

Internal Revenue Service

Department of the Treasury

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October 24, 2000.

LEGEND:

- Company =
- Parent =
- Country =
- Exchange =
- Trading =

This is in response to a letter dated May 25, 2000, submitted by your authorized representative requesting rulings under sections 83, 404(a)(5), 451, 3402, 3101, 3111, and 1032 of the Internal Revenue Code. Specifically, the letter requests rulings, under the facts outlined below, that the grant of an option, with a premium price reimbursement, is a nonstatutory stock option with no readily ascertainable fair market value under section 83; that a participant will not have compensation income when an option vests; that a participant recognizes compensation income when an option is exercised; that the amount of compensation recognized will be subject to income tax withholding under section 3402 and taxes under sections 3101 and 3111; that the company employing the participant at the time of exercise is entitled to a compensation deduction under sections 83 and 404(a)(5); and that no gain or loss will be recognized when stock is issued on exercise of the option. The facts, as submitted, are set forth below.

Company is a wholly owned subsidiary of Parent. Parent is a corporation organized under the laws of Country. Parent's stock is commonly traded on major exchanges around the world.

Parent believes that an equity-based compensation program is essential to attract, retain, and motivate its employees. Additionally, Parent believes that equity-based compensation aligns the interests of management and key personnel with those

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of shareholders by maintaining focus on increasing shareholder value. For these reasons, Parent established the Parent Stock Option Plan 2000 (Plan) to grant nonstatutory stock options to certain employees of Parent, Company, and other subsidiaries of Parent.

Plan participants may be granted nontransferable stock options on an annual basis. The number of options granted annually is determined by reference to long-term incentive values based on appropriate peer companies and the estimated Black-Scholes value of an option on a share of Parent's common stock. Stock options will be granted during the three-month period following the date of the meeting of Parent's supervisory board. A participant may exercise 50% of the options on the second anniversary of grant, and the remaining 50% is exercisable on the third anniversary of grant. Options have a term of 10 years. Options not exercised are generally forfeitable on termination of employment. In the event of retirement, death, disability, or divestiture of a subsidiary of Parent, however, options remain exercisable for a period ranging from one to five years from the date of termination of employment.

To obtain Parent's shareholder approval of Plan and comply with the legal requirements of Country, the exercise price of an option contains a 20% premium. Specifically, the exercise price is based on the average opening and closing prices of Parent's stock in Trading on Exchange on the day before the meeting of the supervisory board in the first quarter of each year (Reference Price), plus a premium of 20% of the Reference Price (Premium Price). For example, if the Reference Price is \$75 per share, the Premium Price is \$90 per share.

When a participant exercise an option, the participant will receive a purchase contribution (a cash payment) equal to the excess of Premium Price over Reference Price, multiplied by the number of shares purchased. The purpose of this cash payment is to neutralize the effect of the 20% premium. This cash payment is only made, however, if at the time the option is exercised, the market value of Parent's stock on the preceding trading day equals or exceeds Premium Price. In the above example, if options are exercised at a time when the market value of Parent's shares is equal or greater than \$90 (Premium Price), then the participant would receive a purchase contribution payment of \$15 per share. If the participant exercises the options when the market value is less than Premium Price, then the participant will not receive a purchase contribution payment. A participant cannot receive a purchase contribution payment without exercising the related option. The right to receive a purchase contribution payment terminates on the exercise or lapse of the related stock option. The purchase contribution payment will be paid by the participant's employer.

Under section 83(a) of the Code, 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 either transferable or not subject to a substantial risk of forfeiture, over the

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amount paid for the property is included in the service provider's gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture.

Section 83(e)(3) of the Code provides that section 83 does not apply to the grant of an option that does not have a readily ascertainable fair market value at the time of grant.

Section 1.83-7(a) of the Income Tax Regulations provides, in part, that if an option, to which section 421 (relating to certain qualified and other options) does not apply, is granted to an employee (of beneficiary thereof) in connection with the performance of services, section 83(a) applies 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 applies 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 that 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 it would have applied to the transfer of property pursuant to an exercise of the option. According to section 1.83-7(b)(2), an option lacks a readily ascertainable fair market value if, among other tests, it is not immediately exercisable.

Under section 83(h) of the Code, the service recipient is allowed a compensation expense deduction, under sections 162 or 212, in an amount equal to the amount included in the service provider's gross income under section 83(a). The deduction is allowed for the taxable year of the service recipient in which or with which ends the service provider's taxable year in which the amount is included in gross income. Where property is substantially vested on transfer, the deduction is allowed in accordance with the service recipient's method of accounting (in conformity with sections 446 and 461). See section 1.83-6(a)(3) of the regulations.

Sections 451(a) of the Code and 1.451-1(a) of the regulations provide that an item of gross income is includible in gross income for the taxable year in which it is actually or constructively received by a taxpayer using the cash receipts and disbursements method of accounting. Under section 1.451-2(a) of the regulations, income is constructively received in the taxable year during which it is credited to a taxpayer's account or set apart or otherwise made available so that the taxpayer may draw on it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

In Rev. Rul. 80-300, 1980-2 C.B. 165, the Service addressed stock appreciation

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rights and the application of the doctrine of constructive receipt. Under the facts of this ruling, exercise of a stock appreciation right would have resulted in the loss of the right to benefit from future appreciation in the employer's stock without risking any capital. The ruling holds that forfeiture of that valuable right constitutes a substantial limitation on the right to receive the income from the stock appreciation right, which precludes constructive receipt of that income. The ruling also holds that an employee is not in constructive receipt of the income from a stock appreciation right before the employee exercises these rights and that the cash payments to which the employee is entitled is includible in gross income in the year in which the stock appreciation right is exercised. See also, Rev. Rul. 82-121, 1982-1 C.B. 79.

Section 404(a) of the Code provides, in part, that if contributions are paid by an employer on account of any employee under a plan deferring the receipt of compensation, such contributions or compensation are not deductible under Chapter 1 of subtitle A of the Code, but if they would otherwise be deductible, they are deductible under section 404, subject to the limitations contained in section 404.

Pursuant to section 404(a)(5) of the Code, contributions to a deferred compensation plan are deductible in the taxable year in which the contribution is includible in the gross income of employees participating in the plan (or that would be includible but for an exclusion under Chapter 1 of the Code), but in the case of a plan in which more than one employee participates, only if separate accounts are maintained for each employee. Section 1.404(a)-12(b)(1) of the regulations clarifies that a deduction for a contribution paid under section 404(a)(5) is allowed only in the taxable year in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includible in income as compensation, and then only to the extent allowable by section 404(a).

The effect of the exercise of the option at a premium and the purchase contribution is the same as the grant of a nonstatutory stock option and results in similar tax treatment. Because the option does not have a readily ascertainable fair market value, a participant in Plan is not taxable under section 83 until the participant exercises or otherwise disposes of the option. At the time of exercise the participant should recognize compensation income under section 83 equal to the fair market value of the option less the amount paid for the option, plus an amount equal to the purchase contribution. Additionally, the service recipient is allowed a compensation expense deduction under section 83(h), 162, and 404(a)(5) equal to the amount included in gross income by the participant.

Sections 3101 and 3111 of the Code impose the employee and employer portions, respectively, of Federal Insurance Contributions Act (FICA) tax on wages paid by an employer to its employee. Section 3101(a) imposes FICA tax "on the income of every individual" in an amount equal to a percentage "of the wages (as defined in section 3121(a)) received by him with respect to employment." Section 3111(a) provides that the employer portion of FICA tax is imposed directly upon the employer as

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“an excise tax, with respect to having individuals in his employ.”

Section 3121(a) of the Code provides that the term “wages” means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions not applicable to a nonstatutory stock option or stock appreciation right.

Section 3102(a) of the Code provides that the employee portion of FICA tax shall be collected by the employer of the employee, by deducting the amount of the tax from the wages as and when paid. Section 3102(b) provides that every employer required to deduct the tax shall be liable for the payment of such tax.

Section 31.3102-1(a) of the Employment Tax Regulations provides that the employer shall collect from each of his employees the employee tax with respect to wages for employment performed for the employer by the employee. The employer is required to collect the tax, notwithstanding that the wages are paid in something other than money, and to pay over the tax in money.

Section 31.3121(a)-1(e) of the regulations relating to FICA taxes provides that the medium in which the remuneration is paid is immaterial. It may be paid in cash or in something other than cash. This provision also provides that “remuneration in items other than cash shall be computed on the basis of the fair value of such items at the time of payment.”

Section 31.3121(a)-2(a) of the regulations provides, in pertinent part, that for FICA purposes, wages are generally received by an employee at the time that they are paid by the employer to the employee, and wages are paid by an employer at the time that they are actually or constructively paid.

Section 31.3121(a)-2(b) of the regulations provides that wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition.

Section 3401(a) of the Code, relating to Collection of Income Tax at Source, provides that “wages,” with certain non-applicable exceptions, means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash.

Section 31.3401(a)-1(a)(4) of the regulations provides that remuneration may be paid in something other than cash and generally the medium in which the remuneration

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is paid is not material.

Section 3402(a) of the Code generally provides that every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary.

Section 31.3401(a)-1(b) of the regulations provides that an employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. Wages are constructively paid when they are credited to the account of or set aside for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without substantial limitation or restriction as to the time or manner of payment or condition upon which is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition.

In Rev. Rul. 78-185, 1978-1 C.B. 304, the Service addressed the exercise of employer-granted nonstatutory stock options and the employment tax treatment of the spread amount. The ruling holds that the spread amount is wages for FICA tax and federal income tax withholding purposes when the option is exercised.

Upon exercise of an employer provided nonstatutory stock option, a participant will receive wages equal to the spread amount subject to FICA taxes and income tax withholding at the time of exercise. Additionally, any purchase contributions (cash payment) received by a participant is wages subject to FICA taxes and income tax withholding at the time of exercise.

Section 1032 of the Code provides, in part, that a corporation will not recognize gain or loss on the receipt of money or other property in exchange for stock of such corporation. Under section 1.1032-1(a) of the regulations, a transfer by a corporation of its own stock as compensation for services is considered, for purposes of section 1032(a), an exchange for money or other property.

Section 1.83-6(d) of the regulations provides, in part, that if the shareholder of a corporation transfers property to an employee of such corporation, the transfer will be treated as though the shareholder first contributes the property to the corporation's capital and then the corporation transfers the property to its employee. Any money or other property paid to the shareholder for such stock shall be considered to be paid to the corporation and then transferred by the corporation to the shareholder.

Section 1.1032-3 of the regulations generally enables a corporate subsidiary to obtain a fair market value basis in parent stock contributed to the subsidiary's capital if the subsidiary disposes of the parent stock in a taxable transaction immediately after it is received from the parent. The regulations achieve this result by treating the

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subsidiary as purchasing the parent stock for fair market value with cash deemed contributed to the subsidiary by the parent. See sec. 1.1032-3(b)(1). Any amount the subsidiary actually transfers to the parent in the transaction reduces the amount of cash deemed contributed by the parent. See sec. 1.1032-3(b)(2). Thus, as a result of the operation of section 1.1032-3, a subsidiary generally does not recognize gain or loss on the transfer of parent stock to the subsidiary's employee when the employee exercises options to acquire parent stock. In addition, intermediary affiliated corporations are protected from gain or loss using the same deemed purchase model. See sec. 1.1032-3(b)(1).

Based on the facts submitted and Company's representations, we rule as follows:

1. Because the option is not immediately exercisable on grant, the grant of the option constitutes the grant of a nonstatutory option having "no readily ascertainable fair market value at grant" for purposes of section 83;
2. A participant will not have compensation income on the date that the options vest;
3. A participant will not be in receipt of compensation income until the option is exercised. At the time of exercise of the option, the participant will recognize compensation income in an amount equal to the sum of (a) the difference between the fair market value of Parent's stock being purchased and the amount paid for such stock, and (b) the purchase contribution (the excess of Premium Price over Reference Price). The amount recognized as compensation to the employee will be subject to income tax withholdings under section 3402 and subject to taxes under sections 3101 and 3111;
4. Assuming an employee was employed by one company during the entire option term and there was no cost sharing agreement between Parent and Company during that term, the company for whom the services were provided will be entitled to a compensation expense deduction, in an amount equal to the amount included in the gross income of the participant, under the rules of sections 83(h) and 1.83-6(a)(1) with regard to the stock received on exercise and section 404(a)(5) with regard to the purchase contribution; and
5. No gain or loss will be recognized by Parent, Company, or any other intermediate affiliated company upon the issuance of the stock to the participant pursuant to the exercise of the option. Any actual or deemed payment for Parent stock by an employee on exercise of an option will not be treated as a distribution with respect to stock.

This ruling is directed only to the taxpayer requesting it. Except as specifically ruled on above, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced above. Specifically, no opinion is expressed concerning the application of section 482 of the Code to the

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sections 83(h) and 404(a)(5) deduction if an employee shifts employment between employers during the option term or if there is a cost sharing agreement between Parent and Company during that term.

Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. The taxpayer should attach a copy of this ruling to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to your authorized representative.

Sincerely,
Robert Misner
Assistant Chief
Executive Compensation Branch
Office of the Division Counsel
/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure: Copy for 6110 purposes