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Department of the Treasury

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December 23, 1999

A =

X =

\$x =

D1 =

This is in response to your letter, dated August 23, 1999, written on behalf of A, in which a ruling is requested concerning the federal income tax treatment of a testamentary transfer to charity of vested nonqualified stock options under sections 83 and 691 of the Internal Revenue Code.

According to the information submitted, A is the retired Chairman and former member of the Board of Directors of X. A presently holds vested nonqualified stock options that have an exercise price of \$x and which will expire on D1. A does not intend to transfer any of these options during his lifetime.

The plan under which the options were granted provides that the stock options may be devised to a beneficiary designated by A at his death. The option term is for a period of not more than 15 years from the grant date, subject to the termination provisions of the plan. At A's retirement, the option agreement provided that any vested options would be exercisable for the balance of the initial exercise period. If A dies prior to the end of the option exercise period, A's unexercised options may be exercised by his beneficiary during the remaining period. A wishes to name a charitable organization, qualified under section 501(c)(3), as the designated beneficiary of a portion of the X nonqualified vested options.

A has requested a ruling that A's bequest of the X nonqualified employer stock options to a charitable organization will result in income in respect of a decedent under section 691 to the charitable organization at the time the options are exercised by the charitable organization, and not to A's estate if it is still open at the time of the exercise, and not to the heirs or devisees of A if A's estate is closed at the time the options are exercised.

Section 691(a)(1) of the Internal Revenue Code provides the

general rule that the amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period shall be included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

Section 691(a)(2) provides that if a right described in section 691(a)(1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term 'transfer' includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

Section 691(a)(3) provides that the right to receive an amount of income in respect of a decedent shall be treated, in the hands of the estate of the decedent or any person who acquired such right by reason of the death of the decedent, as if it had been acquired by the estate or such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross income shall be considered in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount.

Section 1.691(a)-1 of the Income Tax Regulations provides that the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting

employed by the decedent.

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 such services are performed, the excess of--(1) the fair market value of such 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 the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. Under § 83(e)(3), § 83 does not apply to the transfer of an option without a readily ascertainable fair market value.

Section 1.83-1(d) of the regulations provides that if substantially nonvested property has been transferred in connection with the performance of services and the person who performed such services dies while the property is still substantially nonvested, any income realized on or after such death with respect to such property under § 83 is income in respect of a decedent to which the rules of § 691 apply. In such a case the income in respect of the property shall be taxable under § 691 (except to the extent not includible under § 101(b)) to the estate or beneficiary of the person who performed the services, in accordance with § 83 and the regulations thereunder.

Section 1.83-7(a) of the regulations provides, in part, that if there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performances of services, an option to which § 421 (relating generally to certain qualified and other options) does not apply, § 83(a) shall apply to the grant if the option has a readily ascertainable fair market value (determined in accordance with § 1.83-7(b)) at the time the option is granted. If § 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 option grant, §§ 83(a) and 83(b) 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, §§ 83(a) and 83(b) apply to the transfer of property pursuant to the exercise, and the employee or independent contractor realizes compensation upon the transfer at the time and in the amount determined under § 83(a)

or 83(b). If the option is sold or otherwise disposed of in an arm's length transaction, §§ 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as §§ 83(a) and 83(b) would have applied to the transfer of property pursuant to the exercise of an option. See § 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. However, § 1.83-7 is silent regarding the transfer of a nonstatutory option in a non-arm's length transaction.

A taxpayer who has received the transfer of an option in connection with the performance of services that at grant does not have a readily ascertainable fair market value is essentially in the same economic position as a taxpayer who receives nonvested restricted stock. Both taxpayers are not in receipt of current taxable income, but will receive income at some future date when either the stock vests or the option is exercised. Thus, although section 1.83-1(d) refers only to income that is income in respect of a decedent under section 691 when a person who performed services dies before stock vests, that same treatment should be afforded to income attributable to options.

Based on the information submitted and the representations made, we conclude that A's bequest of the X nonqualified employer stock options to a charitable organization will result in income in respect of a decedent under section 691 to the charitable organization at the time the options are exercised by such charitable organization, and not to A's estate if it is still open at the time of the exercise, and not to the heirs or devisees of A if A's estate is closed at the time the options are exercised.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provision of the Code.

This ruling is directed only to the taxpayer 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 A and A's second authorized representative.

Sincerely yours,
J. THOMAS HINES
Acting Branch Chief, Branch 2
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter/Copy for § 6110 purposes