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Department of the Treasury

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Person to Contact:

Telephone Number:

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PLR-117412-00/CC:TEGE:EB:EC

Date:

May 14, 2001

New Parent =

Old Parent =

Subsidiary =

This is in reply to your letter dated September 8, 2000 and subsequent correspondence and representations on behalf of New Parent. New Parent has requested a ruling on the federal income tax consequences under section 83 of the Internal Revenue Code with respect to the exercise of stock options by certain employees of Subsidiary.

Subsidiary was a wholly-owned subsidiary of Old Parent from [redacted]. During this period, the employees of Subsidiary had been granted non-statutory stock options and/or incentive stock options to purchase Old Parent stock (the Old Parent Options). The exercise price of each Old Parent Option was not less than 100 percent of the fair market value of the optioned stock on the date of grant of the options, and none of the Old Parent Options had a readily ascertainable fair market value when granted.

In [redacted], New Parent acquired Subsidiary in a stock acquisition, and Subsidiary became a wholly-owned subsidiary of New Parent. The Old Parent Options were not exchanged as part of the acquisition. Rather, as part of the acquisition, the Old Parent Options that were held by Subsidiary employees became immediately vested and those Subsidiary employees were given a period of ninety days beginning on the date of the acquisition to exercise all their outstanding Old Parent Options. The affected employees were the common law employees of Subsidiary during the entire period from the date of grant of the Old Parent Options, through the date of option vesting, and until the date on which these Old Parent Options were exercised.

In [redacted] until the date of the acquisition of Subsidiary by New Parent, Old Parent was responsible for the payment of all salary, bonus, and stock-related compensation to the employees of Subsidiary. Old Parent performed all the required withholding and deposited all required payroll taxes with respect to all the compensation paid to the employees of Subsidiary during this period, and reflected these payments on Forms W-

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2 for issued to each Subsidiary employee. Shortly after New Parent acquired Subsidiary, Old Parent stopped paying cash wages to the Subsidiary employees because New Parent assumed this responsibility from Old Parent. However, for the ninety days after the acquisition in , Old Parent retained the responsibility to transfer Old Parent stock to the employees of Subsidiary upon the exercise of an Old Parent Option. As required under the terms of the stock option plan, Old Parent was also required to withhold upon and report the compensation income arising from the exercise of the Old Parent Options and make the related payroll tax deposits.

You have represented that Subsidiary did not take a deduction on its pro forma tax return for that short year that ended on the date Subsidiary was acquired by New Parent for any compensation related to the Old Parent Options that were exercised by Subsidiary's employees following the date of the acquisition. You further represent that the terms of the sale of the Subsidiary did not include any allocation to Old Parent of the compensation expense related to the post-acquisition exercise of the Old Parent Options by the employees of the Subsidiary.

Section 83(a) of the Code generally provides that if, in the 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 over the amount paid for the property is included in the service provider's 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 1.83-7(a) of the Income Tax Regulations provides that if stock options do not have a readily ascertainable fair market value at the time the options are granted, the optionee will recognize income when the options are exercised or otherwise disposed of.

Section 83(h) of the Code and section 1.83-6(a)(1) of the regulations provide that in the case of a transfer of property under section 83, the person for whom services were performed shall be allowed a deduction under section 162 equal to the amount included in the gross income of the person who performed the services, but only to the extent that such amount meets the requirements of section 162 and the regulations thereunder. The deduction shall be allowed for the taxable year of the service recipient 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.

Under section 1.83-6(a)(2) of the regulations, the service provider is deemed to have included the amount as compensation if the service recipient timely satisfies all the requirements of section 6041 governing the filing of Forms 1099 or W-2, as appropriate.

Under section 3401(d) of the Code, the term "employer" generally means the person for whom an individual performs any service, of whatever nature, as the employee of such person. However, under section 3401(d)(1), if the person for whom

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the individual performs the services does not have control of the payment of the wages for such services, the term “employer” means the person having control of the payment of such wages.

Section 1.421-7(h)(2) of the regulations provides that in order to qualify for the special tax treatment of section 421, in addition to meeting the requirements regarding the option recipient’s status as an employee of the corporation granting the option at the time the option is granted, an individual exercising an incentive stock option must, at all times during the period beginning with the date of the granting of such option and ending at the time of such exercise or on the day 3 months before the date of such exercise, be an employee of either the corporation granting such option or a related corporation.

Section 421(a)(2) provides that if a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a) are met, no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 424(a) applies, with respect to the share so transferred.

Section 1.1502-76(b)(1)(i) of the regulations provides that a consolidated income tax return must include the common parent’s items of income, gain, deduction, loss and credit for the entire consolidated return year, and each subsidiary’s items for the portion of the year for which it was a member. If the consolidated return includes the items of a corporation for only a portion of its tax year, items for the portion of the year not included in the consolidated return must be included in a separate return (including a consolidated return for another group).

Section 1.1502-76(b)(1)(ii) of the regulations provides that if a subsidiary becomes or ceases to become a member of a consolidated group during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day.

Section 1.1502-76(b)(2)(i) of the regulations provides that the returns for the years that end and begin with the subsidiary becoming (or ceasing to be) a member are separate returns for all Federal income tax purposes. The returns are subject to the rules of the Internal Revenue Code applicable to short periods, as if the subsidiary ceased to exist on becoming a member (or first existed on becoming a nonmember).

Section 1.1502-76(b)(2)(ii) of the regulations provides that although the periods ending and beginning with the subsidiary’s change in status are different tax years, certain items may be ratably allocated between the periods if the subsidiary is not required to change its annual accounting period or its method of accounting as a result of its change in status and if an irrevocable ratable election is made.

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Based on the information provided and the representations made, we conclude that:

(1) Subsidiary, as the service recipient with respect to the Old Parent Options, is entitled under section 83(h) of the Code to claim a deduction under section 162 of the Code with respect to the income arising under section 83(a) from the transfer of Old Parent stock to an employee of Subsidiary upon the exercise of a nonstatutory Old Parent Option after the acquisition of Subsidiary by New Parent, provided that Old Parent has timely satisfied all the requirements of section 6041 governing the filing of Form W-2 with respect to the employee reporting the related stock option income and the deduction otherwise meets the requirements of section 162.

(2) The exercise of incentive stock options by employees of Subsidiary within 90 days of the date of the acquisition of Subsidiary by New Parent will not, in itself, adversely impact the treatment under section 421 of such options or the stock received upon exercise of such options.

(3) Subsidiary is not entitled to a deduction as a result of the exercise of incentive stock options by its employees within 90 days of the date of the acquisition of Subsidiary by New Parent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

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

Copy for 6110 purposes