

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

March 25, 1999

Distributing =

Controlled 1 =

Controlled 2 =

Business A =

Business B =

Business C =

Option Plan A =

Option Plan B =

D =

Dear

This is in response to your letters of October 12, and November 25, 1998, requesting rulings concerning the application of sections 83 and 162 of the Internal Revenue Code to the transaction described below. Other aspects of the transaction are the subject of a separate ruling from the Office of the Assistant Chief Counsel (Corporate).

PLR-103668-99

Distributing is a publicly traded corporation engaged directly and through various subsidiaries in Business A, Business B, and Business C. In order to separate Businesses A, B, and C, Distributing has proposed the following transactions:

(i) Distributing will form Controlled 1 and will contribute the assets of Business B to Controlled 1 in exchange for all of the Controlled 1 stock and the assumption by Controlled 1 of liabilities associated with the contributed property.

(ii) Distributing will form Controlled 2 and will contribute the assets of Business C to Controlled 2 in exchange for all of the Controlled 2 stock and the assumption by Controlled 2 of liabilities associated with the contributed property.

(iii) Following approval by its shareholders, Distributing will distribute the stock of Controlled 1 and Controlled 2 pro rata to its shareholders (the "Distributions"). Business A will remain with Distributing.

Distributing currently has in place Option Plan A and Option Plan B (collectively Distributing Option Plans), pursuant to which nonstatutory stock options, incentive stock options, and awards of restricted stock ("Distributing Options") have been granted to directors, executives and other key employees of Distributing and its subsidiaries. The exercise price of the options equal the fair market value of Distributing's common stock on the date of grant. It has been represented that no "incentive stock options" as described in section 422 of the Code remain outstanding as of the date of this ruling request. In addition it has been represented that the outstanding Distributing Options did not have a readily ascertainable fair market value within the meaning of section 1.83-7(b)(2) of the Income Tax Regulations when granted.

Option Plan A provides that grants of options shall be made by a committee of two or more "outside directors" within the meaning of section 162(m) of the Code.

Prior to the Distributions, the Board of Directors of Controlled 1 and Controlled 2 will adopt the Controlled 1 Stock Option Plan and the Controlled 2 Stock Option Plan (collectively "Controlled Stock Option Plans"). The Distributing shareholders will be asked to approve the Controlled Stock Option Plans when they approve the Distributions. The Organization and Compensation Committee of Distributing's Board of Directors will approve each of the Controlled Stock Option Plans prior to the Distributions.

Under the Controlled Stock Option Plans, nonstatutory and incentive stock options, stock appreciation rights, and other stock-based award may be granted to key employees of Controlled 1 and Controlled 2, respectively and their subsidiaries. It is anticipated that nonstatutory stock options granted under the Controlled Stock Option Plans will not have a readily ascertainable fair market value within the meaning of section 1.83-7(b)(2) of the regulations. Each of the Controlled Stock Option Plans will

PLR-103668-99

be administered by a Compensation Committee of the Board of Directors of Controlled 1 or Controlled 2, respectively.

The following steps will be taken with respect to the Distributing Options:

(i) All outstanding Distributing Options held by each person remaining employed by Distributing or any of its subsidiaries immediately after the Distribution ("Retained Employees") will be replaced with Adjusted Options in Distributing. The Adjusted Options will continue to be exercisable on the same terms and conditions as before the Distribution except that (a) the number of shares of Distributing common stock, and (b) the option price per share of such options will be adjusted to reflect the post-Distribution value of Distributing while preserving the spread between such options' exercise price and the fair market value of the underlying stock.

(ii) All outstanding Distributing Options held by employees who become employed by either Controlled 1 or Controlled 2, or a subsidiary thereof ("Transferred Employees") will terminate in connection with the termination of the Transferred Employee's employment with Distributing. Transferred Employees may choose to exercise their Distributing Options. Alternatively, Transferred Employees will be able to elect, prior to the Distributions, to receive either Controlled 1 or Controlled 2 Options, depending on their post-Distribution employer, in exchange for their Distributing Options. The Controlled 1 and Controlled 2 Options will be subject to the same terms and conditions as the exchanged Distributing Options, except that (a) the number of shares of Controlled 1 or Controlled 2 stock for which the options may be exercised, and (b) the option exercise price per share of such options, will be adjusted to reflect the value of Controlled 1 or Controlled 2 as the case may be.

(iii) All outstanding Distributing Options held by (a) employees whose employment terminates in connection with the Distributions and who are not Transferred Employees, (b) employees who retire under a severance agreement in connection with the Distributions, and (c) non-employee directors of Distributing ("Eligible Optionees") may be exchanged pursuant to an election. Each Eligible Optionee will be able to elect, prior to the Distributions, to have one third of the Distributing Options exchanged for options in each of Distributing, Controlled 1, and Controlled 2. One third of each Eligible Optionee's Distributing Options will be exchanged for Adjusted Options as described in step (i) above; one third will be exchanged for Controlled 1 Options as described in step (ii) above; and one third will be exchanged for Controlled 2 Options as described in step (ii) above. The options described in this paragraph (iii) are collectively referred to as Divided Options.

Divided Options may be exercised by paying the exercise price directly to the company whose stock is subject to the option. At the time of exercise of a Divided Option, the company issuing the shares covered by the Divided Option will withhold all federal, state, local or other taxes required to be withheld. In addition, the company

PLR-103668-99

issuing the shares covered by the Divided Options will provide a statement to the Optionee showing the compensation income recognized under section 83 of the Code during the applicable year.

D, the present chief executive officer of Distributing will retire at the time of the Distributions and become a non-employee director of Controlled 1.

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 (1) the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having a beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount, if any, paid for the property, will be included in the gross income of the person who performed the services in the first taxable year in which the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Under section 83(e)(3) of the Code, section 83 does not apply to the transfer of an option without a readily ascertainable fair market value. Section 1.83-7(a) of the regulations provides, in part, that if there is granted to an employee (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply 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(a) will apply 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 such 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 section 83 would apply to the transfer of property pursuant to the exercise of an option. See section 1.83-7(b) of the regulations for the test to be applied in determining whether an option has a readily ascertainable fair market value.

Pursuant to section 83(h) of the Code, the person for whom the services were performed is allowed as a deduction under section 162 an amount equal to the amount included under section 83 in gross income of the person who performed the services. The deduction is allowed for the taxable year of the person for whom the services were performed in which or with which ends the taxable year the service provider includes the amount in gross income. Section 1.83-6(a)(3) of the regulations provides an

PLR-103668-99

exception to the rule of section 83(h) concerning the taxable year the service recipient is allowed the deduction. Under section 1.83-6(a)(3) of the regulations, if the property is substantially vested upon transfer, the deduction will be allowed in accordance with the service recipient's method of accounting.

Section 162(m)(1) of the Code generally provides a limit of \$1 million on the deduction for compensation paid during any taxable year for the chief executive officer and the other four highest compensated officers of any publicly held corporation.

Section 162(m)(4)(C) of the Code excepts from that limit "performance-based compensation" that, in relevant part, is payable solely on account of attaining one or more performance goals determined by a compensation committee of the board of directors, which is comprised solely of two or more "outside directors."

Section 1.162-27(e) of the regulations provides rules for determining what constitutes "performance-based compensation."

Section 1.162-27(e)(2)(iii)(C) provides, in part, that compensation attributable to a stock option, stock appreciation right, or other stock-based compensation does not fail to satisfy the requirements of regulation section 1.162-27(e)(2) to the extent that a change in the grant or award is made to reflect a change in corporate capitalization, such as any separation of a corporation (including a spinoff or other distribution of stock or property by a corporation).

Section 1.162-27(e)(3)(i) of the regulations provides that a director is an "outside director" if the director (A) is not a current employee of the publicly held corporation; (B) is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year; (C) has not been an officer of the publicly held corporation; and (D) does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.

Section 1.162-27(e)(3)(vi) of the regulations provides that whether a director is an employee or a former officer is determined on the basis of the facts at the time the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a corporation that previously was an affiliated corporation of the publicly held corporation.

Section 1.162-27(e)(3)(ii) of the regulations provides, in relevant part, that for purposes of section 1.162-27(e)(3), remuneration is received, directly or indirectly by a director if remuneration is paid, directly or indirectly, to the director personally.

PLR-103668-99

Distributing, prior to its reorganization, issued the Distributing Options to its employees "in connection with the performance of services." When, pursuant to the proposed transaction, the assets of Business B and Business C are transferred to Controlled 1 and Controlled 2, respectively, and Controlled Options are substituted for the Distributing Options, the Controlled 1 or Controlled 2 Options issued by Controlled 1 or Controlled 2 to Distributing's employees will be issued "in connection with the performance of services" to Controlled 1 or Controlled 2. Compare R.J. Nicoll Co. v. Commissioner, 59 T.C. 37 (1972) acq. 1973-2 C.B. 3.

Where a parent corporation is divided into three corporations and options in the new corporations are issued to pre-distribution parent employees in order to provide them with the same value, the new corporations are entitled to a deduction under section 83(h) of the Code because the new corporations were service recipients when they were part of the parent prior to the change. In accordance with Rev. Rul. 80-76, 1980-1 C.B. 15, however, neither the parent corporation nor the new corporations are entitled to a section 83(h) deduction if the services were performed for a subsidiary of the parent. Instead, the subsidiary would be entitled to the section 83(h) deduction.¹

Accordingly, based on the information submitted and Distributing's representations set forth above, we rule as follows:

(1) Provided the Distributing Options, Controlled Options, and Divided Options have no readily ascertainable fair market value, no income, gain, or loss will be realized by the holders of Distributing Options upon their exchange of Distributing Options for Adjusted Options, Controlled Options or Divided Options. Section 83(e) and section 1.83-7(a).

(2) Because section 83 applies, no gain or loss will be recognized by Distributing, Controlled 1 or Controlled 2 upon the exercise of a Divided Option.

(3) Upon the exercise or disposition of either an Adjusted Option, Controlled Option or Divided Option, the Optionee will recognize compensation income equal to the excess of the fair market value of the shares covered by the Option over the amount paid for such options. Section 83(a).

(4) Amounts includible in the gross income of each holder of a Distributing Option or a Controlled Option who is a current or former employee upon the exercise of the option will be deductible by the company issuing shares in satisfaction of the

¹In Rev. Rul. 80-76, an individual owning stock in corporation P transferred stock to an employee of Corporation S, which was controlled by P within the meaning of section 368(c) of the Code. Rev. Rul. 80-76 holds, in part, that S is allowed the section 83(h) deduction.

PLR-103668-99

Distributing Option or the Controlled Option, provided the deduction meets the requirements of section 162. Section 83(h).

(5) Amounts includible in the gross income of each holder of a Divided Option who is an Eligible Employee will be deductible by the company issuing the shares in satisfaction of such Divided Option, provided the deduction meets the requirements of section 162. Section 83(h).

(6) Assuming the other conditions of section 1.162-27(e)(2) of the regulations are met with respect to the Controlled Options, Divided Options, and Adjusted Options, the spread upon the exercise of Controlled Options, Divided Options, and Adjusted Options will constitute "performance-based compensation" within the meaning of section 162(m) of the Code.

(7) The fact that B was an officer of Distributing will not cause him to be treated as a former officer of Controlled 1 for purposes of section 1.162-27(e)(3)(i)(C) of the regulations and therefore will not preclude B from qualifying as an "outside director" of Controlled 1 within the meaning of section 162(m) of the Code and section 1.162-27(e)(3)(i)(C) of the regulations.

(8) The exercise of a Divided Controlled Option by an individual who ceases to be a Distributing non-employee director, and becomes a non-employee director of Controlled 1 or Controlled 2 will not constitute remuneration for services other than as a director, from Controlled 1 or Controlled 2 (as the case may be) to such individual for purposes of section 1.162-27(e)(3)(i)(D) of the regulations. Such exercise will not preclude such individual from qualifying as an "outside director" of Controlled 1 or Controlled 2 within the meaning of section 162(m) of the Code and section 1.162-27(e)(3) of the regulations.

Except as expressly provided herein, no opinion is expressed or implied concerning 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(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any federal income tax return to which it is relevant.

PLR-103668-99

In accordance with the power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

ROBERT B. MISNER
Assistant Chief, Branch 4
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)

Enclosure:

Copy for section 6110 purpose