

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201610006**
Release Date: 3/4/2016

[Third Party Communication:
Date of Communication: Month DD, YYYY]

Index Number: 461.00-00

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B03
PLR-122710-15

Date:
November 23, 2015

TY:

LEGEND:

- Taxpayer =
- Taxpayer's Subsidiary =
- Company A=
- Company B =
- Company C =
- Products =
- Date 1 =
- Date 2 =
- Date 3 =
- Date 4 =
- Date 5 =
- Date 6 =
- Year 1 =
- Year 2 =
- D =
- E =
- \$X =
- \$Y =
- \$Z =

Dear _____ :

This is in response to the letter sent by your authorized representatives dated _____ . In the letter, your representatives requested a ruling that the tax consequences of the warrants Taxpayer issued on Date 1 be recognized as an expense when they become exercisable by their owners, the subsidiaries of Company A and Company B.

The request is based on sections 1.461-1(a)(2) and 1.83-7(a) of the Income Tax Regulations.

FACTS

Taxpayer is a United States corporation which is the parent company of a consolidated group for U.S. federal income tax purposes, which includes a wholly owned subsidiary, Taxpayer's Subsidiary, as well as other U.S. subsidiaries. Taxpayer and its subsidiaries use the accrual method of accounting for U.S. federal income tax purposes and their taxable year ends on Date 2 of each year.

One of the businesses in which Taxpayer is engaged is the business of purchasing and distributing Products to a variety of providers. Taxpayer's ability to obtain these products from manufacturers in necessary volume and with favorable pricing is critical to satisfying its customers.

On Date 1, Taxpayer and Taxpayer's Subsidiary entered into several contracts with Company A, a domestic corporation, Company B, a foreign corporation, and Company C, a foreign corporation owned by Company A and B. The goal of these contracts was to increase the purchasing power of the parties involved with an objective to realize improved pricing for Products. Central to the new relationship was the execution of a D year purchasing services agreement whereby Taxpayer, through Taxpayer's Subsidiary,

- . Taxpayer remained responsible in the various contracts mentioned above.

In addition, Company C was required to

- . Company C also agreed to . In addition to requiring performance of

the above services,

As part of the agreements, Taxpayer granted contingent equity rights, or warrants, subject to the performance requirements stated above, to each of Company A and Company B (via their respective subsidiaries) to acquire E shares in Taxpayer between Date 3 and Date 4 of Year 1 at \$X per share and to each company to acquire another E shares in Taxpayer between Date 5 and Date 6 of Year 2 at \$Y per share. At the time the warrants were issued, the warrants did not have an ascertainable fair market value as defined in Section 1.83-7(b) of the Income Tax Regulations because, among other things, they were not actively traded on an established market and were not exercisable immediately in full by the recipient. The shares acquired pursuant to the exercise of the warrants will not be subject to a substantial risk of forfeiture, and therefore, will be substantially vested within the meaning of section 1.83-3(b) of the Income Tax Regulations at the time of exercise of the warrants.

Taxpayer granted the stock warrants when Company A, Company B, and Company C signed a contract for Company C to perform services. At the time of the grant, the then price of Taxpayer's stock was \$Z, less than the exercise prices of the warrant tranches under the agreements. Taxpayer's goal was to provide appropriate long-term incentives for Company C to perform its duties under the agreement effectively. The agreements provided that if Company C failed to perform its duties under the agreements in a satisfactory and successful manner, Taxpayer had the right under the agreements to terminate them and cancel the warrants granted to Company A and Company B. Thus, the warrants would only become exercisable in Year 1 and Year 2 if Company C had fully complied with the terms of the agreements, including the performance of the required services, up to the applicable points in time.

LAW AND ANALYSIS

Section 162(a) of the Code allows a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 162(a)(1) includes a reasonable allowance for salaries or other compensation for personal services actually rendered as an ordinary and necessary business expense.

Section 1.461-1(a)(2)(i) of the Income Tax Regulations provides in part that under an accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which: (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability.

Section 1.461-4 of the Regulations provides rules for determining when economic performance occurs with respect to liabilities arising out of the performance of services, the transfer of property, or the use of property, interest on debt, assumption of liabilities in connection with the sale of a trade or business, and certain other liabilities.

Section 1.461-4(d)(2)(i) of the Regulations generally provides that if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided.

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 the fair market value of such property over the amount (if any) paid for such property, shall 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 1.83-3(b) of the Regulations provides that property is substantially vested when it is either transferable or not subject to a substantial risk of forfeiture.

Section 1.83-3(f) of the Regulations provides that property transferred in recognition of the performance of, or the refraining from performance of, services is considered transferred in connection with the performance of services within the meaning of section 83. The section also provides that the transfer of property is subject to section 83 whether such transfer is in respect of past, present, or future services.

Section 83(e)(3) provides that section 83 does not apply to a stock option (which is equivalent to a stock warrant) without a readily ascertainable fair market value.

Section 1.83-7(a) of the Regulations states that if section 83(a) does not apply to the grant of 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).

Section 83(h) provides that the service recipient may take a deduction in an amount equal to the amount included under section 83 in the gross income of the person who performed such services. Furthermore, the deduction is allowed only for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.

Section 1.83-6(a)(3) provides that where property is substantially vested upon transfer, the deduction shall be allowed to such person in accordance with his method of accounting (in conformity with sections 446 and 461).

Thus, when a service provider exercises a stock option (or stock warrant) for substantially vested stock, pursuant to section 83, the fair market value of the stock (minus the exercise price) is included in the service provider's gross income. Pursuant to section 1.83-6(a)(3), the service recipient may take a deduction for the amount included in the service provider's gross income upon the service provider's exercising the stock option (or stock warrant) in accordance with his method of accounting (in conformity with sections 446 and 461).

Under section 1.461-1(a)(2)(i), all events have not occurred that establish the fact of the liability and determine it with reasonable accuracy until the contingencies surrounding the issuance of the warrants have lapsed. In contrast, economic performance will have occurred by the time the contingencies lapse because services by then will have already been provided to Taxpayer. Thus, the only question is whether the contingency lapse occurs when the warrants become exercisable or exercised. The warrants are

subject to section 83 because Taxpayer granted the stock warrants to Company A and Company B in connection with the performance of services

for Taxpayer
on an ongoing basis. Therefore, section 83 determines the timing of the contingency lapse.

The warrants did not have an ascertainable fair market value on the date of grant. Thus, under section 1.83-7(a) of the Regulations, sections 83(a) and 83(b) do not apply on the issuance of the warrants or when they become exercisable, but become applicable only upon the warrants' exercise. Pursuant to sections 83(h) and 1.83-6(a)(3), Taxpayer may claim a deduction in accordance with its method of accounting (in conformity with sections 446 and 461) when the substantially vested E shares are transferred to Company A and/or Company B, as applicable, upon exercise of the stock warrants.

CONCLUSION

Taxpayer may recognize the tax consequences of the warrants issued to Company A and/or Company B, as applicable, when they are exercised.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal income tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

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 Casey
Senior Technician Reviewer, Branch 3
(Income Tax & Accounting)

cc: