

Part I

Section 83.—Property Transferred in Connection with the Performance of Services

26 CFR 1.83-6: Deduction by Employer

Rev. Rul. 2003-98

ISSUE

Under § 83 of the Internal Revenue Code, in the situations described below, which corporation is entitled to deduct the compensation income includible in Employee's gross income as a result of Employee's exercise or disposition of a nonstatutory option?

FACTS

Situation 1. On January 1, 2003, Employee begins employment with Company M and is granted a nonstatutory option to purchase a number of shares of M common stock ("the M Option"). The M Option has no readily ascertainable fair market value when it is granted and is not exercisable until January 1, 2006.

On November 15, 2006, Company N acquires all of the outstanding shares of M for cash. N does not make an election under § 338(g) to treat its acquisition of M as a deemed acquisition of the assets of M, thus treating it instead as an acquisition of the stock of M. Thereafter, M conducts its business as a wholly owned subsidiary of N. Each of M and N is an accrual basis taxpayer with a taxable year ending on September 30.

On the acquisition date, either pursuant to the terms of the M Option or in response to an offer from N, Employee surrenders the M Option to N, and, in exchange, N grants an exercisable nonstatutory option to acquire a number of shares of N common stock ("the N Option") to Employee. The N Option has no readily ascertainable fair market value. On January 15, 2007, while still employed by M, Employee exercises the N Option and receives substantially vested N shares from N.

Situation 2. The facts are the same as in Situation 1, except that, under the terms of the N Option, N has the ability to cancel the option at any time in exchange for a payment in cash or in value-equivalent substantially vested N shares. On January 15, 2007, N cancels the N Option in exchange for a payment (in cash or shares) to Employee.

Situation 3. The facts are the same as in Situation 1, except that the M Option is not exchanged for the N Option on the acquisition date. Instead, the M Option remains

outstanding after the acquisition date until January 15, 2007, when either pursuant to the terms of the M Option or with Employee's agreement, N cancels the M Option and pays the excess of the fair market value of the stock purchasable under the option over the option's exercise price in cash or in value-equivalent substantially vested N shares to Employee.

Situation 4. The facts are the same as in Situation 1, except that on November 15, 2006, M and N merge under State law, with N as the surviving corporation. The merger qualifies as a complete liquidation within the meaning of § 332.

LAW AND ANALYSIS

Under § 83(a), when property is transferred to any person in connection with the performance of services, the service provider must include in gross income (as compensation income) the excess of the fair market value of the property, determined at the first time that the transferee's rights in the property are either transferrable or not subject to a substantial risk of forfeiture ("substantially vested"), over the amount (if any) paid for the property.

Section 83(e)(3) provides that § 83 does not apply to the transfer of an option without a readily ascertainable fair market value on the date of grant. Under § 1.83-7 of the Income Tax Regulations, § 83 applies at the time such an option is exercised, or otherwise disposed of. If the option is exercised, § 83(a) applies to the transfer of property pursuant to the exercise. Under § 1.83-7(a), if the option is sold or otherwise disposed of in an arm's length transaction, §§ 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as §§ 83(a) and 83(b) would have applied to the transfer of property pursuant to an exercise of the option. Under § 1.83-7T, the preceding sentence does not apply to a sale or other disposition of the option to a person related to the service provider that occurs on or after July 2, 2003. For this purpose, a person is not related to the service provider if the person is the service recipient with respect to the option or the grantor of the option.

Thus, in each of the above Situations, because the M Option has no readily ascertainable fair market value when granted, § 83 does not apply to the option at that time. Rather, § 83(a) applies to the consideration received by Employee upon the exercise or disposition of the M Option in the case of Situation 3 and the N Option in the case of Situations 1, 2, and 4.

Under § 83(h) and § 1.83-6(a)(1), the service recipient is allowed a compensation expense deduction, under § 162, for the amount included in the service provider's gross income under § 83(a). Under the general timing rule of § 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. Section 1.83-6(a)(3) provides an exception to that rule: in cases where the property transferred is substantially vested upon transfer, the deduction is allowed to the service recipient under its method of accounting.

Section 1.83-6(d)(1) generally provides that, 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 § 83. See § 1.1032-3 for special rules that may apply to a corporation's transfer of its own stock to any person in consideration of services performed for another corporation or partnership.

Section 332(a) provides that no gain or loss is recognized on the receipt by a corporation (the acquiring corporation) of property distributed in complete liquidation of another corporation (the liquidating corporation).

Section 381(a)(1) provides, in part, that, where the assets of a liquidating corporation are distributed to the acquiring corporation in a transaction to which § 332 applies, the acquiring corporation succeeds to and takes into account, as of the close of the day of distribution, the items described in § 381(c) of the liquidating corporation, subject to the conditions and limitations described in §§ 381(b) and (c).

In a transaction to which § 381(a) applies, § 381(c)(16) permits the acquiring corporation to deduct an assumed obligation of the liquidating corporation, as if it were the liquidating corporation, when that obligation is paid or accrued (1) if such obligation gives rise to a liability after the date of distribution and (2) if the liquidating corporation would have been entitled to deduct that liability in computing taxable income were that liability paid or accrued by the liquidating corporation. See § 1.381(c)(16)-1(a)(1).

Section 1.381(c)(16)-1(a)(4) provides that an obligation of a liquidating corporation gives rise to a liability when the liability would be accruable by a taxpayer using the accrual method of accounting, notwithstanding the fact that the liquidating corporation is not using the accrual method of accounting. See § 1.461-1(a)(2).

Section 1.461-1(a)(2)(i) provides that, under an accrual method of accounting, a liability is incurred, and generally is 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. A liability with respect to an option generally is incurred and taken into account in the year in which the employee exercises the option because that is when the liability becomes fixed and determinable with reasonable accuracy. Therefore, for purposes of § 381(c)(16), a option generally gives rise to a liability when it is exercised.

In Situations 1, 2, and 4, the substitution of the M Option for the N Option does not cause Employee to recognize compensation income under § 83(a). In Situations 1 and 4, Employee recognizes compensation income under § 83(a) in 2007, which is Employee's taxable year in which the N Option is exercised. In Situations 2 and 3, Employee also recognizes compensation income under § 83(a) in 2007, which is Employee's taxable year in which N cancels the substituted N Option or cancels the M Option.

Applying § 83(h) and § 1.83-6 to Situations 1, 2, and 3, because M is the service recipient with respect to either the M Option or the N Option, M, and only M, is permitted to deduct the compensation includible in Employee's gross income as a result of the disposition of the M Option or the exercise or disposition of the N Option.

Although N actually pays the cash or transfers its stock directly to Employee, such payment (or transfer) is treated as a cash capital contribution by N to M (and M is treated as purchasing the stock from N in the case of a stock transfer to the Employee) and as a payment of cash (or transfer of stock) by M to the Employee. See §§ 1.83-6(d)(1), 1.1032-3(b)(1), and § 1.1032-3(e), Example 8. Because the consideration received by Employee upon the disposition of the M Option or the exercise or disposition of the N Option is either cash or substantially vested N shares, the § 1.83-6(a)(3) exception to the general timing rule for deductions in § 83(h) applies. Accordingly, to the extent that the compensation is otherwise deductible, M, and only M, is entitled to deduct the compensation, using its method of accounting, for its taxable year ending September 30, 2007.

In Situation 4, because the merger of M into N qualifies as a liquidation within the meaning of § 332, under § 381, N succeeds to and takes into account those tax items of M described in § 381(c). Because (1) N assumed the obligation of M pursuant to the N Option, (2) after the date of the merger, the N Option gives rise to a liability under § 1.461-1(a)(2) by reason of its exercise, and (3) the liability, if paid or accrued by M would have been deductible in computing M's taxable income, N is entitled to deduct that item when paid or accrued as if it were M. See § 381(c)(16).

Under § 83(h) and § 1.83-6(a), N is entitled to a deduction for the amount of compensation income (if any) included in the gross income of Employee under § 83(a). The amount of compensation income (if any) included in the gross income of Employee is determined on January 15, 2007, when the option is exercised and the stock transferred to Employee. Because the stock is substantially vested when transferred to Employee, to the extent that the compensation recognized by Employee in Situation 4 is otherwise deductible, the deduction is allowed in accordance with N's method of accounting. Thus, the deduction is allowed for N's taxable year ending September 30, 2007.

HOLDINGS

In Situations 1, 2, and 3, the compensation attributable to Employee's disposition of the M Option or exercise or disposition of the N Option, if it is otherwise deductible, is deductible by M. In Situation 4, the compensation, if it is otherwise deductible, is deductible by N, as if it were M.

DRAFTING INFORMATION

The principal author of this revenue ruling is Norm Paul of the Office of Division Counsel/ Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Norm Paul or Robert Misner at (202) 622-6030 (not a toll-free number).