OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Compensation Expense Deduction

This Field Service Advice responds to your memorandum dated January 14, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Company =

Founder =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6	=
Trust	=
Foundation	=
Option	=
Agreement A	=
Agreement B	=
Firm	=
$A	=
$B	=
$C	=
$D	=
$E	=
$F	=
$G	=
$H	=
$J	=
Partnership A	=
Partnership B	=

Issue:

Under the rules of I.R.C. § 83, was Company entitled to a compensation expense deduction as a result of its executives' exercise of an option to purchase Company shares, or was that option earlier converted into a contract obligating the executives to purchase the shares, which would have caused the section 83 event to occur when the executives' contractual rights became substantially vested?[1]

Conclusion:

The restructuring plan and Agreement B converted the Option into a contract obligating the executives to purchase Company shares. Thus, Company was not entitled to a compensation expense deduction attributable to the purported exercise of that option.

Facts:

Founder founded Company in Year 1 and transferred all of his Company shares to Trust in Year 2. Initially, Founder was the sole trustee and sole beneficiary of Trust and, upon his death, Trust's Company stock was to be contributed to Foundation. Founder established Foundation as a vehicle for continuing Company after his death, and because he wanted certain Company executives who were the trustees of Foundation to operate Company in the same manner that he had during his lifetime. Despite those intentions, its was also intended that Foundation constitute a private charitable foundation.

Four years later, Founder was advised that, if Foundation owned the Company stock, it would not be treated as a private charitable foundation for federal tax purposes. As a result, in Year 3, Founder developed a revised plan to maintain Company as a unit after his death. The pertinent feature of that plan ("Agreement A") was the granting of a revocable nonstatutory option ("Option") for all of Trust's Company stock to senior Company executives. The Option was not exercisable until Founder's death, and it expired months thereafter. To participate in the Option, the executive had to be a member of Company's board of directors at the time of Founder's death. When granted, the Option had no "readily ascertainable fair market value," as that term is defined for purposes of I.R.C. § 83.

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1 You have concluded that the executives' partnership interests (discussed below) were transferred in connection with the performance of services, became substantially vested in Company's taxable year ending in Year 6, and resulted in compensation expense deductions for that year. We agree with those conclusions.

A significant feature of Agreement A was that the Option's exercise price was to be redetermined annually, using the same stock valuation method that had been adopted for Company's employee stock ownership plan ("ESOP"). Under that method, both marketability and minority-interest discounts were applied. Thus, because exercise of the Option would convey a majority ownership interest in Company, the executives were effectively afforded an opportunity to purchase control of Company at a considerable discount. In this regard, according to the lawyer who drafted Agreement A, Founder was aware of the discount, intended to confer a benefit on the optionees,

In January of Year 4, after Founder became incapacitated, one of the optionees and an "independent trustee" succeeded Founder as trustees of Trust. Shortly thereafter, it was concluded that the Option, as then structured, created significant problems. Among those problems were a perceived conflict of interest between the executives' roles as directors and their roles as optionees and anticipated difficulties in paying the exercise price even with the discount (i.e., as Company's value increased, so did the Option's exercise price).

By June of Year 5, Firm had developed a restructuring plan, two of the objectives of which were allowing the executives to recognize some of the anticipated benefits of the Option and providing assurance that it would be exercised. Additionally, the restructuring plan was designed to harmonize a number of the basic principles inherent in the previous arrangement, among which were preservation of the executives' contingent equity interests (attributable to the discounted exercise price), the executives (or the Foundation) becoming the eventual owners of Company, Founder's desire to have the executives acquire Company at his death, and Founder's intent to compensate the executives "for their many years of service."

Mindful of those objectives and principles, Company's board of directors approved a restructuring plan and Agreement B. Under the plan, of Company's executives each formed a separate S corporation, which, in turn, collectively formed a general partnership, Partnership A. Thereafter, Company and Partnership A formed another general partnership, Partnership B, and Company transferred substantially all of its assets and liabilities to Partnership B in exchange for an 80-percent general partnership interest in Partnership B. Contemporaneously, Partnership A was transferred a substantially-nonvested 20-percent general partnership interest in Partnership B, one-third of which was to vest annually in each of the subsequent three years. In December of Year 5, a conforming amendment was made to Partnership A's partnership agreement, under which all interests in Partnership A were made substantially-nonvested.

In the restructuring plan memorandum explaining the transaction, Partnership A's interest in Partnership B was described as follows:

> In summary, the Plan will, subject to certain vesting requirements, place an aggregate 20% equity interest in [Company's] business collectively in the hands of the remaining Optionees. * * * <u>The transfer of this equity interest will be in substitution for the contingent equity interest</u> which they now hold by virtue of the exercise price discount provided by the [Option]. (Emphasis added.) In order to complete this substitution, the Optionees will agree to pay the per share fair market value of [Company] when they exercise the [Option] (<u>i.e.</u>, the discount in the current exercise price will be eliminated).

The memorandum described the executives' rights to the remaining portion of Company as follows:

> The [Option] will remain outstanding following consummation of the Plan, and the Optionees will enter into an option exercise agreement [Agreement B] which <u>will commit them to exercise of the [Option] when it becomes exercisable</u>. [Agreement B] will be supported by a standby credit facility and by the deposit of the surplus cash received by [Partnership A] from [Partnership B] in an escrow account. (Emphasis added.)

Consistent with the above statements, Agreement B contained the following language in paragraph 1, entitled "<u>Exercise of [Company] Stock Option: Increase in Exercise Price</u>":

> 1. (a) In the event that the Stock Option shall become exercisable in accordance with its terms, each of the Optionees <u>shall</u>, in accordance with the terms of the Stock Option, join in the exercise of the Stock Option.

Consistent with the terms of Agreement B, Agreement A, which was the stock option agreement executed by Founder before the restructuring, was amended to provide as follows:

> 2. The Stock Option Agreement <u>requires</u> the Option to be exercised within months of [Founder's] death. (Emphasis added.)

Consistent with Agreement B's requirement that the Option be exercised, Agreement B also required that the executives pay liquidated damages if the Option was not exercised. Specifically, paragraph 3(e) of Agreement B and the Escrow Agreement provided that the cash held in the escrow account would be returned to Company if the option was not exercised. Additionally, subparagraph 3(a) of Agreement B, entitled "Right of Repurchase; Liquidated Damages," provided as follows:

> If the optionees (i) permit the period during which the Stock Option is exercisable to expire without exercising the Stock Option, or (ii) prior to the Stock Option's becoming exercisable have all ceased to be members of the Board of Directors of Company (whether by death, resignation or involuntary termination or otherwise) (each such circumstance, a "Default"), then Company shall, upon the occurrence of such Default, have a perpetual option (the "repurchase Option"), exercisable at any time, to purchase or cause the partnership to redeem all, but not less than all, of the partners' general partnership interest in the partnership . . . . The exercise price of the Repurchase Option shall be equal to the fair market value of such partnership interest (determined as provided below) as of the last day of the last full fiscal quarter of the Partnership next preceding the date of the Exercise Notice."

Under the restructuring plan, some new requirements were imposed on the executives and on Company, which included (1) the executives entering into five-year employment contracts with Company, (2) Company's release from some deferred compensation obligations to the executives, unless an executive's employment was involuntarily terminated prior to the purchase of Company stock, and (3) the amendment of Company's ESOP to provide that Company was required to purchase the Company shares owned by the ESOP at their fair market value (i.e., without marketability or minority interest discounts, and without adjustment for certain special allocations in the Partnership B partnership agreement). If there was a bona fide offer to acquire Trust's Company shares, Company agreed to purchase the ESOP's shares at the higher of that offer price or the formula price contained in the revised ESOP agreement. Annual valuations of Company's stock would continue. The parties implemented the restructuring by forming Partnership B.

Agreement B also provided that, until the earlier to occur of the exercise or the expiration of the Option, the executives would cause Partnership A to annually deposit all Excess Cash to an Escrow Account. “Excess Cash” was defined as all cash distributions made by Partnership B to Partnership A during the fiscal year in excess of the optionees’ federal, state, and local tax liabilities attributable to the operation of Partnership B and the income generated by the Escrow Account.

The Escrow Agreement (which was between Partnership A, Company, the executives, and Firm) (containing the escrow account mentioned in the restructuring plan) provided that the escrowed funds would be released as follows: (1) if, prior to the death of Founder, all of the executives ceased to be members of the board of directors, Company would receive the funds; (2) if the Option was exercised, Partnership A would control release of the funds; (3) if the Option expired unexercised, Company would receive the funds; and (4) if Partnership A, Company, and Trust jointly agreed, the funds would be released as so agreed. Firm was the escrow agent.

On December 31 of Year 5, in anticipation of a proposed change in the tax law that was intended to limit the deductibility of executive compensation, Company accelerated the full vesting of the executives’ interests in Partnership A and Partnership A’s 20-percent interest in Partnership B. As a result, the executives included the fair market values of their individual partnership interests in their Year 5 gross incomes under the rules of section 83.

In Year 6 Founder unexpectedly died. After Founder’s death, third parties approached the executives with proposals to purchase Company, and Firm requested and received a right of first refusal enabling it to match one of the offers. Eventually, Firm and the executives agreed to a sale of Company, which included the following terms:

(1) The three executives would purchase certain Company assets (that Firm did not want) for balloon payment notes of $F;

(2) Upon exercise of the Option, Firm would purchase the optioned stock from the executives for a total of $G (which reflected the cancellation of the $F in balloon payment notes);

(3) Firm would purchase the three S Corporations’ interests in Partnership A for an aggregate amount of $H; and

(4) The executives would enter into employment agreements, consulting agreements, and non-competition agreements with Firm.

At the time that the restructuring plan was formulated, it was assumed that the executives would finance at least part of the shares' purchase price, and a $N shelf note facility was obtained for that purpose. However, because the purchase and sale of the stock to Firm were scheduled to take place at the same time, the executives did not need to obtain financing for the purchase.

Close in time to the transactions' closings, Firm and the executives revised the acquisition agreement to address certain tax issues. One change provided that Company would claim a compensation expense deduction attributable to the exercise of the Option that would not exceed the difference between Firm's purchase price for the stock and the Option's exercise price. (Determined by the parties to be the $B at issue.) Another change was that Firm agreed to in effect "gross up" the executives by agreeing to pay them 100 percent of its first in tax savings resulting from the deduction. Any tax savings exceeding were to be paid 75 percent to the executives and 25 percent to Firm.

<u>Analysis</u>:

Under I.R.C. § 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 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 that includes that day. According to section 83(h), the service recipient is allowed a deduction of the amount included in the service provider's gross income under section 83(a).

Stated differently, property is not taxable under section 83 until it is transferred to and substantially vested in the service provider (or beneficiary thereof). Until the property becomes substantially vested, the transferor of the property is considered to be the owner of the property, and any income from the property received by the service provider (or beneficiary thereof) constitutes additional compensation to the service provider for the taxable year in which it is received. See Treas. Reg. § 1.83-1(a)(1).

A "transfer" of property occurs when a person acquires a beneficial ownership interest in the property (disregarding any "lapse restriction," as defined in Treas. Reg. § 1.83-3(i). See Treas. Reg. § 1.83-3(a)(1). The grant of an option to purchase property does not constitute a transfer of such property. See the first sentence of Treas. Reg. § 1.83-3(a)(2).

As a preliminary matter, was the Option or the contract transferred "in connection with the performance of services"?

Treas. Reg. § 1.83-3(f) provides that property transferred to an employee or an independent contractor (or beneficiary thereof) in recognition of the performance (or the refraining from performance) of services is considered "transferred in connection with the performance of services" within the meaning of section 83. The transfer of property is subject to section 83 if it is in respect of past, present, or future services.

When addressing the intended scope of the term "in connection with the performance of services," the Court in Montelepre Systemed, Inc. v. Commissioner, T.C. Memo. 1991-46, aff'd, 956 F.2d 496 (5th Cir.1992), stated as follows:

> By using the term "in connection with," the plain language of the statute does not require the property to be transferred as "compensation" for the performance of services. [Citing Alves and MacNaughton]. Rather, the statute only envisions *some sort* of relationship between the services performed and the property transferred. (T.C. Memo. at page 1786) (Emphasis added.)

Various judicial decisions have developed the required nexus of this relationship, and there are essentially four factors that those decisions have considered: (1) Whether the property right is granted at the time the employee or independent contractor signs his employment contract; (2) whether the property restrictions are linked explicitly to the employee's or independent contractor's tenure with the employing company; (3) whether the consideration furnished by the employee or independent contractor in exchange for the transferred property is services; and (4) the employer's intent in transferring the property. See Centel Communications Co. v. Commissioner, 92 T.C. 612 (1989), aff'd, 920 F.2d 1335 (7th Cir. 1990); Bagley v. Commissioner, 806 F.2d 169 (8th Cir. 1986), aff'g 85 T.C. 663 (1985); and Alves v. Commissioner, 734 F.2d 478 (9th Cir. 1984).

Based on the information submitted it is clear that the Option, both before and after its revision, was transferred "in connection with the performance of services." In this regard, we note that under no circumstances could the Option be exercised by an executive who left Company prior to its becoming exercisable (i.e., the executives had to perform substantial *future* services in order to exercise the revised option).

Was Company entitled to a compensation expense deduction as a result of its executives' exercise of an Option, or was the Option earlier converted into a contract obligating the executives to purchase the shares, which caused the section 83 event to occur when the executives' contractual rights became substantially vested?

Section 83(e)(3) provides that section 83 does not apply to the transfer of an option without a readily ascertainable fair market value. In this case, were we to conclude that an "option" was transferred to the executives it would clearly be an option without a readily ascertainable fair market value because the underlying stock was not traded on any established securities market and because the Option was not immediately exercisable. See Treas. Reg. § 1.83-7(a) and (b). However, for the following reasons, we conclude that these rules applicable to options did not apply in the case because, upon completion of the restructuring plan, the executives' Option was converted into a contract to purchase Company and the contract became vested in the executives when they were serving on Company's board at the date of Founder's death. Thereafter the contract remained an option in name only.

The term "property" is not defined in the statute; however, that term is broadly defined in Treas. Reg. § 1.83-3(e) as including real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. Clearly, under this definition a contract to purchase would be included in the term property.

Although section 83 and the regulations thereunder do not define the term "option" for purposes of that section, Treas. Reg. § 1.421-7(a)(1) provides a currently useful definition of "option" that was also applied by the predecessor regulations to section 83's regulations:

> 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 [specified] price . . . , such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. 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. (Emphasis added.)

In Theophilos v. Commissioner, 85 F.3d 440 (9th Cir. 1996), rev'g T.C. Memo. 1994-45, the Court of Appeals for the Ninth Circuit considered the issue of whether the service provider was transferred a contract to purchase stock or an option. The court held that a binding contract requiring a service provider to purchase a service recipient's stock is "property" for purposes of section 83, and that, if such a contract is taxable under the rules of section 83, then the subsequent purchase of stock pursuant to that contract is not. The court found that, when the service provider entered into the contract, he became personally obligated to purchase the stock (as long as the service recipient completed a reorganization), regardless of whether he thought that the stock continued to be an attractive purchase. The court noted that the fact that the service provider was obligated to pay the stock's purchase price was strong evidence that he had already received property under section 83 when he made that binding commitment. On this point the court states at page 446:

> Moreover, the 1986 shareholder agreement provided for the number and price of the Class B stock the taxpayer would purchase after GSM's recapitalization, not for the stock he could purchase. (Emphasis provided by the court.)

In reaching its conclusions, the Theophilos court referenced Moser v. Western Harness Racing Association, 200 P.2d 7, 12 (Cal. Ct. App. 1948), where Moser stated that "An offer to purchase stock and to accept and pay for it upon specified conditions becomes binding upon the parties when it is accepted by the corporation, and the subscriber can thereafter withdraw only upon the failure of the corporation to meet the conditions." It also referenced Ballantine on Corporations, § 193 at 457-58 (1946), which states that "Ordinarily, a conditional subscription should be regarded, if possible, as constituting a present contract with conditions precedent to the duty to pay or to deliver a certificate, from which the subscriber cannot withdraw unless the corporation fails in performance of the condition."

An application of the above-cited authorities to the facts in this case requires us to conclude that the Option was converted by the restructuring plan and Agreement B into a contract to purchase Company shares, and that the contract became vested in the executives who remained on Company's board of directors when Founder died. Five factors lead us to that conclusion. First, the parties noted that the executives could not afford to exercise the Option in its form prior to restructuring, and thus devised a plan that would, effectively, guarantee its exercise. Second, the parties specifically noted in Agreement B that the perpetual compensatory element that existed in the initial Option was exchanged for the partnership interests, and that, thereafter, the executives would pay full value for the remainder of Company. Third, after revision of the Option, all of the transaction documents provided that the Option would be exercised, not that it could be exercised, a particular notable fact since, unlike the situation in Theophilos, the purchase price was to be reduced if the value of Company decreased.[2] Fourth, Agreement B called for damages to be suffered by the executives if they failed to purchase the stock, a provision that is not compatible with an option. [3] Finally, the executives were prepared to purchase the shares using a standby letter of credit in a transaction that would never have been, absent a gross up payment, treated by them as compensatory.

We anticipate that Company, citing to Treas. Reg. § 1.83-3(a)(2), will oppose this conclusion by contending that the transaction continued to be in substance an option after Agreement B was executed, because the executives' personal liability was limited under the damages clause. Treas. Reg. § 1.83-3(a)(2), provides, in part, as follows:

> The grant of an option to purchase certain property does not constitute a transfer of such property . . . In addition, if the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is no personal liability to pay all or a substantial part of such indebtedness, such transaction may be in substance the same as the grant of an option. The determination of the substance of the transaction shall be based upon all the facts and circumstances. The factors to be taken into account include the type of property involved, the extent to which the risk that the property will decline in value has been transferred, and the likelihood that the purchase price will, in fact, be paid . . . .

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2 In fact, this could be viewed as a stronger case than Theophilos for reaching the conclusion that a contract was transferred rather than an option. In Theophilos, the employee agreed to purchase the stock for a fixed price and, thereafter, until the stock was actually purchased, did nothing. Here, after the restructuring, a mechanism was put in place to ensure that the stock would, in fact, be purchased.

3 And those damages could have been significant: the executives would have been required to sell their partnership interests back to Company for a price that would have been determined at least three months prior to the sale and would have forfeited the amount held in escrow (which could have been significant if Founder had not unexpectedly died).

Even were we to concede (we do not) that the damages clause in Agreement B was in substance tantamount to a purchase with nonrecourse financing, we believe that other surrounding facts and circumstances indicate that, but for Firm's offer, there was a transfer of a contract. A transfer of a contract occurred because the facts and circumstances in toto indicate that there was a likelihood that the purchase price would be paid.[4] Chief among those facts is the "type of property involved," which was a contract to purchase a controlling interest in a company that for many years had been the executives' employer. That is, even if at the vesting date of the contract, the value of Company was less than the executives' purchase price, there would have been a likelihood that the purchase price would have been paid by the executives in order to ensure that their future employment was not jeopardized. Other facts that show a likelihood that the purchase price would have been paid include, as previously mentioned, the language of Agreement B that required payment, and the restructuring plan, which was designed to ensure payment.

Case Development, Hazards and Other Considerations:

We think that the facts submitted provide a strong basis for concluding that the revised Option was actually a contract. Even so, the Service faces some litigation hazards.

In Theophilos, the Service and the courts had the advantage of having contentious parties before them (an employer and an ex-employee), each with strong differences of opinion as to how their transaction should be taxed. In contrast, here, because the executives were paid a portion of Company's tax saving, it would be against their interests to testify that they were not paid compensation income, and they may contend that they were never committed to purchase the stock under the contract.

The Service should, however, be able to overcome those arguments by referencing the above-cited provisions of the documents; by noting that, here, the executives' purchase price increased (or decreased) dollar for dollar with the changing value of Company (a fact not present in Theophilos); and by noting that, until Firm insisted that the executives include part of *Firm's* purchase price as compensation, the Option, as revised, had *nowhere* been characterized as a compensatory transaction. [redacted]

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4 Example (2) of Treas. Reg. § 1.83-3(a)(7), which interprets Treas. Reg. § 1.83-3(a)(2), notes that the mere existence of nonrecourse financing does not require the conclusion that property has not been transferred.

[redacted]

[redacted] that Company will probably contend, as mentioned above, that the mere existence of a “liquidated damages clause” (which relieved the executives of any threat that Company could put the stock to them and thereby create a personal debt obligation from them to Company) requires a conclusion that the Option, until the closing date, always retained the attributes of an “option.” Given the fact that there has been little litigation in this area other than the cases discussed above, it is difficult to predict how a court will view the liquidated damages clause.

On balance, it seems that a successful response to the anticipated liquidated damages argument, in addition to that mentioned above, would be that, under general contract law, specific performance of a sales contract is almost never awarded, so the fact that Company could not have “put” the stock to the executives does not mean that a contractual requirement to purchase did not exist. Additionally, because general contract law requires that damages be mitigated, and that, thereafter, the only damages available to sellers are lost profits, Agreement B’s statement that “If a Default occurs hereunder for any reason the parties hereto agree that the Trust and [Company] will suffer damages which are substantial but difficult to ascertain“ lends credence to the argument that the Option was, under local law, a binding contract to purchase. Thus, in a court’s view, the existence of the liquidated damages clause may serve to bolster the argument that the executives had a contract, not an option.[5] [redacted]

DEBORAH A. BUTLER

By: ______________________________
CLIFFORD M. HARBOURT
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5 See, generally, The Law of Contracts, 4th edition, Calamari & Perillo, sections 14.15, 14.23, and 16.1.

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