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May 6, 1999

Legend:

Plan =

Company =

Sub =

Sub A =

Sub B =

Country A =

State B =

State C =

State D =

Currency A =

X Board =

Y Board =

Z Stock
Exchange =

(XX) =

Dear

This is in reply to your letter dated December 29, 1998, in which rulings are requested, on behalf of Company and its subsidiaries, regarding the federal income tax consequences of Awards to be made under the Plan.

The information submitted states that Company is a Country A stock corporation that owns 100% of the common shares (84% of the voting shares) of Sub. Sub, which is a State B corporation, is the parent corporation of Sub A, which is a State C corporation. Company is also the parent corporation of Sub B, which is a State D corporation. Company's stock is required to be registered under section 12 of the Securities Exchange Act of 1934.

Company wishes to adopt a nonstatutory stock option plan for certain management and executive employees of Company and its subsidiaries. However, under Country A Stock Corporation Law, Company may not reserve its shares for future issuance upon the exercise of employee stock options.

Thus, in order to implement the equivalent of an employee stock option plan under Country A corporate law, Company has established the Plan. Under the Plan, Awards to employees will take the form of a Currency A-denominated Convertible Bond and a corresponding Employee Loan. Upon payment of the Conversion Price, the Convertible Bonds will be converted into either Nonvoting Preference Shares of Company ("Preference Shares").

Convertible Bonds will be Currency A-denominated, will have a face amount equal to the nominal (par) value of a Preference Share (XX) multiplied by the number of Preference Shares into which the Convertible Bonds may be converted and will bear interest at a rate determined by the Y Board. The Y Board will also determine the period over which the Convertible Bonds will vest. Convertible Bonds will not be

transferable or assignable except by will or the laws of descent and distribution or pursuant to a qualified domestic relations order. Convertible Bonds will be unfunded and unsecured obligations of Company.

Employee Loans will be Currency A-denominated; will be evidenced by a non-recourse note secured solely by the related Convertible Bond; will be for an amount equal to the face amount of the related Convertible Bond; will bear interest at the same rate and payable at the same time as the interest on the related Convertible Bond; will mature on the date that the Award expires; and will be prepayable upon the earlier of conversion of the related Convertible Bond or its redemption upon termination of employment.

Upon vesting, Convertible Bonds will be convertible into Preference Shares at a Conversion Price equal to the "standard price"¹ of a Preference Share on the Z Stock Exchange on the first business day following the date of the grant of the corresponding Award. The Conversion Price of the portion of the Convertible Bonds to be converted is payable in full at the time of conversion. Upon conversion, a Participant must pay an amount equal to the Conversion Price less the face amount of the Convertible Bond being converted plus the amount of the corresponding Employee Loan.

Upon termination of employment, the Participant (or his or her Beneficiary or Personal Representative) generally will have 90 days to convert the Convertible Bonds or will have one year if the termination is due to death or Disability. If, however, the termination is for cause, the conversion right will cease upon termination. The Y Board has the discretion to lengthen the conversion period upon termination of employment. Upon expiration or termination of the conversion right, the Convertible Bond will be redeemed, the corresponding Employee Loan will be due and payable, and those obligations will offset each other in all respects.

Under section 83 of the Code, if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property, on the first day that the rights to the property are either transferable or not subject to a substantial risk of forfeiture, over the amount paid for the

property is included in the service provider's gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture.

¹ The "standard price" is the Country A stock quote that represents the actual trading price of a given class of stock on the Z Stock Exchange, determined once each day at 12:30 p.m. local time.

A "transfer" of property occurs when a person acquires a beneficial ownership interest in the property (disregarding any "lapse restriction," as defined in section 1.83-3(i) of the Income Tax Regulations). See section 1.83-3(a)(1). The grant of an option to purchase property does not constitute a transfer of such property. See section 1.83-3(a)(2). Similarly, no "transfer" may occur where property is transferred under conditions that require its return upon the happening of an event that is certain to occur, such as the termination of employment. In such a case, whether there is, in fact, a transfer depends upon all the facts and circumstances. Factors indicating that no transfer has occurred are described in sections 1.83-3(a)(4), (5) and (6). See section 1.83-3(a)(3).

Neither section 83 of the Code nor the regulations thereunder define the term "option, and there is no particular form of words necessary to create an option. However, an option is generally understood to be a document that expresses an offer to sell property at a specified price for a stated period of time, with the offeree being under no obligation to purchase the property. Compare section 1.421-7(a) of the regulations.

In Rev. Rul. 75-114, 1975-1 C.B. 138, an employee owned subordinated debentures that were convertible into his employer's common stock. The debentures were convertible for a specified time, which included the period between the time that the employer notified the employee that it was redeeming the debentures and the stated redemption date. The issue addressed by this Revenue Ruling was whether the convertible debentures were "options to purchase stock" for purposes of former Code section 422(c)(3)(C). Based on the provisions of section 1.421-6(b)(1) of the regulations, the Ruling held that the convertible debentures were "options to purchase stock."

Section 83(e)(3) of the Code provides that section 83(a) does not apply to the transfer of an option without a readily ascertainable fair market value. For example, an option does not have a readily ascertainable fair market value when granted if, at that time, it is not actively traded on an established market, or, among other things, is not transferrable. See sections 1.83-7(b)(1) and (2) of the regulations. However, section 83(a) does apply to such an option at the time that it is exercised, sold, or otherwise disposed of. If the option is exercised, section 83(a) applies to the transfer of property pursuant to the exercise. If the option is sold or otherwise disposed of in an

arm's length transaction, section 83(a) applies to the transfer of money or other property received in the same manner as it would have applied to the transfer of property pursuant to an exercise of the option. See section 1.83-7(a).

Under section 83(h) of the Code, the service recipient is allowed a compensation expense deduction, under section 162, in an amount equal to the amount included in the service provider's gross income under section 83(a). For this purpose, the service provider is deemed to have included the amount as compensation in gross income if the service recipient timely satisfies all of the requirements of section 6041 or 6041A with respect to that amount of compensation. See section 1.83-6(a)(2) of the regulations.

However, no deduction is allowed under section 83(h) to the extent that the transfer of property constitutes a capital expenditure, an item of deferred expense, or an amount properly includible in the value of inventory items. In the case of a capital expenditure, for example, the basis of the property to which such capital expenditure relates is increased at the same time and to the same extent as any amount includible in the service provider's gross income in respect of such transfer. Thus, for example, no deduction is allowed to a corporation in respect of a transfer of its stock to a promoter upon its organization, notwithstanding that such promoter must include the value of the stock in gross income in accordance with the rules under section 83. See section 1.83-6(a)(4) of the regulations. Additionally, section 280G of the Code provides that no deduction is allowed for any "excess parachute payment," as defined therein.

Under section 83(h), the deduction is generally allowed for the taxable year of the service recipient in which or with which ends the service provider's taxable year in which the amount is included in gross income. However, section 1.83-6(a)(3) of the regulations provides an exception to the general timing rule for the deduction. In cases where the property transferred is substantially vested upon transfer, the deduction is allowed to the service recipient in accordance with the recipient's normal method of accounting.

For purposes of section 83 of the Code, property is substantially nonvested when it is both subject to a "substantial risk of forfeiture" and is "nontransferable" within the meaning of sections 1.83-3(c) and (d) of the regulations, respectively. Property is substantially vested when it is either transferable or is not subject to a substantial risk of forfeiture.

Under section 1.83-6(d)(1) of the regulations, if a shareholder of a corporation transfers property to an employee (or independent contractor) of the corporation in consideration for services performed by the employee for the corporation, the transaction is considered to be a contribution of the property by the shareholder to the corporation and, immediately thereafter, a transfer of the property by the corporation to the employee. The transfer of property to the employee is considered to be in

consideration for services performed by the employee for the corporation if either the property is substantially nonvested at the time of transfer or if an amount is includible in the gross income of the employee at the time of transfer under the rules of section 83 of the Code. In the case of such a transfer, any money or other property paid to the shareholder for the contribution is considered to be paid to the corporation and transferred immediately thereafter by the corporation to the shareholder as a distribution to which section 302 of the Code applies.

Revenue Ruling 80-76, 1980-1 C.B. 15, holds that a majority shareholder of a corporation recognizes no gain or loss on its transfer of stock of that corporation to an employee of a subsidiary of that corporation, but must allocate its basis in the transferred stock to any shares that it retains. The Ruling additionally holds that the subsidiary-employer is entitled to deduct the amount includible in the employee's gross income under the rules of section 83, but does not recognize gain or loss as a result of the transfer.

Applying the above rules to the facts submitted, we rule as follows:

(1) The grant of a Convertible Bond and a corresponding Employee Loan constitutes the grant of a nonstatutory option having "no readily ascertainable fair market value at grant" for purposes of section 83;

(2) A Participant will not be in receipt of compensation income when the Convertible Bond and the corresponding Employee Loan are awarded or when the right to convert the Convertible Bond vests, but will be in receipt of compensation income when the Convertible Bond is converted into Preference Shares or (if later) when such shares become substantially vested. The amount of such income will be the difference, if any, between the fair market value of the Preference Shares on the conversion date (or vesting date) and the amount paid by the Participant (both measured in Currency A on the applicable date);

(3) The Employee Loan and the interest payable thereon, and the related Convertible Bond and the interest payable thereon, will be disregarded for all purposes of the Code. Accordingly, a Participant will not be in receipt of gross income on account of any interest receivable on the Convertible Bond and will not be entitled to any interest expense deductions on account of interest payable on the corresponding Employee Loan;

(4) Neither Sub A nor any other employer company will be in receipt of gross income when a Convertible Bond is awarded, when the right to convert the Convertible Bond vests, upon the conversion of a Convertible Bond into Preference Shares, or on the issuance of Preference Shares;

(5) The company employing a service provider who receives Preference Shares will be entitled to a compensation expense deduction attributable to those shares under the rules of sections 83 of the Code and the regulations thereunder; and

(6) No gain or loss will be recognized by Company upon the issuance of the Preference Shares on account of the conversion of a Convertible Bond.

Except as ruled above, no opinion is expressed as to the federal tax consequences of the transaction described above under any provision of the Internal Revenue Code. In particular, no opinion is expressed regarding the effect of adjustments to Conversion Prices or amendments to Awards or regarding the method of valuing Preference Shares. Additionally, if the Plan is amended, the above rulings may not remain in effect.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the companies' federal income tax return(s) for the year in which the Plan is implemented. A copy is enclosed for that purpose.

Sincerely yours,

ROBERT B. MISNER
Assistant Chief, Branch 4
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)

Enclosures: 2
Copy of this letter
Copy for section 6110 purposes

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