

**Internal Revenue Service**

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Washington, DC 20224

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Date:  
December 23, 2003

Taxpayer  
Subsidiary =  
Date a =  
Date b =

Dear \_\_\_\_\_ :

This letter is in response to a request for a ruling submitted on behalf of the Taxpayer. The request asks for a determination concerning whether a swap of compensatory warrants for compensatory options in a merger is taxable under section 83 of the Internal Revenue Code.

In 2001, the Taxpayer and Subsidiary entered into a merger agreement whereby Taxpayer acquired a controlling interest in Subsidiary. As part of this agreement, shareholders of Subsidiary could either exchange their stock in Subsidiary for securities in Taxpayer, or retain their shares in Subsidiary and receive warrants to acquire stock in Subsidiary. Also, under the agreement, holders of non-qualified stock options that had been granted under Subsidiary's employee stock option plan were to be granted warrants to acquire subsidiary stock if the option holder was still employed by Subsidiary on the date the warrants were issued.

These Subsidiary Warrants were issued on date a, subject to a Warrant Agreement. This agreement provided, among other things, that in the event of a subsequent merger, warrant holders were to receive substituted warrants from the acquirer, with terms that would be substantially similar to the original warrants issued by Subsidiary. At the time they were granted, the Warrants were not tradable on any exchange; however, they later became publicly traded.

On date b, Subsidiary and the Taxpayer entered into a merger agreement under which Taxpayer will acquire all of the outstanding Subsidiary stock. The merger was structured as a reorganization under section 368(a) of the Code. Each warrant for the stock in Subsidiary will be swapped for warrants for stock of the Taxpayer. With regard

to warrants that were non-compensatory, Taxpayer intends that this exchange will be tax-free under sections 354 and 356. Warrants received by employees pursuant to the merger agreement remained non-transferable for 90 days after the date of issuance.

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 which by their 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 performing 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.

Section 83(e) provides that section 83 will not apply to the transfer of an option without a readily ascertainable fair market value. Section 1.83-7T of the Income Tax Regulations provides that if there is granted to an employee (or beneficiary thereof) in connection with the performance of services, an option to which section 421 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.

Options are considered to have a readily ascertainable fair market value if they are actively traded on an established market. When an option is not actively traded on an established market, it does not have a readily ascertainable fair market value unless its fair market value can otherwise be measured with reasonable accuracy. An option is not considered to have a readily ascertainable fair market value unless the taxpayer can show that all the conditions listed in section 1.83-7(b)(2) exist.

If section 83(a) does not apply at the time an option is granted because the option does not have a readily ascertainable fair market value, then section 83(a) will not apply until the option is exercised or otherwise disposed of, even if the fair market value of the option becomes readily ascertainable before then. If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise. If the options are sold or otherwise disposed of in an arms length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to an exercise of the option. Section 1.83-7T(a)(1).

When the Subsidiary Warrants were granted they did not have a readily ascertainable fair market value and were thus not subject to section 83 of the Code at that time. According to section 1.83-7T(a), when an option at the grant date is not subject to section 83 because it lacks a readily ascertainable fair market value, section 83 applies

when the option is either exercised or sold or disposed of in an arms length transaction. The regulations concerning options do not provide a rule to be applied in situations wherein an option that did not have a readily ascertainable fair market value at grant is exchanged for an option that also lacks such a readily ascertainable fair market value. Compare, however, section 1.83-1(b) concerning the subsequent sale, forfeiture, or other disposition of non-vested property. There, in paragraph (3), it is provided that “no gain shall be recognized on any sale, forfeiture, or other disposition . . . to the extent that any property received in exchange therefore is substantially non-vested. Instead, section 83 and this section shall apply with respect to such property received (as if it were substituted for the property disposed of).” We see no reason why this same principle should not be applied to the exchange of options that are not subject to section 83 on the grant date.

Accordingly, provided that facts are as set out above, we rule as follows:

The Taxpayer Warrants received by the warrant holders upon the exchange of the Subsidiary Warrants for the Taxpayer Warrants will not be subject to section 83 on the exchange date. Section 83 will apply at the time those Taxpayer Warrants are exercised or otherwise disposed of in an arm’s length transaction.

Except as specifically ruled on above, no opinion is expressed or implied concerning the tax consequences of any item of any transaction or item discussed above.

This ruling is provided only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be cited as precedent. In accordance with the power of attorney on file, a copy of this letter is being sent to your authorized representative. The taxpayer should attach a copy of this ruling to any income tax return to which it is relevant.

Sincerely,

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Robert B. Misner  
Senior Technician Reviewer  
Executive Compensation Branch  
Office of the Division Counsel/Associate  
Chief Counsel (Tax Exempt and  
Government Entities)