Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact: 199903036

Telephone Number:

Refer Reply to:
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Date: OCT 1 1998

Legend:

Partnership =

Company A =

Company B =

Company C =

This is in reply to your letter of May 22, 1998, in which rulings are requested regarding the federal income tax consequences resulting from the exercise of nonstatutory options ("Options") to acquire Company B stock or Company C stock and stock appreciation rights ("SARs") by employees of Partnership.

The facts submitted are that Company C is the parent company of Company A, Company A owns 62 percent of Partnership, and Company B owns 38 percent of Partnership. Company A and Company C (and their subsidiaries) file a consolidated return and have a taxable year ending on December 31. Company B and its subsidiaries file a consolidated return and have a taxable year ending on September 30.

Certain employees of Company A, Company B, and their corporate subsidiaries have been (or will be) transferred to Partnership ("Partnership Employees"). Partnership Employees previously employed by Company A (or one of its subsidiaries) retained (or will retain) the Options and SARs granted to them under Company C's 1990 Stock Plan. Similarly, Partnership Employees previously employed by Company B (or one of its subsidiaries) retained (or will retain) the Options and SARs granted to them under Company B's 1997 Stock Incentive Plan. It is anticipated that additional Options and SARs will be granted by Company B and Company C to Partnership Employees.

In all cases, the exercise prices of the Options were (or will be) not less than 100 percent of the fair market value of the optioned stock on the date of grant of the Options, and none of the Options had (or will have) a readily ascertainable fair market value when granted. Upon the exercise of SARs, Partnership Employees will receive stock, cash, or a combination thereof.

Under section 83 of the Internal Revenue 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.

However, 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. Instead, section 83(a) applies 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 of the Income Tax Regulations.

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). The deduction is 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. 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.

However, no deduction is allowed under section 83(h) of the Code 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.

Section 451(a) of the Code provides that the amount of any item of gross income is included in gross income for the taxable year in which the taxpayer receives it, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period. Section 1.451-1(a) of the regulations provides, in part, that, under the cash receipts and disbursements method of accounting, amounts are included in gross income when they are actually or constructively received.

Section 1.451-2(a) of the regulations provides that income, although not actually reduced to a taxpayer's possession, is constructively received in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting of the stock on the books of the corporation does not constitute receipt.

Revenue Ruling 80-300, 1980-2 C.B. 165, applies the principle of constructive receipt when it concludes that an employee is not in constructive receipt of the income from stock appreciation rights (SARs) before the employee exercises those rights. Under the facts of Rev. Rul. 80-300, exercise of the SARs would have resulted in the loss of the right to benefit from future appreciation in the employer's stock without risking any capital. Rev. Rul. 80-300 concludes that forfeiture of that valuable right constitutes a substantial limitation on the right to receive the income from the SARs, which precludes constructive receipt of that income. See also Revenue Ruling 82-121, 1982-1 C.B. 79.

Under section 404(a) of the Code, compensation paid or accrued by an employer on account of any employee under a plan deferring the receipt of such compensation is not deductible under Chapter 1 of the Code, but, if it is otherwise deductible, is deductible under the limitations of section 404.

Section 404(a)(5) of the Code provides that payments by an employer to employees under a nonqualified deferred compensation plan are deductible by the employer in the taxable year in which they are includible in the gross incomes of the employees receiving the payments. However, in the case of a plan in which more than one employee participates, deductions are allowed under this section only if separate accounts are maintained for each employee. Section 1.404(a)-12(b)(1) of the regulations clarifies that, to the extent allowable under section 404(a) of the Code, a deduction is allowed for employer contributions under a nonqualified deferred compensation plan only in the taxable year of the employer in which or with which ends an employee's taxable year in which an amount attributable to the contributions is includible in the employee's gross income as compensation.

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 the corporation to an employee of a subsidiary of the 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, and, because section 83 applies to the transfer, does not recognize gain or loss as a result of the transfer.

Generally, no gain or loss is recognized by a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. See section 1032(a) of the Code.

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

(1) The deduction allowable under section 83(h) arising from the transfer of Company B or Company C stock to a Partnership Employee upon the exercise of an Option or a SAR will be allowed to the entity employing the optionee when the Option was granted (or to that entity's successor if the employing entity is no longer in existence).

(2) The deduction allowable under section 404(a)(5) arising from the transfer of cash to a Partnership Employee upon the exercise of a SAR will be allowed to the entity employing the optionee when the SAR was granted (or to that entity's successor if the employing entity is no longer in existence).

(3) No gain or loss is recognized by Company A, Company B, or Company C as the result of the transfer of Company B or Company C stock to a Partnership Employee upon the exercise of an Option or a SAR.

(4) No gain or loss is recognized by Partnership as the result of the transfer of Company B or Company C stock to a Partnership Employee upon the exercise of an Option or a SAR.

Except as specifically ruled above, no opinion is expressed regarding the subject transactions under any provision of the Internal Revenue Code. Additionally, this letter 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,

Robert B. Misner

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

Enclosures: 2
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