

Part III – Administrative, Procedural, and Miscellaneous

Transfers of Compensatory Stock Options to Related Persons

Notice 2003-47

This notice addresses a transaction being promoted to and used by taxpayers to avoid or evade federal income and employment taxes related to compensatory stock options. This notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This notice also identifies some of these transactions as listed transactions and alerts taxpayers and their representatives to certain responsibilities that may arise from participating in these transactions.

Concurrent with this Notice, Treasury and the IRS are issuing temporary and proposed regulations providing prospectively that, for purposes of § 83 of the Internal Revenue Code and § 1.83-7, a sale or other disposition of a nonstatutory compensatory stock option¹ to a related person will not be treated as a transaction that closes the application of § 83 with respect to the option.

I. The Transaction

The transaction involves an individual, generally an employee, who has been granted a nonstatutory compensatory stock option. The individual transfers the option to a related person. The related person may be a family member or an entity in which the individual or members of the individual's family hold a substantial interest. But, for purposes of this notice, a related person does not include (1) a person who is related to the individual by being the service recipient with respect to the option or (2) the grantor of the option. As part of the transfer, the related person pays an amount purportedly equal to the option's value. The payment often is in the form of a long-term (e.g., 30-year), unsecured and non-

¹ A nonstatutory compensatory stock option refers to a stock option granted in connection with the performance of services that does not qualify as an incentive stock option described in § 422 or an option granted under an employee stock purchase plan described in § 423.

negotiable note, calling for a balloon payment of the purchase price at the end of the note's term. Other payment forms may include other deferred payment obligations, cash or combinations of these types of payments. The related person often is a thinly capitalized entity, with no operating business, and the terms of the note (e.g., the rate of interest and the extent of any security) often fail to reflect the associated risk of nonpayment.

Promoters contend that the options should be treated as sold or otherwise disposed of in an arm's length transaction for purposes of § 1.83-7, with the result that the individual will not recognize compensation income when the related person exercises the stock option. Furthermore, if the related person pays for the option with a note or other deferred payment obligation, promoters argue that the individual does not recognize compensation income for the purchase price until the related person pays the amounts due under the note or other deferred payment obligation.

II. Intent to Challenge Transaction

The IRS intends to challenge the purported tax benefits for the above-described transaction on a number of grounds, including, in appropriate cases:

A. Characterization of Transfer as an Arm's Length Transaction

Although the recipient of a compensatory stock option receives a valuable right, the recipient historically has not recognized income at the time of the option grant unless the option had a readily ascertainable fair market value. See Comm. v. LoBue, 351 U.S. 243 (1956); § 1.421-6.² This treatment of compensatory stock options generally was continued with the enactment of § 83 and the promulgation of § 1.83-7, which currently govern the taxation of the grant of a nonstatutory compensatory stock option. Section 83(e)(3) provides that § 83 does not apply to require the recognition of income when an option is granted unless the option has a readily ascertainable fair market value. Section 1.83-7(b) defines when an option will be considered to have a readily ascertainable fair market value at grant. This standard is met where the option is actively traded on an established market. Section 1.83-7(b)(1). Otherwise, an option has a readily ascertainable fair market value only if it can be shown that its fair market value can be measured with reasonable accuracy, including a demonstration that the fair market value of the option privilege is readily ascertainable. Section 1.83-7(b)(2). Options that are not taxed at grant generally result in compensation income at the time of exercise, in an amount equal to the excess of the fair market value of the stock purchased over the amount paid by the option recipient.

Section 1.83-7(a) provides an exception to this treatment if the recipient of an

²Except as provided in the transition rules under § 1.83-8(b), § 1.421-6 does not apply to options granted on or after July 1, 1969. See § 1.421-6(a)(2).

option that does not have a readily ascertainable fair market value at the time of grant sells or otherwise disposes of the option in an arm's length transaction. The transactions described in Section I of this Notice rarely, if ever, reflect terms that would be agreed to between unrelated parties dealing at arm's length. Accordingly, the Service will challenge the transactions described in Section I as not satisfying the exception under § 1.83-7(a) for arm's length transactions.

B. Treatment of the Deferred Payment Obligation

In any case in which the transaction includes a disposition of an option without a readily ascertainable fair market value at the time of grant and the individual receives a deferred payment obligation, the IRS intends to challenge any deferral of income with respect to the deferred payment obligation. The preceding sentence applies regardless of whether the transaction is treated as an arm's length transaction or a non-arm's length transaction for purposes of § 1.83-7.³ Thus, in any such case, the IRS will argue that the option recipient recognizes income to the extent that the amount of the deferred payment obligation transferred to the option recipient, plus any cash or other property received by the individual, exceeds the amount, if any, the option recipient paid for the option.

Employers and other service recipients are reminded that, under § 83(h), a service recipient is entitled to a deduction for the compensation attributable to the transfer of the option only when the person who performed the services includes an amount in income under § 83(a). Accordingly, the Service will seek to ensure that there is no mismatch of income and deduction between the person who performed the services and the service recipient.

III. Other Bases for Challenge

When appropriate, the Service will not respect the transaction or certain aspects of the transaction, and nothing in this notice is intended to imply otherwise. Accordingly, where the related entity to whom the option is sold or disposed of is not bona fide, lacks substance, or lacks a business purpose, the use of the entity will be treated accordingly. Where the transfer of the option is not bona fide, lacks substance, or lacks a business purpose, the transfer will also be treated accordingly. Finally, where the deferred payment obligation lacks substance, the obligation will be treated accordingly.

IV. Listed Transactions

The following transactions, and any transaction that is substantially similar to the following transactions, are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and § 301.6111-2(b)(2) and

³ Compare § 1.83-1(a) (transferor of substantially nonvested property in a non-arm's length transaction must include in income the sum of any money and the fair market value of any substantially vested property received in such disposition).

§ 301.6112-1(b)(2) of the Procedure and Administration Regulations. Transactions in which an individual purports to sell or otherwise dispose of an option described in § 83(e)(3) to a related person are listed transactions with respect to the individual and the related person if the purported sale or other disposition is in exchange for an amount that includes any deferred payment of money or property.

It should be noted that, independent of any classification as “listed transactions” for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2) of the regulations, transactions that are the same as, or substantially similar to, the transactions described in this notice may already be subject to the disclosure requirements of § 6011, the tax shelter registration requirements of § 6111 or the list maintenance requirements of § 6112 (§§ 1.6011-4, 301.6111-1T, 301.6111-2, and 301.6112-1).

Persons who are required to satisfy the registration requirement of § 6111 with respect to the transactions described in this notice and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the transactions and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions, or, as applicable, on persons who participate in the reporting of this transaction or substantially similar transactions, including the accuracy-related penalty under § 6662 and the return preparer penalty under § 6694.

V. Temporary and Proposed Regulations

Treasury and the IRS are issuing temporary regulations and proposed regulations concurrent with this notice providing that a stock option sale or other disposition to a related person will not be treated as a transaction that closes the application of § 83 with respect to the option for purposes of § 1.83-7.

VI. Drafting Information

The principal author of this notice is Stephen Tackney of the Office of Division Counsel / Associate Chief Counsel (Tax Exempt and Government Entities), though other officials from the Office of Chief Counsel and Treasury participated in its development. For further information regarding this notice contact Stephen Tackney on (202) 622-6030 (not a toll-free call).