

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

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Refer Reply To:

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Date: July 5, 2002

Dear [REDACTED]:

This responds to your letter dated January 31, 2002, in which you requested general information on the application of the election under § 311(e) of the Taxpayer Relief Act of 1997 (TRA 97), 1997-4 (Vol. 1) C.B. 1, 49-50 (as amended by § 314(c) of P.L. 106-554 and § 414 of P.L. 107-147), to incentive stock options (ISOs). Specifically, you requested information on whether a taxpayer may make a § 311(e) election and still maintain ISO tax benefits in two situations. In the first situation, employees are holding ISOs that were granted to them prior to 2001, but were not exercised as of January 1, 2001. In the second situation, employees were granted and exercised ISOs during November 2000. We provide the following general information.

Under § 1(h)(1) of the Internal Revenue Code, gain resulting from the sale or exchange of most capital assets is taxed at a capital gains rate of 20 percent (10 percent for gain otherwise taxed at an ordinary rate of 15 percent or less). Section 1(h)(2)(B) provides that the 20-percent capital gains rate is reduced to 18 percent for qualified 5-year gain resulting from the sale or exchange of property with a holding period beginning after December 31, 2000. Qualified 5-year gain is defined generally by § 1(h)(9) as “the aggregate long-term capital gain from property held for more than 5 years.”

Section 311(e)(1)(A) of TRA 97 allows a noncorporate taxpayer holding any readily tradeable stock (which is a capital asset) on January 1, 2001, to elect to treat that asset as “having been sold on such next business day for an amount equal to its closing market price on such next business day (and as having been reacquired on such next business day for an amount equal to such closing market price).” Section 311(e)(4) of TRA 97 defines “readily tradeable stock” as “any stock which, as of January 1, 2001, is readily tradable on an established securities market or otherwise.” Section 311(e)(1)(B) of TRA 97 provides a similar election for any other capital asset or § 1231 asset, treating those assets as having been sold and reacquired for their fair market value on January 1, 2001. If a taxpayer makes a § 311(e) election, the holding period for the elected asset begins after December 31, 2000. This makes the asset eligible for the 18-percent rate if it is later sold after having been held by the taxpayer for more than 5 years from the date of the deemed sale.

Section 421(a) provides, in part, that if a share of stock is transferred to an individual in a transfer in which the requirements of § 422(a) are met, no income shall result to the individual at the time of transfer of the stock upon exercise of the option, no deduction under § 162 shall be allowable to the employer corporation at any time with respect to

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the shares transferred, and no amount other than the price paid for the option shall be considered as received by the issuing corporation for the share transferred.

Section 422(a) provides, in part, that the rules of § 421 apply to the transfer of stock to an individual pursuant to the exercise of an incentive stock option if no disposition of the share is made within 2 years from the date of grant of the option or within 1 year after the transfer of the share.

Section 424(c) provides, with certain exceptions that are not applicable here, that for purposes of part II of subchapter D (§§ 421-424), the term “disposition” includes a sale, exchange, gift, or transfer of legal title.

The disposition of a share of stock acquired by the exercise of a statutory option before the expiration of the holding period described in § 422(a) makes § 421(a) inapplicable to the transfer of such share. Section 421(b) provides that income attributable to such transfer shall be treated by the individual as income received in the taxable year in which the disqualifying disposition occurs.

Section 83 governs the tax consequences resulting from a disqualifying disposition of stock. Section 83(a) provides the general rule that the excess of the fair market value of the property transferred to an employee in connection with the performance of services over the amount paid for such property shall be included in the gross income of the employee in the first taxable year in which the rights of the person are transferable or are not subject to a substantial risk of forfeiture.

Section 56 provides the rules for the alternative minimum tax treatment of ISOs. Section 56(b)(3) provides that for alternative minimum tax purposes, § 421 shall not apply to the transfer of stock acquired pursuant to the exercise of an ISO. Section 56(b)(3) also provides that the adjusted basis of any stock so acquired shall be determined for alternative minimum tax purposes on the basis of the rules applicable for alternative minimum tax purposes. Thus, in general, for alternative minimum tax purposes, the exercise of an ISO is a taxable event and determines the basis of the stock for alternative minimum tax purposes if the stock is later sold.

The primary issue with respect to ISOs and the § 311(e) election appears to be whether the deemed sale of the § 311(e) election is a disposition within the meaning of § 424(c). If a deemed sale is a disposition under § 424(c) and the holding periods of § 422(a) are not met for the stock with respect to which the § 311(e) election is made, then the deemed sale would subject the holder of the stock to taxation under the rules of § 83.

With respect to situation 1, you ask whether the ISO option holder could have a “deemed exercise” of the option in order to have the holding period start in 2001. There

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is no provision in either section 311(e) of TRA 97 or the ISO rules providing for a “deemed exercise.”

In situation 2, it appears that any deemed sale of the stock acquired upon exercise of an ISO would be treated as a disqualifying disposition for purposes of the ISO rules. This would trigger the application of § 83.

We hope this information is helpful to you. This letter does not constitute a ruling on any issue. The interaction of the ISO rules with the § 311(e) election is a novel issue that the Service has not addressed. Therefore, you may want to request a private letter ruling on this issue pursuant to the rules of Rev. Proc. 2002-1, 2002-1 I.R.B. 1. If you have any further questions, please call [REDACTED] or me at (202) 622-4950.

Sincerely,
Associate Chief Counsel
(Income Tax & Accounting)

By: _____
Christopher F. Kane
Branch Chief