

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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to: Mark Hulse  
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from: Thomas Scholz, Senior Counsel  
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subject: Disposition of Shares under §424(c)(1)

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ISSUE

Whether there is a disposition within the meaning of §424(c)(1) of the Internal Revenue Code (Code) of stock acquired pursuant to an incentive stock option under §422 when the stock is converted into acquirer stock and other consideration pursuant to an acquisition that does not qualify as a reorganization under §368(a).

CONCLUSION

There is a disposition within the meaning of §424(c)(1) of stock acquired pursuant to an incentive stock option under §422 when the stock is converted into acquirer stock and other consideration pursuant to an acquisition that does not qualify as a reorganization under §368(a). There is no disposition within the meaning of §424(c)(1) of such stock if the acquisition qualifies as a reorganization under §368(a). The two factual scenarios below illustrate the tax consequences of the stock conversion when there is no disposition within the meaning of §424(c)(1) and when there is a disposition within the meaning of §424(c)(1).

FACTUAL SCENARIOS

*Scenario 1.* Corporation X and Corporation Y are unrelated corporations that are

incorporated under the laws of State B. On July 1, 2011, Corporation X grants a stock option to A, an employee of Corporation X since January 4, 2011, entitling A to purchase 100 shares of Corporation X voting common stock for \$15.00 per share. The stock option qualifies as an incentive stock option, as defined in §422. On December 30, 2011, A exercises the option when the fair market value of Corporation X stock is \$25.00 per share, and 100 shares of Corporation X voting common stock are transferred to A on that date.

On January 3, 2012, Corporation X and Corporation Y enter into an agreement (the merger agreement) pursuant to which Corporation Y will acquire Corporation X by forming a new subsidiary (Corporation Z) that will merge with and into Corporation X, with Corporation X surviving (the Merger). Pursuant to the Merger, each outstanding share of Corporation X voting common stock will be converted into one share of Corporation Y voting common stock with a value of \$25.00 and \$1.50 in cash. The exchange does not have the effect of the distribution of a dividend under §356(a)(2). The stock of Corporation Z will be converted into voting common stock of Corporation X. Corporation Z merges into Corporation X in a transaction that qualifies as a reorganization described in §368(a)(1)(A) by reason of §368(a)(1)(E). Following the Merger, Corporation X continues in existence as a wholly owned subsidiary of Corporation Y. Since January 4, 2011, A and Corporation X have maintained a continuous employment relationship, and on August 1, 2013, A sells the 100 shares of Corporation Y stock for \$40.00 per share.

*Scenario 2.* Assume the same facts as in *Scenario 1*, except that each share of Corporation X common stock is converted into one share of Corporation Y common stock with a value of \$16.50 and \$10.00 in cash. The transaction does not meet the requirements of §368(a)(2)(E)(ii) because shareholders of Corporation X did not exchange for Corporation Y stock voting stock of Corporation X that constitutes control (80 percent) of Corporation X, but rather exchanged more than 20 percent of Corporation X's stock for cash. As a result the transaction does not qualify as a reorganization under §368(a)(1)(A) by reason of §368(a)(2)(E), or any other provision of §368(a).

## LAW

Section 354(a)(1) provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan or reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 356(a)(1) provides that if § 354 or 355 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by § 354 or 355 to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other

property.

Section 358(a) provides that in the case of an exchange to which § 351, 354, 355, 356, or 361 applies, the basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged, decreased by—(i) the fair market value of any other property (except money) received by the taxpayer, (ii) the amount of any money received by the taxpayer, and (iii) the amount of loss to the taxpayer which was recognized on such exchange, and increased by—(i) the amount which was treated as a dividend, and (ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

Section 368(a)(1)(A) provides that the term “reorganization” includes a statutory merger or consolidation. Under §368(a)(2)(E), a statutory merger otherwise qualifying under §368(a)(1)(A) is not disqualified by reason of the fact that stock of a corporation (the controlling corporation) that is in control of the merged corporation is used in the transaction if (i) after the transaction, the corporation surviving the merger owns substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction), and (ii) in the transaction, former shareholders of the surviving corporation exchanged for voting stock of the controlling corporation stock of the surviving corporation which constitutes control of that corporation. “Control” is defined in §368(a)(3) as ownership of stock possessing at least 80% of the combined voting power of all voting classes of stock and at least 80% of the total number of shares of all other classes of stock of the corporation.

Section 421(a)(1) provides that if a share of stock is transferred to an individual in a transfer in respect of which the requirements of §422(a) are met, then no income shall result at the time of the transfer of such share to the individual upon the exercise of the option with respect to such share.

Section 421(b) provides that if the transfer of a share of stock to an individual pursuant to his exercise of an option would otherwise meet the requirements of §422(a) except that there is a failure to meet any of the holding period requirements of §422(a)(1), then any increase in the income of such individual or deduction from the income of the employer corporation for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred.

Section 422(a)(1) provides that §421(a)(1) applies with respect to the transfer of a share of stock to an individual pursuant to the exercise of an incentive stock option if (1) no disposition of such share is made by him within 2 years from the date of grant of the option nor within 1 year after the transfer of such share to him, and (2) at all times during the period beginning on the date of grant of the option and ending on the day three months before the date of such exercise, such individual was an employee of

either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transfer to which §424(a) applies.

Section 424(c)(1) and §1.424-1(c) provide that the term “disposition” includes a sale, exchange, gift or a transfer of legal title, but does not include an exchange to which § 354, 355, 356, or 1036 (or so much of §1031 as relates to §1036) applies.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in §1011 for determining gain, and the loss is the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1001(b) provides that the amount realized from the sale or other disposition of the property is the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c), provides that, except as otherwise provided in Subtitle A, the entire amount of the gain or loss, determined under §1001, on the sale or exchange of the property shall be recognized.

## ANALYSIS

### *Scenario 1*

In Scenario 1, the Merger qualifies as a reorganization described in §368(a). Section 354 does not apply to the exchange of each outstanding share of Corporation X voting common stock for one share of Corporation Y voting common stock because the Corporation X shareholders are also receiving \$1.50 per share in cash and the exchange is therefore not solely for stock. However, §356 applies to the exchange of Corporation X stock for Corporation Y stock plus cash because the exchange would qualify under §354 except for the receipt of cash. Pursuant to §424(c)(1), the term “disposition” does not include an exchange to which §356 applies. Because §356 applies to the exchange, there is no disposition within the meaning of §424(c)(1) of the Corporation X stock held by A even though A recognizes gain of \$1.50 per share on the receipt of the cash under §356(a)(1).

Because A paid \$15.00 for each share of Corporation X stock, A's basis in each share of the Corporation X stock is \$15.00. Pursuant to §356(a)(1), A recognizes \$1.50 of gain for each share of Corporation X stock in the exchange. Because A exchanged 100 shares of Corporation X, A recognizes \$150.00 of gain in the exchange. Pursuant to §358(a), A's \$15.00 basis in each share of Corporation Y stock received in the exchange is decreased by the \$1.50 received by A and increased by the gain of \$1.50 recognized by A. A's basis in each share of Corporation Y stock after the exchange is \$15.00 and the total basis of A's 100 shares is \$1,500.00.

Because the exchange of Corporation X stock for Corporation Y stock is not a disposition of the Corporation X stock, A has satisfied the holding period requirements under §422(a)(1) when A sells the Corporation Y stock. The sale of the shares on August 1, 2013 is a qualifying disposition and A recognizes \$2,500.00 (\$4,000.00 sale price - \$1,500.00 basis) of capital gain.

### *Scenario 2*

In Scenario 2, the Merger does not qualify as a reorganization described in §368(a). Therefore, neither §354 nor §356 applies to the exchange of each outstanding share of Corporation X voting common stock for one share of Corporation Y voting common stock with a value of \$16.50 and \$10.00 in cash. Pursuant to §424(c)(1), the term “disposition” does not include an exchange to which §354 or §356 applies. Because neither §354 nor §356 applies to the exchange, there is a disposition within the meaning of §424(c)(1) of the Corporation X stock held by A and §1001 applies to the exchange.

Because §1001 applies to the exchange, A recognizes gain on the disposition of the Corporation X stock in the amount of \$1,150.00 (\$1,650.00 fair market value of Corporation Y stock (\$16.50 per share x 100 shares) plus \$1,000.00 (\$10.00 per share x 100 shares) less \$1,500.00 basis in the Corporation X stock). The exchange is a disqualifying disposition because A has not satisfied the holding period requirements in §422(a)(1) at the time of the exchange. Therefore, on the date of the exchange, A must include in gross income \$1,150.00, which includes \$1,000 as compensation (\$2,500.00 fair market value of Corporation X stock on the date of exercise of the option - \$1,500.00 exercise price for the Corporation X stock) and \$150.00 as capital gain. A's basis in the 100 shares of Corporation Y stock is \$1,650.00 (\$16.50 per share). A recognizes a capital gain when A sells 100 shares of Corporation Y stock for \$40.00 per share. Pursuant to §1001, the amount of the gain is \$2,350.00.

Please call Ilya Enkichev at (202) 317-5600 if you have any further questions.