

Internal Revenue Service

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Person To Contact:

Telephone Number:

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Date:
June 27, 2007

Dear _____,

This is in reply to your January 2007 letter requesting an information letter with respect to certain tax consequences of (a) the exercise of a compensatory stock option and (b) the sale and exercise of a call option covering the same class of stock subject to the compensatory stock option. Specifically, you asked for information on the amount that should be reported on Form W-2 with respect to an employee who exercises a nonstatutory stock option.

Section 2.04 of Revenue Procedure 2007-1, 2007-1 I.R.B. 1, defines an "information letter" as a statement issued by the Internal Revenue Service that calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. This section also states that an information letter is advisory only and has no binding effect on the Internal Revenue Service.

The federal income tax treatment of stock options granted in exchange for services is well established. In general, the income tax consequences associated with an option arise when the option is exercised. When an employee exercises a compensatory stock option not described in section 421 of the Internal Revenue Code (Code) (commonly known as a "nonstatutory option"), both section 83 of the Code and long-standing judicial authority require that the difference between the fair market value of the stock and the option exercise price be included in the employee's gross income as compensation. See, e.g., Commissioner v. LoBue, 351 U.S. 243 (1956).

Section 83(a) of the Code provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom the services are performed, the excess of the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) over the amount, if any, paid for the property, will be included in the gross income of the person who performed the services. This inclusion will take place in the first

taxable year in which the rights of the person having the beneficial interest 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 (Regulations) provides that if there is granted to an employee (or beneficiary) in connection with the performance of services, an option to which section 421 does not apply, section 83(a) shall apply to the grant if the option has a readily ascertainable fair market value at the time the option is granted.

Section 1.83-7(a) of the Regulations provides that section 83 will not apply to the transfer of an option without a readily ascertainable fair market value.

Section 1.83-7(b) of the Regulations provides that options are considered to have a readily ascertainable fair market value if they are actively traded on an established market. When an option is not actively traded on an established market, it does not have a readily ascertainable fair market value unless its fair market value can otherwise be measured with reasonable accuracy. An option is not considered to have a readily ascertainable fair market value unless the taxpayer can show that all of the following conditions exist:

1. The option is transferable by the optionee;
2. The option is exercisable immediately in full by the optionee;
3. The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option; and
4. The fair market value of the option privilege is readily ascertainable.

If section 83(a) of the Code does not apply at the time an option is granted because the option does not have a readily ascertainable fair market value, then section 83(a) will not apply until the option is exercised or otherwise disposed of, even if the fair market value of the option becomes readily ascertainable before then. When the option is exercised or otherwise disposed of, sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise.

Applying the above rules and assuming the nonstatutory stock option does not have a readily ascertainable fair market value, section 83(a) will apply to the option at the time the option is exercised. At the time of exercise, the excess of the fair market value of the stock acquired upon exercise of the option over the aggregate exercise price paid for the stock (referred to as the "spread") will be included in the gross income of the employee. The spread must be reported on Form W-2 in accordance with section 6041

of the Code and the corresponding Regulations. The spread must be reported in box 1 of Form W-2 and must also be reported in box 12 of Form W-2 using code "V." Further detail regarding the W-2 reporting requirements in connection with the exercise of a nonstatutory stock option can be found in the instructions to Form W-2.

The income inclusion and reporting requirements with respect to the exercise of a nonstatutory option summarized above are not affected by the optionholder's sale of a call option covering the same class of stock that was subject to the compensatory stock option or by the exercise of such call option.

We hope that the above general information is helpful to you. This letter does not constitute a ruling on any of the matters discussed and may not be relied upon as such. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Sincerely,

William C. Schmidt
Senior Counsel, Executive Compensation Branch
(Employee Benefits)
(Tax Exempt & Government Entities)