

## INTERNAL REVENUE SERVICE

Number: **200207005**  
Release Date: 2/15/2002  
Index No.: 424.01-00

CC:TEGE:EB:EC/PLR-123855-01  
November 1, 2001

### LEGEND:

Company =  
Plan 1 =  
Plan 2 =  
Plan 3 =

This is in reply to a letter dated April 25, 2001, submitted by your authorized representative, in which a ruling is requested that the transaction described below is not a "modification," as defined in section 424(h) of the Internal Revenue Code.

The facts submitted are that Company currently maintains three stock option plans for its employees, Plan 1, Plan 2, and Plan 3 ("the Plans"). Options granted under the Plans may be either "incentive stock options" ("ISOs"), as defined in section 422(b) of the Code, or nonstatutory options. Each of the Plans is administered by the Compensation Committee of the Board ("the Committee"), which is appointed by and responsible to Company's board of directors.

With respect to ISOs granted under the Plans, Section 6.C.(ii) of each of the Plans provides as follows:

#### *Form of Payment*

Payment of the option price for incentive stock options shall be made in cash or in the Common Stock of the Company valued at its fair market value (as the same shall be determined by the Committee), or a combination of such common stock and cash. Where payment of the option price is to be made with Common Stock acquired under a Company compensation plan (within the meaning of Opinion No. 25 of the Accounting Principles Board), such Common Stock will not be accepted as payment unless the optionee has beneficially owned such common stock for at least six months (increased to one year if such Common Stock was acquired under an incentive stock option prior to such payment).

The Committee intends to establish procedures under which Company's employees would use Company's intra-Company Local Area Network (LAN) website to exercise options granted under the Plans. In conjunction with implementing those procedures, the Committee proposes to interpret the above-quoted "*Form of Payment*"

provision to allow employees, when paying the exercise price of an option with *already-owned* Company shares ("Payment Shares"), to make a "constructive exchange" of those shares instead of actually tendering them to Company.

If the optionee's already-owned shares are being held for the optionee by a registered securities broker "in street name," the optionee will send Company an e-mail attesting to the specific number of those shares that are intended to be used as Payment Shares. If certificates for the Payment Shares are actually held by the optionee, he or she will provide those shares' certificate numbers to Company.

Upon receipt of the e-mail attesting to ownership of the Payment Shares, or upon confirmation of ownership of those shares by reference to Company's records, Company will treat the Payment Shares as having been constructively delivered in payment of the option price. Thereafter, Company will issue to the optionee a certificate for "the net number" of shares (*i.e.*, the number of Company shares purchased under the option less the number of Payment Shares).

In pertinent portion, section 421(a) of the Code provides that, if a share of stock is transferred to an individual in a transfer in which the requirements of section 422(a) are met, no income shall result to the individual at the time of the transfer, no deduction under section 162 shall be allowable at any time to the employer corporation with respect to the share transferred, and no amount other than the price paid under the option shall be considered as received by the employer corporation for the share transferred.

Under section 421(b), if the transfer of a share of stock to an individual pursuant to his exercise of an option would otherwise meet the requirements of section 422(a) except that there is a failure to meet the holding period requirements of section 422(a)(1) (there is a "disqualifying disposition"), then any increase in the income of such individual or deduction from the income of his or her employer corporation for the taxable year in which such exercise occurred attributable to such disposition is treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred.

Section 422(a) of the Code provides that section 421(a) will apply to the transfer of a share of stock to an individual pursuant to the exercise of an "incentive stock option" if (1) no disposition of the stock is made by the individual *within two years after the date of grant of the option nor within one year after the transfer of such share to the optionee*, and (2) at all times during the period beginning with the date that the option is granted and ending 3 months before the date of its exercise, the optionee remains an employee of the granting corporation, a parent or subsidiary corporation of such corporation, or a corporation (or parent or subsidiary corporation of such corporation) issuing or assuming a stock option in a transaction to which section 424(a) applies. Section 422(b) defines an "incentive stock option" as an option that meets the requirements set forth in paragraphs (1) through (6) of that section.

Under section 1.421-7(f) of the Income Tax Regulations, for purposes of section 421 through 424, the term "exercise," when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. A promise to pay the option price does not constitute an exercise of the option unless the optionee is subject to personal liability on such promise. An agreement or undertaking by the employee to make payments under an employee stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

Under section 83(a), 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. However, under section 83(e), section 83 does not apply to a transaction to which section 421 of the Code applies. Rather, the rules of section 83 govern the tax consequences resulting from disqualifying dispositions of stock to the extent that section 421 does not apply. See section 1.422A-1(b)(1) of the Proposed Income Tax Regulations.

Section 424(h) of the Code and the regulations thereunder provide the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a statutory option. Under section 1.425-1(e)(2) of the regulations, any modification, extension, or renewal of the terms of an option to purchase stock is considered as the granting of a new option.

The time or date when an option is modified, extended, or renewed is determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option that are provided in section 1.421-7(c). For purposes of sections 421 through 424, the term "modification" means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change which provides more favorable terms for the payment for the stock purchased under the option, is a modification. Where an option is amended solely to increase the number of shares subject to the option, the increase is not considered to be a modification of the option, but is treated as the grant of a new option for the additional shares. See section 1.425-1(e)(5)(i).

Applying the above law to the information submitted, we rule as follows:

(1) An employee's compliance with the Plans' "paperless exercise" procedures and with the Committee's authorized interpretation of the Plans to allow the exercise of options granted under the Plans through a constructive exchange of

Payment Shares will constitute an "exercise" of the option for purposes of sections 421, 422, and 424 of the Code; and

(2) The Committee's authorized interpretation of the Plans, whereby an employee's compliance with the stock-ownership-attestation provisions incorporated into the "paperless exercise" procedure is deemed to constitute a constructive delivery of the Payment Shares in payment of an ISO's exercise price, is not a "modification" of the ISO within the meaning of section 424(h)(1) of the Code.

Except as ruled above, no opinion is expressed regarding the federal tax consequences of the transaction described above under any provision of the Internal Revenue Code. In this regard, please note that we specifically express no opinion regarding (1) the extent (if any) that the "paperless exercise" procedures will result in "disqualifying dispositions" of the Payment Shares or of any other shares; (2) the effects of application of the rules of section 1.422A-2(i) of the regulations; or (3) the effects of application of the rules of section 1.83-6 of the regulations.

Additionally, temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations to the extent that the regulations are inconsistent with any conclusion in this ruling. However, when the criteria set forth in section 12.05 of Revenue Procedure 2001-1, 2001-1 I.R.B. 1, 47, are satisfied, a ruling is not revoked or modified retroactively, except in rare and unusual circumstances.

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 Company's federal income tax return for the year in which the above rulings are granted. A copy is enclosed for that purpose.

Sincerely yours,  
ROBERT B. MISNER  
Acting Chief, Executive Compensation Branch  
Office of the Division Counsel /  
Associate Chief Counsel  
(Tax Exempt and Government Entities)