

DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224

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Number: **199941033** July 19, 1999

Release Date: 10/15/1999

UILC: 83.11-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel

(Employee Benefits and Exempt Organizations)

SUBJECT:

This Field Service Advice responds to your memorandum dated April 13, 1999. 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:

Company =

Company P =

Program =

Date 1 =

Date 2 =

ISSUE:

Whether, under the rules of I.R.C. § 83, Company was required to recognize gain as a result of the grant of nonstatutory options for Company P shares to Company's employees and employees of Company's subsidiaries and affiliates.

CONCLUSION:

Company was not required to recognize gain as a result of either the grant or the exercise of the options. See Revenue Ruling 80-76, 1980-1 C.B. 15.

FACTS:

Company is a domestic subsidiary of Company P (its foreign parent). Under the Program, employees of Company, its subsidiaries, and its affiliates were granted nonstatutory options for Company P common stock. None of the options had readily ascertainable fair market values when they were granted. Employees who exercised options paid the exercise prices directly to Company P, which then transferred its shares directly to the employees.

During Company's taxable years ending on Date 1 and Date 2, employees of Company and of Company A (one of Company's affiliates) exercised options. Upon an audit of Company, Company claimed compensation expense deductions equal to the excesses of the fair market values of Company P stock on the dates of exercise over the amounts that the employees paid for the stock. IRS Examination then concluded that Company was required to recognize gain on the transactions under either one of two alternative positions: (1) Company was required to recognize gain equal to the fair market value of the stock transferred upon exercise of the options; or (2) Company was required to recognize gain equal to the sum of: (a) the amount that the employees paid for the stock less Company's adjusted basis in the stock (\$-0-) plus (b) the amount of the compensation expense deductions. Appeals agrees with Exam's second alternative.

LAW AND ANALYSIS:

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, on the first day that the rights to the property are transferable or not subject to a substantial risk of forfeiture ("substantially vested"), over the amount paid for the property is included in the service provider's gross income for the taxable year that includes that day.

For purposes of section 83, a "transfer" of property occurs when a person acquires a beneficial ownership interest in the property (disregarding any "lapse restriction," as defined in Treas Reg. § 1.83-3(i)). See section 1.83-3(a)(1). Property is substantially vested when it is either not subject to a substantial risk of forfeiture or is transferrable. See section 1.83-3(b).

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, 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, 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(a).

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

Under section 1.83-6(d)(1) of the regulations, if a shareholder of a corporation transfers property to an employee (or independent contractor) of the corporation in consideration for services performed by the employee for the corporation, the transaction is considered a contribution of the property by the shareholder to the corporation and, immediately thereafter, a transfer of the property by the corporation to the employee. The transfer of property to the employee is considered to be in consideration for services performed by the employee for the corporation if either the property is substantially nonvested at the time of transfer or if an amount is includible in the gross income of the employee at the time of transfer under the rules of section 83 of the Code. In the case of such a transfer, any money or other property paid to the shareholder for the contribution is considered to be paid to the corporation and transferred immediately thereafter by the corporation to the shareholder as a distribution to which section 302 of the Code applies.

Section 1.83-6(b) of the regulations provides that, except as provided in section 1032 of the Code, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property. In addition, at the time that a deduction is allowed under sections 83(h) of the Code and 1.83-6(a) of the regulations, gain or loss is recognized to the extent of the difference between (i) the sum of the amount paid plus the amount allowed as a deduction under section 83(h), and (ii) the sum of the taxpayer's basis in the property plus any amount recognized pursuant to the previous sentence.

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 and, "because section 83 applies," does not recognize gain or loss as a result of the transfer.

We note here that section 1.83-6(d) of the proposed income tax regulations contained language dealing with the transaction that is addressed in Revenue Ruling 80-76. Specifically, in order to fulfill section 83's statutory mandates¹ when zero-basis stock of a member of the employer's corporate family is the compensation in question, proposed section 1.83-6(d) would have applied a "cash-purchase model" when analyzing such transactions:²

Where a corporation transfers its stock to a person who has performed services for a subsidiary of such corporation, the transaction shall be considered - (1) A contribution of money by the corporation to its subsidiary's capital, (2) A purchase of the stock by the subsidiary from the corporation for its full value, and (3) A transfer of the stock by the subsidiary to its employee.

Mindful of a pending study of the problem just described and other "zero-basis stock" issues, the drafters decided to delete the referenced sentence when enacting the final regulations in 1978. It soon became apparent, however, that taxpayers would need interim guidance with regard to zero-basis stock compensation arrangements involving members of corporate families. So, for the interim, Revenue Ruling 80-76 was published using broad language ("because section 83 applies") as its rationale for shielding the subsidiary-employer from gain.

Recently, proposed regulations were issued, intending to amend section 1.83-6(d) and the regulations issued under section1032, which specifically address the transaction described in Revenue Ruling 80-76. See 63 Fed. Reg. 50816 (1998) and 1998-41 I.R.B. 10. When analyzing such transactions, these proposed regulations would apply the same cash-purchase model that appeared in proposed regulation section 1.83-6(d). Additionally, the preamble to the recently proposed

I.e., that the service providers recognize compensation income under section 83(a), and that the service recipients be allowed compensation expense deductions under the rules of section 83(h).

Prior to the enactment of section 83, it was the Service's position that, when a parent transferred its stock in connection with its subsidiary's employees' performance of services, neither the parent nor the subsidiary was entitled to a compensation expense deduction; the parent because it was not its expense, and the subsidiary because it did not pay the expense. See Revenue Ruling 69-369, 1969-2 C.B. 27.

regulations indicates that, when they are published in final form, it is intended that Revenue Ruling 80-76 will be revoked.

However, until Revenue Ruling 80-76 is revoked, it remains the Service's position on the issue in question. In this regard, we note that, when reaching its conclusions, the revenue ruling makes no distinction between the gain recognizable under the first sentence of section 1.83-6(b) and the gain or loss recognizable under the second sentence of that regulation.

If you have any questions about this memorandum, please call (202) 622-6060.

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