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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9067

RIN 1545-BC21

Transfers of Compensatory Options

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations that provide rules governing transfers of certain compensatory stock options (nonstatutory stock options). The regulations affect persons who have been granted nonstatutory stock options, as well as service recipients who may be entitled to deductions related to the options. The text of the temporary regulations also serves as the text of the proposed regulations on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective July 2, 2003.

Applicability Dates: For dates of applicability, see §§1.83-7(d) and 1.83-7T(d).

FOR FURTHER INFORMATION CONTACT: Stephen Tackney (202) 622-6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

These regulations amend 26 CFR part 1. Section 83 of the Internal Revenue Code (Code) provides that 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 (1) the fair market value of the property (determined without regard to lapse restrictions) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for such property, is included in the gross income of the service provider in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture.

Section 83(e)(4) provides that section 83 does not apply to the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant.

Section 83(e)(3) provides that section 83 does not apply to the transfer of an option without a readily ascertainable fair market value. Under §1.83-7(a), section 83 generally applies to the transfer of the property subject to the option at the time of exercise.

Section 1.83-7(a) further provides that section 83 applies to the transfer of money or other property received upon the sale or disposition in an arm's length transaction of an option without a readily ascertainable fair market value at the time of grant.

Recent transactions promoted by certain parties have raised issues concerning when a transfer of an option to a related person, typically a family member or an entity a substantial interest in which is owned by the option holder or family members, is an arm's length transaction. See Notice 2003-47. The determination of whether a transfer to a related person is an arm's length transaction requires scrutiny of the facts and

circumstances surrounding the transfer. Furthermore, if conducted under the terms promoted, Treasury and the IRS believe these transfers will rarely constitute an arm's length transaction.

Explanation of Provisions

The regulations provide that a sale or other disposition of a nonstatutory stock option to a related person will not be treated as a transaction that closes the application of section 83 with respect to the option. For these purposes, a person is related to the service provider if (I) the person and the service provider bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the modifications (i) that "20 percent" is used in place of "50 percent" each place it appears in section 267(b) and section 707(b)(1) and (ii) that section 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family, or (II) the service provider and such person are engaged in trades or businesses under common control (within the meaning of section 52(a) and (b)); provided that a person is not related to the service provider if the person is the service recipient with respect to the option or the grantor of the option. The regulations do not alter the treatment of the sale or disposition of an option in an arm's length transaction with an unrelated person. In those circumstances, section 83 applies to the transfer of money or other property received in the exchange.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5

U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these regulations are being submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these temporary regulations is Stephen Tackney of the Office of Division Counsel / Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *.

Par. 2. Section 1.83-7 is amended by adding paragraph (d) to read as follows:

§1.83-7 Taxation of nonqualified stock options.

* * * * *

(d) Effective dates. This section applies for periods before July 2, 2003. For periods on or after July 2, 2003, see §1.83-7T.

Par. 3. Section 1.83-7T is added to read as follows:

§1.83-7T Taxation of nonqualified stock options (Temporary).

(a) In general. If there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to such grant if the option has a readily ascertainable fair market value (determined in accordance with paragraph (b) of this section) at the time the option is granted. The person who performed such services realizes compensation upon such grant at the time and in the amount determined under section 83(a). If section 83(a) does not apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant, sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time. If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise, and the employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under section 83(a) or 83(b). If the option is sold or otherwise disposed of in an arm's length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to an exercise of the option. The preceding sentence does not apply to a sale or other disposition of the option to a person related to the service provider that occurs on or after July 2, 2003. For this purpose, a person is related to the service provider if--

(1) The person and the service provider bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the modifications that the language “20 percent” is used instead of “50 percent” each place it appears in sections 267(b) and 707(b)(1), and section 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family; or

(2) The person and the service provider are engaged in trades or businesses under common control (within the meaning of section 52(a) and (b)); provided that a person is not related to the service provider if the person is the service recipient with respect to the option or the grantor of the option.

(b) and (c) For further guidance, see §1.83-7(b) and (c).

(d) Effective dates. This section applies on or after July 2, 2003. For dates before July 2, 2003, see §1.83-7.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved: June 26, 2003

Pamela F. Olson,
Assistant Secretary of the Treasury.