Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201043015**
Release Date: 10/29/2010

Index Number: 1361.01-01, 1361.01-04

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B02
PLR-109232-10
Date:
July 29, 2010

Legend

X =

A =

B =

L =

M =

N =

O =

a =

b =

c =

d =

e =

f =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

State =

Year =

Dear :

This responds to a letter dated March 1, 2010, submitted on behalf of X by X's authorized representative, requesting rulings under §1361(b)(1) of the Internal Revenue Code (the Code).

The information submitted states that X was incorporated under the laws of State on Date1, and X elected to be an S corporation effective Date2. X has a shares of Class A voting common stock outstanding, which are owned by A. X also has b shares of Class B nonvoting common stock outstanding, c shares of which are owned by A and the remaining d shares are owned by B.

As part of its normal business operations, X borrows funds from commercial lenders. In Year, X restructured some of its outstanding debt. On Date3, certain lenders agreed to restructure X's existing debt and to extend new debt to X. In return for these agreements, the lenders received warrants to acquire Class B nonvoting common stock of X. The debt restructuring was effectuated through an amendment and restatement of X's existing debt, which was held by entities affiliated with L, including M, N and O (collectively referred to as the "Lenders"). In this restructuring, the Lenders provided additional financing to X through the creation of three tranches of new debt aggregating $e. The existing debt, prior to the restructuring, was set to mature on Date4. Pursuant to the restructuring, both the existing debt and the new debt mature by Date4.

The warrants entitle the warrant holders to purchase, upon exercise, a specified amount of Class B common stock of X for $f per share (the "exercise price"). The warrant holders may exercise the warrants during the period between Date5 and Date4. The exercise price of the warrants is subject to reduction if X distributes to its shareholders cash, evidence of indebtedness, or other property. The exercise price is reduced to the extent of the value distributed on a per share basis. If the exercise price

is reduced to zero as a result of a distribution, any remaining portion of such distribution is distributable to the warrant holders. X represents that it has made no distributions since the issuance of the warrants that would require such adjustment or distribution.

The exercise price and the number of shares that may be purchased upon the exercise of the warrants are also subject to customary anti-dilution adjustments regarding stock distributions, stock splits, and other similar corporate events. The warrant agreement also provides for customary anti-dilution adjustments in the case of the merger, reorganization, or recapitalization of X. X represents that none of the foregoing events have occurred since the warrants were issued.

The warrants are subject to various put and call rights that are effective for periods before the exercise period of the warrants. Warrant holders may put the warrants to X during a certain period of time prior to the exercise period. In addition, X may call the warrants during another certain period of time prior to the exercise period. The amount payable upon the exercise of the put and call options represents a total repurchase price for the X stock that falls within the range of estimates of the fair market value of the stock underlying the warrants at the time of their issuance. These put and call rights were designed by X with the intent that such warrants would never be exercised.

X further makes the following representations:

1) The Class A voting common stock and Class B non-voting common stock of X differ only as to voting rights, and each outstanding share of X stock has identical rights to distribution and liquidation proceeds;
2) The principal purpose of X's issuance of the warrants was to secure the agreement of the Lenders to a restructuring of the debt of X;
3) The warrants were not issued by X with a principal purpose of circumventing the one class of stock requirement of § 1361(b)(1)(D), or the limitation on S corporation shareholders of §§ 1361(b)(1)(A), (B) and (C);
4) The issuance of the warrants did not have a tax avoidance purpose;
5) The Lenders are actively and regularly engaged in the business of lending, within the meaning of § 1.1361-1(l)(4)(iii)(B)(*1*);
6) The warrants were issued in connection with a commercially reasonable loan to X, within the meaning of § 1.1361-1(l)(4)(iii)(B)(*1*), and are typical of financing arrangements with commercial lenders;
7) X has made no distributions since issuing the warrants and, accordingly, no distributions have been made to the warrant holders;
8) No events have occurred since X issued the warrants that would trigger any of the anti-dilution adjustments applicable to the warrants;
9) The warrant holders have not transferred any portion of their rights with respect to the warrants;

10) X and its shareholders have not treated the warrants as outstanding stock of X or the warrant holders as shareholders of X for any purpose; and

11) X's intent has always been to repurchase the warrants before their exercise by the warrant holders.

Section 1361(a)(1) 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 such year.

Section 1361(b)(1) 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 § 1361(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(b)(1) provides that, for purposes of subchapter S, chapter 1 of the Code and the regulations thereunder, the term small business corporation means a domestic corporation that is not an ineligible corporation (as defined in § 1361(b)(2)) and that does not have (i) more than the number of shareholders provided in § 1361(b)(1)(A); (ii) as a shareholder, a person (other than an estate, a trust described in § 1361(c)(2), or, for taxable years beginning after December 31, 1997, an organization described in § 1361(c)(6)) who is not an individual; (iii) a nonresident alien as a shareholder; or (iv) more than one class of stock.

Section 1.1361-1(l)(1) provides that, in general, 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. 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)(4)(i) provides that, in general, instruments, obligations, or arrangements are not treated as a second class of stock for purposes of § 1.1361-1(l) unless they are described in § 1.1361-1(l)(4)(ii) or (iii). However, in no event are instruments, obligations, or arrangements described in § 1.1361-1(l)(4)(iii)(B) and (C) (relating to the exceptions and safe harbor for options), § 1.1361-1(l)(4)(ii)(B) (relating to

the safe harbors for certain short-term unwritten advances and proportionally-held debt), or § 1.1361-1(l)(5) (relating to the safe harbor for straight debt), treated as a second class of stock for purposes of § 1.1361-1(l).

Section 1.1361-1(l)(4)(iii)(A) provides, in part, that, except as otherwise provided in § 1.1361-1(l)(4)(iii), a call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder under § 1.1361-1(b)(1), or materially modified. Section 1.1361-1(l)(4)(iii)(A) further provides that a call option does not have a strike price substantially below fair market value if the price at the time of exercise cannot, pursuant to the terms of the instrument, be substantially below the fair market value of the underlying stock at the time of exercise.

Section 1.1361-1(l)(4)(iii)(B)(*1*) provides, in part, that a call option is not treated as a second class of stock for purposes of § 1.1361-1(l) if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation.

Based solely on the facts submitted and the representations made, we conclude that the warrants described above fall within the exception under § 1.1361-1(l)(4)(iii)(b)(*1*) and therefore are not treated as a second class of stock of X for purposes of § 1361(b)(1)(D) and § 1.1361-1(b)(1)(iv), and the warrants described above (prior to their exercise) do not cause the Lenders to be treated as shareholders of X for purposes of § 1361(b)(1) and § 1.1361-1(b)(1).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code, including whether X was or is a small business corporation within the meaning of § 1361(b).

The ruling contained in this letter is 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.

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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 2
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

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