INTERNAL REVENUE SERVICE

October 22, 2001

Number: **200206003**
Release Date: 2/8/2002
CC:TEGE:EB:EC
WTA-N-139438-01
UILC: 83.08-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel
(Tax-Exempt and Government Entities) CC:TEGE:EB:EC

SUBJECT:

This Field Service Advice responds to your memorandum dated July 17, 2001. 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 A =

Company B =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Year =

ISSUE:

Whether, under the rules of I.R.C. § 83, Company A was entitled to deduct the compensation expenses arising from its officers' filing of section 83(b) elections for their Company B shares.

CONCLUSION:

Under the rules of section 83(h), because the shares for which the section 83(b) elections were filed were “substantially nonvested” when they were transferred to the officers, Treas. Reg. § 1.83-6(a)(3)’s exception from section 83(h)’s general rule for the timing of deductions was not available. Accordingly, the deductions were properly deductible by Company B for its taxable year in which or with which ended the officers’ taxable year in which the corresponding amounts were included in their gross incomes.

FACTS:

The facts submitted are that, prior to the merger in question, certain officers of Company A held nonstatutory options for Company A stock that were granted under its 1989 stock option plan (“the 1989 Plan”). None of the options had a “readily ascertainable fair market value” when they were granted.[1]

Under the 1989 Plan (unless the Compensation Committee of Company A’s Board of Directors determined otherwise), upon a change in control of Company A, all of an employee’s outstanding options would become immediately exercisable and would be canceled and exchanged for a payment of cash equal to the excess of the “change in control price” over the exercise price of the options (“the cash-out provision”). However, during preparation for the merger, it was determined that this cash-out provision violated the financial accounting “pooling of interest” provisions. Accordingly, prior to the merger, the Compensation Committee agreed to amend the cash-out provision, with the effect that the option holders would thereafter be entitled to receive Company B stock (rather than cash) in exchange for their options, using the same stock-exchange ratio that was to be used for Company A’s shareholders under the plan of merger. This amendment was made subject to the Board’s approval of the merger.

On Date 1, Company A and Company B entered into an Agreement and Plan of Merger (“the Agreement”). On Date 2, Company A’s shareholders approved the merger, and its Closing Date was Date 3. For federal tax purposes, the merger was treated as a nontaxable reorganization described in I.R.C. § 368(a)(1)(A). For accounting purposes, the merger was accounted for using the “pooling of interests accounting” method.

---

[1] Options granted under the 1989 Plan could not be sold or transferred other than by will or the laws of descent and distribution.

In accordance with the Agreement, each outstanding option[2] for Company A shares was converted into a right to receive Company B common shares. In this regard, Section 5.6 of the Agreement provided that the Company A options would be converted into a right to receive Company B shares *after* receipt of Company A's shareholders' approval of the merger *but prior* to its Effective Time (the Closing Date of the merger). Section 2.1 of the Agreement provided (in effect) that, upon "shareholder approval," a change of control would be considered to have occurred for purposes of the options.

Under the Agreement, the formula for conversion of the Company A options into Company B shares ("the Adjusted Fair Value") was percent of *the excess of* (i) the closing price of Company B shares on the date on which Company A shareholder approval was obtained ("the Closing Value"), multiplied by (ii) the exchange ratio (shares of Company B stock for each share of Company A stock) *over* (iii) the exercise price per share of the option. The number of Company B shares issuable to each option holder equaled the option holder's Adjusted Fair Value divided by the Closing Value, and the value of that number of shares was included in his or her Form W-2 for Year.

The prospectus for the plan of merger indicated that the Company B shares to be issued to Company A's shareholders was registered under the Securities Act. In this regard, the Explanation of Items accompanying the Notice of Proposed Adjustment ("NPA") states that the Company B shares could be traded freely and without restrictions by those shareholders not deemed to be "affiliates" of Company A or Company B, as that term is defined in the Securities Act; that, under that definition, an "affiliate" for purposes of the subject merger would have been a person who, directly or indirectly, controlled Company A or Company B; that, under applicable securities law, a post-merger transfer by an affiliate of Company A would have had to have complied with the resale provisions of Rule 145 under the Securities Act (or Rule 144 in the case of persons becoming affiliates of Company B); and that, at the time of the merger, the Companies expected that those rules would apply to their directors and executive officers.[3]

---

[2] The outstanding options included options that were granted in May of 1997 under a separate "employee stock purchase plan" that was maintained by Company A.

[3] Please note that this office is relying on the NPA's conclusions regarding the meaning and applicability of "pooling of interest" and Securities Act provisions, and we suggest that, if you have any doubt as to accuracy of those conclusions, you should verify them with a securities law expert.

The NPA also states that SEC guidelines regarding qualification for the pooling of interests method of accounting would have limited sales of Company B shares by affiliates of either company. It states that those guidelines indicate that the pooling of interests method of accounting will generally not be challenged on the basis of sales by such affiliates *if* they do not dispose of any of the shares of the corporation that they receive in connection with the merger during the period *beginning* 30 days prior to the merger *and ending* when financial results covering at least 30 days of post-merger operations of the combined entity have been published ("the pooling restriction period").

On the day prior to the Closing Date, most of Company A's officers who were considered "affiliates" under the Securities Act filed section 83(b) elections for the Company B shares that they were going to receive on the Closing Date. Each election indicated that the Company B shares were transferred to the officer on Date 2 (the date that Company A's shareholders approved the merger), and that the shares' value was determined as of that date.

On the Closing Date (Date 3), all of Company A's officers surrendered their options for Company A shares and, in exchange therefor, were transferred Company B shares. The NPA states that the Company B shares for which the elections were filed became substantially-vested in the officers on Date 4.

Company A deducted the amounts reported on the officers' elections on its return filed for its Year short taxable year (January 1 through March 28). The total deduction claimed was in excess of million, of which in excess of million was attributable to the officers who were considered to be "affiliates."[4] In its response to Information Request Number 50, Company A states that a deduction was not claimed with respect to the options exchanged by members of Company A's board of directors and two of its officers, because they did not make section 83(b) elections. Rather, the compensation expense deductions attributable to their options were claimed on Company B's consolidated return for Year.

Examination proposes to disallow the deductions claimed in Company A's final (short-period) return and proposes to allow them to Company B for Year. The applicable income tax rate for Company A was 35 percent, and the rate for Company B was the 20-percent AMT rate.

Company A acknowledges that, for its officers who were considered to be "affiliates," the pooling of interests accounting method imposed a substantial risk of forfeiture on the Company B stock that they were transferred. However, it is Company A's position that, as a result of the officers' filings of section 83(b)

[4] This included the compensation expenses attributable to options granted in 1997 under Company A's employee stock purchase plan.

elections, it is allowed the deductions under the timing rule of section 1.83-6(a)(3) of the regulations. As a result, Company A concludes that the deductions were allowable for its short-period taxable year, because, on the date that the shares were transferred to the officers, the “all events” and “economic performance” tests had already been met, and the amounts of the liabilities were reasonably estimable.

LAW AND ANALYSIS:

Nonstatutory options are taxable, and the compensation attributable to such options is deductible, under the rules of section 83. 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 (disregarding any lapse restriction), determined on the first day that the transferee's rights in the property are transferable or 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(a). More simply put, property is not taxable under section 83 until it is “transferred” to and “substantially vested” in the service provider (or beneficiary thereof).

A "transfer" of property occurs when a person acquires a beneficial ownership interest in the property (disregarding any "lapse restriction"). Treas. Reg. § 1.83-3(a)(1). The term "lapse restriction" means a restriction other than a “nonlapse restriction” and includes (but is not limited to) a restriction that carries a substantial risk of forfeiture. See Treas. Reg. § 1.83-3(i).

For purposes of section 83, property is “substantially vested” when it is either not subject to “a substantial risk of forfeiture” or is “transferable,” as defined in Treas. Reg. §§ 1.83-3(c) and (d), respectively. Property is "substantially nonvested" when it is both subject to a substantial risk of forfeiture and not transferable. See Treas. Reg. § 1.83-3(b). Until section 83 property becomes substantially vested, the transferor of the property is considered to be the owner of the property, and any income from the property received by the service provider (or beneficiary thereof) constitutes additional compensation to the service provider for the taxable year in which it is received. See Treas. Reg. § 1.83-1(a)(1).

Under Treas. Reg. § 1.83-3(k), section 83 property is considered “substantially nonvested” while it remains subject to a restriction on transfer to comply with the “Pooling of Interests Accounting” rules set forth in Accounting Series Release Numbered 130 (10/5/72) and Accounting Series Release Numbered 135 (1/18/73).

Section 83(b) and Treas. Reg. § 1.83-2(a) provide that, if property is transferred in connection with the performance of services, the service provider may elect to include in gross income the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in section 1.83-3(i)) over the amount (if any) paid for the property, as compensation for services. If this election is made, the substantial-vesting rules of section 83(a) and the regulations thereunder do not apply to the property, and (with an exception not applicable here) any subsequent appreciation in the value of the property is not taxable as compensation to the service provider. Thus, the value of property with respect to which a section 83(b) election is made is includible in gross income as of the date that the property is transferred, even though the property is substantially nonvested when transferred, and no compensation is includible in gross income when the property becomes substantially vested.

I.R.C. § 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, 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. See Treas. Reg. § 1.83-7(a).

Under section 83(h) and Treas. Reg. § 1.83-6(a)(1), the service recipient is allowed a compensation expense deduction, under I.R.C. § 162, equal to the amount included in the service provider's gross income under section 83(a). Under the “general 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. However, Treas. Reg. § 1.83-6(a)(3) 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 (in conformance with I.R.C. §§ 446 and 461).

For purposes of section 1.83-6(a)(1), the service provider is *deemed* to have included the amount as compensation in gross income if the service recipient satisfies in a timely manner all of the information reporting requirements of I.R.C. § 6041 or § 6041A (and the regulations thereunder) with respect to that amount of compensation. Whether the service provider satisfies all of the requirements of those sections is determined without regard to Treas. Reg. § 1.6041-3(c) (exceptions for payments to corporations). See Treas. Reg. § 1.83-6(a)(2).

Treas. Reg. § 1.83-6(a)(4) provides that *no* deduction is 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 property to which the capital expenditure relates is increased at the same time and to the same extent as any amount includible in the employee’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 the promoter must include the value of the stock in gross income under the rules of section 83.

In Revenue Ruling 73-146,1973-1 C.B. 61, a target corporation paid its employees to cancel their outstanding 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 was required 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. In this regard, 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 the deductibility of the amounts in question.

Applying the above rules, we conclude that, because, under the rules of section 1.83-3(k), the Company B shares transferred to Company A's officers were *not* substantially vested upon transfer, the *exception* from section 83(h)’s general timing rule for deductions that is found in section 1.83-6(a)(3) did not apply in this case. Accordingly, we resultantly conclude that the compensation expenses attributable to those transfers (if otherwise deductible under section 83(h) and the regulations thereunder) were deductible only for Company A’s taxable year in which or with which ended the officers’ taxable year in which the corresponding amounts were included in their gross incomes. In this regard, we note that the fact that section 83(b) elections were filed with respect to the Company B shares did not change the fact that the officers’ rights in those shares were substantially nonvested upon transfer or that they remained so thereafter. In support of this conclusion is the fact that a section 83(b) election may *only* be filed for “substantially-nonvested” property, and the fact that section 1.83-2(a) contains rules governing the tax consequences of the forfeiture “while substantially nonvested” of property for which a section 83(b) election has been filed.

In the case of a merger described in I.R.C. § 368(a)(1)(A), I.R.C. § 381(a)(2) provides that the acquiring corporation succeeds to and takes into account, as of the close of the day of transfer, the items of the transferor corporation described in I.R.C. § 381(c). In this case, Company B is the acquiring corporation, and Company A is the transferor corporation. The item described in section 381(c) that is at issue here is the treatment, under section 381(c)(4), of the compensation expense deductions arising from the filing of the section 83(b) elections.

In pertinent part, section 381(c)(4) and Treas. Reg. § 1.381(c)(4)-1(a)(1) provide that, in a transaction to which section 381(a) applies, the acquiring corporation shall use the same method of accounting used by the transferor corporation on the date of transfer unless different methods of accounting were used on that date by the two corporations. If different methods of accounting were used, the acquiring corporation takes into account the dollar balances of those accounts of the transferor corporation representing items of income or deduction which, because of its method of accounting, were not required or permitted to be included or deducted by the transferor in computing taxable income for taxable years ending on or before the date of transfer.

Section 461(a) provides that the amount of any deduction or credit is taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 461(h) and Treas. Reg. § 1.461-1(a)(2)(i) provide that, under the accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability. Section 461(h)(2)(A)(i) provides that, if the liability of the taxpayer arises out of the providing of services to the taxpayer by another person, economic performance occurs as that person provides the services.

In this case, although the compensation expenses in question were incurred (and, therefore, properly accruable) by Company A just prior to the merger (as a result of the filing of the elections), this does not change the fact that, when section 83(h)'s "general rule" for the timing of deductions applies, it does so *regardless* of the accounting method used by the service recipient (or successor thereto) who may be entitled to the deduction. Accordingly, we resultantly conclude that the compensation expenses attributable to the filing of those elections (if otherwise deductible under section 83(h) and the regulations thereunder) were deductible only for Company B's taxable year in which or with which ended the officers' taxable year in which the corresponding amounts were included in their gross incomes.

<u>CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS</u>:

[redacted]

[redacted]

If you have any questions about this memorandum, please feel free to call [redacted] (202) 622-6030.

ALAN TAWSHUNSKY
Assistant Chief Counsel
By: ROBERT B. MISNER
Acting Chief,
Executive Compensation Branch
Office of the Division Counsel /
Associate Chief Counsel
(Tax-Exempt and Government Entities)