

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

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date: September 30, 2015

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from: John B. Richards, Senior Technician Reviewer
Executive Compensation Branch (Employee Benefits)
(Tax Exempt & Government Entities)

subject: Tax Matter

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayers =

Parent =

Affiliates =

Common Stock =

Grant Date =

Valuation =

Exercise Price =

The Office of Chief Counsel disagrees with the positions taken by Taxpayers in their Response to the Notices of Proposed Adjustments (NOPAs), dated July 17, 2015 (Response). The NOPAs propose adjustments to Taxpayers' income tax returns based on compensation deferred under Taxpayers' option to purchase Common Stock of Parent (Option) that is required to be included in Taxpayers' gross income under section 409A(a) of the Internal Revenue Code (Code). As described in the NOPAs, because the Common Stock was readily tradable on an over-the-counter market on the grant date of the Option (Grant Date), the exercise price of the Option must have been based on actual transactions in the Common Stock reported by such established securities market. Because the actual exercise price of the Option (Exercise Price) was less than the fair market value of the Common Stock on the Grant Date as determined by such actual transactions, the Option provided for the deferral of compensation from the Grant Date. Even assuming that the Common Stock was not readily tradable on the established securities market, the valuation of the Common Stock used by Taxpayers to establish the Exercise Price (Valuation) was not reasonable. See CCA 201521013 (12/18/2014) for discussion of these issues. This memorandum replies to specific arguments of Taxpayers in the Response.

The Common Stock Was Readily Tradable On an Established Securities Market

For purposes of determining the fair market value of stock that is readily tradable on an established securities market, §1.409A-1(b)(5)(iv)(A) provides that the determination must be based on a reasonable method using actual transactions in the stock as reported by the established securities market. In the Response, Taxpayers assert that the Common Stock should not be treated as "readily tradable" on the Grant Date.¹ Under §1.409A-1(b)(5)(vi)(G), stock is treated as readily tradable if it is "regularly quoted by brokers or dealers making a market in such stock." Therefore, a stock is readily tradable if brokers or dealers make the stock available to trade by listing it on an established securities market. The "readily tradable" standard therefore requires only the ability to buy and sell the stock through a third party. Therefore, the Common Stock was readily tradable on the over-the-counter market on the Grant Date.

¹ Taxpayers' assertion is contrary to the fact that Parent took steps necessary to establish the over-the-counter market beginning two days before the Grant Date.

shares of Common
the first trading date, Parent intended and understood that the Common Stock was readily tradable beginning on the first trading date.

Because potentially all
could have been sold on

In the Response, Taxpayers also assert that contracts to purchase the Common Stock, rather than the Common Stock itself, were purchased on the when-issued, over-the-counter market on the Grant Date. Taxpayers argue that there were therefore no actual transactions in the Common Stock as reported by the over-the-counter market for purposes of determining the fair market value of the Common Stock under §1.409A-1(b)(5)(iv)(A) on the Grant Date.² However, the rule does not require that the Common Stock must actually exchange hands on the trading date, but rather only that there are “actual transactions in such stock” on the trading date. Transactions in stock generally mean either the sale or transfer of stock. Even assuming that only contracts to purchase the Common Stock were actually purchased on the Grant Date, the contracts provided for the transfer of the Common Stock. The buyers were contractually obligated to complete their when-issued purchases of the Common Stock if the _____ occurred. The _____ had already occurred _____ on the Grant Date before the over-the-counter market opened for that trading date. Moreover, the buyers were contractually obligated to pay the auction price that applied at the time that they purchased the Common Stock on the Grant Date regardless of the auction prices of the Common Stock on the settlement date. Thus, there is no basis for treating the when-issued purchases of the Common Stock as anything other than “actual transactions in such stock” reported by the established securities market.

² The cases cited by Taxpayers do not support Taxpayers’ position. The *Stavisky* court assumed that contracts to purchase stock when issued reflect the fair market value of the stock on the date the contract is entered into: “In the case at bar the performance of the original contract—that is, the purchase of the shares—at the price fixed—remained what it had been.” *Stavisky v. Comm’r*, 291 F.2d 48, 49 (2d Cir. 1961). Furthermore, the *Stavisky* holding applied to a transaction that occurred before the enactment of section 1233. Section 1233(e)(2)(A) treats stock traded on a when-issued basis the same as the stock. Under Example 6 of §1.1233-1(c)(6), the price contracted to sell stock when issued applies for purposes of determining the applicable gain or loss when the stock is actually issued.

Because the Common Stock was readily tradable on an established securities market on the Grant Date, §1.409A-1(b)(5)(iv)(A) applies to determine the fair market value of the Common Stock on the Grant Date. The closing auction price per share of Common Stock on the over-the-counter market on the Grant Date was more than the Exercise Price. Under §1.409A-1(b)(5)(iv)(A), the Exercise Price was therefore less than the fair market value per share of the Common Stock on the Grant Date.

Even Assuming that the Common Stock Was Not Readily Tradable, the Valuation Used By Taxpayers Was Not Reasonable

If stock is not readily tradable on an established securities market, §1.409A-1(b)(5)(iv)(B) provides that the determination of the fair market value of the stock must be based on the reasonable application of a reasonable valuation method. Whether a valuation method is reasonable,³ or whether an application of a valuation method is reasonable, is based on the facts and circumstances as of the valuation date. A valuation method is not reasonably applied if it is not revised to take into account information that becomes available after the valuation is calculated that may materially affect the value of the corporation. Because recent arm's length transactions involving the sale or transfer of the stock must be considered under a reasonable valuation method, such transactions must also be taken into account after a valuation is calculated. This principle is further reflected under §1.409A-1(b)(5)(iv)(B)(3), which provides that a reasonable method using actual transactions in the stock as reported by the established securities market must be used once a stock becomes readily tradable on an established securities market. These rules reflect that the fair market value of stock is most accurately determined on the basis of contemporaneous arm's length transactions in the stock.⁴ Thus, contrary to Taxpayers' interpretation of §1.409A-1(b)(5)(iv)(B)(3), the exercise price is properly established as of the grant date of an

³ Under §1.409A-1(b)(5)(iv)(B), the factors to be considered for determining whether a valuation method is reasonable include the value of tangible and intangible assets of the corporation; the present value of anticipated future cash flows of the corporation; the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to the corporation, the value of which may be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's length transaction); recent arm's length transactions involving the sale or transfer of such stock or equity interests; and other relevant factors.

⁴ This principle reflects the basic common law definition for the determination of fair market value, as stated, for example, under §1.170A-1(c)(2) and §20.2031-1(b) and in Rev. Rul. 59-60, 1959-1 CB 237: "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Rev. Rul. 59-60 also provides that "the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented."

option only if it takes into account all information that may materially affect the value of the corporation as of the grant date.

The Methodology for Calculating the Proposed Adjustments is Consistent with the Requirements of Section 409A

In the Response, Taxpayers assert that the methodology for calculating the proposed adjustments based on the proposed regulations is not entitled to deference. However, Taxpayers do not suggest an alternative method for determining the amount includible in gross income under section 409A for an option that is treated as a nonqualified deferred compensation plan. The methodology under the proposed regulations is consistent with the final regulations. Section 1.409A-1(b)(2) provides that the entire appreciation in value of the stock underlying an option that is subject to section 409A is treated as compensation deferred under the option.

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Please call (202) 317-4572 if you have any further questions.

By: _____
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