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December 10, 2003

LEGEND:

Taxpayer =
Year One =
Year Two =
$A = $

Dear :

This is in response to a request for rulings dated July 28, 2003, and subsequent correspondence, submitted by Taxpayer's authorized representative concerning proposed amendments to Taxpayer's employee stock option plans. The proposed amendments will allow employees holding options to transfer them to an unrelated third party in exchange for cash and a deferred payment obligation.

Taxpayer has granted nonqualified stock options to substantially all full time employees, with the exception of certain executives. Grants of options were made under two stock option plans, the first adopted in Year One, the second in Year Two.

Normally, the exercise price of options granted under the stock option plans was equal to the fair market value of Taxpayer's stock on the date of grant and the options would typically vest within 4 ½ years. The options were not transferable, other than by will or by the laws of descent and distribution, and would expire either shortly after the grantee's termination of employment, or after a set number of years after the vesting date, whichever occurred first.

Taxpayer proposes to amend its outstanding options to allow employees to make a one-time election to transfer all their options to a designated third party, for a price to be established by the third party under a formula. The current options will only be amended (and the options will only become transferable) once the option holders have made the election to transfer their options to the third party. Options held by non-electing option holders will therefore not become transferable.

In the event an employee elects to transfer his or her options, the options will be transferred to the third party and the entire purchase price will be paid to Taxpayer. Option holders who elect to transfer their options and whose options have a total value of $A or less will receive the full purchase price from Taxpayer in a single lump sum at the time of transfer. Option holders who elect to transfer their options and whose options have a total value of greater than $A will receive from Taxpayer an initial payment upon transfer, which will be the greater of $A or 33% of the total payment. The remainder of the purchase price will be deferred to later taxable years and paid in accordance with a payment schedule.

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 the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) over the amount, if any, paid for the property, will be included in the gross income of the person who performed the services. This inclusion will take place in the first taxable year in which the rights of the person having the beneficial interest are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

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

According to section 83(h), in the case of a transfer of property to which section 83 applies, there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which the property was transferred, an amount equal to the amount included under section 83(a) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.

Where, however, property is substantially vested upon transfer, the deduction is allowed in accordance with the service recipient's method of accounting. Treas. Reg. §1.83-6(a)(3).

When the property transferred is a stock option, the service provider will recognize taxable income under section 83(a) if the option has a readily ascertainable fair market value at the date of grant. Treas. Reg. § 1.83-7T(a). An option will have a readily ascertainable fair market value if it is traded on an established market. Treas. Reg. § 1.83-7(b)(1). If it is not so traded, according to § 1.83-7(b)(2), the option will have a readily ascertainable fair market value only if the taxpayer can show that the following conditions exist:

1. The option is transferable by the optionee;
2. The option is exercisable immediately in full by the optionee;
3. The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value on the option; and
4. The fair market value of the option privilege is readily ascertainable.

According to §1.83-7T(a), if the option does not have a readily ascertainable fair market value at the time of grant, then sections 83(a) and (b) shall apply at the time the option is exercised or otherwise disposed of, even if the fair market value of the option had become readily ascertainable before such time. If the option is exercised, sections 83(a) and (b) apply to the transfer of property pursuant to such exercise. If the option is sold or otherwise disposed of in an arm's length transaction, sections 83(a) and (b) apply to the money or other property received in the same manner as sections 83(a) and (b) would have applied to the transfer of property pursuant to an exercise of the option. (See the last sentence of § 1.83-7T(a) concerning the sale or other disposition of an option to "a person unrelated to the service provider.")

Under the facts described above, the terms and conditions of the options, as well as their economic value, remain substantially unchanged after the amendment adding the transferability feature. Therefore, for purposes of § 1.83-7T, the amendment of the options is not considered to be a disposition of the options, and there is no grant of new options. If the value of an option becomes readily ascertainable after the date of grant, the holder will not recognize income until the option is exercised or disposed of. Therefore, the non-electing option holders will not recognize income until they are exercised or otherwise disposed of. This would be true even if the options did obtain a readily ascertainable fair market value when the transferability feature was added.

Option holders who elect to transfer their options to the designated unrelated third party will recognize income relative to the cash and installment obligation in the same manner as sections 83(a) and (b) would have applied to the transfer of the stock. Thus, they will recognize income immediately upon transfer for the portion of the purchase price they receive at the time of the transfer. The remaining amount of the purchase price, which will remain subject to a substantial risk of forfeiture, will be included when it becomes substantially vested.

In accordance with the foregoing, we rule as follows:

1. When the options are amended to include a feature allowing the options to be transferred, section 83(a) will not apply to the options on the basis that they have a "readily ascertainable fair market value."

2. As to an employee who elects, after the options have been amended, to transfer options to the designated unrelated third party in exchange for cash and a deferred payment obligation, the employee must include in gross income under section 83(a) the cash received in the taxable year and thereafter, with regard to the cash due under the installment obligation, in the taxable year in which an employee's rights to that cash becomes substantially vested.

3. Taxpayer will be entitled to a deduction under section 83(h) for amounts included in each employee's gross income under section 83(a) as set out in Ruling 2. The first cash payment will be deductible in accordance with the Taxpayer's method of accounting. Payments in subsequent taxable years will be deductible in Taxpayer's taxable year(s) in which or with which ends the taxable year(s) of the employee in which the amounts are included in the employee's gross income.

Except as specifically ruled on above, no opinion is expressed or implied concerning the tax consequences of any item of any transaction or item discussed above.

This ruling is provided only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be cited as precedent. In accordance with the power of attorney on file, a copy of this ruling has been sent to the taxpayer's authorized representative. The taxpayer should attach a copy of this ruling to any income tax return to which it is relevant.

Sincerely,

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Robert B. Misner
Senior Technician Reviewer
Executive Compensation Branch
Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities)