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INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

District Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Ident. No.:

Taxable Years at Issue:

Date of Conference:

Legend:

Company A =

Company B =

Company C =

ISSUE:

Whether, under the rules of section 83 of the Internal Revenue Code, Company A was entitled to deduct the compensation income that was includible in its employees' gross incomes as a result of cancellation of certain nonlapse restrictions on their Company A shares.

FACTS:

As initially organized, Company A was a professional services corporation that was wholly owned by doctors (as was required by State law). From the outset, all Company A shares were subject to nonlapse book-value buyback provisions that would be triggered upon a doctor's termination of employment with Company A.

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Eventually, the business of Company A came to include the management of medical clinics. In 1994, the doctors decided to separate their clinic-management business from their medical practice and contemporaneously took the following integrated steps (here, in simplified form) to effectuate the separation: (1) they canceled the book-value buyback provisions on their Company A shares (2) they then formed Company B by contributing their employment contracts with Company A to Company B and received, in exchange, all of the shares of Company B (Company A became the parent corporation of Company B); (3) they then caused Company A to redeem .005 of each outstanding Company A share held by them; and (4) in consideration for the redemption, they caused Company A to transfer to each of them the number of Company B shares equal to the number of Company A shares then owned by them. After completion of these transactions, the doctors' medical practice was housed in Company B, the clinic-management business remained with Company A, and the doctors owned Company B in the same proportions that they owned Company A. Almost immediately thereafter, the doctors sold their Company A shares to Company C.

The Service and the Companies agree that Company A's cancellations of the nonlapse restrictions on the doctors' Company A shares were compensatory. On its return filed for its taxable year ending or , 1994, Company A deducted the compensation income attributable to cancellation of the nonlapse restrictions. When doing so, it used the "normal method of accounting" exception to the general timing-rule for deductions governed by section 83(h) of the Code.

APPLICABLE LAW AND ANALYSIS:

Under section 83(a), if, in connection with the performance of services, property is transferred to anyone other than the service recipient, the excess of the fair market value of the property over the amount paid for the property is included as compensation income in the service provider's gross income for the first taxable year in which the rights to the property are transferable or not subject to a substantial risk of forfeiture ("substantially vested"). For this purpose, the fair market value of the property is determined on the date that the rights to the property become substantially vested and without regard to restrictions that lapse.

Under section 83(d)(2), if a nonlapse restriction imposed on section 83 property is canceled, then, unless the taxpayer establishes (i) that the cancellation was noncompensatory, and (ii) that the person who would be allowed a deduction (if the cancellation were treated as compensatory) will treat the transaction as noncompensatory, the excess of the fair market value of the property at the time of cancellation (determined without regard to the restriction) over the sum of (i) the fair market value of the property immediately before the cancellation (taking the restriction into account), and (ii) the amount (if any) paid for the cancellation, is treated as compensation income for the taxable year in which such cancellation occurs.

Under section 83(h), the service recipient is allowed a compensation expense deduction, under section 162 of the Code, in an amount equal to the amount included in the service provider's gross income under section 83(a). Under the general rule of section 83(h), the deduction is allowed for the service recipient's taxable year 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 Income Tax Regulations provides an exception to the general timing rule for the deduction. In cases (such as here) where the property transferred (here, cancellation of the restrictions) is substantially vested upon transfer, the deduction is allowed to the service recipient in accordance with its normal method of accounting.

Section 482 of the Code provides that, in the case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances among such organizations, trades, or businesses, if the Secretary determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such organizations, trades, or businesses.

Applying the above rules to the facts of the instant case, we conclude that a deduction is allowed under the rules of section 83(h) for the amounts includible in the doctors' gross incomes as a result of the cancellation of the nonlapse restrictions on their Company A shares. However, in cases such as this, where cancellation of a nonlapse restriction is contemporaneous with a reorganization of the employer corporation into a parent corporation and a subsidiary corporation, the rules of section 482 should be referenced to determine whether the section 83 deductions attributable to the cancellation should be allocated between the resulting corporations under those rules. Compare Revenue Ruling 80-198, 1980-2 C.B. 113. In this regard, please note that no opinion is expressed, and none was requested, as to allocation of the deductions under the rules section 482.

CONCLUSION:

Under the rules of section 83, deductions were allowable for the compensation income that became includible in the doctor's gross incomes as a result of cancellation of the nonlapse restrictions on their Company A shares. Section 482 should be referenced to determine whether the deductions should be allocated between Company A and Company B to clearly reflect their incomes.

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A copy of this technical advice memorandum is to be given to the Companies. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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