

## INTERNAL REVENUE SERVICE

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June 12,2002

### LEGEND:

Company =

Plan =

Dear

This is in reply to a letter dated January 15, 2002, submitted on behalf of Company by its authorized representative, in which a ruling is requested that the Plan qualifies as an "employee stock purchase plan," as defined in section 423(b) of the Internal Revenue Code. Additional rulings are requested concerning the tax consequences of the Plan.

The facts submitted are that Company's board of directors adopted the Plan on August 5, , and that its shareholders approved the Plan on May 10, , effective October 1, . Initially, the aggregate maximum number of shares of Company common stock that could be purchased through the exercise of options granted under the Plan was . However, as allowed under the Plan, that maximum number of shares was later increased to to reflect changes in the capitalization of Company. The Plan, as most recently amended and restated by Company's board of directors, became effective on June 5, .

Under the Plan, only employees of Company or of a participating subsidiary corporation who are employed by an Employer may participate in the plan. For purposes of the Plan, the term "Employer" is defined to include only Company and any "Subsidiary" of Company. The term "Subsidiary" is defined in the Plan to include any corporation in an unbroken chain of corporations beginning with Company, each of which (other than the last corporation in the chain), at the time of the granting of the option in question, owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

Employees become eligible to participate in the Plan on the Commencement

Date next following the date that they begin employment. "Commencement Date" is defined in the Plan as the first day of a Plan Period, of which there are four. "Plan Period" is defined as successive periods of three months beginning on October 1 of one year and ending on September 30 of the following year.

An employee may not be granted an option if, immediately after the option is granted, the employee owns stock possessing five percent or more of the total combined voting power or value of all classes of stock of Company or of a "subsidiary corporation" (as defined in section 424(f) of the Code). For purposes of these determinations, the rules of section 424(d) of the Code and 1.423-2(d)(2) of the regulations will apply, and stock that the employee may purchase under outstanding options (whether issued pursuant to the Plan or otherwise) will be treated as owned by the employee. Additionally, no employee may be granted an option that permits the employee's rights to purchase stock under all employee stock purchase plans of Company and its and subsidiary corporations to accrue at a rate that exceeds \$25,000 of fair market value of such stock (determined at the time such option is granted) for each calendar year in which such option is outstanding at any time.

Employees who are eligible to participate in a Plan Period will be furnished a summary of the Plan and an enrollment form. Employees who elect to participate in the Plan Period will complete the form and file it with their Employer no later than 7 days prior to the next Commencement Date. The enrollment form will authorize the Employer to deduct from the employee's compensation an after-tax amount during each payroll period equal to either a specific dollar amount (at least \$5.00) or a specified percentage (up to 15 percent) of the employee's Base Pay on the Commencement Date. For this purpose, "Base Pay" is defined as monthly wages and salary, and average monthly tips, but not overtime or bonuses. A participant's base pay is determined before subtracting elective deferrals to Company's section 401(k) and nonqualified deferred compensation plans, and salary reduction contributions to a cafeteria plan described in section 125 of the Code. The dollar amount deducted each payday is credited to the participant's contribution account. Contributions may not commence at any time during the Plan Period other than on a Commencement Date. Employees who elect to participate in the Plan are enrolled in the Plan as of their first payday after the Commencement Date following their submission of the enrollment form.

Employees can change their contribution rates or discontinue contributions. Except during the last 10 days of a Plan Period, employees may withdraw their contributions and, thereby, become ineligible to participate in *that* Plan Period. Additionally, employees who neither discontinue their contributions nor withdraw them may make one lump-sum contribution to their account during each Plan Period. Lump-sum contributions must be paid by check at least 10 days prior to the last day of the Plan Period. In no event, however, may the total contributions to an employee's account exceed 15 percent of the employee's Base Pay per month on the relevant Commencement Date multiplied by three months.

On the Grant Date (the first trading date of each Plan Period on the NASDAQ

National Market System), each participating employee will be granted an option to purchase Company shares. The maximum number of shares that may be purchased on Exercise Dates falling within the same calendar year will equal the lesser of 2500 shares or the number of shares allowed under section 423(b)(8) of the Code. The term "Exercise Date" is defined in the Plan as the last trading day of each Plan Period on the NASDAQ National Market System.

The Exercise Price of options granted under the Plan will be the lesser of 85 percent of the Closing Market Price of Company stock on the Exercise Date or 85 percent of the average of the Closing Market Price Company stock on the Grant Date and the Closing Market Price of Company stock on the Exercise Date. For this purpose, the Closing Market Price for such dates is defined as the last sale price of the stock as reported in the NASDAQ National Market System on the date in question, or, if no sales occur on that date, the last sale price of the stock on the most recent date preceding the date specified in which a sale of the stock occurred.

On the Exercise Date, all options that were granted on the corresponding Grant Date will be automatically exercised, except that options granted to employees who have terminated employment or withdrawn their account balances will automatically expire. The amount credited to a participant's account will be used to purchase the maximum number of whole shares that is determined by dividing the option's Exercise Price into the participant's account balance. At the participant's election, any balance remaining in the account will either be returned to the participant or retained for future purchases under the Plan by the participant. On the Exercise Date, Employees who purchase shares will be able to vote those shares, receive declared dividends on those shares, and will have normal liquidation rights with respect to those shares.

Options granted under the Plan are not assignable or transferable by the participating employee other than by will or by the laws of descent and distribution and are exercisable during the optionee's lifetime only by the optionee. The Plan provides that all employees granted options under the Plan will have the same rights and privileges with respect to such options.

In pertinent portion, section 421(a) of the Code provides that, if a share of stock is transferred to an individual in a transfer in which the requirements of section 423(a) are met, no income results to the individual at the time of the transfer, no deduction under section 162 is allowable at any time to the employer corporation with respect to the share transferred, and no amount other than the price paid under the option is considered as received by the employer corporation for the share transferred.

Under section 421(b), if the transfer of a share of stock to an individual pursuant to his exercise of an option would otherwise meet the requirements of section 423(a) except that there is a failure to meet any of the holding period requirements of section 423(a)(1), then any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred

attributable to such disposition, is treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred.

Section 423(a) of the Code provides that section 421 will apply to the transfer of a share of stock to an individual pursuant to the exercise of an option granted under an employee stock purchase plan if (1) no disposition of the stock is made by the individual within two years after the date of grant of the option nor within one year after the transfer of such share to him or her, and (2) at all times during the period beginning with the date that the option is granted and ending 3 months before the date of its exercise, the optionee remains an employee of the granting corporation, a parent or subsidiary corporation of such corporation, or a corporation (or parent or subsidiary corporation of such corporation) issuing or assuming a stock option in a transaction to which section 424(a) applies.

For purposes of these determinations, section 424(e) of the Code defines "parent corporation" as any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations (other than the employer corporation) owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain. Section 424(f) defines "subsidiary corporation" as any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

Section 1.421-7(a)(1) of the Income Tax Regulations provides, in part, that, for purposes of sections 421 and 423 of the Code, the term "option" includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under section 1.421-7(e), such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

Section 1.421-7(c)(1) of the regulations provides, in part, that, for purposes of sections 421 and 423 of the Code, the words "the date of the granting of the option" and "the time such option is granted" (and similar phrases) refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option.

For purposes of determining when an option is granted, a corporation "completes

corporate action," within the meaning of section 1.421-7(c)(1) of the regulations, when, pursuant to the terms of its offer, the number of shares of stock that may be purchased is fixed and determinable. If an offer to sell stock does not designate a fixed and determinable maximum number of shares that an employee may purchase, corporate action has not been completed. See Revenue Ruling 68-317, 1968-1 C.B. 186, and Revenue Ruling 70-358, 1970-2 C.B. 96, both of which are clarified by Revenue Ruling 73-223, 1973-1 C.B. 206.

Section 1.421-7(f) of the regulations provides, in part, that, for purposes of sections 421 and 423 of the Code, the term "exercise," when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. Generally, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the employee. A mere promise to pay the option price does not constitute an exercise of the option, unless the optionee is subject to personal liability on the promise. An agreement or undertaking by the employee to make payments under an employee stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

Section 423(b) of the Code defines an "employee stock purchase plan" as a plan that meets the requirements set forth in paragraphs (1) through (9) of that section. Section 423(b)(5) provides that, under the terms of the plan, all employees granted options under the plan must have the same rights and privileges, except that the amount of stock that may be purchased by any employee under the option may bear a uniform relationship to the total compensation (or the basic or regular rate of compensation) of employees, and the plan may provide that no employee may purchase more than a maximum amount of stock designated therein. See also section 1.423-2(f) of the regulations.

Under section 423(c) of the Code, if a share acquired under an employee stock purchase plan is held for the applicable holding periods, then, upon disposition of the share, a special rule applies if the option's exercise price was less than the share's fair market value when the option was granted. Under that rule, the optionee recognizes compensation income, in the taxable year in which the disposition occurs, equal to the lesser of (1) the excess of the fair market value of the share on the date of its disposition over the exercise price, or (2) the excess of the fair market value of the share when the option was granted over the exercise price. Additionally, the optionee recognizes long-term capital gain to the extent that the amount received upon the disposition exceeds the sum of (1) the amount (if any) paid for the option, (2) the option's exercise price, and (3) the compensation that was included in the optionee's gross income under the special rule. Similar rules apply if the stock is held until the optionee dies.

Section 83 of the Code governs the tax consequences resulting from disqualifying dispositions of Plan stock to the extent that section 421 does not apply. (Compare section 1.422A-1(b) of the Proposed Income Tax Regulations relating to "incentive stock options" described in section 422(b) of the Code).

Under section 83(a), 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 on the first day that the transferee's rights in the property are transferable or 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. Under section 1.83-7(a) of the regulations, if an option that was not taxable when granted is exercised, section 83(a) applies to the shares acquired pursuant to the exercise.

Applying the above law to the information submitted, we rule as follows:

- (1) The Plan qualifies as an "employee stock purchase plan" under section 423 of the Code.
- (2) Options granted to employees under the Plan are "options" for purposes of sections 421 and 423 of the Code.
- (3) The Plan's determination of payroll deductions and lump sum contributions that a participant may make to the Plan using the participant's "base pay" (which is determined before subtracting elective deferrals to Company's section 401(k) Plan, salary reductions contributed to Company's "cafeteria plan," and elective deferrals to Company's deferred compensation plan) satisfies section 423(b)(5) of the Code.
- (4) The Plan provision that permits employees to make one lump sum contribution to the Plan during each Plan Period satisfies section 423(b)(5).
- (5) For purposes of sections 421 and 423 of the Code, the date on which an option granted under the Plan will be considered to be "granted" will be that option's Grant Date as defined in the Plan.
- (6) For purposes of sections 421 and 423 of the Code, the date on which an option granted under the Plan will be considered to be "exercised" will be that option's Exercise Date as defined in the Plan.
- (7) An employee who exercises an option under the Plan will not recognize taxable income at the time of grant or exercise of the option.
- (8) If an employee disposes of shares purchased under the Plan *after* satisfying the holding period requirements of section 423(a)(1) of the Code, or if an employee dies while holding shares purchased under the Plan:
  - (a) The employee must include in income, as compensation, in the employee's taxable year in which the disposition or death occurs, an amount equal to the lesser of (i) the excess of the fair market value of the shares at the time of disposition or death over the amount paid for the shares, or (ii) the

excess of the fair market value of the shares on the Grant Date over the amount paid for the shares. See section 423(c) of the Code.

(b) Except in the case of death, the employee's basis in such shares at the time of their disposition will be the price paid for the shares increased by the amount included in the employee's gross income as compensation. Gain in excess of the employee's basis will be short-term or long-term capital gain as determined under the Code provisions applicable at the time of the disposition. In the case of death, an employee's estate's basis in the shares will be determined under section 1014 of the Code. See section 1.423-2(k)(2) of the regulations.

(c) If the fair market value of shares on the date of their disposition or the employee's death is less than the option price, then no amount is includible in the employee's gross income as compensation, and the full amount of any loss recognized (assuming that the stock was sold in an arm's length transaction) will be treated as short-term or long-term capital loss as determined under the Code provisions applicable at the time of the disposition. Compare Example (2) under section 1.423-2(k)(3) of the regulations.

(9) If an employee disposes of shares purchased under the Plan *before* satisfying the holding period requirements of section 423(a)(1) of the Code:

(a) The employee must include in gross income, as compensation, an amount equal to the excess of the fair market value of the shares on the applicable Exercise Date over the amount paid for those shares. Such amount will be includible in the employee's gross income for the taxable year in which the disposition occurs.

(b) The basis of the shares in the hands of the employee will consist of the amount paid for the shares plus the amount (if any) included in the employee's gross income as compensation, and the holding period for such shares will commence on the Exercise Date on which those shares were acquired. Gain in excess of the basis will be short-term or long-term capital gain as determined under the Code provisions applicable at the time of the disposition. If the employee's basis is greater than the amount received for the shares, the excess of that basis over the amount received will be short-term or long-term capital loss as determined under the Code provisions applicable at the time of the disposition.

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. In particular, we specifically note that no opinion is expressed regarding: (1) the methods used under the Plan to compute the fair market value of shares; (2) in what circumstances the issuance of stock certificates under the terms of section 8.1 of the Plan will result in either a "disposition" of the stock or a "disqualifying

disposition"; (3) the effects of any adjustments made under section 10.3 of the Plan; (4) the effect of section 10.5 of the Plan; and (5) the treatment of any options granted under the Plan that have a Grant Date prior to June 5, 2002. Finally please note that, if the Plan is amended, the above rulings may not remain in effect.

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

A copy of this letter should be attached to Company's federal income tax return for the year in which the Plan is implemented. A copy is enclosed for that purpose.

Sincerely yours,

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ROBERT B. MISNER  
Senior Technical Reviewer  
Executive Compensation Branch  
Office of the Division Counsel /  
Associate Chief Counsel  
(Tax Exempt and Government Entities)