INTERNAL REVENUE SERVICE
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September 22, 1999

Taxpayer =

Company =

Plan A =

Plan B =

Plan C =

date *a* =

date *b* =

date *c* =

date *d* =

date *e* =

date *f* =

date *g* =

year *1* =

year *2* =

year *3* =

h years =

i years =

j shares =

k =

l =

v% =

w% =

x% =

Dear

This replies to a ruling request submitted on your behalf by your authorized representative, concerning the application of section 83 and the gift and estate tax provisions of the Internal Revenue Code, to the proposed transfer of certain stock options by gift.

Company has voting common stock outstanding. The stock is publicly traded. Company has three stock option plans, Plan A, Plan B, and Plan C.

Taxpayer, an employee of Company, was born on date *a*, and has been employed by Company since year *1*. As of date *b*, Taxpayer owned *j* shares of Company common stock directly. Taxpayer was granted *k* nonqualified stock options on date *c* under Plan A and was granted *l* nonqualified stock options on date *d* under Plan B. Taxpayer and Taxpayer's family members do not own in the aggregate, by vote or value, fifty percent or more of Company's common stock.

Plan A and Plan B are administered by a committee appointed by Company's board of directors. All of the committee members are non-employee directors appointed annually by the board.

Under the Plans, option holders may purchase Company common stock at a specified price after various conditions are met. The Plans provide that the option price per share is determined by the committee; however, the option price may not be less than the fair market value of a share on the date the option is granted. Each option is

granted for an option period fixed by the committee. The option period, however, may not exceed ten years from the date the option is granted. All of the stock options received by Taxpayer have a ten-year term.

The option received under Plan A vests in installments of one-quarter per year on each of the first through fourth anniversary dates of the option grant. In addition, the stock received under Plan A must meet certain price appreciation thresholds during the first *h* years of the option period before the option may be exercised. Further, except as otherwise provided, the optionee must be employed by Company at the time of the exercise. The option received under Plan A vests and becomes exercisable in stages. One-quarter of the option is exercisable after the one-year holding period; one-quarter of the option vests after a two-year holding period and is exercisable when the underlying stock achieves a *v* % increase; one-quarter of the option vests after a three-year holding period and is exercisable when the underlying stock achieves a *w* % increase; and one-quarter of the option vests after a four-year holding period and is exercisable when the underlying stock achieves a *x* % increase. In the *i* years, the option is fully exercisable regardless of stock price. The option received under Plan A expires ten years after the date of the option grant.

Similarly, the option received under Plan B vests annually in four equal installments of one-quarter per year on each of the first through fourth anniversary dates of the option grant, and, except as otherwise provided, the optionee must be employed by Company at the time the option is exercised. Further, the option received under Plan B expires ten years after the date of the option grant. The option received under Plan B, however, is subject to different price appreciation thresholds during the first *h* years of the option period before the option or a portion of the option may be exercised. One-third of the option received under Plan B is not subject to any price appreciation threshold and is exercisable after the portion of the option is vested; one-third of the option is exercisable when the underlying stock achieves a *v*% price increase; and the final one-third of the option is exercisable when the underlying stock achieves a *w*% price increase. In the *i* years, the option is fully exercisable regardless of stock price.

In addition, subject to a one-year continuous employment rule and price appreciation requirements, options received under Plan A and Plan B are exercisable if the optionee (i) attains age sixty while employed by Company; (ii) dies while employed by Company; (iii) retires from Company on or after his 65th birthday; (iv) retires from Company on or after his 55th birthday after having completed ten years of service with Company; or (v) retires from Company on or after the date the sum of the optionee's age and years of service when rounded up to the next highest number equals at least 70 and the optionee has completed ten years of service with Company and

employment terminates for any reason other than death, resignation, willful misconduct, or activity deemed detrimental to the interest of Company.

Plan A and Plan B agreements have been amended to provide that the options are transferable to members of the optionee's immediate family, to trusts solely for the benefit of optionee's immediate family, and to partnerships in which the only partners are the optionee's immediate family members and/or trusts solely for the benefit of optionee's immediate family. For this purpose, immediate family members means the optionee's spouse, parents, children, stepchildren, grandchildren, and legal dependents.

Under Plan A and Plan B, if an optionee retires from Company, the optionee's stock options expire at the end of the option period fixed by the committee. If an optionee's employment with Company is terminated other than by retirement or death, the optionee's options expire three months after the termination of employment. If an optionee dies while employed by Company, the stock options expire at the end of the option period fixed by the committee. If, however, the optionee dies within the period after retirement or other termination of employment, the stock options are exercisable until the later of twelve months after death, or the date the options expire under the Plans.

Further, if the optionee ceases to be employed by Company due to disability, the optionee is treated as remaining in the employ of Company until the earlier of (i) cessation of payments under a disability plan of Company; (ii) the disabled optionee's death; or (iii) the disabled optionee's 65th birthday.

Taxpayer intends to make a donative transfer after date *e* and no later than date *f* of a portion of his stock options granted during date *g* to a member of his immediate family, to a trust solely for the benefit of such family member, or to a partnership in which such family member and/or trust are the only members. Taxpayer represents that he will transfer only options granted under Plan A and Plan B which are vested and exercisable.

After Taxpayer transfers the stock options, he will have no power or right to determine when the stock options are exercised, or to otherwise affect the stock options. Upon transfer, Taxpayer will have no beneficial ownership interest in or control over the stock options. Taxpayer will have no power to require the transferee to exercise or to refrain from exercising the stock options, to revest the beneficial title to the stock options in himself, to name new beneficiaries of the gift or to change the beneficiaries of the gift.

Section 83(a) of the Code provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom the

services are performed, the excess of (1) the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having a beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount, if any, paid for the property, will be included in the gross income of the person who performed the services in the first taxable year in which the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Under section 83(e)(3) of the Code, section 83 does not apply to the transfer of an option without a readily ascertainable fair market value.

Pursuant to section 83(h) of the Code, there is allowed a deduction under section 162 of the Code, to the person for whom were performed the services in connection with which the property was transferred, an amount equal to the amount included under section 83 in the gross income of the person who performed the services. The deduction will be allowed 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 the services. Section 1.83-6(a)(3) of the Income Tax Regulations provides an exception to the rule of section 83(h) concerning what taxable year the service recipient is allowed the deduction. There, it is provided that, if property is substantially vested upon transfer, the deduction will be allowed in accordance with the service recipient's method of accounting.

Section 1.83-7(a) of the regulations provides, in part, that if there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to the grant if the option has a readily ascertainable fair market value at the time the option is granted. If section 83(a) does not apply to the grant of the option because it does not have a readily ascertainable fair market value at the time of the grant, section 83 will apply at the time the option is exercised or otherwise disposed of, even though the fair market value of the option may have become readily ascertainable before such time. If the option is exercised, section 83(a) applies to the transfer of property pursuant to the exercise, and the employee or independent contractor realizes compensation upon the transfer at the time and in the amount determined under section 83(a). 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 section 83 would apply to the transfer of property pursuant to the exercise of an option. See section 1.83-7(b) of the regulations for the tests to be applied in determining whether an option has a readily ascertainable fair market value.

Section 1.83-4(b) of the regulations provides in part that, if property to which section 83 applies is acquired by any person (including a person who acquires such property in a subsequent transfer which is not at arm's length), while such property is still substantially nonvested, such person's basis in the property should reflect any amount paid for the property and any amount includible in the gross income of the person who performed the services.

In this case, the options do not have a readily ascertainable fair market value at the date of grant. Also, because the transfer of them to the family member or trust will not be pursuant to an arm's length transaction, they will not be considered to be disposed of under section 1.83-7(a) of the regulations. Accordingly, section 83(a) of the Code will apply when the options are exercised and stock is transferred to the family member or trust.

Section 2501 of the Code imposes a tax for each calendar year on the transfer of property by gift during the calendar year by an individual. Section 2511 of the Code provides that the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Under section 2512(a) of the Code, if the gift is made in property, the value of the property at the date of the gift shall be considered the amount of the gift. Section 2512(b) provides that, where property is transferred for less than adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration is deemed a gift.

Section 25.2511-2(b) of the Gift Tax Regulations provides that, as to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property, the donor reserves any power over its disposition, the gift may be wholly incomplete or may be partially complete and partially incomplete, depending upon all the facts in the particular case.

Revenue Ruling 98-21, 1998-18 I.R.B. 7, considers the transfer of a nonstatutory stock option by the optionee to a family member for no consideration. The facts in Rev. Rul. 98-21 provide that Company grants to A a nonstatutory stock option conditioned on the performance of additional services by A . If A fails to perform the services, the option cannot be exercised.

Because the option cannot be exercised if A fails to perform the services, Rev. Rul. 98-21 provides that, before A performs the services, the rights that A possesses in the stock option have not acquired the character of enforceable property rights

susceptible of transfer for federal gift tax purposes. A can make a gift of the stock option to B, one of A's children, for federal gift tax purposes only after A has completed the additional required services because only upon completion of the services does the right to exercise the option become binding and enforceable. In the event the option were to become exercisable in stages, each portion of the option that becomes exercisable at a different time is treated as a separate option for the purpose of applying this analysis. Rev. Rul. 98-21 concludes that the transfer of a nonstatutory stock option by A, the optionee, to B, a family member, for no consideration is a completed gift under § 2511 on the later of (i) the date of the transfer or (ii) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the transferor.

In the present case, Taxpayer, an employee of Company, holds options to purchase Company common stock under both Plan A and Plan B. Taxpayer is under age fifty and has been employed by Company for less than thirteen years. At the time of this ruling, the options received under Plan A met all of the price appreciation thresholds required by Plan A; however, only a portion of the options received under Plan A satisfied the holding period requirements for vesting. Further, at the time of this ruling, the options received under Plan B had not met all of the price appreciation thresholds required by Plan B, and only a portion of the option received under Plan B satisfied the holding period requirements for vesting.

Although all of the stock price appreciation requirements for the option issued to Taxpayer under Plan A have been met, the option owned by Taxpayer under Plan A is not completely vested. Further, the option owned by Taxpayer under Plan B has not met all of the stock appreciation thresholds, nor is the option owned by Taxpayer under Plan B completely vested. Taxpayer proposes to transfer only the portions of the options granted under Plan A and Plan B that are both vested and exercisable. After the proposed transfers, Taxpayer will have no power or right to determine when the transferred portion of the option is exercised. Because Taxpayer proposes to transfer only portions of the Plan A and Plan B options that are vested and exercisable, we conclude that his proposed transfers of the portions of his Plan A and Plan B options that are vested and exercisable to one or more of his children or to a trust for the benefit of one or more of his children will constitute completed gifts on the date of transfer for purposes of section 2511, provided that under the terms of the trust, Taxpayer will not retain any power that would render the gifts incomplete.

Section 2701 of the Code provides special valuation rules to determine the amount of a gift when an individual transfers an equity interest in a corporation or partnership to a member of the individual's family. In order for section 2701 to apply, the transferor or an applicable family member must, immediately after the transfer, hold an "applicable retained interest." Section 25.2701-1(a) of the regulations.

Section 2701(a)(2)(B) of the Code and section 25.2701-1(c)(3) of the regulations provide that section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest.

Section 25.2701-2(b)(1) of the regulations provides that the term "applicable retained interest" means any equity interest in a corporation or partnership with respect to which there is either an "extraordinary payment right" or, in the case of a controlled entity, a "distribution right." Section 25.2701-2(b)(2) provides that, with certain exceptions, an extraordinary payment right is any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or non-exercise of which affects the value of the transferred interest. A call right includes any warrant, option, or other right to acquire one or more equity interests.

Section 2703 of the Code provides that for purposes of the estate, gift, and generation-skipping transfer taxes, the value of any property is determined without regard to (1) any option, agreement, or other right to acquire or use the property at a price less than fair market value of the property (without regard to such option, agreement or right), or (2) any restriction on the right to sell or use such property.

Section 2703(b) of the Code provides an exception to the application of section 2703(a) in the case of a right or restriction, where (1) the right or restriction is a bona fide business arrangement, (2) the right or restriction is not a device to transfer the property to the natural objects of the transferor’s bounty for less than adequate and full consideration in money or money’s worth, and (3) at the time the right or restriction is created, the terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm’s length transaction.

Section 25.2703-1(b)(3) of the regulations provides that a right or restriction is considered to meet each of the three requirements described in section 2703(b) of the Code if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of section 25.2701-6 of the regulations) by individuals who are not members of the transferor’s family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor.

In the present case, Taxpayer holds common stock and options to acquire common stock. Under the option agreements, the option holder has the right to acquire common stock. Taxpayer proposes to transfer stock options granted to him by his employer, to one or more of his children or to a trust for the benefit of one or more of his children. The options must be exercised within a specified term set forth in the option agreement. Until the options are exercised, the holder of the options has no right to receive dividends and no right to vote shares of the corporation. The holder has only the right to purchase an equity interest (i.e., shares of stock). In purchasing the

shares of stock, the holder would then obtain an equity interest in which he would have these rights. The holder of the options, thus, does not hold an equity interest in the corporation and a transfer of the options is not subject to section 2701 of the Code. Therefore, the proposed transfers of the stock options granted under Plan A and Plan B from Taxpayer to one or more of his children, or to a trust for the benefit of one or more of his children will not be subject to section 2701.

In addition, we note that, in this case, the stock options satisfy the requirements of section 2703(b). Therefore, we conclude that the proposed transfers of the stock options granted under Plan A and Plan B from Taxpayer to one or more of his children, or to a trust for the benefit of one or more of his children will not be subject to section 2703.

Section 2033 of the Code provides for the inclusion in the gross estate of any property in which the decedent had an interest at the time of his death.

Section 2035(d) of the Code provides for the inclusion in the gross estate of property transferred within three years of the decedent's death, if the property would have been included under sections 2036, 2037, 2038, or 2042 if the decedent had retained the transferred property until death. Other transfers made within three years of death are not includible in the gross estate. Sections 2036, 2037, and 2038 provide for the inclusion in the gross estate of property of which the decedent has made a transfer and in which the decedent has either retained an interest in the property or a power over the property. Section 2042 provides for the inclusion in the gross estate of the proceeds of life insurance over which the decedent has retained any incidents of ownership.

Section 2041 of the Code provides that the gross estate shall include any property with respect to which the decedent has, at the time of his death, a general power of appointment or with respect to which the decedent has at any time released or exercised such power of appointment by a disposition which, had the property been owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 through 2038, inclusive. A general power of appointment is a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, except where the decedent's power is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent.

In the present case, Taxpayer proposes to transfer portions of options that he received as an employee of Company, to one or more of his children, or to a trust for the benefit of one or more of his children. The portions of the options transferred will be vested and exercisable at the time of the transfer. Because the portions of the options transferred will be vested and exercisable at the time of the transfer, exercise of the

options will not be conditioned on continued future employment of Taxpayer at the time of transfer. The transferees may exercise the portions of the options transferred and purchase the stock at their discretion after the transfer.

After the transfers to the individuals or the trust, Taxpayer will retain no interest or reversion in the portion of the options transferred or the stock upon exercise and has no right to alter, amend, or revoke the transfer of the options or stock. In addition, Taxpayer holds no general power of appointment over the portions of the options transferred or the stock.

Accordingly, we conclude that, after the proposed transfer of the portions of the options by Taxpayer to one or more of his children, or to a trust for the benefit of one or more of his children, neither the options nor the shares obtained upon the exercise of the options will be includible in Taxpayer's gross estate.

Based on the information submitted, we rule as follows:

1. The transfer of the stock options to the transferee will not cause the recognition of taxable income or gain to Taxpayer.

2. If the transferee subsequently exercises the stock options, Taxpayer (or, if Taxpayer is not then living, Taxpayer's estate) will be deemed to receive taxable compensation under section 83 of the Code, and Company will receive a corresponding deduction under section 162 of the Code.

3. If the transferee exercises the stock options, the transferee's basis in the stock so acquired will be its fair market value on the date of exercise which consists of the consideration paid by the transferee and income taxed to Taxpayer (or Taxpayer's estate) under section 83 of the Code.

4. Taxpayer's transfers of his Plan A options and Plan B options to one or more of his children or to a trust for the benefit of one or more of his children will constitute completed gifts on the date of transfer for purposes of section 2511 of the Code, provided that under the terms of the trust, Taxpayer will not retain any power that would render the gift incomplete.

5. The proposed transfers of the stock options granted under Plan A and Plan B from Taxpayer to one or more of his children, or to a trust for the benefit of one or more of his children will not be subject to sections 2701 and 2703 of the Code.

6. After the transfer of the options by Taxpayer to one or more of his children, or to a trust for the benefit of one or more of his children, neither the options nor the

shares obtained upon the exercise of the options will be includible in Taxpayer's gross estate.

No opinion is expressed as to the federal tax consequences of the transaction described above under any other provisions of the Code. Also, no opinion is expressed on the value, for gift tax purposes, of the options at the date of transfer.

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.

Sincerely yours,

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

Enclosure:
Copy for section 6110 purposes