 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

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circumstances.

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 section 1361(b)(1)(D) and section 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 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)(2)(iii)(C) 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) or if the book value is used for a substantial nontax purpose.

Section 1.1361-1(b)(3) provides that, for purposes of subchapter S, stock that is issued "in connection with the performance of services" (within the meaning of section 1.83-3(f)) and that is "substantially nonvested" (within the meaning of section 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 section 83(b) of the Code.

Section 1.1361-1(b)(4) provides that an instrument, obligation, or arrangement is not treated as outstanding stock if it: (i) does not convey the right to vote; (ii) is an unfunded and unsecured promise to pay compensation; (iii) is issued to an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and (iv) is issued under a plan with respect to which the employee or independent contractor is not taxed currently on income. A deferred compensation plan that has a current payment feature (e.g., payment of a dividend equivalent amounts that are taxed currently as compensation) is not for that reason excluded under section 1.1361-1(b)(4).

Under section 83(a) of the Code, if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) over the

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amount, if any, paid for the property is included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are either transferable or not subject to a substantial risk of forfeiture.

Rev. Rul. 80-196, 1980-2 C.B. 32 held that the transfer of a corporation's stock by the corporation's two shareholders to three employees to retain their valuable services was compensation, made for adequate and full consideration, and was not subject to gift tax.

Section 1.83-5(a) of the Income Tax Regulations provides that in the case of property subject to a nonlapse restriction, the price determined under the formula will be considered to be the fair market value of the property unless established to the contrary by the Commissioner. If stock in a corporation is subject to a nonlapse restriction which requires the transferee to sell such stock only at a formula price based on book value, then the price so determined will ordinarily be regarded as determinative of the fair market value of such property for purposes of section 83.

Section 1.83-6(a)(1) provides that in the case of a transfer of property to which section 83 applies, a deduction is allowable under section 162 to the person for whom the services were performed, but only to the extent the amount meets the requirements of section 162 and the regulations thereunder. The deduction is allowed only for the taxable year of that person in which or with which ends the taxable year of the service provider in which the amount is included as compensation.

Section 1.83-6(d)(1) provides that if a shareholder of a corporation transfers property to an employee of such corporation in consideration of services performed by the corporation, the transaction will be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property to the employee.

Section 451(a) of the Code and section 1.451-1(a) provide that an item of gross income is includible in gross income in the taxable year in which it is actually or constructively received by the taxpayer using the cash receipts and disbursements method of accounting. Under section 1.451-2(a), income is constructively received in the taxable year during which it is credited to a taxpayer's account, set apart or otherwise made available so that the taxpayer may draw on it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

In Rev. Rul. 80-300, 1980-2 C.B. 165, a corporation granted to its key employees stock appreciation rights that entitled them to a cash payment for each right exercised equal to the excess of the fair market value of a share of a corporation's common stock on the date of exercise over the fair market value of a share on the date the right was granted. The revenue ruling held that an employee possessing stock appreciation rights is not in constructive receipt of income by virtue of the appreciation of the employer's stock because

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the employee's right to benefit further from appreciation of stock without risking any capital is a valuable right, the forfeiture or surrender of which is a sufficient restriction precluding the application of the doctrine of constructive receipt.

CONCLUSION

Based solely on the facts and representations made by X, we conclude:

X's issuance of nonvoting common stock will not cause it to have more than 1 class of stock for purposes of section 1361(b)(1)(D);

The arrangement for payment of bonuses will not cause X to have more than one class of stock for purposes of section 1361(b)(1)(D);

A key employee is not a shareholder during the vesting period for any purpose of Subchapter S of the Code by virtue of the At Will Employment Agreement and/or the Stock Transfer Agreement;

The amount allowable as a deduction by X, and includable in a key employee's gross income, with respect to the Incentive Stock is the book value of such stock at the time the Incentive Stock is transferred;

A key employee becomes a shareholder for all purposes of Subchapter S of the Code upon receiving the Incentive Stock at the conclusion of the vesting period;

A Founder's transfer of Incentive Stock to a key employee, is treated under section 83 as a contribution of such stock by the Founder to the capital of X and an immediate transfer by X to the key employee;

The Stock Transfer Agreement, the Agreement Regarding Book Value, the Agreement Regarding Stock, and the buy-sell agreement dated D1, are disregarded in determining whether or not X has more than 1 class of stock for purposes of section 1361(b)(1)(D); and

The mere contractual right of a key employee to a severance payment equal to the book appreciation of the Incentive Stock upon termination without cause will not result in taxable income to the employee prior to his or her termination without cause.

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.

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In accordance with the Power of Attorney on file with this office, the original of this letter is being sent to the taxpayer's representative and a copy is being sent to the taxpayer.

Sincerely,
/s/David R. Haglund
Senior Technician Reviewer, Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)

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