

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of January 2002. See Rev. Rul. 2002-2, page 271.

Section 83.—Property Transferred in Connection With Performance of Services

26 CFR 1.83-6: Deduction by employer.

Options & Spin-off: Income tax treatment of options and restricted stock in spin-offs, under the facts presented. See Rev. Rul. 2002-1, page 268.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of January 2002. See Rev. Rul. 2002-2, page 271.

Section 355.—Distributions of Stock and Securities of a Controlled Corporation

26 CFR 1.355-1: Distribution of stock and securities of a controlled corporation. (Also §§: 1.83-6, 1.1032-3).

Options and spin-off. Income tax treatment of options and restricted stock in spin-offs, under the facts presented.

Rev. Rul. 2002-1

ISSUE

Under the facts presented below, after a distributing corporation (D) distributes the stock of a controlled corporation (C) in a transaction to which § 355(c) of the Internal Revenue Code applies,

(1) Does D recognize gain or loss when restrictions lapse on C stock held by D employees that is received in connection with the § 355 transaction? Does D recognize gain or loss when stock options for C stock held by D employees that are received in connection with the § 355 transaction are exercised?

(2) Does C recognize gain or loss when restrictions lapse on D stock held by C employees that is received before the § 355 transaction? Does C recognize gain or loss when stock options for D stock held by C employees that are received in connection with the § 355 transaction are exercised?

(3) Who is entitled to deductions for amounts includible in employees' income as a result of the lapse of restrictions on D and C stock and the exercise of options to acquire D and C stock described above?

FACTS

D is a domestic corporation of which A is an employee at all times relevant to this ruling. C is a wholly-owned domestic subsidiary of D of which B is an employee at all times relevant to this ruling.

In Year 1, D implements a plan to attract and retain qualified personnel and to provide incentives for continued performance of services by providing additional compensation to its employees and to the employees of C in the form of: (i) stock of D that is not transferable and is subject to a substantial risk of forfeiture, as defined in § 83(c), for a period of five years beginning in Year 1 (restricted stock); and (ii) non-statutory options to purchase shares of D stock (the pre-division options). The plan is not implemented in anticipation of a spin-off.

Under the plan, in Year 1 D issues restricted D stock to A, and to B on behalf of C, for the employees' services performed for their respective employers. In the event of forfeiture, the restricted stock would revert to D. A and B do not make an election in Year 1 pursuant to § 83(b) with respect to the restricted stock. Also in Year 1, D grants to A, and to B on behalf of C, pre-division options for their services. The options do not have a readily ascertainable fair market value (within the meaning of § 1.83-7(b) of the Income Tax Regulations) at the time they are issued.

In Year 3, D distributes the stock of C *pro rata* to D's shareholders in a transaction that qualifies for nonrecognition of gain to D under § 355(c) (hereinafter

referred to as the spin-off). In the spin-off, the shareholders of D receive one share of C stock for each share of D stock.

Although, under § 83, A and B are not treated as the owners of the restricted D stock for Federal tax purposes, A and B have rights in the D stock and receive, in connection with the spin-off, a distribution of C stock with restrictions identical to the restrictions on the D stock in order to preserve their pre-spin-off economic interest in the pre-spin-off restricted D stock. In the event of forfeiture, the restricted D stock would revert to D and the restricted C stock would revert to C. Thus, after the spin-off, A and B each hold restricted stock in both D and C.

Also as part of the spin-off, the pre-division options held by A and B are canceled and replaced with new options (the post-division options) to acquire stock in D from D and stock in C from C. Pursuant to the terms of the post-division options, the post-division options' exercise price is paid directly to the issuing corporation in exchange for the stock. Except to the extent that the post-division options separate the pre-division options into two instruments, the post-division options are designed to preserve the economic terms of the pre-division options. The total exercise price of the post-division options held by each of A and B, respectively, is equal to the total exercise price of the pre-division options held by each of A and B, respectively. The total number of shares of D stock subject to the post-division options held by each of A and B, respectively, is equal to the total number of shares of D stock subject to the pre-division options held by each of A and B, respectively. The total number of shares of C stock subject to the post-division options held by each of A and B, respectively, is equal to the total number of shares of D stock subject to the pre-division options held by each of A and B, respectively. Finally, the ratio of (a) the exercise price for each share subject to a post-division option to acquire D stock to (b) the exercise price of each share subject to a post-division option to acquire C stock is equal to the ratio of (x) the estimated fair market value of all of the outstanding D stock, excluding the estimated

fair market value attributable to D's ownership of C stock immediately prior to the spin-off to (y) the estimated fair market value of all of the outstanding C stock immediately prior to the spin-off.

In Year 6, the restrictions lapse on the restricted stock held by A and B. Also in Year 6, A and B exercise all of their post-division options.

LAW AND ANALYSIS

Under § 83(a), when property is transferred to a person in connection with the performance of services, the service provider must include in gross income an amount equal to the fair market value of such property, less the amount (if any) paid for the property. However, if the property transferred is not transferable and is subject to a substantial risk of forfeiture in the hands of the service provider, the fair market value of the property, less the amount (if any) paid for the property, is not includible in the service provider's gross income until the property is transferable or is not subject to a substantial risk of forfeiture, unless the service provider elects to include such amount in gross income at the time of the transfer under § 83(b). Section 83(e)(3) provides that § 83 does not apply to the grant of an option without a readily ascertainable fair market value.

Under § 83(h), the service recipient is allowed a deduction under § 162 in an amount equal to the amount included in the service provider's gross income under § 83(a). Where the property is not substantially vested on transfer, 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 the service provider's gross income. See § 1.83-6(a)(1), (2) of the Income Tax Regulations. Where property is substantially vested on transfer, the deduction is allowed in accordance with the service recipient's method of accounting (in conformity with §§ 446 and 461). See § 1.83-6(a)(3).

Section 1.83-6(b) states that, except as provided in § 1032, at the time of a transfer of property in connection with the performance of services, the transferor recognizes gain to the extent that the transferor receives an amount that exceeds its basis in the property. In addition,

at the time a deduction is allowed under §§ 83(h) and 1.83-6(a), the transferor recognizes gain or loss to the extent of the difference between (1) the sum of the amount paid plus the amount allowed as a deduction under § 83(h), and (2) the sum of the transferor's basis in the property plus any gain recognized at the time of the transfer.

Section 1032(a) provides, in part, that no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. Under § 1.1032-1(a), for purposes of § 1032(a), a transfer by a corporation of its own stock as compensation for services is considered a disposition for money or other property. Thus, when a corporation compensates employees with its own stock, the corporation does not recognize gain or loss under § 1032.

Section 1.1032-3 generally provides that in certain transactions in which a corporation (the acquiring entity) acquires money or other property in exchange, in whole or in part, for stock of a corporation (the issuing corporation), the acquiring entity is treated as purchasing the stock of the issuing corporation from the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation. If the issuing corporation receives money or other property in payment for its stock, the amount of cash deemed contributed is the difference between the fair market value of the issuing corporation stock and the amount of money or fair market value of other property that the issuing corporation receives as payment. Section 1.1032-3 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. Thus, as a result of the operation of § 1.1032-3, a subsidiary generally does not recognize gain or loss on the immediate transfer of parent stock to the subsidiary's employee.

A and B recognize income in Year 6 under the rules of § 83 when the restrictions on the D and C stock lapse and when they exercise their options to acquire D and C stock. The following dis-

cussion addresses the Federal income tax consequences to D and C when these events occur.

The characterization of the events that occur in Year 6 should reflect the relationship of D and C that existed in Year 1 and continued until immediately before the spin-off. Cf. Rev. Rul. 83-73, 1983-1 C.B. 84 (applying a relation-back principle to characterize indemnity payments made by former shareholders of a merged corporation to the acquiring corporation). Specifically, to determine whether D recognizes gain or loss in Year 6 when the restrictions lapse on the restricted C stock held by A, whether C recognizes gain or loss in Year 6 when the restrictions lapse on the restricted D stock held by B, whether D recognizes gain or loss in Year 6 when A exercises the post-division options for C stock, and whether C recognizes gain or loss in Year 6 when B exercises the post-division options for D stock, it is appropriate to take into account the terms of the original arrangement created in Year 1, and the parent-subsidiary relationship between D and C that existed in Year 1 and continued until immediately before the spin-off.

Prior to the spin-off, the stock of D reflected an interest in C. Although, prior to the spin-off, A was not treated as the owner of the restricted D stock for Federal tax purposes, A had valuable economic rights with respect to that stock and, indirectly, with respect to D's stock ownership interest in C. Similarly, although the pre-division options did not give A ownership in D stock, the pre-division options did give A valuable economic rights with respect to D stock by reason of the right to acquire D stock at a fixed price, which would have included an indirect ownership interest in C if the spin-off had not occurred. Thus, A's receipt in connection with the spin-off of the restricted C stock and the post-division options to acquire D and C stock preserved A's economic rights with respect to the entire pre-spin-off D enterprise, which included C.

Because the restricted C stock and the post-division options to acquire C stock are a substitute in part for pre-spin-off restricted D stock and the pre-division options, it is appropriate for purposes of §§ 1032 and 355 to treat a post-spin-off lapse in restrictions on the restricted C

stock held by A and A's exercise of post-division options to acquire C stock in the same manner under §§ 1032 and 355 as a pre-spin-off lapse of restrictions on the restricted D stock held by A and A's pre-spin-off exercise of pre-division options, respectively, would be treated followed by the spin-off. Accordingly, because D would have recognized no gain or loss under § 1032 by reason of the pre-spin-off lapse of restrictions on D stock held by A and A's pre-spin-off exercise of the pre-division options to acquire D stock, and because § 355(c) applies to the spin-off in Year 3, in Year 6 D recognizes no gain or loss with respect to the C stock by reason of the lapse of restrictions on the restricted C stock issued to A and on A's exercise of the post-division options to acquire C stock. Further, under § 83(h), in Year 6 D is entitled to a deduction under § 162 in the amount that A includes in income under § 83(a) as a result of the lapse in restrictions on the C stock and the exercise of the post-division options to acquire C stock.

Similarly, it is appropriate for purposes of § 1032 to treat a post-spin-off lapse in restrictions on the restricted D stock held by B and B's exercise of post-division options to acquire D stock in the same manner under § 1032 as a pre-spin-off lapse of restrictions on the restricted D stock held by B and B's pre-spin-off exercise of pre-division options, respectively, would be treated followed by the spin-off. C would have recognized no gain or loss under § 1032 by reason of the pre-spin-off lapse of restrictions on D stock held by B and B's pre-spin-off exercise of the pre-division options to acquire D stock. *See* §§ 1.83-6(d) and 1.1032-3; *see also* § 1.1032-3(e), exs. 6, 8. Consistent with this analysis, the consequences of the post-spin-off lapse of restrictions on the restricted D stock held by B and B's post-spin-off exercise of D options are characterized by reference to the parent-subsidiary relationship between D and C that existed in Year 1 and continued until immediately before the spin-off. Accordingly, in Year 6, for purposes of § 1032, C is treated as if it bought the D stock from D at fair market value after a shareholder capital contribution from D, with the result that C recognizes no gain or loss with respect to the D stock by reason of the lapse of restrictions on the

restricted D stock issued to B and on B's exercise of the post-division options to acquire D stock. *See* §§ 1.83-6(d) and 1.1032-3. Under § 83(h), in Year 6 C is entitled to a deduction under § 162 in the amount that B includes in income under § 83(a) as a result of the lapse of restrictions on the D stock and the exercise of post-division options to acquire D stock.

Under § 1032, in Year 6 D recognizes no gain or loss when the restrictions lapse on the restricted D stock held by A and B and when A and B exercise the post-division options to acquire D stock. In addition, under § 1032, C recognizes no gain or loss when the restrictions lapse on the restricted C stock held by A and B and when A and B exercise the post-division options to acquire C stock.

HOLDING

Under the facts presented above, after D distributes the stock of C in a transaction to which § 355(c) applies,

(1) D recognizes no gain or loss when restrictions lapse on the C stock held by A that is received in connection with the spin-off; D recognizes no gain or loss when stock options for C stock held by A that are received in connection with the spin-off are exercised;

(2) C recognizes no gain or loss when restrictions lapse on D stock held by B that is received before the spin-off; C recognizes no gain or loss when stock options for D stock held by B that are received in connection with the spin-off are exercised; and

(3) D is entitled to deductions for amounts includible in A's income as a result of the lapse of restrictions on D and C stock and the exercise of options to acquire D and C stock, and C is entitled to deductions for amounts includible in B's income as a result of the lapse of restrictions on D and C stock and the exercise of options to acquire D and C stock.

DRAFTING INFORMATION

For further information regarding this revenue ruling, contact Mark Weiss of the Office of Associate Chief Counsel (Corporate) at 202-622-7790 (not a toll-free call).