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INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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MEMORANDUM FOR ASSOCIATE AREA COUNSEL

CC:SB:DEN:SLC (Small Business/Self-Employed Division)
Attn: David W. Sorensen

FROM: Jasper L. Cummings
Associate Chief Counsel CC:CORP

SUBJECT:

This memorandum responds to your request for Field Service Advice, received July 3, 2001, and supplements a Field Service Advice, dated December 6, 2000 (the "Prior FSA"), issued by Assistant Chief Counsel (Employee Benefits). This memorandum is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Employees =

Company A =

Company B =

Company C =

Company D =

Company E =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

\$K =

ISSUE:

Whether the consolidated group, of which Company C is the parent (the "Company C group"), may deduct the compensation payments made to and included in income by the employees of Company A and Company B (the "Employees") when they sold their callable nonstatutory options for Company C stock to Company C.

TL-N-2608-00

CONCLUSION:

The Company C group may deduct the compensation payments made to and included in income by the Employees when they sold their options to Company C.

FACTS:

The facts are stated in the Prior FSA and are summarized here. Employees were employees of Company A and Company B. Company A and Company B granted nonstatutory options to Employees to purchase common stock in those companies. At the time those options were issued, they had no readily ascertainable fair market value. By Date 1, the options had fully vested.

Company C was the common parent of an affiliated group of corporation filing a consolidated federal income tax return (the "Company C group"). Company C owned all of the stock of Company D, which owned all of the stock of Company E. On Date 2:

(1) Through a series of steps, Company C, Company D and Company E each acquired stock of Company A and Company B in exchange for cash and notes. Collectively, the Company C group acquired all of the stock of Company A and Company B (the "acquisition");

(2) Company C and Company D transferred all of their Company A and Company B stock to Company E;

(3) Company A and Company B were liquidated into Company E (the "liquidation"); and

(4) Employees exchanged their vested Company A and Company B options for vested nonstatutory options to acquire shares of Company C. None of the options for Company C stock had a readily ascertainable fair market value when they were granted. Some of the options for Company C stock were callable by Company C.

On Date 3, Company C exercised its calls and paid Employees \$K for their Company C options. For Company D's taxable year ending Date 4 (its taxable year during which Employees' relevant calendar/taxable year ended), it reported a \$K compensation expense deduction attributable to Employees' sale of their callable options to Company C.¹

¹The submission does not state why Company D reported the deduction, when Company E is the successor to both Company A and Company B and, therefore, should have reported the deduction. For purposes of determining the Federal income tax liability of the Company C group, it does not matter which member of the group reports the deduction. However, for certain accounting purposes under the consolidated return regulations (basis of stock, earnings and profits of the member), it

TL-N-2608-00

The Prior FSA concluded that:

Under the rules of I.R.C. § 83(h), because Company D was not “the person for whom were performed the services,” it was not entitled to the deduction. Rather, if the deduction was otherwise allowable under that section, it was allowable only to Company A or Company B.

The Prior FSA noted that, although Company D has similarly concluded that it was not a “service recipient” with respect to the options in question, it offers an alternative rationale for its entitlement to the deduction:

When [Company A] and [Company B] liquidated into [Company E] in a Section 332 transaction, [Company E] became their successors under Section 381 and Treasury Regulations Section 1.381(c)(4)-1. As such, [Company E] was properly entitled to take the deduction with respect to the Callable Options.

We are not suggesting that [Company E] is entitled to the deduction due to its being the service recipient of the services with respect to which the Callable Options were issued, but instead, that [Company E] is entitled to the deduction due to its “stepping into the shoes” (by operation of Section 332 liquidation) of each of [Company A] and [Company B] - the entities that were the service recipients with respect to which the Callable Options were issued.

In order for I.R.C. § 332 to apply to the liquidation, the acquisition must be respected as a separate step. If it is not, then the transaction could be recast as an acquisition by Company E of the assets of Company A and Company B. Under this recast, the liquidation would be disregarded. Below, we comment on whether this recast is appropriate, and if it is not, whether the taxpayer’s alternative argument is correct.

DISCUSSION:

The Acquisition

If the acquisition by the Company C group of the stock of Company A and Company B each qualifies as a qualified stock purchase within the meaning of I.R.C. § 338(d)(3), then each stock purchase will each be treated as a separate step from the liquidation of each of Company A and Company B. Section 338(d)(3) provides that the term “qualified stock purchase” means any transaction or series of transactions in which stock

does matter. Also, the submission does not explain why the common parent of the group is listed as Company D instead of Company C. For the sake of consistency, we will refer to the group as the Company C group.

TL-N-2608-00

(meeting the requirements of section 1504(a)(2)²) of one corporation is acquired by another corporation by purchase during the twelve-month acquisition period. Pursuant to I.R.C. § 338(h)(8), the acquisition of the stock of the target corporation by the members of the same affiliated group is treated as made by one corporation. Thus, the acquisition of all of the stock of Company A and Company B by the members of the Company C group each qualifies as a qualified stock purchase by the group even though no one member of that group by itself acquired a sufficient amount of the stock of either Company A or Company B for that acquisition to so qualify.

As a result, even though the Company C group acquired all of the stock of each of Company A and Company B in a qualified stock purchase apparently pursuant to a plan to acquire their assets (because it immediately liquidated them), the step transaction doctrine does not apply to treat, in each case, the stock acquisition and liquidation as an asset purchase. See Rev. Rul. 90-95, Situation 2, 1995-2 C.B. 67, 68.

Rev. Rul. 90-95 further states:

Under section 338, asset purchase treatment turns on whether a section 338 election is made (or deemed made) following a qualified stock purchase of target stock and not on whether the target's stock is acquired to obtain the assets through a prompt liquidation of the target. The acquiring corporation may receive stock purchase treatment or asset purchase treatment whether or not the target is subsequently liquidated. A qualified stock purchase of target stock is accorded independent significance from a subsequent liquidation of the target regardless of whether a section 338 election is made or deemed made.

Id. at 68-69.

Thus, in each case, the acquisition is considered a separate step from the liquidation, even though the liquidation occurred immediately after the acquisition.

The Liquidation

Once, in each case, the liquidation is considered a separate step from the acquisition, it is clear that the liquidation qualifies under I.R.C. § 332. For example, if the transfers (of the Company A and Company B stock by Company C and Company D to Company E) and the liquidations are considered separate steps, then Company E directly owns all of the Company A and Company B stock. Because, under this scenario, Company E satisfies the ownership requirements of I.R.C. § 332(b)(1), each liquidation qualifies under I.R.C. § 332.

² Section 1504(a)(2) provides that the ownership of stock of any corporation meets the requirements of this paragraph if it possesses at least 80 percent of the total voting power of the stock of such corporation and has a value of at least 80 percent of the total value of the stock of such corporation.

TL-N-2608-00

On the other hand, even if Company C and Company D had not transferred their Company A and Company B stock to Company E (or such transfer is disregarded), the stock of Company A and Company B owned by Company C, Company D and Company E would be aggregated. See Treas. Reg. § 1.1502-34.³ In that case, each liquidation still would have qualified under I.R.C. § 332.

Section 381

In the case of a liquidation to which I.R.C. § 332 applies, I.R.C. § 381 provides that the acquiring corporation shall succeed to and take into account the items of the distributor corporation described in I.R.C. § 381(c). See I.R.C. § 381(a)(1). In this case, Company E is the acquiring corporation, and Company A and Company B are each a distributor corporations. The item described in I.R.C. § 381(c) that is at issue is certain option obligations of the distributor corporation under I.R.C. § 381(c)(16).

Section 381(c)(16) and Treas. Reg. § 1.381(c)(16)-1(a)(1) provide that if, in a transaction to which I.R.C. § 381(a) applies, the acquiring corporation assumes an obligation of a distributor corporation which gives rise to a liability after the date of distribution and if the distributor corporation would be entitled to deduct such liability in computing taxable income were it paid or accrued after that date by such corporation, then under the provisions of I.R.C. § 381(c)(16) and this section, the acquiring corporation shall be entitled to deduct such liability as if it were the distributor corporation.

Treas. Reg. § 1.381(c)(16)-1(a)(4) provides that, for purposes of this section, an obligation of a distributor corporation gives rise to a liability when the liability would be accruable by a taxpayer using the accrual method of accounting notwithstanding the fact that the distributor corporation is not using the accrual method of accounting. See Treas. Reg. § 1.461-1(a)(2).

Treas. Reg. § 1.461-1(a)(2)(i) provides that, under an accrual method of accounting, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which: (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability.

In this case, pursuant to Treas. Reg. § 1.461-1(a)(2)(i), the liability to Employees did not become accruable to the Company C group until Date 3, a date after the liquidation. This was so even though the fact of the liability was established by Date 1, the date the options vested. As noted above, Date 1 is a date before the liquidation. Also, economic performance also occurred at least by Date 1. Pursuant to I.R.C. § 461(h)(2)(A)(i), if the liability of the taxpayer arises out of the providing of service to

³ In that case, however, I.R.C. § 337(a) would not apply to provide tax-free treatment to Company A and Company B upon the liquidation because that provision only applies if there is one shareholder that meets the ownership requirements of I.R.C. § 332(b). See I.R.C. § 337(c). Instead, I.R.C. § 336 would apply.

TL-N-2608-00

the taxpayer by another person, economic performance occurs as such person provides such services. We do not know the exact date when these services were completed. However, it is clear that they were completed by Date 1.

The amount of the liability, however, could not be determined with reasonable accuracy until the Employees sold their options to Company C on Date 3, a date after the liquidation. Until that event, the options did not have a readily ascertainable fair market value. See Treas. Reg. § 1.83-7(b). Thus, the amount of the liability was not determinable with reasonable accuracy until the options were redeemed on Date 3.

Under Treas. Reg. § 1.461-1(a)(2)(i), the obligation was not accruable until Date 3. As a result, under Treas. Reg. § 1.381(c)(16)-1(a)(4), the obligation to the Employees did not give rise to a liability until Date 3. Consequently, under Treas. Reg. § 1.381(c)(16)-1(a)(1), the Company C group may deduct the amounts paid to Employees to cancel their options because Company E is the successor to Company A and Company B.

Please contact

if you have any questions.

Sincerely,
Jasper L. Cummings
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By:

Steven J. Hankin
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cc: