Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

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Refer Reply To:
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Date:
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Parent =

Subsidiary A =

Subsidiary B =

Option Plan A =

Option Plan B =

x =

y =

Date 1 =

Date 2 =

z =

Subsidiary B Option Plan =

This is in response to your letter of February 19, 1999, requesting rulings under section 83 of the Internal Revenue Code. The facts as represented are set forth below.

On Date 1, Parent transferred its ownership interest in various entities as well as certain other assets to Subsidiary A, its newly created wholly owned subsidiary. Parent then distributed the stock of Subsidiary A to its shareholder in a transaction qualifying as tax-free under section 355 of the Internal Revenue Code ("Spin-Off"). Immediately following the Spin-Off, Parent merged into Subsidiary B, its wholly owned subsidiary, with Subsidiary B as the surviving entity. The tax consequences of the Spin-Off were addressed in a prior ruling.

Prior to the Spin-Off, Parent employees held statutory and nonstatutory stock options to purchase shares of Parent stock, none of which had readily ascertainable fair market values when they were granted. These options were under Option Plan A and Option Plan B (collectively "Option Plans"). The Option Plans provided for the equitable adjustment of previously granted options in the event of a reorganization or similar event. Accordingly, as part of the Spin-Off, the Parent Options were canceled and each Parent Option holder received in exchange Substituted Subsidiary B Options and Substituted Subsidiary A Options (collectively "Substituted Options").

Parent Options holders received options to acquire the number of shares of Subsidiary B common stock and Subsidiary A common stock that they would have received if they had exercised all of their Parent Options immediately prior to the effective date of the Spin-Off and participated in the reorganization on the same basis as the other Parent shareholders. Thus, for each share of Parent common stock covered by an unexercised Parent Option, Parent employees received a Substituted Subsidiary B Option to purchase x shares of Subsidiary B common stock and a Substituted Subsidiary A Option to purchase y shares of Subsidiary A stock.

Employees of Subsidiary A who exercise their Substituted Subsidiary B Options pay the exercise price directly to Subsidiary B, which transfers its shares directly to the exercising Subsidiary A employees. Subsidiary B notifies Subsidiary A of such exercise and Subsidiary A withholds and deposits all applicable taxes due upon the exercise of a Substituted Subsidiary B option by Subsidiary A employees. Subsidiary A also provides its employees with Forms W-2 reporting the compensation income recognized by the employees as a result of the exercise of the Substituted Subsidiary B Options. Employees of Subsidiary B exercise their substituted Subsidiary A Options in a similar fashion, paying the exercise price directly to Subsidiary A and receiving a Form W-2 relating to the exercise from their employer, Subsidiary B.

On Date 2, prior to the Spin-Off described above, approximately z employees of Parent ("Service Providers") received options for Subsidiary B stock issued under the Subsidiary B Option Plan (Subsidiary B Options). The Subsidiary B Options were issued to the Service Providers in exchange for services provided to Subsidiary B. At the time a Service Provider exercises a Subsidiary B Option, Subsidiary B will provide a Form 1099 to the option holder showing the income recognized due to the exercise of the Subsidiary B Option.

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 other than a restriction which by its 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 who performed 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.

Under section 83(e)(3) of the Code, section 83 does not apply to the transfer of an option without a readily ascertainable fair market value.

Section 1.83-7(a) of the regulations provides, in part, that if there is granted to an employee (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) 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. If section 83(a) does not apply to the grant of the option because it does not have a readily ascertainable fair market value at the time of the grant, section 83(a) will apply at the time the option is exercised or otherwise disposed of, even though the fair market value of the option may have become readily ascertainable before such time. If the option is exercised, section 83(a) applies to the transfer of property pursuant to the exercise, and the employee recognizes compensation upon the transfer at the time and in the amount determined under section 83(a). 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 section 83 would apply to the transfer of property pursuant to the exercise of an option. See section 1.83-7(b) of the regulations for the test to be applied in determining whether an option has a readily ascertainable fair market value.

Pursuant to section 83(h) of the Code, the person for whom the services were performed is allowed as a deduction under section 162 an amount equal to the amount included under section 83 in gross income of the person who performed the services. The deduction is allowed for the taxable year of the person for whom the services were performed in which or with which ends the taxable year the service provider includes the amount in gross income. Section 1.83-6(a)(3) of the regulations provides an exception to the rule of section 83(h) concerning the taxable year the service recipient is allowed the deduction. Under section 1.83-6(a)(3) of the regulations, if the property is substantially vested upon transfer, the deduction will be allowed in accordance with the service recipient's method of accounting. In cases where an entity receiving services is divided after the grant of an option, section 83 does not provide guidance concerning which entity is the service recipient. Upon such an occurrence, the deduction may be claimed by the corporations under a system that clearly reflects income. See section 482 of the Code. In those cases, the determination of how the section 83(h) deduction should be claimed by the post-division entities is a question of fact. Section 4.02(1) of Rev. Proc. 2000-3, 2000-1 I.R.B. 103, 111, provides that the Service will ordinarily not issue ruling letters on any matter in which the determination requested is primarily one of fact.

Accordingly, based on the information submitted and the representations set forth above, we rule as follows:

1) Subsidiary A will not recognize gain or loss upon a Subsidiary A employee's exercise of a Substituted Subsidiary A Option or a Substituted Subsidiary B Option. Subsidiary B will not recognize gain or loss upon a Subsidiary B employee's exercise of a Substituted Subsidiary A Option or a Substituted Subsidiary B Option.

2) Amounts includible in the gross income of a Service Provider upon the exercise of a Subsidiary B Option will be deductible by Subsidiary B, provided the deduction meets the requirements of section 162.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of the transaction described above under any provision of the Internal Revenue Code. Specifically, no opinion is expressed as to which entity may deduct amounts includible in the gross income of a Substituted Option holder upon the exercise of a Substituted Option because the question of whether the deduction is taken under a method that clearly reflects income is a question of fact.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any federal income tax return to which it is relevant.

In accordance with the power of attorney on file in this office, a copy of this letter is bring sent to your authorized representative.

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