

INTERNAL REVENUE SERVICE

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel
(Employee Benefits)

SUBJECT:

This Field Service Advice responds to your memorandum dated August 31, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Employees =

Company A =

Company B =

Company C =

Company D =

Company E =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

\$K =

ISSUE:

Whether, under the rules of I.R.C. § 83, Company D was entitled to deduct the compensation income recognized by Employees when they sold their callable nonstatutory options for Company C shares to Company C.

CONCLUSION:

Under the rules of section 83(h), because Company D was not “the person for whom were performed the services,” it was not entitled to the deduction.

Rather, if the deduction was otherwise allowable under that section, it was allowable only to Company A or Company B.

FACTS:

On Date 1, Employees entered into employment agreements with Company A and Company B and were granted nonvested nonstatutory options to purchase common shares of those companies. The options had no readily ascertainable fair market value when they were granted, and they became fully vested five years thereafter (on Date 2).

Employees remained employees of Companies A and B until Date 3. On that date, Companies C, D, and E acquired all of the shares of Companies A and B and immediately merged Companies A and B into Company E. Company C was the parent corporation of Company D, which was the parent corporation of Company E. On that same day, Employees exchanged their vested Company A and Company B options for vested nonstatutory options to acquire shares of Company C. None of the options for Company C shares had a readily ascertainable fair market value when they were granted. Some of the options for Company C shares were callable by Company C.

Two days after Date 3, Company C exercised its calls and paid Employees \$K for their callable Company C options. For Company D's taxable year ending Date 4 (its taxable year during which Employees' relevant calendar/taxable year ended), it reported a \$K compensation expense deduction attributable to Employees' sale of their callable options to Company C.

DISCUSSION:

Under section 83(a) 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, determined on the first day that the transferee's rights in the property are 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 taxable year which includes that day.

Section 83(e)(3) provides that section 83 does not apply to the transfer of an option without a readily ascertainable fair market value. However, under Treas. Reg. § 1.83-7(a), section 83 does apply to such an option at the time that it is exercised, sold, or otherwise disposed of. If the option is exercised, sections 83(a) and (b) apply to the transfer of property pursuant to the exercise. If the option is sold or otherwise disposed of in an arm's length transaction, sections

83(a) and (b) apply to the transfer of money or other property received in the same manner as they would have applied to the transfer of property pursuant to an exercise of the option.

Under section 83(h), the service recipient is allowed a compensation expense deduction, under section 162 of the Code, for the amount included in the service provider's gross income under section 83(a). Under the general timing 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. Section 1.83-6(a)(3) of the regulations provides an exception to that rule: in cases where the property transferred is substantially vested upon transfer, the deduction is allowed to the service recipient under its normal method of accounting.

However, in no event is a deduction 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 the 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.

In Revenue Ruling 73-146, 1973-1 C.B. 61, a target corporation paid its employees to cancel their outstanding stock options for target shares. The cancellations and payments occurred before the acquiring corporation purchased all of the target's outstanding shares. The question considered was whether the amount paid to cancel the options was a deductible expense arising out of a pre-acquisition compensation obligation, or whether it was an expense that had to be capitalized as a cost of the stock purchase. This Revenue Ruling holds that the amount paid to cancel the options was deductible as a pre-existing obligation.

Thus, as required under section 83(e)(3) of the Code and section 1.83-7 of the regulations, because Employees' options for Company A and Company B shares were not subject to taxation under section 83 when they were granted, sections 83(a) and 83(b) applied to the consideration received by Employees upon their disposition of those options. Consequently, because what Employees received for surrender of their options was (in relevant part) callable nonstatutory options for Company C shares that had no readily ascertainable fair market value when they were granted, the options for Company C shares were also not subject to taxation under section 83 at that time. Accordingly, for their taxable year in which Company C exercised its calls on their options, Employees were required to

recognize compensation income equal to the excess of the amount paid to them by Company C over the amount (if any) paid by them for their Company A, Company B, and Company C options.

Applying the rules of section 83(h) of the Code and section 1.83-6 of the regulations, we conclude that, because Company A and Company B were the only “service recipients” with respect to the options in question, only those Companies were entitled to deduct the amounts includible in Employees’ gross incomes as a result of Company C’s call of the options. Here, because the “property received” by Employees for disposition of their options was the nonforfeitable cash paid by Company C, section 1.83-6(a)(3)’s exception to section 83(h)’s general timing rule for deductions applied. Accordingly, to the extent that the compensation paid was otherwise deductible, Companies A and B were entitled to deduct it using their normal methods of accounting.

Under section 1.83-6(a)(4) of the regulations, the service recipient is denied a deduction to the extent that the transfer of property constitutes a capital expenditure. Here, although the compensation paid by Company C to Employees was a capital expenditure by *that* Company,¹ Company A’s and Company B’s compensation liabilities that were discharged thereby existed prior to the merger. In this regard, Revenue Ruling 73-146 holds that amounts paid to satisfy a corporation’s compensation obligations existing before a reorganization are deductible and need not be capitalized as an expense of the reorganization.

Thus, because we have concluded that the relevant facts of the instant case are not materially distinguishable from the facts in Revenue Ruling 73-146, we have also concluded that application of the rules of section 1.83-6(a)(4) does not result in disallowance of Company A’s and Company B’s deduction of the amounts in question.

¹ Here, Companies C, D, and E determined the price that they were willing to pay for Company A’s and Company B’s shares and Employees’ options on the basis of estimating all of the targets’ items of income and expense at the time of closing of the acquisition. The result was that the amount of cash that the shareholders of Company A and Company B received for their shares was diminished by the amount of *those companies’ liabilities* that were assumed by the purchasing companies. Thus, the shareholders of Companies A and B received less cash for their shares than they would have received if, before the reorganization, either Companies A and B had repurchased Employees’ options or Employees had exercised their options. Viewed in this light, Company E’s payments to Employees were, from the standpoint of Companies C, D, and E, tantamount to stock acquisition costs.

We note here that, although Company D has similarly concluded that it was not a “service recipient” with respect to the options in question, it offers an alternative rationale for its entitlement to the deduction:

When [Company A] and [Company B] liquidated into [Company E] in a Section 332 transaction, [Company E] became their successors under Section 381 and Treasury Regulations Section 1.381(c)(4)-1. As such, [Company E] was properly entitled to take the deduction with respect to the Callable Options.

We are not suggesting that [Company E] is entitled to the deduction due to its being the service recipient of the services with respect to which the Callable Options were issued, but instead, that [Company E] is entitled to the deduction due to its “stepping in the shoes” (by operation of Section 332 liquidation) of each of [Company A] and [Company B] – the entities that were the service recipients with respect to which the Callable Options were issued.

Accordingly, as discussed between representatives of our offices, we have forwarded your request for assistance to the office of the Associate Chief Counsel (Corporate) for their consideration of the efficacy of Company C’s alternative position. In this regard, the materials submitted by your office indicate that the extended statute for this case expires on March 31, 2001, and we have since learned that the Revenue Agent intends to obtain an additional extension from the taxpayer.

If you have any questions about this memorandum, please feel free to call Norm Paul at (202) 622-6030.

ALAN TAWSHUNSKY
Assistant Chief Counsel
By: CHARLES T. DELIEE
Chief, Executive Compensation Branch
Office of the Division Counsel /
Associate Chief Counsel
(Tax Exempt and Government Entities)