

**INTERNAL REVENUE SERVICE**

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4999.00-00

(202) 622-6030

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November 8, 2001

LEGEND:

Taxpayer =

Company A =

Company B =

Lender =

\$X =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year =

This is in reply to a letter dated May 10, 2001, which you submitted on behalf of Taxpayer, in which a ruling is requested that the vesting of certain shares upon a "change of control" was not a "payment in the nature of compensation" for purposes of sections 280G and 4999 of the Internal Revenue Code.

The facts submitted are that on Date 1, Taxpayer and others ("founders") formed Company A in a transaction described in section 351 of the Code and received substantially-vested Company A shares. Sales of the shares were subject to Company A's right of first refusal at fair market value. In a letter dated Date 2, Lender agreed to lend founders \$X in consideration for (among other things) an option to purchase securities of Company A "to be issued in [Company A's] next equity financing."

On Date 3, the "next equity financing" occurred, and, as required by Lender, certain restrictions, previously not contemplated, were placed on some of each founder's shares. The result was that Taxpayer's rights in those shares became "substantially nonvested," as that term is defined in section 1.83-3(b) of the Income Tax Regulations. As of Date 3, Taxpayer owned \_\_\_\_\_ shares, of which \_\_\_\_\_ were substantially vested, an additional \_\_\_\_\_ of which were to become substantially vested on Date 4, and the remaining \_\_\_\_\_ shares of which were to become substantially vested in \_\_\_\_\_. Thus, as of Date 5, all of Taxpayer's rights in his shares were to be substantially vested. A significant feature of the arrangement was that, upon a "change in control," 50 percent of each founder's substantially-nonvested shares would resultantly vest.

In January of Year, Company A was sold to Company B, and founders exchanged their Company A shares for substantially-vested and substantially-nonvested Company B shares in the same proportion that they had held their Company A shares. The sale to Company B was considered a "change in control" that triggered the vesting of 50 percent of the founders' substantially-nonvested shares.

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* (determined without regard to any "lapse restriction") on the first day that the transferee's rights in the property are 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.

Stated differently, property is not taxable under section 83 until it is transferred to and substantially vested in the service provider (or beneficiary thereof). Until the 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 section 1.83-1(a)(1) of the regulations.

A "transfer" of property occurs when a person acquires a beneficial ownership interest in the property (disregarding any "lapse restriction," as defined in section 1.83-3(i) of the regulations). See section 1.83-3(a)(1). The grant of an option to purchase property does not constitute a transfer of such property. See section 1.83-3(a)(2). Similarly, no "transfer" may occur where property is transferred under conditions that

require its return upon the happening of an event that is certain to occur, such as the termination of employment.

For purposes of section 83 of the Code, property is "substantially *nonvested*" when it is both subject to a "substantial risk of forfeiture" and is "nontransferable," within the meaning of sections 1.83-3(c) and (d) of the regulations, respectively. Property is substantially vested when it is either transferable or is not subject to a substantial risk of forfeiture. See section 1.83-3(b). Once a service provider's rights in property are substantially vested and are, thereby, taxed under the rules of section 83, any *subsequent* income or gain with respect to that property is not compensation income.

Here, it is represented that, at the time that Lender required the imposition of forfeiture provisions on the founders' Company A shares, each founder's rights in those shares were already transferred to and substantially-vested in them. Accordingly, we conclude that the subsequent imposition of the forfeiture provisions on the founders' Company A shares must necessarily have been accomplished in the *absence of a* section 83 "transfer" (*i.e.*, the shares were *already owned* for section 83 purposes), and that, therefore, those provisions had no effect for section 83 purposes.

Section 280G of the Code provides that no deduction will be allowed for any excess parachute payment. Section 280G(b)(1) of the Code defines the term "excess parachute payment" as an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.

Section 280G(b)(2)(A) of the Code defines the term "parachute payment" as any payment *in the nature of compensation* to (or for the benefit of) a disqualified individual if (i) such payment is contingent on a change (I) in the ownership or effective control of the corporation, or (II) in the ownership of a substantial portion of the assets of the corporation; and (ii) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual which are contingent on such change equals or exceeds an amount equal to three times the base amount.

Section 4999(a) of the Code imposes on any person who receives an excess parachute payment a tax equal to 20 percent of the amount of the payment.

Applying the above law to the information submitted, and based strictly on the facts as outlined above, we conclude that the substantial vesting of Taxpayer's shares resulting from the "change of control" was not a "payment in the nature of compensation" for purposes of sections 280G and 4999 of the Code, because, as of Date 1, Taxpayer already owned those shares under the rules of section 83.

Except as ruled above, no opinion is expressed regarding the federal tax consequences of the transaction described above under any provision of the Internal Revenue Code. This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to Taxpayers' federal income tax return for the year in which the above rulings are granted. A copy is enclosed for that purpose.

Sincerely yours,  
ROBERT B. MISNER  
Acting Chief, Executive Compensation Branch  
Office of the Division Counsel /  
Associate Chief Counsel  
(Tax Exempt and Government Entities)

Enclosures (2):  
Copy of this letter  
Copy for 6110 purposes