

INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director, SB/SE Compliance

Taxpayers' Names:

Taxpayers' Address:

Taxpayers' Ident. No.:

Taxable Year at Issue:

Date of Conference:

Legend:

Taxpayer A =

Taxpayer B =

Company =

Plan =

Underwriting
Agreement =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

ISSUES:

- (1) Under the rules of section 83 of the Internal Revenue Code, when was the compensation income attributable to Taxpayer A's exercises of certain incentive stock options includible in his alternative minimum taxable income.
- (2) Under the rules of section 83, how is the amount of compensation income computed.

FACTS:

The facts submitted are that, on August 27 and November 18 of Year 1, Taxpayer A was granted ISOs under the Plan. Liability under section 16(b) of the 1934 Securities Exchange Act expired for those options on February 27 and May 18 of Year 2, respectively.

On May 5 of Year 2, Company sold shares of its common stock in an initial public offering. As required under the Underwriting Agreement (and other agreements), Taxpayer A (and other Company insiders holding shares or options exercisable within six months following the date of the offering) agreed not to sell, otherwise dispose of, or hedge any common shares, options, warrants, or convertible securities of Company from May 5 through November 2 of Year 2 ("the lock-up period").

Also in May of Year 2, Company adopted an Insider Trading Compliance Program, under which, as applied to Year 2, insiders (such as Taxpayer A) could trade Company shares only between November 5 and November 30 of that year ("the trading window"). After expiration of that trading window, Company denied Taxpayer A the right to trade in Company shares from December 1 of Year 2 until May of Year 3. Under the Program, if Taxpayer A had traded Company shares without Company's permission, Company had the right to terminate his employment.

The exercise of ISOs was not prohibited under the referenced agreements, and Taxpayer A exercised portions of his ISOs in July, August, and November of Year 2 and in April, June, and August of Year 3. In August and December of Year 3, Taxpayer A sold the shares that he acquired through the ISOs.

The above facts can be summarized as follows:

<u>Date of Grant</u>	<u>Dates 16(b) Expired</u>	<u>Dates of Exercise</u>	<u>Lock-Up Periods</u>	<u>Dates Sold</u>
Aug. 27 of Year 1	Feb. 27 of Year 2	July, Aug. & Nov. of Year 2; Apr., June & Aug. of Year 3	May 5 to Nov. 5 of Year 2; Dec. 1 of Year 2 to May of Year 3	Aug. & Dec. of Year 3
Nov. 18 of Year 1	May 18 of Year 2	Nov. of Year 2; Apr. & June of Year 3	May 5 to Nov. 5 of Year 2; Dec. 1 of Year 2 to May	Aug. & Dec. of Year 3

of Year 3

On their joint federal income tax return filed timely for Year 2, Taxpayer A and Taxpayer B ("Taxpayers") reported a tax preference item of \$499,521 that was attributable to the ISOs, and an overall Alternative Minimum Tax liability of \$151,053. On May 29 of Year 4, Company filed for bankruptcy. On October 16 of Year 4, Taxpayers filed an amended return for Year 2, seeking a \$148,758 abatement of that tax, claiming as follows:

The Internal Revenue Code requires that the fair market value of ISP [sic] stock at the time it is acquired be included in an AMT preference calculation if it is not sold the year it is acquired. Normally, the fair market value is the market price. However, where the stock is restricted, *i.e.*, where the stock cannot be liquidated at an ascertainable price or sold on the open market, the fair market value is not the same as the market price. The market value is of little assistance when valuing restricted stock.

The AMT as originally calculated for [Taxpayer A] was based on the market price of [Company] stock when it was acquired by [him]. As [his] stock was restricted, the fair market value was mistakenly assigned the market price. As noted above, the underlying stock could only be sold during a three-week window during the calendar year [Year 2], that is, 25 out of 365 days in Year 2. Accordingly, the fair market value used in the AMT preference should have reflected the fact that the stock could only have been transferred or liquidated during a three-week window in Year 2. Thus, the AMT preference must be adjusted to reflect the true fair market value of [Taxpayer A's Company] stock.

Because the stock was not liquid when acquired and in fact could only be transferred for a three-week period in [Year 2], we are proposing in the amended return to adjust the AMT preference to 0. Equity, fairness and the intent and purpose of the AMT laws mandate an adjustment of [Taxpayer A's] original AMT. Otherwise, he has a tax liability of more than \$165,000 and restricted stock that became worthless in about a year's time. The current liability is an absurdity and a surreal result clearly not contemplated by Congress when it devised the AMT law.

Additionally, Taxpayers contend that, because Taxpayer A would have been subject to penalties under Securities Exchange Commission ("SEC") Rule 10b-5 ("Rule 10b-5") if he had sold Company shares anytime during the period beginning in January of Year 2 and ending in May of Year 3, his rights in the Company shares purchased through exercise of his ISOs during those years were substantially nonvested during that period.

On their federal income tax return filed for Year 3, Taxpayers reported a tax preference item of \$183,866 attributable to ISOs.

LAW AND ANALYSIS:

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 422(a) are met (relating to ISOs), 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. Section 422(b) of the Code defines an ISO as an option that meets the requirements set forth in paragraphs (1) through (6) of that section.

Section 55 of the Code imposes an alternative minimum tax upon certain tax preference items such as ISOs. For purposes of computing alternative minimum taxable income, section 56(b)(3) of the Code provides that section 421 shall not apply to the transfer of stock acquired pursuant to the exercise of an ISO. The result is that, for alternative minimum tax purposes, the rules of section 83 of the Code that apply to nonstatutory options also apply to determine the compensation income (if any) attributable to ISOs.

Under section 83(a) of the Code, 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 (disregarding any lapse restriction), 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. More simply put, property is not taxable under section 83 until it is "transferred" to and "substantially vested" in the service provider (or beneficiary thereof).

For purposes of section 83 of the Code, a "transfer" of property occurs when a person acquires a beneficial ownership interest in the property (disregarding any "lapse restriction"). See section 1.83-3(a)(1) of the Income Tax Regulations.

Under section 1.83-3(h), a restriction which, by its terms, will never lapse (also referred to as a "nonlapse restriction") is a permanent limitation on the transferability of property that will require the transferee of the property to sell (or offer to sell) the property at a price determined under a formula and that will continue to apply and be enforced against the transferee or any subsequent holder (other than the transferor). An obligation to resell (or to offer to sell) the transferred property to a specific person or persons at its fair market value at the time of the sale is not a nonlapse restriction.

The term "lapse restriction" means a restriction other than a nonlapse restriction and includes (but is not limited to) a restriction that carries a substantial risk of forfeiture. See section 1.83-3(i) of the regulations.

For purposes of section 83 of the Code, property is substantially nonvested when it is both subject to a "substantial risk of forfeiture" and is "nontransferable" within the meaning of sections 1.83-3(c) and (d) of the regulations, respectively. Property is substantially vested when it is either transferable or not subject to a substantial risk of forfeiture.

Whether a risk of forfeiture is substantial (or not) depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person or the occurrence of a condition related to the purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Property is not subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, will not result in a substantial risk of forfeiture. See section 1.83-3(c)(1) of the regulations.

For purposes of section 83 of the Code, the rights of a person in property are "transferable" if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the transferee's rights in the property are not subject to a substantial risk of forfeiture. Accordingly, property is transferable if the person performing the services or receiving the property can sell, assign, or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to any person other than the transferor of the property and if the transferee is not required to give up the property or its value in the event that the substantial risk of forfeiture materializes. See section 1.83-3(d) of the regulations.

Section 83(e)(3) of the Code provides that section 83(a) does not apply to the transfer of an option without a readily ascertainable fair market value. However, section 83(a) does apply to such an option at the time that it is exercised, sold, or otherwise disposed of. If the option is exercised, section 83(a) applies to the transfer of property pursuant to the exercise. 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 it would have applied to the transfer of property pursuant to an exercise of the option. See section 1.83-7(a) of the regulations.

Under section 83(c)(1) of the Code and section 1.83-3(j) of the regulations, if the sale of property at a profit within six months after the purchase of the property could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934 ("section 16(b)"), the person's rights in the property are treated as subject to a substantial risk of forfeiture, and as not transferable, until the earlier of (1) the expiration of such six-month period, or (2) the first day on which the sale of such property at a profit will not subject the person to suit under section 16(b).

Section 16(b) is triggered by either a "purchase and sale" or a "sale and purchase" of a security within a period of less than six months by an officer, director, or greater-than-10% owner of the corporation. The combination of a purchase and a sale event (in either order) is what triggers section 16(b) liability.

Prior to 1991, the acquisition of a stock option was not typically viewed as a "purchase" for section 16(b) purposes, because there was no *requirement* to purchase

the stock. Rather, section 16(b) applied to the stock that was purchased through exercise of the option.

However, in 1991, section 16(b) was changed: thereafter, for purposes of that section, options generally had the same status as stock.¹ Stated another way, the SEC began treating transactions in derivative securities (e.g., options) as transactions in the underlying security (the stock), because, when an option has a fixed exercise price (such as Taxpayer A's ISOs), its grant locks in the opportunity to profit from a transaction in the underlying stock.

In implementing this change, the SEC went so far as to state that any acquisition or disposition of an option involves either a "purchase" or "sale" for section 16(b) purposes. The quid pro quo was that the SEC exempted from section 16(b) most exercises and conversions of options. In other words, after 1991, the six-month holding period under section 16(b) starts when an option is granted, not when it is exercised.

Thus, after 1991, section 16(b) interacts with section 83 of the Code as follows: if, for example, shares are acquired through the exercise of a nonstatutory option in a transfer taxable under the rules of section 83, such shares will *not* be subject to section 16(b) liability unless they are acquired during the six-month period beginning with the date of grant of the option. In this regard, section 1.83-3(j) of the regulations provides that, for purposes of section 83(c)(3), the six-month period under section 16(b) expires upon *the earlier of*:

- (1) the expiration of the six-month period; or
- (2) the first day on which the sale of such property at a profit will not subject the employee to section 16(b) liability.

Applying the above rules, because the ISOs were granted to Taxpayer A on August 27 and November 18 of Year 1, the section 16(b) periods applicable to those options expired on February 27 and May 18 of Year 2, respectively. Accordingly, both of those section 16(b) periods expired *before* the dates that Taxpayer A first exercised his ISOs and the Company shares purchased thereby were transferred to him (in July of Year 2 under the February option and in November of Year 2 under the August option). Thus, we conclude that neither section 16(b) nor section 83(c)(3) of the Code imposed a substantial risk of forfeiture on any of those shares. In this regard, because, when enacting section 83(c)(3) of the Code, Congress decided that the only provision of the securities law that would delay taxation under section 83(c)(3) of the Code would be section 16(b), we also conclude that Rule 10b-5 did not cause Taxpayer A's rights in

¹ Although an exception to this treatment may be elected under section 16(b), whereby liability under that section will apply to the stock instead of the option, Taxpayers have never claimed to have made that election.

the Company shares purchased through exercise of his ISOs to be substantially nonvested when they were transferred to him.

Moreover, under section 83's definitions of "substantially vested" and "transferable," it is clear that, in order for the lock-up agreements, *standing by themselves*, to have prevented section 83's taxation of Taxpayer A's rights in his shares when they were transferred to him, those agreements would have had to have made those rights subject to a "substantial risk of forfeiture." In this regard, we have been provided no information suggesting that Taxpayer A's or any subsequent transferee's retention of rights in the shares were conditioned upon *anyone's* "future performance (or refraining from performance) of substantial services." Thus, we conclude that the provisions of those agreements could not have prevented section 83's taxation of those rights when the shares were transferred to him.

Regarding valuation of the shares, it is clear that any transfer restrictions imposed on Taxpayer A's sales (or other trading) of the shares by the referenced agreements were "lapse restrictions" (as defined above), and that this is demonstrated by both their tolling (in the case of the Underwriter's Agreement and the lock-up agreements) and the window periods during which they were inapplicable (in the case of the Insider Trading Compliance Program). Thus, we conclude that those restrictions must be ignored when valuing the shares obtained under the ISOs under the rules of section 83. See section 83(a).

Finally, we note the issues in this case are (in relevant portion) the same as those considered in *Tanner v. Comm'r.*, 117 T.C. 237 (2001), *aff'd*, No. 02-60463 (5th Cir. Mar. 26, 2003), and that the conclusions reached in this technical advice memorandum are consistent with the decisions reached in that case.

CONCLUSIONS:

(1) Under the rules of section 83 of the Internal Revenue Code, the compensation income attributable to Taxpayer A's exercises of the ISOs was includible in his alternative minimum taxable income when the shares purchased under the ISOs were transferred to him.

(2) Under the rules of section 83, the amount of compensation income attributable to Taxpayer A's exercises of the ISOs is determined without regard to the stock-transfer restrictions imposed by the Underwriter's Agreement, the lock-up agreements, or Company's Insider Trading Compliance Program.

A copy of this technical advice memorandum is to be given to Taxpayers. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.