

## Internal Revenue Service

## Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

**February 5, 2002**

### Legend

Company A =  
Company B =  
Company C =  
Company D =  
Company E =  
Shareholder X =  
Employee Y =  
Plan K =  
Plan L =  
Plan M =  
\$ Q =  
\$ R =  
Date 1 =

This is in response to a October 1, 2001 letter from your representative requesting rulings as to a certain transaction involving an assignment of stock options.

### FACTS

Company A is a holding company and the common parent of an affiliated group of corporations of which Company B is a member.

Companies D and E are former members of the affiliated group including Company A. Company D was a holding company owning 100% of the outstanding stock of Company C.

Shareholder X served as chairman of the board of directors of Company D and Company E.

Company D established Plan K and Company E established Plan L. The plans were

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established with the intent of providing stock options to Shareholder X. The stock options granted under Plan K and Plan L were transferable, voluntarily or involuntarily.

Subsequently, Company A and Company D merged with Company A as the surviving entity. On the same day, Company B, Company C and Company E merged with Company B as the surviving entity.

On the date of the merger, Company A adopted Plan M, intended as a restatement of Plan K and Plan L. The number of stock options issued under Plan M and the exercise price of the stock options issued were determined using the conversion ratios used for the mergers. In addition to receiving stock options as a result of the conversion of stock options issued under Plan K and Plan L to stock options issued under Plan M, Shareholder X received additional stock options as a result of certain anti-dilution provisions contained in Plan M. The options granted under Plan M are transferable, voluntarily or involuntarily.

Subsequent to the merger, the shareholders of Company A approved an amendment to Plan M. Pursuant to this amendment, the exercise price for options granted under Plan X is to be equal to the fair market value of the stock as of the date certain debentures of Company A are converted to stock, and the number of shares that could be issued under Plan M is frozen, so that the options granted will no longer be increased under the anti-dilution provision.

Shareholder X holds stock options issued under Plan M. The exercise price of those stock options is \$ Q per share. The fair market value of the stock as of March 31, 2001, as determined by an independent valuation, was \$ R.

Shareholder X intends to assign stock options for 100 shares of common stock of Company A to Employee Y. Employee Y is an employee of Company B and a director of Company A.

You have represented that the stock options held by Shareholder X did not have a reasonably ascertainable value at the date of grant for purposes of section 1.83-7 of the regulations. Without ruling on this issue, we will assume for purposes of this letter that the stock options did not have a reasonably ascertainable value.

#### RULINGS REQUESTED

You have requested the following rulings:

- (1) that Employee Y will not recognize income at the time of the assignment;
- (2) that Shareholder X will not recognize any income at the time of the assignment;
- (3) that Shareholder X will not recognize any income at the time Employee Y exercises the stock options; and

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- (4) that Company B will be entitled to a compensation expense deduction equal to the amount included as ordinary income of Employee Y.

## LAW AND ANALYSIS

Section 83(a) 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 such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) 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, will be included in the gross income of the person who performed such services 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, whichever is applicable.

Section 1.83-7(a) of the Income Tax Regulations provides, in part, that 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 does not apply, section 83(a) shall apply to such grant if the option has a readily ascertainable fair market value at the time the option is granted. 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 an 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.

Section 1.83-6(d) provides a special rule for transfers by shareholders. Generally, if a shareholder of a corporation transfers property to an employee of such corporation or to an independent contractor (or to a beneficiary thereof), in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee or independent contractor under paragraphs (a) and (b) of this section. For purposes of section 1.83-6(d), such a transfer is considered to be in consideration for services performed for the corporation if either the property transferred is substantially nonvested at the time of transfer or an amount is includible in the gross income of the employee or independent contractor at the time of transfer under section 1.83-1(a)(1) or 1.83-2(a). In the case of such a transfer, any money or other property paid to the shareholder for such stock shall be considered to be paid to the corporation and

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transferred immediately thereafter by the corporation to the shareholder as a distribution to which section 302 applies. See also section 1.1032-3.

Section 83(h) provides generally that in the case of a transfer of property to which section 83 applies, there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included in the gross income of the person who performed such services.

In this instance, Shareholder X intends to assign stock options to purchase Company A stock to Employee Y. You have represented that the intent of this assignment is to provide an additional employment incentive relating to Employee Y's services as an employee of Company B, while maintaining confidentiality. Shareholder X is receiving no cash or consideration for the assignment from either Company A or Employee Y, except for the indirect benefit of Employee Y's services as an employee of Company B.

The proposed transaction would not be a typical arm's length transaction in that Shareholder X would not be transferring the property for any direct money or other similar consideration. However, the transaction also would not resemble a typical non-arm's length transaction in that Shareholder X does not intend the transfer to be a gift to Employee Y, or that Employee Y will provide nonexistent or inadequate consideration for the stock option. Instead, Shareholder X intends that Employee Y provide consideration for the stock option in the form of services as an employee of Company B. Viewed in this respect, the transaction resembles the transfer of property by a shareholder to a corporate employee addressed in sections 1.83-6(d) and 1.1032-3 of the Income Tax Regulations. See section 1.1032-3(e), example 9.

Accordingly, the substance of the proposed transaction resembles a transfer or forfeiture of the option by Shareholder X to Company A for no consideration, with Company A then transferring or re-issuing the option to Employee Y in return for services as an employee of its subsidiary, Company B. Viewed in this manner, Shareholder X will recognize no income upon the transfer of the stock option. Because the option is treated at the time of the transfer as forfeited to Company A for no consideration, Shareholder X also will not recognize any income when the Employee Y exercises the stock options.

Employee Y is receiving the stock options in exchange for services provided as an employee of Company B. As the service recipient under section 83(h) of the Code, Company B will be entitled to a deduction equal to the amount of compensation income recognized by Employee Y, at the time Employee Y recognizes that income.<sup>1</sup>

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<sup>1</sup>Because at the time of the transfer of the option the fair market value of the stock exceeds the exercise price, no ruling is given as to the appropriate timing of the inclusion of income by Employee Y or payment of wages to Employee Y. See Rev. Proc. 2001-3, 2001-1 I.R.B. 115, at section 4.01(4).

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No opinion is expressed as to whether the stock options at issue have a readily ascertainable value under section 1.83-7 of the regulations. No opinion is expressed as to the correct timing of the inclusion of income to Employee Y due to the assignment or exercise of the stock options. Except as expressly provided in this ruling, no opinion is expressed as to the treatment of the transaction under section 1032 of the Code or section 1.1032-3 of the regulations.

This ruling is directed only to the taxpayer requesting 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 your authorized representative.

The rulings contained in this letter are 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.

Sincerely,  
Robert B. Misner  
Assistant Chief,  
Executive Compensation Branch  
Office of Associate Chief Counsel /  
Division Counsel  
(Tax Exempt and Government Entities)

Enclosure:

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