**8795. What restrictions apply to an S corporation’s ability to issue stock?**

An S corporation must be a domestic corporation with only a single class of stock.

A corporation will be treated as having one class of stock if all of its outstanding shares confer identical rights to distribution and liquidation proceeds.[[1]](#footnote-1) Also, it is permissible to have two classes of stock if the only difference between the two classes is the ability to vote.[[2]](#footnote-2) “Bona fide agreements to redeem or purchase stock at the time of death, disability or termination of employment” will be disregarded for purposes of the one-class rule unless a principal purpose of the arrangement is to circumvent the one-class rule.

Similarly, bona fide buy-sell agreements will be disregarded unless a principal purpose of the arrangement is to circumvent the one-class rule and they establish a purchase price that is not substantially above or below the fair market value of the stock. Agreements that provide for a purchase price or redemption of stock at book value or a price between book value and fair market value will not be considered to establish a price that is substantially above or below fair market value.[[3]](#footnote-3)

Agreements triggered by divorce and forfeiture provisions that cause a share of stock to be substantially nonvested are disregarded in determining whether a corporation’s shares confer identical rights to distribution and liquidation proceeds.[[4]](#footnote-4)

**Planning Point**: The application of the second class of stock rules can sometimes arise in unexpected situations. For example, employment agreements or buy sell agreements may contain provisions which establish a different purchase/sale price for different shareholders or situations. These contractual rights could potentially be construed to violate the prohibition against having a second class of stock. Therefore, care must be given to the consequences which one agreement may have upon another.

1. . Treas. Reg. §1.1361-1(l)(1). [↑](#footnote-ref-1)
2. . IRC Sec. 1361(c)(4). [↑](#footnote-ref-2)
3. . Treas. Reg. §1.1361-1(l)(2)(iii). See IRC Secs. 1361, 1362. [↑](#footnote-ref-3)
4. . Treas. Reg. §1.1361-1(l)(2)(iii)(B). [↑](#footnote-ref-4)