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COORDINATED ISSUE
ALL INDUSTRIES
TRANSFER OR SALE OF COMPENSATORY OPTIONS OR RESTRICTED STOCK TO RELATED PERSONS
UIL: 9300.28-00

FACTS:

The transaction generally involves three parties: (1) an individual who holds nonstatutory stock options (the executive); (2) the corporation that granted the options; and (3) a person or entity related to the individual, such as a family limited partnership (the related person). The related person purports to purchase the options from the executive in exchange for an unfunded, unsecured long-term balloon payment obligation in an amount equal to the fair market value of the options. The related person may then exercise the options but does not make any payments to the executive (except perhaps interest on the obligation) until the balloon payment comes due.

The parties generally contend that the purpose of the related person is to aggregate and diversify assets. Often the executive retains the vast majority of the ownership of the related person (for example, up to a 99% limited partnership interest), or may be a general partner in, or manager of, the related person. Generally, the related person is thinly capitalized at the time of the transfer, funded only by the executive's initial contribution of personal stock holdings or cash.

This transaction typically involves the transfer of stock options. However, variations may include transfers of restricted stock or a combination of stock options and restricted stock. The related person receiving the options typically is a limited partnership, all of the members of which consist of the executive and members of his or her immediate family. Other related persons may include a limited liability corporation or a foreign or domestic trust. Usually, the executive transferring the option is a corporate officer and employee. However, individuals transferring options or restricted stock have included non-employee directors.

The executive transfers the option or restricted stock for a deferred payment obligation payable by the related person to the executive. The obligation may be evidenced by a promissory note, or contained only in the contractual agreement. The obligation typically is structured as an unsecured, non-negotiable 15- to 30-year obligation, with the principal amount not due until the end of the term. The obligation generally provides for stated interest at a rate equal to or greater than the applicable Federal rate; often the obligation provides for periodic interest payments. Variations include the use of private annuities as the deferred payment device, often in conjunction with a foreign trust or foreign corporation as the related person.

Typically the promoter prepares, or provides access to a person who prepares, a valuation of the stock options at the time of transfer, purporting to use a Black-Scholes or similar methodology. Often, however, the options are valued at a figure equal to the spread (the difference between the fair market value of the underlying stock less the exercise price). Thus the stated principal amount of the deferred payment obligation often equals the spread at the date of transfer.

Often the transfer of the stock option, the exercise of the option, and the sale of the acquired stock occur within a very short period of time, for example on the same day or within the same week. When substantially nonvested stock options or restricted stock are transferred, the sale of the underlying stock by the related person typically is delayed until the options or restricted stock vest.

The sale of the acquired stock by the related person typically will generate a capital gain or loss. Where the stock is sold on the same day, the related person may claim that the cost basis equals the amount realized, so that there is no gain or loss.

At the time of transfer of the stock options and at the time of exercise, the corporation typically does not issue a Form W-2 to the executive (Form 1099 for non-employee directors) and income is not reported on the executive's Form 1040. Often the corporation has formally agreed not to report any income related to the transfer or exercise of the stock options.

Generally, though not always, the corporation does not claim a deduction in the year of transfer of the stock options or restricted stock, or the year of exercise of the stock options or vesting of the restricted stock. Rather, the corporation has agreed to forgo the deduction until principal payments are made on the obligation. In some cases, however, the corporation has taken a deduction, and perhaps issued a Form 1099 to the related person upon exercise of the stock option in an attempt to justify a deduction.

Fees are paid to the promoters of the transaction and typically have been deducted by the party who has paid the fees or included in the basis of the related person in calculating gain from the sale of the acquired stock. In some instances, all parties to the transaction have paid and deducted or included in basis promoter fees.

ISSUES:

If a compensatory stock option or restricted stock is transferred to a related person under terms substantially similar to those described in Notice 2003-47 (a Notice 2003-47 transaction):

1. Is the transfer treated as an arm's length transaction for purposes of §§ 1.83-1 and 1.83-7?[1]

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[1] For purposes of this paper, references to a section refer to a section of the Internal Revenue Code or a section of the Treasury Regulations, except as otherwise indicated.

a. Is the transfer a per se arm's length transaction under §§ 1.83-1 and 1.83-7 if the options or restricted stock are transferred in exchange for a deferred payment obligation in an amount equal to the fair market value of the transferred options or restricted stock?

2. Does the receipt of the deferred payment obligation, such as a note, contractual agreement or annuity, at the time of the transfer result in the immediate recognition of income under §§ 1.83-1 or 1.83-7?

3. Is the employer, or other service recipient, entitled to a deduction under section 83(h), and if so when, and may the deduction be limited by section 162(m)?

4. When and to what amounts do the FICA, FUTA and Federal income tax withholding provisions apply with respect to the transaction?

   a. Is the common law employer corporation or the related person the employer who is liable for withholding and payment of employment taxes under the FICA, FUTA and Federal income tax withholding provisions?

5. If the Notice 2003-47 transaction is found not to result in immediate income recognition, should the Service argue, in the alternative, that the related person does not acquire basis in the stock options or restricted stock with respect to any portion of the payment that the executive does not include in gross income under section 83?

6. May the transaction be recast for federal tax purposes under § 1.701-2 as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances?

7. May the transaction be challenged under judicial doctrines?

8. Will the deferred payment obligation be recognized as valid debt?

9. Where the transaction is in whole or in part a sham or lacks economic substance, will the legal expenses or fees paid or incurred to create the transaction be deductible under sections 162 and 212?

10. Do the disclosure provisions of § 1.6011-4 apply to Notice 2003-47 transactions that were entered into prior to the release of Notice 2003-47?

11. Should the Service assert the negligence or disregard of rules or regulations or the substantial understatement of income tax provisions of section 6662 against a taxpayer for engaging in a Notice 2003-47 transaction?

CONCLUSIONS:

1. The transfer is not an arm's length transaction for purposes of §§ 1.83-1 and 1.83-7.

   a. Such transfers are not per se arm's length transactions under §§ 1.83-1 and 1.83-7 if the options or restricted stock are transferred in exchange for a deferred payment obligation in an amount equal to the fair market value of the transferred stock options or restricted stock.

2. The receipt of a deferred payment obligation, such as a note, contractual agreement or annuity, at the time of the transfer results in the immediate recognition of income under § 1.83-1 or § 1.83-7.

3. If the employer did not issue a Form W-2 or Form 1099 to the executive in a timely manner reflecting income related to the Notice 2003-47 transaction, the employer is entitled to a deduction under section 83(h) in the taxable year in which or with which ends the executive's taxable year in which an amount is included in the executive's gross income. Under appropriate facts and circumstances, the duty of consistency may also prevent the employer from taking a deduction based on a position inconsistent with the executive's failure to recognize income from the Notice 2003-47 transaction, where the executive's taxable year in which the transaction occurred has closed. Where the executive is a "covered employee" for purposes of section 162(m), the $1 million deduction limitation may serve to disallow all or a portion of the deduction under section 83(h), depending on the specific facts and circumstances.

4. FICA, FUTA and Federal income tax withholding apply to the transfer of the obligation to the executive at the time of the Notice 2003-47 transaction. FICA, FUTA and Federal income tax withholding may also apply at the time of exercise of the stock option or the lapse of the restrictions on the restricted stock, to the extent the fair market value of the acquired stock on that date exceeds the amount, if any, paid by the executive for the stock option or restricted stock and the amount included as wages at the time of the transfer of the stock option or restricted stock.

   a. The common law employer corporation, and not the related person, is the employer who is liable for withholding and payment of employment taxes under the FICA, FUTA and Federal income tax withholding provisions.

5. If the transfer in exchange for the deferred payment obligation is found not to result in income recognition, the Service should argue, in the alternative, that the related person does not acquire basis in the stock options or restricted stock with respect to any portion of the payment that the executive does not include in gross income under section 83.

6. Under appropriate facts and circumstances, the transaction may be recast for federal tax purposes under § 1.701-2, as appropriate to achieve tax results that are

consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.

7. Under appropriate facts and circumstances, the transaction may be challenged under judicial doctrines including, but not limited to, the economic substance, sham transaction and step transaction doctrines.

8. Under appropriate facts and circumstances, the deferred payment obligation may fail to qualify as valid debt.

9. Where the transaction is in whole or in part a sham or lacks economic substance, the legal expenses or fees paid or incurred to create the transaction are not deductible under sections 162 and 212.

10. For all Notice 2003-47 transactions entered into by individuals, trusts, partnerships, or S corporations before January 1, 2001, there is no disclosure requirement under § 1.6011-4. For those transactions entered into on or after January 1, 2001, for which the transaction was reported on a return filed by June 14, 2002, there is no disclosure requirement under § 1.6011-4. However, if the transaction is entered into on or after January 1, 2001, and the transaction was not reported on a return filed on or before June 14, 2002, the individual, trust, partnership, or S corporation is subject to the disclosure rules under § 1.6011-4 or § 1.6011-4T, as applicable. Those regulations also provide rules applicable for transactions that are subsequently identified as listed transactions.

11. Under appropriate facts and circumstances, the Service should assert the negligence or disregard of rules or regulations and/or the substantial understatement of income tax provisions of section 6662 against a taxpayer for engaging in a transaction or substantially similar transaction described in Notice 2003-47. For purposes of applying the penalty provisions, the executive’s position that the Notice 2003-47 was an arm’s length transaction and resulted in deferral of the recognition of income will not be considered to be based upon substantial authority.

OVERVIEW:

The transactions described herein are designated as listed transactions pursuant to Notice 2003-47, 2003-30 I.R.B. 1 (July 28, 2003) (identified as a listed transaction on July 1, 2003). The notice concludes that (1) the transfer of the stock options is not an arm's length transaction for purposes of § 1.83-7, and (2) the receipt of the deferred payment obligation from the related person results in immediate recognition of income. Accordingly, compensation income is recognized at the time of the transfer, with the potential for further compensation income at the time of exercise of the stock option by the related person.

In addition to Notice 2003-47, temporary regulations under section 83 issued concurrently with the notice provided that effective on or after July 2, 2003, the sale or other disposition of an option to a related person will not constitute an arm's length transaction for purposes of § 1.83-7. The regulations provide a definition of a related person that includes various family entities. Those regulations have subsequently been replaced with final regulations adopting the same rules. 68 FR 48392 (Aug. 10, 2004).

There are several statutory and judicial bases for challenging transactions described in Notice 2003-47. The applicability of some of the legal arguments depends upon the facts and circumstances of the particular case, and not all arguments are applicable to each case. Factual development is necessary to evaluate and assess each transaction.

Different fact patterns may exist. For example, variations could exist with respect to the transaction structure; the type of obligation transferred; the transaction reporting methodology; the timing and amount of the corresponding deduction claimed; the purported business purpose of the related person and the extent to which such business purpose was executed.

The transaction may or may not have been disclosed to the Service in accordance with Notice 2003-47. Disclosure should be a factor when considering application of penalties.

This transaction may be reported in various documents. SEC Form 10-K, Annual Report, or the Definitive Proxy Statement may reveal stock options or restricted stock transferred to or held by certain shareholders, officers and Board of Directors in family limited partnerships or family trusts. The disclosure usually is in a footnote below the table reporting the stock holdings of certain key individuals.[2] In addition, employment or consulting agreements may describe the transaction. The employment agreement may also be signed by the family limited partnership or trust as a party to the agreement.

In addition, SEC Form 4, Statement of Changes in Beneficial Ownership, required to be filed by certain executives, may also report the transfer of stock options or restricted stock to a related person in footnotes or may indicate indirect ownership by the related person.

Board of Directors and Compensation Committee minutes may reflect activities relating to the transaction. Corporate payroll records may reflect the payment made to the related person instead of the executive.

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[2] Confirmation should be made that the transfer was not intended as and treated by the taxpayers as a gift. For federal income tax purposes, the transfer would be treated as a non-arm's length transfer under § 1.83-1 and § 1.83-7. See, for example, Priv. Ltr. Rul. 199927002 (Aug. 19, 1999). For treatment of the transaction under the gift, estate and transfer tax provisions, see Rev. Proc. 98-34, 1998-1 C.B. 983.

The partnership return Form 1065, Schedule D, should report the disposition of the stock acquired upon exercise of the stock options or vesting of the restricted stock. Any resulting capital gain or loss should also be reported. However, Schedule D may not properly reflect the details of the sale, or may only reflect the net effect of the sale instead of details of the sales price and cost or other basis. The Schedule L balance sheet may also report the deferred payment obligation as a large liability for the family partnership and may report the stock options as assets.

Coordination and statute protection of the relevant returns is crucial and requires prompt attention. Examiners should consider application of the 6-year statute provisions to the executive's Form 1040 or the related person's Form 1065 where applicable. If an executive purports to sell options or restricted stock to a partnership in which the executive is a member and the partnership is subject to TEFRA provisions, a TEFRA audit may be necessary.

Examiners should be alert to potential estate and gift tax issues. For example, in some circumstances transfers or sales of stock options may be made for less than adequate and full consideration resulting in a gift to the related person. Similarly, a below-market interest rate on a note may result in a gift. Examiners should complete referrals where appropriate. In addition, examiners should consider and protect statutes for corporate tax returns including the Form 1120, if any related deduction has been claimed, and corporate employment tax returns, as employment taxes may be applicable.

Examination teams are directed to contact Area Counsel and the Technical Advisors for Cafeteria Plans/Executive Compensation to assist with the factual development and coordination of these cases.

DISCUSSION:

The basic provisions governing the taxation of compensatory nonstatutory stock options and restricted stock are section 83 and the regulations thereunder. To assist in understanding both the executive's arguments and the Service's analysis, a brief outline of section 83 is provided.

Section 83 – Taxation of Property Transferred in Connection with the Performance of Services

Section 83 governs the federal income tax consequences stemming from the transfer of property in connection with the performance of services. Under section 83(a) the excess (if any) of the fair market value of property transferred, over the amount paid (if any) for the property, is includible in the gross income of the person who performed the services for the first taxable year in which the property becomes transferable or is not subject to a substantial risk of forfeiture.

Section 83 and Nonstatutory Stock Options[3]

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 Commissioner v. LoBue, 351 U.S. 243 (1956); Treas. Reg. § 1.421-6.[4]

This treatment of compensatory stock options generally was continued with the enactment of section 83 and the promulgation of § 1.83-7, which currently govern the taxation of the grant, transfer and exercise of nonstatutory compensatory stock options.

Under section 83(e)(3), section 83 does not apply to the transfer of an option without a readily ascertainable fair market value at the time of grant. However, under section 83(e)(4), section 83 applies to the transfer of property pursuant to the exercise of an option without a readily ascertainable fair market value at the date of grant.

Section 1.83-7(b) defines when an option will be considered to have a readily ascertainable fair market value at grant. Section 1.83-7(b)(1) provides that this standard is met where the option is actively traded on an established market. Section 1.83-7(b)(2) provides that if not publicly traded, 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.

These standards rarely are met, and thus compensatory nonstatutory stock options typically are not taxed at grant.

Rather, section 83(a) generally applies at the time the options are exercised, resulting in compensation income in an amount equal to the excess, if any, of the fair market value of the stock purchased over (1) the amount, if any, paid for the option (typically zero), plus (2) the amount paid for the stock (the exercise price).

Section 1.83-7(a) provides an exception to this treatment if the recipient of an option not having a readily ascertainable fair market value at the time of the grant sells or otherwise disposes of the option in an arm's length transaction. Specifically, under Section 1.83-7(a) if the option is sold or otherwise disposed of in an arm’s length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to an exercise of the option. Under this treatment, the

[3] Nonstatutory stock options refer to options which are not incentive stock options, as defined in section 422, or options granted under a qualified employee stock purchase plan, as defined in section 423. Notice 2003-47 transactions should not involve incentive stock options or options under an employee stock purchase plan, as those options are not transferable.

[4] Except 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).

compensation element is closed at the time of transfer and the option recipient recognizes no further compensation income at the time of exercise of the option.

Section 1.83-7 does not address the federal tax consequences of a non-arm's length transaction. However, an analogy may be made to the regulations governing non-arm's length transfers of substantially nonvested stock. Under § 1.83-1(c), the service provider who receives substantially nonvested stock in connection with the performance of services recognizes income at the time of a non-arm's length transfer of the stock, equal to the amount of any money or substantially vested property received at the time of the transfer. However, the compensation element remains open and that person may recognize further compensation income at the time the stock substantially vests. Analogous rules should apply in the case of a non-arm's length transfer of stock options. At the time of the transfer, the option recipient recognizes income equal to the amount of money or property received at the time of the transfer. However, the compensation element remains open and that person may recognize further compensation income at the time of the exercise of the option. This further compensation would equal the excess of the fair market value of the stock acquired over the sum of (1) the exercise price paid for the stock; (2) the amount included in income at the time of transfer of the option to the related person; and (3) the amount (typically zero) paid by the executive for the option.

Section 83 and Restricted Stock

Section 83(a) provides that if property is transferred in connection with the performance of services, the excess (if any) of the fair market value of property transferred, over the amount paid (if any) for the property, is includible in the gross income of the person who performed the services for the first taxable year in which the property becomes transferable or is not subject to a substantial risk of forfeiture. Thus, the fair market value of stock transferred in connection with the performance of services, less any amount paid for the stock, is includable in income at the time of grant unless the stock is substantially nonvested, meaning that it is both subject to a substantial risk of forfeiture and nontransferable.

Whether the stock is subject to a substantial risk of forfeiture depends on the facts and circumstances. A substantial risk of forfeiture exists where rights in the stock 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 a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. See § 1.83-3(c)(1).

The stock will be considered transferable if the recipient can transfer any interest in the stock to any person other than the grantor of the stock, but only if the stock transferred is not subject to a substantial risk of forfeiture. See § 1.83-3(d). So if the stock transferred continues to be subject to a substantial risk of forfeiture in the hands of the subsequent holder, it will not be considered transferable.

Generally the recipient of substantially nonvested stock will recognize income when the stock substantially vests (becomes transferable or is no longer subject to a substantial risk of forfeiture, whichever occurs first). However, if the substantially nonvested stock is sold in an arm's length transaction, the transferor recognizes compensation income in an amount equal to the excess of the amount realized on the sale over the amount (if any) paid for the stock. See § 1.83-1(b). If the substantially nonvested stock is transferred in a non-arm's length transaction, the transferor recognizes compensation income in an amount equal to the sum of any money and the fair market value of any substantially vested property received in the transfer. However, section 83 continues to apply to the property. Accordingly, when the stock substantially vests in the hands of the person to whom it was transferred, the original recipient recognizes further compensation income equal to the fair market value of the stock at the time of vesting, less the amount paid (if any) for the stock, which includes any amounts taken into income at the time of the non-arm's length transfer. See § 1.83-1(c) (including example).

Section 83 and Nonqualified Deferred Compensation

Section 83 applies only to transfers of property. The term "property" includes real and personal property. But the term "property" does not include money or an unfunded and unsecured promise to pay money or property in the future. See § 1.83-3(e). Under this exception, section 83 generally does not apply to benefits under a nonqualified deferred compensation plan, provided that the benefit qualifies as an unfunded and unsecured promise to pay money in the future.

In contrast, the receipt of a funded promise to pay would result in the immediate recognition of income. Under the economic benefit doctrine, an employee has currently includible income from an economic or financial benefit received as compensation, though not in cash form. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for the employee's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174, Situation 4. This concept has been encapsulated in the definition of property under § 1.83-3(e) which includes a beneficial interest in a trust, the assets of which are set aside from the transferor's creditors. This is true even if the employee has no immediate right to distributions from the trust. On the other hand, where the employer's promise is evidenced by a bookkeeping entry, backed only by the employer's general assets that are subject to the employer's creditors, the promise generally would not be considered funded. See Rev. Rul. 60-31, Situation 2.

The Transaction and the Purported Benefits

Under section 83, compensatory options rarely qualify as having a readily ascertainable fair market value at the date of grant. Accordingly, the executives transferring options as part of a Notice 2003-47 transaction generally would not have been required to recognize an amount of income at the time of grant. Rather, the executives would be

required to recognize income upon exercise of the option or transfer of the option, whichever occurs first.

The executive argues here that the transfer of stock options to the related person is an "arm's length transaction" under § 1.83-7(a) because the executive receives an obligation the value of which is equal to the fair market value of the stock options. Under this treatment, sections 83(a) and (b) apply to the receipt of any money or other property in the transaction in the same manner as sections 83(a) and (b) would have applied to the transfer of property pursuant to an exercise of the option. However, the compensation element would be closed, and the executive would not be required to include any further compensation upon exercise of the option.

The executive then argues that there is no recognition of income at the time of the transfer, but rather the income is deferred until the time payments on the obligation are received. To reach that result, the executive points to § 1.83-3(e), arguing that the obligation is an unfunded and unsecured promise to pay money in the future, such that the executive has not received money or other property at the time of the transfer and is not required to recognize income until money or other property is received – i.e. when payments on the obligation are received.

In Notice 2003-47 the Service responded that the transaction fails to generate the tax benefits claimed for several reasons, including: (1) the transfer of the stock options to a related person for a long-term unfunded, unsecured balloon obligation is not an arm's length transaction; and (2) in any event, the executive's receipt of the obligation is taxable currently.

In addition to Notice 2003-47, the Service issued a temporary regulation, § 1.83-7T, providing that for purposes of the "arm's length transaction" language of Treas. Reg. § 1.83-7(a), a transfer to a related person is not an arm's length transaction for transactions occurring on or after July 2, 2003, and providing a definition of related person which generally includes family entities. Final regulations published August 10, 2004 adopted these regulations without change. 68 FR 48392 (August 10, 2004).

The service recipient corporation generally takes the position that the compensation deductions that would otherwise be available when the options were exercised would be deferred until the executive recognized income – i.e. until the executive received payments on the obligation. Typically the corporation agreed to forego the deduction, and sometimes formally executed documents agreeing not to report any income upon the transfer or exercise of the option. Some corporations have taken the deduction, however, without reporting any income to the executive.

With respect to employment taxes, the employing corporation typically takes the position that liability does not arise until the executive received payments on the obligation. Furthermore, the employing corporation may also take the position that the related person, instead of the corporation, is the party responsible for employment taxes.

The related person typically takes the position that it receives basis in the option or restricted stock equal to the stated principal amount of the deferred payment obligation. In the case of an option, the related person receives further basis in the stock acquired upon exercise of the option equal to the exercise price paid for the stock. Thus, the related person generally claims a substantial basis in the stock when the stock is sold.

ISSUES PRESENTED

1. **Is the transfer treated as an arm's length transaction for purposes of §§ 1.83-1 and 1.83-7?**

Under the traditional definition of an arm's length transaction, the transaction must occur between unrelated parties. See Black's Law Dictionary 103 (7th Ed. 1999) (defining "arm's-length" as "of or relating to dealings between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power, not involving a confidential relationship"); Black's Law Dictionary 109 (6th Ed. 1990) (defining "arm's length transaction").[5] In some circumstances, however, courts have recognized that related parties may potentially act at arm's length. See Bank of New York v. U.S., 526 F.2d 1012 (3d Cir. 1975) (estate tax). However, even in those circumstances courts have stressed that transactions between family members are subject to special scrutiny. See, e.g., Kimbell v. U.S., 2004 U.S. App. LEXIS 9911 (May 20, 2004); Harwood v. Commissioner, 82 T.C. 239 (1984), aff'd 786 F.2d 1174 (9th Cir. 1986), cert. denied, 479 U.S. 1007 (1986) (gift tax). Some courts have concluded that where the transaction involves a community of interests, such that the interests of the family members on one side of the transaction may coincide to some degree with the family members on the other side, the transaction is not considered to occur at arm's length. See Bank of New York v. U.S., 526 F.2d 1012 (3d Cir. 1975); Crème Manufacturing Co., Inc. v. U.S., 492 F.2d 515 (5th Cir. 1974) (excise tax).

Thus in determining whether the transaction occurred at arm's length, the entirety of the transaction should be considered. If an independent third party would not have participated in the transaction in the manner in which the related parties participated, the parties did not act at arm's length. Where an executive transfers a valuable option or restricted stock for a long-term, unsecured obligation with a balloon payment

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[5] The Sixth Edition provides the following, potentially contradictory language:

> Said of a transaction negotiated by unrelated parties, each acting in his or her own self interest; the basis for a fair market value determination. A transaction in good faith in the ordinary course of business by parties with independent interests. Commonly applied in areas of taxation when there are dealings between related corporations, e.g., parent and subsidiary. The standard under which unrelated parties, each acting in his or her own best interest, would carry out a particular transaction. For example, if a corporation sells property to its sole shareholder for $10,000, in testing whether $10,000 is an "arm's length" price it must be ascertained for how much the corporation could have sold the property to a disinterested third party in a bargained transaction. (citation omitted)

schedule, this standard generally would not be met, especially where the executive retains a large equity interest in the entity, the entity has no operating business, and the entity is funded predominantly by the very property which the executive transferred. See, e.g., Turner v. Commissioner, 2004 U.S. App. LEXIS 18473 (Sept. 1, 2004).

Valuation of the Stock Options

Executives generally argue that a payment equal to the fair market value of the options necessarily results in classification of the transfer as an arm's length transaction. As stated below, the Service does not agree with this position. Regardless, many of these transactions fail to constitute a payment equal to the fair market value of the option.

As stated in § 1.83-7(b)(3), the fair market value of an option is not merely the difference between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. The option privilege in the case of an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Similarly, the option privilege in the case of an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of property subject to the option.

In many Notice 2003-47 transactions, the options were valued at the difference between the exercise price and the fair market value of the stock at the time of the transaction. Had the transaction been between independent parties, however, the value of the options would have included the option privilege in the option value, as reflected in the Black-Scholes and similar valuation methodologies used to value options. Consequently, in those Notice 2003-47 transactions where the transfer price of the options does not include the option privilege, the transfer was not an arm's length transfer under § 1.83-7(a).

1a. Is the transfer a per se arm's length transaction under §§ 1.83-1 and 1.83-7 if the options or restricted stock are transferred in exchange for a deferred payment obligation with a fair market value equal to the transferred options or restricted stock.

It is the Service's position that for section 83 purposes a transfer of stock options or restricted stock is not necessarily at arm's length merely because payment was equal to the fair market value of the options or restricted stock. Although an arm's length sale of property generally should result in a payment equal to the property's fair market value, a mere payment equal to the stock option's purported fair market value does not necessarily render a transaction an arm's length transaction for section 83 purposes. As stated above, the grant of a stock option is not taxed at grant unless the option has a readily ascertainable fair market value at the time of grant. The stock options transferred in a Notice 2003-47 transaction will not have had a readily ascertainable fair market value at grant, and therefore would not have been subject to immediate taxation. Rather, the appreciation in the underlying stock would remain subject to taxation as

compensation income until the option was exercised or the option was transferred in an arm's length transaction.

Under the executives' analysis, treatment as an arm's length transaction would rely solely on a comparison of values, regardless of whether the entire facts and circumstances of the transaction reflected terms and conditions to which independent parties would have agreed. In other words, despite the fact that the regulations fail to tax the option immediately upon grant because the option does not have a readily ascertainable fair market value, executives argue that individuals should be allowed to reach that same result when the option is transferred to a related person based solely on the purported correct valuation of the option (which does not have a readily ascertainable value). The treatment of a transfer of a stock option as an arm's length transaction should not be read in such as manner as to render meaningless the readily ascertainable fair market value standard. Rather, the term "arm's length transaction" for purposes of § 1.83-7 means something broader, incorporating examination of the entirety of the transaction and not just whether fair market value was paid. See Turner v. Commissioner, 2004 U.S. App. LEXIS 18473 (Sept. 1, 2004) (distinguishing an arm's length transaction from a bona fide sale for adequate consideration).

Furthermore, § 1.83-1(c) provides that the amount of compensation includible in the gross income of the transferor at the time of a non-arm's length disposition of restricted property may not exceed the fair market value of the property disposed of at the time of disposition (disregarding lapse restrictions), reduced by the amount paid for such property. Thus § 1.83-1(c) indicates that a transfer may be treated as a non-arm's length disposition even if the transferor receives an amount equal to or exceeding the property's fair market value at the time of disposition. This same reasoning should apply to the sale or disposition of a stock option. Finally, had the terms "arm's length" and "fair market value" been considered synonymous for section 83 purposes, section 83 and § 1.83-7 would reference the payment of the property's fair market value, a term used repeatedly in the statute and accompanying regulations, rather than requiring an arm's length transaction. See also Crème Manufacturing Co., Inc. v. U.S., 492 F.2d 515 (5th Cir. 1974) (distinguishing concepts of arm's length transaction and fair market price)

Executives will point to certain decisions suggesting that for section 83 purposes, the payment of fair market value means the transaction is treated as an arm's length transaction. See Pagel, Inc. v. Commissioner, 91 T.C. 200 (1988), aff'd 905 F.2d 1190 (8th Cir. 1990) (sale of option by corporation service provider to sole shareholder); Bagely v. Commissioner, 85 T.C. 663 (1985) aff'd 806 F.2d 169 (8th Cir. 1986) (cashout of option); Rupprecht v. U.S., 11 Cl. Ct. 689 (Cl. Ct. 1987), aff'd without opinion, 829 F.2d 43 (Fed. Cir. 1987) (sale of option to entity purchasing corporation). However, none of these cases involved sales to family entities or an attempt to defer the recognition of income in a manner similar to the transactions covered by Notice 2003-47.[6] Furthermore, the analysis of the issue is minimal, § 1.83-1 is not cited or

[6] The Tax Court opinion in Weigl v. Commissioner, 84 T.C. 1192 (1985) applied the same fair market value standard to the transfer of an option by an employee to a family trust, although under pre-

discussed, and the issue of whether the sale of an option should close the compensatory transaction was not contested.

Some executives have argued that section 7872 suggests that, as long as a loan provides for interest at or above the applicable federal rate (AFR), it is treated as an arm's length transaction.[7] Section 7872 addresses certain types of loans, including gift loans and compensation-related loans. Section 7872 recharacterizes such loans if the loan is made at a below-market interest rate. Although section 7872 may be cited as supporting the notion that the interest rate charged may be another factor to strengthen the arm's length nature of the transaction for purposes of § 1.83-7, the fact that an obligation carries interest equal to or in excess of the AFR may not be dispositive of whether a transaction is "arm's length" as that term is used in § 1.83-7.

Similar arguments are made with respect to section 482. Section 482 generally addresses the authority of the IRS to allocate income and deductions among common controlled "organizations, trades, or businesses" to the extent necessary to reflect true taxable income. The regulations set forth a broad framework of principles and methodologies for determining appropriate transfer prices for transfers of tangible and intangible property, the provision of services and interest on indebtedness. The overarching principle under the section 482 regulations is the arm's length standard, which in every case determines whether the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. See § 1.482-1(b). This, in turn, generally is determined by reference to comparable transactions. Thus the primary emphasis under the section 482 regulations is to determine true taxable income generally by comparing the results in the controlled and uncontrolled transactions to determine whether the results in the controlled transaction reflect an arm's length result. If not, proper adjustments are made to such results so that they more accurately reflect an arm's length result.

Although taxpayers may argue that the section 482 regulations provide some support, the extensive framework of the section 482 regulations is not directly applicable for section 83 purposes. Indeed, the regimes work differently. In contrast to the section 482 regulations, the section 83 regulations focus on facts and circumstances but make no adjustments in an attempt to reach an arm's length result. Rather, the section 83 regulations simply provide for one consequence if the facts and circumstances of the

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section 83 regulations. However, the opinion invites the Commissioner to notify the court and request a hearing if it disagrees with the arm's-length nature of the amount paid, indicating that this issue was not litigated. Furthermore, the central issues of the case involved whether the original transfer of the option to the employee's employer was in connection with the performance of services, and whether the family trust was a valid trust, and not whether the transfer from the employee to the trust was an arm's length transfer. Finally, given the court's finding that the proceeds from the trust's exercise of the option and sale of the stock two weeks later correlated with the valuation of the option, treatment of the transaction as non-arm's length would not have had much significance.

[7] Section 7872 only applies to bona fide loans.

transaction justify treatment as an arm's length transaction, and another consequence if the facts and circumstances of the transaction justify treatment as other than an arm's length transaction. Accordingly, the comparability framework set forth in the section 482 regulations is not relevant to the section 83 analysis.

Furthermore, depending on the specific facts and circumstances, a transaction described in Notice 2003-47 may not satisfy the standards set forth in section 482. Accordingly, any representation that the transaction would meet these standards should be questioned.

2. **Does the receipt of a deferred payment obligation, such as a note, contractual agreement or annuity, at the time of the transfer result in the immediate recognition of income under §§ 1.83-1 or 1.83-7?**

As stated in Notice 2003-47, the Service's position is that the receipt of a deferred payment obligation, including an annuity, from a third party in exchange for a compensatory stock option or restricted stock results in immediate recognition of income. The executive recognizes income to the extent the amount of the deferred payment obligation transferred to the executive, plus any cash or other property received by the executive, exceeds the amount, if any, the executive paid for the option or restricted stock. This position applies regardless of whether the transaction is treated as an arm's length transaction, or a non-arm's length transaction for purposes of § 1.83-1 or 1.83-7. There are two bases for this position. First, the receipt of the obligation constitutes the receipt of property for purposes of §§ 1.83-1 and 1.83-7, resulting in application of sections 83(a) and (b) and immediate inclusion of income. Moreover, even if the obligation were not treated as section 83 property, the Service's position is that the gain on the sale is compensation income that cannot be deferred by a cash basis taxpayer. See § 1.1001-1; § 1.83-7(a) (last sentence); § 15A.453-1(d)(2).

Treatment of Obligation as Section 83 Property

The first basis for the Service position is that the receipt of the obligation, including an annuity, of a person other than the service recipient, received in full payment of the service recipient's obligation to pay for the services, constitutes property under §§ 1.83-1 and 1.83-7.

Section 1.83-7(a) provides that "if an option is sold or otherwise disposed of in an arm's length transaction, sections 83(a) and (b) apply to the transfer of money or other property received in the same manner as sections 83(a) and (b) would have applied to the transfer of property pursuant to an exercise of the option." This language requires that the related person's deferred payment obligation be treated as a third-party obligation provided as compensation to the employee upon exercise of the option.

Therefore, if the obligation is treated as section 83 property, the employee recognizes compensation income equal to the fair market value of the obligation less any amount paid for the original option (generally zero). Although § 1.83-7 does not expressly

address non-arm's length transactions, by analogy to the § 1.83-1 regulations the same analysis should apply where a deferred payment obligation is provided as part of a non-arm's length transaction. Substantially similar rules apply to the receipt of money or property upon the transfer of substantially nonvested stock. See § 1.83-1.

The use of a third-party obligation to pay for services results in an economic benefit to the recipient, resulting in immediate inclusion in income. In essence, the third-party obligation is treated as property received. See U.S. v. Christine Oil & Gas Co., 269 Fed. 458 (W.D. La. 1920) ("If [the taxpayer] accepts the notes of third persons in absolute payment, the result would be different. But where the effect of the transaction is a mere promise to pay, it cannot be said to be income"); Walls v. Commissioner, 21 B.T.A. 1417 (1931), aff'd 60 F.2d 347 (10th Cir. 1932) (attorney assigned a 1/8 interest in an oil lease by client in exchange for services received property with a fair market value and includible in income when received).

This treatment of third-party obligations is demonstrated in Rev. Rul. 69-50, 1969-1 C.B. 140, amplified by Rev. Rul. 77-420, 1977-2 C.B. 172. In that ruling, the taxpayer physician performed medical services for individual patients pursuant to an agreement whereby the amounts were paid to the physician by a non-profit corporation. The physician was allowed to elect to defer a certain amount of the payment. The ruling finds that: "The participating physician's right to the compensation payments credited to his account by the corporation emanates from the medical services that he has rendered to patient-subscribers. Under the agreement the patient-subscribers have compensated the participating physician for these services by investing him with such right. In effect, they have funded their obligation to the participating physician with the corporation, and, in so doing, they have conferred an economic or financial benefit on the participating physician." See also Rev. Rul. 77-420, 1977-2 C.B. 172 (extending Rev. Rul. 69-50 to require recognition of income even where the deferred payment obligation was subject to a substantial risk of forfeiture back to the non-profit corporation). Note that were the corporation the service provider to the patients, such that the physician was employed by or provided services to the corporation, the result would have been different.[8]

Executives most commonly rely upon the definition of property in the regulations accompanying section 83. Section 1.83-3(e) defines property to exclude an unfunded and unsecured promise to pay money or property in the future. Executives argue that

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[8] Executives may point to the decision in Minor v. U.S., 772 F.2d 1472 (9th Cir. 1985), involving a similar arrangement. In a footnote, the court dismissed the Service's reliance on Rev. Rul. 69-50, characterizing the ruling as a constructive receipt ruling, rather than an economic benefit ruling. However, the court appears to have distinguished the facts of the case, stating that while the facts in Rev. Rul. 69-50 were similar, in the ruling "the physician had effectively obtained the income because his right to immediate compensation emanated from the medical services rendered to patients, independent of his voluntary agreement with the corporation to defer a percentage of payments otherwise due for those services." Similarly, the compensation in a Notice 2003-47 transaction emanates directly from the employer, independent of the employee's voluntary agreement with the related person.

this definition is broad and intended to cover any unsecured deferred payment obligation, including third-party obligations.

This interpretation of the regulation is not supported by the authorities concerning application of the constructive receipt or economic benefit doctrines. If an employee would be required to recognize compensation income upon the receipt of a third party obligation as a payment for services rendered, section 83 should not be read to alter this result. The language in § 1.83-3(e) mirrors the language of Rev. Rul. 60-31, 1960-1 C.B. 174, which provides the general rules governing application of the constructive receipt doctrine to deferred compensation arrangements. That ruling provides that a "mere promise to pay, not represented by notes or secured in any way, is not regarded as receipt of income within the intendment of the cash receipts and disbursements method." However, the ruling addresses only obligations relating to the agreement to perform services between a service recipient and a service provider, with no indication of an intent to cover any promise other than an unfunded, unsecured promise of the service recipient. <u>See</u> Rev. Rul. 69-50, discussed above, addressing third-party obligations.

Even if viewed as more expansive to cover a third party's promise to pay compensation, this exclusion from property would not cover a third party's promise to pay an employer an amount for noncompensatory purposes (for example, to purchase widgets), transferred by the employer to the employee as a compensation payment. For example, Rev. Rul. 69-474, 1969-2 C.B. 105, distinguished Rev. Rul. 69-50, finding no immediate income recognition where the physician-partners in a medical partnership performing services for a corporation were allowed to participate in the corporation's nonqualified deferred compensation plan. Because there was no contractual relationship between the partnership and the corporation, the ruling found no income flowing to the partnership from any interest in the plan. Rather, the corporation's obligation under the plan was treated as the corporation's unfunded, unsecured promise to pay the physician. But the corporation's promise constituted a direct promise to pay from the corporation to the service-providing physician for services provided to the corporation, and was not used as payment by the partnership for the physician's services. In contrast, as provided in § 1.83-7, the related person's obligation to purchase the stock options is viewed as replacing the employer's original obligation to transfer the underlying stock, and not as a payment for any services provided to the related person.

Executives may next cite the Tax Court's decision in <u>Childs v. Commissioner</u>, 103 T.C. 634 (1994), <u>aff'd without op</u>. 89 F.3d 856 (11th Cir. 1996), as providing that third party obligations are not treated as property for section 83 purposes. The case involved a structured settlement providing for the payment of attorneys' fees. The plaintiffs' attorneys had agreed to a contingent fee arrangement. When the parties entered into a settlement agreement, the defendant agreed to pay the attorneys their portion of the fees directly, and to purchase an annuity to provide the payment. The court stated that the attorneys were not in constructive receipt because the agreement was reached before the payment was offered. The court then went directly into the analysis of

whether the annuity funded the defendant's obligation to pay the attorneys, and so was property under section 83. Executives argue that this should be read to provide that third party obligations are not property for section 83 purposes. However, the court failed to address whether the attorneys had already received property because the plaintiff (service recipient) had paid for the attorneys' services by giving the attorneys the defendants' promise to pay.[9]

Furthermore, the case involves a structured settlement in which the service provider's compensation was contingent upon and to stem directly from the payment by the third party. In essence, the service recipient (the plaintiff) established a portion of its own funds (the potential settlement) as the only source from which the service provider would be paid. Although technically the service provider received a promise from the third party (the defendant), the service provider in substance continued to possess an unsecured interest in a portion of the service recipient's funds (the potential settlement which otherwise would have been paid to the service recipient), which would not be available until the settlement was paid. So, for example, the decision may mean that an employee who was promised a commission on a sale if and when the customer paid, which instead of being paid to the employer and then forwarded to the employee would be paid directly by the customer to the employee when the product was purchased, would not be deemed to have received property if the employee received only the customer's unsecured promise to pay. In contrast, the decision does not address situations such as a Notice 2003-47 transaction where a third party obligation is treated as a payment by the service recipient for services unrelated to the issuance of the obligation, without any prearrangement between all the parties. Accordingly, the decision does not address whether under those circumstances the obligation would be viewed as section 83 property.

Treatment as a Sale or Exchange of Property

The second basis for the Service's position is that the provisions governing transfers of options contained in § 1.83-7 were not intended to alter the treatment of the transfer of the option or restricted stock as a sale or exchange of property. Rather, the application of section 83 only confirms that the gain is treated as compensation income.

Prior to the enactment of section 83 and the regulations thereunder, § 1.421-6 provided rules governing the treatment of compensatory options that lacked a readily ascertainable fair market value at the date of grant. The regulations provided that the options were not taxed at grant. The regulations provided further that when such an option "is transferred in an arm's length transaction, the employee realized

[9] Some commentators have noted that the court may have failed to address the correct issue. See Polsky, Gregg D., "A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees", 37 Ga. L. Rev. 57, 96-102 (2002); Gordon T. Butler, "Economic Benefit: Formulating a Workable Theory of Income Recognition", 27 Seton Hall L. Rev. 70, 119-120 (1996); see also 740 T.M. Accounting Methods - General Principles, at A-64 & n. 764 (rule that cash-method taxpayer recognizes income from receipt of third party note "dates from the dawn of federal tax law").

compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting."

The enactment of section 83 was not intended to change this treatment. The differences between the § 1.421-6 regulations and its successor regulations at § 1.83-7 with respect to the sale or disposition of options were intended only to bring the transaction within the framework of section 83, and to insure that any gain recognized by the service recipient was includible under section 83(a) or (b) so that the service recipient could deduct under section 83(h), even though the consideration received on the sale may not be provided by the service recipient. The provisions of § 1.83-7 should be read to apply section 83 to the amount received upon the sale in the same manner as section 83 would have applied to the transfer of property upon exercise of the option. See Realty Loan Corp. v. Commissioner, 54 T.C. 1083 (1970), aff'd, 478 F.2d 1049 (9th Cir. 1973) (citing Sorensen v. Commissioner, 22 T.C. 321 (1954) as providing that the sale of a compensatory option for a note "could not change the nature of that for which it was substituted or the time at which the amount was includible in income"). Accordingly, the recognizable gain on the transaction must be recognized under section 83(a) unless the amount realized upon the sale or exchange is substantially nonvested.

A transfer of options by the service provider in exchange for the deferred payment obligation is a "sale or disposition" within the meaning of section 1001(a). Under current law, the gain upon the sale or disposition of property in exchange for a deferred payment obligation generally must be recognized immediately, unless installment reporting applies. See section 1001(c); § 15A.453-1(d)(2)(i) ("Receipt of an installment obligation [in an installment sale] shall be treated as a receipt of property, in an amount equal to the fair market value of the installment obligation … whether or not such obligation is the equivalent of cash"). Under section 1001(a), the gain equals the excess of the amount realized over the adjusted basis. As a general rule, the amount realized upon a sale or other disposition of property is the sum of the cash and the fair market value of any other property received. See Section 1001(b). For certain deferred payment obligations issued in exchange for property, § 1.1001-1(g) provides rules to determine the amount realized. In general, the issue price of the obligation, including a deferred payment obligation resulting from a sales contract, determines the amount realized.

Accordingly, the transfer of the option or restricted stock in return for a deferred payment obligation results in recognizable gain generally equal to the issue price of the obligation less any adjusted basis in the option (typically zero), unless installment reporting applies. Brought within the section 83 framework and the application of sections 83(a) and (b), this recognizable gain is taxable immediately as compensation income unless substantially nonvested. Because the transaction results in compensation income, the installment method of reporting under section 453 is not available. See Sorensen v. Commissioner, 22 T.C. 321 (1954); Realty Loan Corp. v. Commissioner, 54 T.C. 1083 (1970), aff'd, 478 F.2d 1049 (9th Cir. 1973) Although the

executive may cite Mitchell v. Commissioner, 65 T.C. 1099 (1976), aff'd. 590 F.2d 312 (9th Cir. 1979) as providing otherwise, the Mitchell decisions center on the characterization of the payments as compensation income rather than capital gain, and fail to address the timing issue or application of section 453.

Executives participating in Notice 2003-47 transactions involving private annuities generally will cite Rev. Rul. 69-74, 1969-1 C.B. 43, as authority for deferring recognition of compensation income at the time of the transfer. There, one issue was whether "gain" was realized on appreciated property when a taxpayer used that property to purchase a private annuity. Rev. Rul. 69-74 would not apply to determine whether and when a taxpayer received gross income in connection with the performance of services under section 83. Rather, consistent with the principles applied in Sorenson denying installment reporting treatment to sales or dispositions of property resulting in compensation income, the Service should argue that the deferred recognition of income upon receipt of an annuity pursuant to section 72 is not applicable to sale or exchange transactions resulting in compensation income.

3. Is the employer, or other service recipient, entitled to a deduction under section 83(h). and if so when, and may the deduction be limited by section 162(m)?

Section 83(h) and § 1.83-6(a) provide generally that in the case of a transfer of property to which section 83 applies, there shall be allowed as a deduction under section 162 or 212, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services.

Under the general rule, the deduction is allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services. Section 1.83-6(a)(3) provides, however, that where property is substantially vested upon transfer, the deduction is allowed to such person in accordance with his method of accounting (in conformity with sections 446 and 461).

For these purposes, the income recognized upon the transfer of the option or restricted stock should be considered an amount included under section 83(a) or (b). Accordingly, a deduction equal to that amount should be allowed as a deduction to the extent otherwise available under section 162 or 212. Because the deferred payment obligation received typically will not be subject to a substantial risk of forfeiture, the obligation would be considered substantially vested. Accordingly, the deduction typically would be allowed in accordance with the service recipient's method of accounting under § 1.83-6(a)(3), rather than the general timing rule contained in section 83(h).

For the amount to be deducted, it must have been recognized and included as income under section 83(a), (b) or (d). Section 1.83-6(a)(2) provides that for purposes of the

deduction, the service provider is deemed to have included the amount as compensation in gross income if the person for whom the services were performed satisfies in a timely manner all requirements of section 6041 or 6041A, and the regulations thereunder, with respect to that amount of compensation. The requirements of sections 6041 and 6041A typically are satisfied by timely filing a Form W-2 or Form 1099. Because employers involved in Notice 2003-47 transactions generally will not have provided a Form W-2 including any income related to the transaction, and because the executive generally will not have included any compensation income related to the transaction in gross income, the requirements for a deduction will not be met.

Taxpayers may cite Robinson v. United States, 335 F.3d 1365 (2003), cert. denied 157 L.Ed 889 (2004). In that decision, the Federal Circuit held that an amount must only be includable under section 83, and not actually included, to justify a deduction. Accordingly the court also invalidated the Form W-2/Form 1099 safe harbor contained in Treas. Reg. § 1.83-6(a)(2). The Service has not acquiesced to that decision. Accordingly, the Service continues to apply this regulation. However, due to the Robinson decision, this position will not be supportable in the Federal Court of Claims.

The Duty of Consistency

In instances where the executive's tax year containing the transfer of the options or restricted stock has closed and the executive has not taken any amounts into income related to the transfer, the duty of consistency may also limit the ability of the corporation or other service recipient to take a current deduction. The duty of consistency is often described as an equitable remedy. It is based on the theory that a taxpayer owes the Commissioner the duty to be consistent with his tax treatment of the same or related items and will not be permitted to benefit in a later year from an error or omission made in a prior year which cannot be corrected because the statute of limitations has expired.

The doctrine requires the presence of three elements: (1) the taxpayer represented a fact or reported an item for Federal income tax purposes for a particular year; (2) the Service acquiesced in or relied upon the representation of fact or the reported item for that year; and (3) the taxpayer attempts to change the representation or reporting in a subsequent year, after expiration of the period of limitation, and the change is detrimental to the Service. Herrington v. Commissioner, 854 F.2d 755 (5th Cir. 1988); Club v. Commissioner, 105 T.C. 324, 332 (1995); Erickson v. Commissioner, T.C. Memo. 1991-97, citing Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 838-839 (1980). Once these elements are established, the Service may proceed as if the initial representation or reported fact is true and the taxpayer may not argue to the contrary. Herrington, 854 F.2d at 758.

The duty of consistency can apply in a typical Notice 2003-47 transaction. The representation of fact in these cases is the failure of the executive to report the transfer of options or restricted stock in a year that is now closed. The taxpayer who seeks to

change this representation in a later year is not the executive, but is instead the corporation or other service recipient who now seeks to take a deduction based on the amounts which the executive should have, but did not, include in income under § 1.83-1 or § 1.83-7 at the time of the transfer of the option or restricted stock, This creates two potential questions as to the application of the duty of consistency: (1) whether the doctrine can apply to an omission, and (2) whether a party other than the taxpayer making the representation can be estopped.

In answer to the first question, a taxpayer's representation of fact can consist of either the inclusion or omission of a particular item on a tax return. Thus, failure to report a particular item of income may be an implied representation of fact with respect to that item, which the taxpayer cannot repudiate at a later date. Wentworth v. Commissioner, 244 F.2d 874 (9th Cir. 1957) (failure to report receipt of funds on an income tax return was a representation that the funds were a loan repayment); Estate of Letts v. Commissioner, 109 T.C. 290 (1997).

In answer to the second question, courts have applied the duty of consistency to a taxpayer other than the taxpayer that filed the return in the closed year, where the two taxpayers are in a "privity-type" close relationship. LeFever v. Commissioner, 100 F.3d at 788 ("The duty of consistency is usually understood to encompass both the taxpayer and parties with sufficiently identical economic interests."); Cluck v. Commissioner, 105 T.C. 324 (1995).

In the context of the transactions at issue here, if it is determined that the corporation or other service recipient and the executive are in privity sufficient to invoke the duty of consistency, then any representation by either party in a now-closed year cannot be contradicted by any future treatment of the item by the other party without being subject to the duty of consistency.

Characteristics that may be taken into account in determining whether the corporation or other service recipient and the executive acted in privity include the following: (1) the corporation agreed, formally or informally with the executive not to report any income on a Form W-2 or Form 1099; (2) the corporation agreed, formally or informally, with the executive not to claim a deduction based upon the transfer of the option or restricted stock, the exercise of the option or the vesting of the restricted stock; (3) the corporation actively amended the corporation's stock option or restricted stock plan to permit the transfer to the executive's related person which was not permitted prior to the amendment; (4) the corporation manually overrode the payroll system to prevent issuance of Form W-2 or Form 1099, when the stock option or restricted stock was transferred to the related person or the time when the option was exercised or the restricted stock substantially vested; (5) the payroll distribution records of the corporation indicate transfer of the stock upon exercise of the stock option directly to the related person instead of directly to the executive as would be the normal course; (6) the corporation assisted the executive in completing and submitting SEC Form 4 to report the transaction; (7) the corporation pays and deducts a portion of the executive's fees for the transaction.

Section 162(m)

Section 162(m) may also, in certain instances, limit the deduction available to the corporation with respect to compensation income of certain employees. Section 162(m)(1) provides that compensation in excess of $1 million that is paid by a publicly held corporation to the corporation's "covered employees" generally is not deductible.

Under section 162(m)(3) and § 1.162-27(c)(2), "covered employees" are the chief executive officer and the four other most highly compensated officers, as of the last day of the corporation's tax year, as reported in the company's proxy statement.

Subject to certain exceptions, the deduction limitation applies to all otherwise deductible compensation of a covered employee for a taxable year, regardless of the form in which the compensation is paid or the year in which the compensation was earned.

Certain types of compensation, however, are not subject to the deduction limitation. The most relevant exception is for performance-based compensation. Under section 162(m)(4)(C) and § 1.162-27(e), compensation is treated as qualified performance-based compensation if (1) the compensation is payable solely on account of the attainment of one or more preestablished, objective performance goals; (2) the performance goal under which the compensation is paid is established by a compensation committee comprised solely of two or more outside directors; (3) the material terms of the performance goal under which the compensation is to be paid are disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid; and (4) the compensation committee certifies in writing prior to payment of the compensation that the performance goals and any other material terms were in fact satisfied.

With respect to compensation attributable to a stock option, the compensation will be deemed to be compensation payable solely on account of the attainment of one or more preestablished, objective performance goals if (1) the grant or award is made by the compensation committee; (2) the plan under which the option is granted states that maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and (3) under the terms of the option, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant. See § 1.162-27(e)(2)(vi). The grant must be approved by a compensation committee comprised solely of two or more outside directors, and the stock option plan or grant must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid. However, the compensation committee need not certify that the performance goals were met if the compensation is based solely on an increase in the value of the stock after the date of grant. See § 1.162-27(e)(5).

Grants of restricted stock are not subject to the special rules governing stock options, and must meet all of the otherwise applicable requirements to be classified as qualified performance-based compensation.

The application of the section 162(m) deduction limitation is complex, and many special rules are contained within § 1.162-27. However, where a deduction of over $1 million has been claimed based upon compensation paid to an employee who is a "covered employee," and it appears that all of the requirements have not been met for classification of the payment as qualified performance-based compensation, further development of the issue may be warranted.

4. <u>When and to what amounts do the FICA, FUTA and Federal income tax withholding provisions apply with respect to the transaction?</u>

Sections 3101 and 3111 impose Federal Insurance Contributions Act (FICA) taxes on "wages," as that term is defined in section 3121(a). FICA taxes consist of the Old Age, Survivors and Disability Insurance tax (social security tax) and the Hospital Insurance tax (Medicare tax). These taxes are imposed on an employer under section 3111(a) and (b) on wages paid by the employer with respect to employment (employer portion of FICA taxes) and on an employee under section 3101(a) and (b) on wages received by the employee with respect to employment (employee portion of FICA taxes). Section 31.3121(a)-2(a) provides that wages are received by an employee at the time they are paid by the employer to the employee. Section 3102(a) provides that the employee portion of FICA tax must be collected by the employer of the employee by deducting the amount of the tax from the wages as and when paid.

Section 3301 imposes Federal Unemployment Tax Act (FUTA) tax on an employer with respect to "wages," as that term is defined in section 3306(b), paid by the employer with respect to employment. Additionally, section 3402(a), relating to Federal income tax withholding (ITW), generally requires every employer making a payment of wages to deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary.

Section 3121(a) defines the term "wages" for FICA purposes as all remuneration for employment including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions. Section 3306(b) for FUTA purposes and section 3401(a) for ITW purposes contain similar definitions.

Section 3121(a)-2(a) generally provides for FICA purposes that wages are considered paid by an employer at the time they are actually or constructively paid. Section 31.3121(a)-2(b) provides that wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to his possession. However, to constitute payment the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and

disposition. Section 31.3301-4 for FUTA purposes and § 31.3402(a)-1(b) for ITW purposes contain similar provisions.

Sections 31.3121(a)-1(e), 31.3306(b)-1(e), and 31.3401(a)-1(a)(4) provide that in general the medium in which the remuneration is paid is immaterial. It may be paid in cash or other than in cash. Remuneration paid in any medium other than cash is computed on the basis of the fair market value of such items at the time of payment. Section 31.3102-1(a) provides that the employer is required to collect the tax, notwithstanding that wages are paid in something other than money, and to pay over the tax in money. Section 31.3402(a)-1(c) for ITW purposes provides that if the wages are paid in property other than money, the employer should make necessary arrangements to insure that the amount of the tax required to be withheld is available for payment in money.

Sections 31.3121(a)-1(i) and 31.3306(b)-1(i) provide that, unless specifically excepted, remuneration for employment constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed the services. Section 31.3401(a)-1(a)(5) for ITW purposes contains a similar provision.

The event that gives rise to employment tax liability is the payment of wages. There is limited case law and guidance that deal with the issue of payment of wages involving compensatory nonstatutory stock options or restricted stock. There is also no specific authority addressing the payment of wages when a transfer to a third party occurs prior to the exercise of a stock option or when a restriction lapses on restrictive stock. Generally, absent an intervening event, courts have held that wages are considered paid for employment tax purposes when a compensatory nonstatutory stock option (with no ascertainable value at the time of grant) is exercised. See Commissioner v. Smith, 324 U.S. 166 (1945) and LoBue. The Court in Smith found that the excess of the fair market value of the stock over the exercise price when the employee exercised the option was compensation for services and income taxable to the employee.

The employment tax obligations similarly arise at such time under the regulatory provisions discussed above. For example, the Service held in Rev. Rul. 67-257, 1967-2 C.B. 359, that where an employee has an unconditional right to receive stock on the date of exercise of a compensatory nonstatutory stock option, at the time of exercise the excess of the fair market value of the stock over the exercise price is compensation includible in the employee’s gross income and wages subject to ITW under Section 3402(a) and the applicable ITW regulations.

Additionally, in Rev. Rul. 79-305, 1979-2 C.B. 350, a corporation transferred common stock to an employee subject to a substantial risk of forfeiture. The employee made no election to include the fair market value of the stock in gross income in the year of transfer under section 83(b). The ruling holds that, under section 83, the fair market value of the stock at the time the risk lapses is includible in the employee's gross income for the year in which risk lapses. The ruling also holds that when the risk lapsed

the stock was made available to be used by the employee without any substantial limitation or restriction. Therefore, the fair market value of the stock at the time the risk lapses is wages for purposes of sections 3121(a), 3306(b), and 3401(a).

Furthermore, in Rev. Rul. 78-185, 1978-1 C.B. 305, at the end of each month a company contributed to an employee stock purchase plan (that did not qualify under sections 401 or 423) on behalf of each participant an amount equal to a percentage of the dollar amount of the participant's contribution to the plan for that month. On the same day as the contribution, a credit was made to each employee's account for the number of shares of stock that could be purchased with the amount of the combined contributions. The value of stock was determined by the average closing price of the stock on the New York Stock Exchange for each trading day of the month. The excess of the fair market value of the stock on the date of the crediting of the stock to the employee's account over the amount of the employee's contributions was found to be wages for purposes of FICA, FUTA, and ITW. Thus, for purposes of §§ 31.3121(a)-1(e) and 31.3306(b)-1(e) (remuneration paid in items other than cash shall be computed on the basis of fair market value at the time of payment for FICA and FUTA purposes) and § 31.3401(a)-1(a)(4) (similar provision for ITW purposes), the revenue ruling held that the time of payment was when the stock was actually credited to the employee's account. See also Rev. Rul. 67-366, 1967-1 C.B. 165, which required the inclusion of a payment as income and as wages subject to ITW at the time made by an employer and paid to an employee for the cancellation of a nonstatutory stock option that had no ascertainable value at the time of issuance.

Thus, absent an intervening event, wages are considered paid and employment tax liabilities arise under the applicable employment tax provisions when a compensatory nonstatutory stock option is exercised. Similarly, absent an intervening event, employment taxes would be imposed when the restriction lapses on restricted stock.

When an intervening event occurs, the key determination is whether there has been an actual or constructive payment of wages by the employer to the employee. There is no authority that provides that section 83 principles shall apply in this determination. Rather, an independent analysis of the employment tax statutes, regulations, and guidance controls this determination. Under the employment tax statutes, regulations and guidance, a similar analysis to that used under section 83 regulations regarding the determination of income in a non-arm's length transfer should be made for determining when wages are paid under these circumstances for purposes of FICA, FUTA and ITW purposes. While the Service's position for employment tax purposes is consistent with its section 83 position, it is not based upon section 83 provisions, but rather based on an independent interpretation of when wages are considered paid under the FICA, FUTA, and ITW provisions. While there is a lack of specific guidance with regard to the employment tax treatment of these transactions, the Service believes the discussion below represents the best analysis of the transactions under the applicable employment tax provisions.

Application of the employment tax provisions discussed above indicates that at the time of the transfer or sale of a compensatory nonstatutory stock option or restricted stock in a non-arm's length transfer, the portion of the property that is available for the employee's use without substantial limitation or restriction is subject to employment taxes. Likewise, the portion of the property that remains subject to a restriction or limitation, and is not made available until the restriction or limitation is lifted, will be subject to employment tax liabilities at the time of the lifting of the restriction or limitation (i.e., the option is exercised or the restriction on the stock lapses).

A non-arm's length transfer of a compensatory nonstatutory stock option or restricted stock to a third party for money or other property results in the imposition of employment tax at the time of the transfer upon the amount of money or other property (including a deferred payment obligation as discussed above) received, with the potential for further employment taxes at the time the option is exercised by the related party or the restriction lapses on the restricted stock held by the related party. At such later time, employment taxes would be imposed to the extent the fair market value of the stock purchased pursuant to the exercise of the compensatory nonstatutory stock option or, in the case of restricted stock whose restriction has lapsed, the value of the stock, exceeds (1) the amount, if any, paid by the employee for the acquired stock plus (2) the amount of wages paid as a result of the transfer or sale of the compensatory nonstatutory stock option or restricted stock to the related party. In no event would wages be considered paid later than the time of the exercise of a compensatory nonstatutory stock option or when the restriction lapses for restricted stock (such as a later time based upon the payment of the deferred payment obligation by the related party).

Similar to the treatment under § 1.83-1 and § 1.83-7 where an arm's length transfer to a third party closes the income tax element of the transfer so that no additional income is recognized at the time of exercise or when a restriction lapses, it is the Service's position that the employment tax element would also close at the time of the arm's length transfer. At the time of the arm's length transfer, an amount has been credited to or set aside for the employee's use without any restriction or substantial limitation as to the time or manner of payment or condition upon which payment is to be made to the employee. Because the option or restricted stock has been sold in an arm's length transaction, no additional amount is treated as set aside for the employee's use. Thus, the employee will not receive additional wages or be subject to additional employment taxes at the time of exercise or when a restriction lapses.

Duty of Consistency

If the employer's employment tax return is closed, the duty of consistency may apply for employment tax withholding purposes, requiring application of the employment tax provisions consistent with the employer's position on the employment tax returns filed in the closed year. Accordingly, employment taxes may be due at the time any payments are made on the deferred payment obligation, including any accelerated payments. The legal underpinnings of this duty are discussed in detail under question 3.

4a. Is the common law employer corporation or the related person the employer who is liable for withholding and payment of employment taxes under the FICA, FUTA and Federal income tax withholding provisions.

In addition to the issues of when and to what amounts employment taxes apply, there is the issue of who is the employer that is liable for the employer portion of FICA tax and for FUTA tax, and for withholding and paying over the employee portion of FICA tax and the ITW. Is the employer (1) the common law employer corporation that granted a compensatory nonstatutory stock option (or issued restricted stock) or (2) the related person?

Section 31.3121(d)-2 generally provides for FICA purposes that a person who employs one or more employees is an employer. For FUTA purposes, the term employer is generally defined in section 3306(a)(1) as any person who (A) during any calendar quarter in the calendar year or the preceding calendar year paid wages of $1,500 or more, or (B) on each of some 20 days during the calendar year or during the preceding calendar year, each day being in a different calendar week, employed at least one individual in employment for some portion of the day.

Section 31.3121(d)-1(c)(1) provides that an individual is an employee under the usual common law rules if the relationship between him and the person for whom he performs services is the legal relationship of employer and employee. Whether the relationship of employer and employee exists under the usual common law rules is determined upon an examination of the particular facts of each case. See § 31.3121(d)-1(c)(3). Section 31.3306(i)-1 for FUTA purposes contains a similar provision. Thus, generally whether a person is an employer is determined under the common law rules for FICA and FUTA purposes (also referred to as the common law employer). This would be the corporation service recipient in a Notice 2003-47 transaction.

However, section 3401(d)(1) defines the term "employer" for ITW purposes as the person for whom the individual performs or performed any service, of whatever nature, as the employee of such person, except that, if the person for whom the individual performs or performed services does not have control of the payment of wages for such services, the term "employer" means the person having control of the payment of such wages. Section 31.3401(d)-1(f) provides generally that the term "employer" means the person having legal control of the payment of the wages.

Neither the FICA nor FUTA provisions contain a definition of employer as meaning the person having control of the payment of wages contained in section 3401(d)(1). However, court decisions have extended section 3401(d)(1) to FICA and FUTA for determining liability. See Otte v. United States, 419 U.S. 43 (1974) and In re Armadillo Corp., 561 F.2d 1382 (10th Cir. 1977).

When determining whether a person other than the common law employer is the employer for employment tax purposes under section 3401(d)(1), consideration must be

given to (1) who has legal control of the payment of the wages and (2) the nature of the relationship of the parties (the related party, the common law employer and the employees).

The legislative history of section 3401(d)(1) establishes that the intent of this Code section was "designed solely to meet unusual situations" and it was not intended as a departure from the basic purpose to centralize responsibility for withholding, returning and paying taxes in the common law employer. S.Rep. No. 221, 78th Cong. 1st Sess., May 10, 1943.

In Otte, the Supreme Court found that section 3401(d)(1) was intended to place responsibility for withholding at the point of control, which in that case meant the bankruptcy trustee with the duty of paying wages to the bankrupt employer's employees.

In Century Indemnity Co. v. Riddell, 317 F. 2d 681 (9th Cir. 1963), legal control was defined as the "legal power to control the actual payment of wages, rather than merely what actually may have been practiced by voluntary forbearance of the person actually having such legal power." See also Bellus v. U.S., 198 B.R. 782 (Bankr. N.D. Cal. 1995), aff'd in part, rev'd in part on other issues, 125 F.3d. 821(9th Cir. 1997).

Court decisions have been inconsistent on the amount of control necessary to find a section 3401(d)(1) employer, and one case, In re Southwest Restaurant Systems, Inc., 607 F.2d. 1237 (9th Cir. 1979), appears to stand for the proposition that the mere control over the account from which payment is made is sufficient to find a section 3401(d)(1) employer. However, typically the courts have also considered whether the third party is independently liable for the payment of the wages and the relationship between the parties. See U. S. vs. Garami, 184 B.R. 834 (Bankr. M. D. Fla. 1995) (the court found no indication that a third party would pay employment taxes regardless of whether a fee was received from the employer and found that the third party was not in control of the payment of wages*);* In re Earthmovers, Inc., 199 B.R. 62 (Bankr. M.D. Fla. 1996), vacated as moot, 242 B.R. 49 (M.D. Fla. 1999) (although common law employer remained in control of the payment of wages, the court found that the leasing company was contractually and statutorily bound to pay wages and, thus, constituted the § 3401(d)(1) employer).

Thus, it has been the Service's position that, where there is a conduit relationship between the common law employer and the third party such that the third party does not make payment until it receives such payment from the common law employer, the third party does not have legal control and a section 3401(d)(1) relationship does not exist. See 1998 FSA LEXIS 259 (April 9, 1998).

In determining which party has the legal control of the payment for finding a section 3401(d)(1) employer, courts have found a third party to be a section 3401(d)(1) employer only where (1) some type of relationship between the third party and the common law employer exists, (2) the third party has a relationship to the employee that is in connection with the employee's employment relationship with his common law employer, and (3) the third party is otherwise independently liable for the employment taxes.

For employment tax purposes, in the Notice 2003-47 transaction, wages arise from the compensatory nonstatutory stock option granted or the restricted stock issued by the corporation. The corporation controlled the issuance of the property, decided what, if any, restrictions should be placed on the property and made the property transferable. Absent the intervening transfer, the corporation would be liable for employment taxes upon the exercise of the option or when the restriction lapses as to the restricted stock. The intervening transfer or sale to the related party serves to make the property (or a portion of the property) available to the employee without substantial limitations or restrictions sooner than it otherwise would have been. However, the related party does not enter into any type of agreement or understanding with the corporation to make payments on behalf of the corporation.

Further, the related party's relationship with the employee is not in connection with the employee's employment relationship with the common law employer. The employee performed services for the corporation for which the employee was paid wages. Other than entering into a transaction with the employee to purchase the property from the employee, the related party has no direct obligation upon which to find a legal obligation to pay wages.

In Notice 2003-47 transactions, there is no relationship (or agreement) between the corporation and related party upon which to base a finding that the corporation's liability for employment taxes has shifted to the related party. Thus, although factual inquiries are involved and the courts have varied in their application of the control standard, it is the Service's position that (1) the related person is not a section 3401(d)(1) employer in Notice 2003-47 transactions and (2) the common law employer corporation is the employer who is liable for the employer portion of FICA tax and FUTA tax, and for withholding and paying over the employee portion of FICA tax and ITW. Although the corporation may have administrative concerns (i.e., no direct funds may be available from which to satisfy its employment tax obligations, and the corporation may not have knowledge of when the transfer takes place), these concerns should have been considered and addressed by the corporation when it decided to make the property transferable. Further, the corporation has a regulatory obligation to insure that funds are available, and it is the corporation's responsibility to secure necessary information to satisfy its withholding obligations.

5. <u>If the Notice 2003-47 transaction is found not to result in immediate income recognition, should the Service argue, in the alternative, that the related person does not acquire basis in the stock options or restricted stock with respect to any portion of the payment that the executive does not include in gross income under section 83?</u>

In general, taxpayers receive a cost basis in property acquired with a debt instrument, with the cost equaling the issue price of the debt instrument. <u>See</u> § 1.1012-1(g)(1); <u>Crane v. Commissioner</u>, 331 U.S. 1 (1947). However, under the consistency principles set forth in the section 83 regulations, basis may not be available to the purchaser of property subject to section 83 where the service provider selling the property has not included an amount in compensation income.

Under § 1.83-4(b), if property to which section 83 applies is acquired by any person, including a person who acquires such property in a subsequent transfer which is not at arm's length, while the property is still substantially nonvested, such person's basis for the property must reflect any amount paid for the property and any amount includible in the gross income of the person who performed the services.

Section 1.83-7 does not directly address the basis issue when an option is transferred. However, applying the principles of § 1.83-4(b), the person acquiring the option would have a basis in the option equal to any amount paid for the option, and any amount includible in the gross income of the person who performed the services at the time the option is exercised.

Under § 1.83-3(g), the term “amount paid” for purposes of section 83 refers to the value of any money or property paid for the transfer of property to which section 83 applies.

In a Notice 2003-47 transaction, the related person would thus have a basis in the acquired stock equal to any money or property paid for the transfer of the stock option or restricted stock, plus any amount included in the executive’s income upon the exercise of the stock option or the vesting of the restricted stock. If the deferred payment obligation is treated as property subject to section 83 at the time of the transfer, than the amount of the obligation would be includible in the related person’s basis in the stock option, and ultimately the acquired stock.

However, if a court holds that the deferred payment obligation does not result in the immediate recognition of income by the executive because it does not constitute money or property under section 83, then it should not count as an amount paid either. Accordingly, the related person would not be entitled to basis under § 1.83-4(b).

Taxpayers may argue that this is not consistent with the position taken with respect to employee notes used to acquire property. For example, the regulations contemplate that indebtedness used to purchase restricted stock may be treated as an amount paid. <u>See</u> § 1.83-4(c); Rev. Rul. 2004-37, 2004-11 I.R.B. 583. However, these positions are consistent with the Service’s view that these obligations, which are not obligations of the

service recipient to the service provider as part of the arrangement to provide services, are property for section 83 purposes and are not excluded from property as unfunded, unsecured promises to pay under § 1.83-3(e). Accordingly, the obligation may be included in the amount paid. Consistent with this reasoning, the structure of § 1.83-4(b) indicates that the section 83 regulations were not intended to permit deferral of compensation upon a sale or disposition of either restricted stock or an option based on the argument that a deferred payment obligation is not section 83 property. However, in the event a court finds otherwise, the related person should not be allowed to benefit from the classification of the obligation as property for the purposes of one part of the regulation but not another.

More problematic is the situation in which the executive's tax year has closed. The denial of basis in such circumstances would require an assertion that the transfer of the obligation did not constitute an amount paid, which is only intended as an alternative argument should the Service's position that the obligation is property for section 83 purposes not be upheld. However, consideration should be given as to whether duty of consistency principles could be applied to force the related person to maintain a position consistent with the executive's position in the closed tax years that the obligation did not constitute section 83 property. Privity would appear likely to be found where the executive controlled the related person, whether through a substantial ownership position or as a manager of the related person's affairs. For a discussion of the duty of consistency principles, see above.

6. <u>May the transaction be recast for federal tax purposes under § 1.701-2 as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances?</u>

Section 1.701-2(a), the partnership anti-abuse rule, provides in pertinent part that subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements:

> (1) the partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose;
>
> (2) The form of each partnership transaction must be respected under substance over form principles; and
>
> (3) Except as otherwise provided, the tax consequences under subchapter K to each partner of the partnership operations and of transactions between the partnership and the partner must accurately reflect the partners' economic agreement and clearly reflect the partner's income.

Section 1.701-2(b) provides that the provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in § 1.701-2(a). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Service can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of subchapter K in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Service can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K: (1) the purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners; (2) one or more of the purported partners of the partnership should not be treated as a partner; (3) the methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income; (4) the partnership's items of income, gain, loss, deduction or credit should be reallocated; or (5) the claimed tax treatment should otherwise be adjusted or modified.

Section 1.701-2(c) provides that whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. Section 1.701-2(c) lists factors that may be considered in making the determination but those factors do not create a presumption that a partnership was or was not used in a manner inconsistent with subchapter K.

One of the factors on the list indicative of a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is that the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership assets and conducted the partnership's activities directly. See § 1.701-2(c)(1). Assuming that the executive's arguments with respect to the amount and timing of compensation income recognition in a Notice 2003-47 transaction were valid, the present value of the partners' aggregate federal tax liability would be much greater if the executive who held the compensatory stock option retained individual ownership of the stock option and then carried out the activity of the partnership by exercising the option directly, because the executive would have to recognize the compensation income immediately upon exercise of the option. This is true whether the partnership was formed for the purpose of engaging in this transaction or an existing partnership was used to engage in the transaction. Another factor on the list is that one or more partners who are necessary to achieve the claimed tax results have a nominal interest in the partnership. See §1.701-2(c)(3). In many of the Notice 2003-47 transactions, the

partners other than the individual holding the compensatory stock option have very minor interests in the partnership. A third factor indicative of intent is that substantially all of the partners are related (directly or indirectly) to one another. See § 1.701-2(c)(4). A fourth factor is that the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the individual (or a related party). See § 1.701-2(c)(6). In these transactions, the executive's family members are usually the other partners in the partnership, thereby maintaining control of the property within the executive's family.

The Service believes that a partnership formed or availed of in connection with a Notice 2003-47 transaction does not operate in a manner consistent with the intent of subchapter K. In the Notice 2003-47 transactions, the requirement that each partnership be bona fide and that each partnership transaction or series of related transactions be entered into with a substantial business purpose is not met. A partnership formed or availed of in connection with this transaction often engages in a minimal amount of investment transactions to generate the appearance of a business purpose in the event the transaction is challenged. Other than these minimal investment activities, the partnership may engage in no other business activity. The real purpose of the partnership is the delay or avoidance of the recognition of compensation income and gain through the Notice 2003-47 transaction. Although establishment of substantial business purpose is a fact-specific inquiry, the reasonably expected pre-tax profit from the investment transactions is minimal when compared to the purported avoidance of tax liability achieved through this transaction.

Courts have found that, despite following all the formalities for creating a partnership, the alleged partners' conduct and relationship was such that a bona fide partnership did not exist. Merryman v. Commissioner, 873 F.2d 879 (5th Cir. 1989), aff'g, T.C. Memo. 1988-72; ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000), aff'g, T.C. Memo 1998-305, cert. denied, 531 U.S. 871 (2000).

In Merryman, the court disregarded a partnership that lacked economic substance and served no purpose other than to create tax benefits for its partners. The partnership consisted of the key employees and officers of the company, the company itself acting as managing partner, and another partnership consisting of the shareholders of the company who were all members of a single family. Formation of the partnership allowed the company to retain control of a major asset, an oil rig, while passing along various tax advantages to the partners. On the day of the partnership's formation, the partnership purchased the oil rig from the company and simultaneously surrendered control of the rig back to the company. Despite all appearances that the company, as managing partner, had control of the partnership's affairs, in actuality one of the partners, who was also the president and chairman of the company, made the ultimate decisions. The only partner who paid the required capital contribution to the partnership was the company. The partnership, which purchased the oil rig apparently for fair market value, was not required to make a down payment; a promissory note was accepted. The court noted, "This sale by the managing partner on exceedingly favorable terms to the partnership raises doubts about the existence of an arms-length

deal and provides evidence of a transaction lacking economic substance. Here, in fact, [the company] became both mortgagee and co-mortgagor on the note." (Internal citations omitted).

Many of the facts described in the Merryman case are relevant to a determination of whether a bona fide partnership and transactions with a substantial business purpose exist. With regard to the transfer of the stock options or restricted stock in the Notice 2003-47 transactions, some considerations should include (but not be limited to) whether the executive was the only partner who contributed to the partnership, whether there was any real change in control from executive to partnership of the stock options or restricted stock, whether any of the other partners are tax neutral, whether the partners complied with the terms of the partnership agreement, and whether there was any business purpose or profit motive for creating and maintaining the partnership.

The second requirement of the anti-abuse rule in § 1.701-2(a) that the form of each partnership transaction must be respected under substance over form principles is not met in a Notice 2003-47 transaction. It is axiomatic that the substance rather than the form of a transaction governs the federal income tax treatment of the transaction. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). Substance over form and related judicial doctrines all require "a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened." Harris v. Commissioner, 61 T.C. 770, 783 (1974). The issue of whether any of those doctrines should be applied involves an intensely factual inquiry. See Gordon v. Commissioner, 85 T.C. 309, 327 (1985). Even if the transaction does comply with the requirements under the Code, transactions that literally comply with the language of the Code but produce results other than what the Code and regulations intended are not given effect. In Gregory v. Helvering, 293 U.S. 465, 470 (1935), the Supreme Court found that even though the transaction complied with the Code, "the transaction upon its face lies outside the plain intent of the statute." Therefore, the Court found that to give the transaction effect would be to "exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id. In Knetsch v. United States, 364 U.S. 361 (1960), the Supreme Court once again found a transaction abusive, even though the transaction met every literal requirement of the Code. The Court stated that "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." Id. at 366. A transaction that is entered into solely for the purpose of tax reduction and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. Estate of Franklin v. Commissioner, 64 T.C. 752 (1975); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Nicole Rose Corp. v. Commissioner, 117 T.C. 27 (2001).

The substance of the Notice 2003-47 transaction is that the executive exercises the compensatory stock options or transfers the restricted stock and effectively retains control (directly and through family members) of the proceeds. The form of the transaction makes it appear that the exercise of the options is carried out by a separate

party and that individuals other than the executive have control of the proceeds. The form does not reflect the substance of the transaction. Moreover, there was nothing of substance to be realized from the transaction aside from the avoidance of tax. An anti-abuse rule challenge under the substance over form principles should include (but not be limited to) the following: the close relationship of the partners, the almost immediate exercise of the options by the related party, retention of the benefits and burdens of the options and acquired stock by the executive/partner, the creation of the partnership in order to engage in this transaction, the transaction causing the executive/partner's federal tax liability to be substantially less than had the executive/partner owned the partnership's assets and conducted the partnership's activities directly, and a determination that the partnership does not engage in other substantial activities.

Section 1.701-2(b) gives the Service broad authority to recast a transaction or series of transactions in the event that a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. In light of this, the partnership anti-abuse rule should be applied to disregard the partnership or some of the partners or to disregard the purchase of the compensatory stock options or restricted stock by the partnership, depending on the particular facts of the transaction.

If a partnership is formed in connection with a Notice 2003-47 transaction, the Service may disregard the partnership and recast the transaction in a manner that is consistent with the partners engaging in the activities directly. This approach will eliminate the delay or avoidance of compensation income and gain recognition. Other authorities support the Service's disregard of the purported Partnership. Under § 761, a partnership includes "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate." See also Section 7701(a)(2). The Supreme Court in Commissioner v. Culbertson, 337 U.S. 733, 742 (1949), stated that a partnership is created for federal income tax purposes if:

> [C]onsidering all the facts -- the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent – the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

The Tax Court in Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964), set forth the following nonexclusive list of factors relevant to the consideration of whether a partnership is created:

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party had made to the venture; the parties' control

over income and capital and the right of each to make withdrawals; whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over the assumed mutual responsibilities for the enterprise.

In ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000), aff'g, T.C. Memo 1998-305, cert. denied, 531 U.S. 871 (2000), the Court of Appeals for the D.C. Circuit found that a partnership formed for a tax purpose and which engages in de minimis business activity in furtherance of that tax purpose is not a valid partnership. ASA, 201 F.3d at 512; see also Boca Investerings Partnership v. United States, 314 F.3[d] 625 (D.C. Cir. 2003). Moreover, the ASA court stated that whether "the 'sham' be in the entity or the transaction . . . the absence of a nontax business purpose is fatal." ASA, 201 F.3d at 512.

Applying this analysis to the facts before it, the court of appeals in ASA found that even though the "investment in LIBOR Notes might have had a business purpose, the prior three-week investment in and subsequent sale of the private placement Notes (PPNs) was . . . a business activity merely conducted for tax purposes." Id. at 513. The Court of Appeals realized that the taxpayer may have had an interest in potential gain from its investments, but those interests were "dwarfed by its interest in the tax benefit." Id. at 513. In concluding that ASA Investerings was not a legitimate partnership, the court further clarified that "[a]lthough a taxpayer may structure a transaction so that it satisfies the formal requirements of the Internal Revenue Code, the Commissioner may deny legal effect to a transaction if its sole purpose is to evade taxation." Id. (quoting Zmuda v. Commissioner, 731 F.2d 1417, 1421 (9th Cir. 1984)). Hence, the standard in the D.C. Circuit is that a de minimis business purpose will not validate a partnership whose true purpose is the pursuit of tax benefits. Rather, the relevant legal inquiry, as found by the Court of Appeals for the D.C. Circuit, is a comparison of the purported business purpose to the expected tax benefit. Id. at 513. The weight placed upon this legal factor led the D.C. Circuit to disregard the partnership entity. Id. at 516.

On the issue of risk, the D.C. Circuit Court of Appeals in ASA allowed for the existence of de minimis risk in the transaction noting that "no investment is entirely without risk." Id. at 514. The court further concluded that a carve out of de minimis risk is consistent with the Supreme Court's view that "a transaction will be disregarded if it did 'not appreciably affect [taxpayer's] beneficial interest except to reduce his tax.'" Id. (quoting Knetsch v. United States, 364 U.S. 361, 366 (1960)).

As with the transactions in ASA and Boca, it is possible that de minimis risk exists in the Notice 2003-47 transactions. The partnership will bear some risk of loss if the options are not exercised shortly following the sale from the executive; however in most cases, the options were exercised quickly after the sale. The minor investment activities engaged in by many of the partnerships are de minimis compared to the amount of the claimed tax savings. Further, the modicum of business purpose asserted by the executives for the formation of the partnership in a Notice 2003-47 transaction does not alter the fact that the true purpose for the partnership is the reduction of tax liability. Thus, the partnership entity should be disregarded.

In cases in which an operating partnership engages in a Notice 2003-47 transaction, it may not be appropriate to disregard the partnership. In these cases, § 1.701-2 applies to permit the Service to recast the transaction in a manner consistent with the intent of subchapter K. A Notice 2003-47 transaction, whether engaged in through a partnership formed primarily for use in the transaction or through a previously operating partnership, reduces substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. The fact that such reduction was a principal purpose of engaging in the transaction is apparent from the lack of legitimate economic purpose for the transaction. A comparison of the tax gain generated by the transaction to the economic benefit that the transaction could be reasonably expected to generate is a significant factor indicating that the principal, if not sole, purpose for engaging in a Notice 2003-47 transaction is the tax delay or avoidance generated by the transaction.

It follows from this that the Service may recast the transaction by, among other things, disregarding the purchase of the compensatory stock options or restricted stock by the partnership. If the purchase is disregarded, the purported delay or avoidance of compensation income and gain recognition generated by the Notice 2003-47 transaction will be eliminated.

7. May the transaction be challenged under judicial doctrines?

There are numerous judicial doctrines used to analyze the true nature of a transaction and determine whether it has any business function or can be disregarded because it is solely driven by a tax purpose. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). Economic substance, sham and related judicial doctrines all require "a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened." Harris v. Commissioner, 61 T.C. 770, 783 (1974). The issue of whether any of these doctrines should be applied involves an intensely factual inquiry. See Gordon v. Commissioner, 85 T.C. 309, 327 (1985), Gaw v. Commissioner, T.C. Memo. 1995-531. Use of these judicial doctrines would have the effect of forcing the executive to report the income and would eliminate the avoidance or delay of compensation income and gain recognition inherent in the Notice 2003-47 transaction.

Lack of Economic Substance

When a transaction lacks economic substance, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is without effect for federal income tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935); Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); ACM Partnership v. Commissioner, 157 F.3d 231, 246-247 (3d Cir. 1998), aff'g in part and rev'g in part, T.C. Memo. 1997-115, cert. denied, 526 U.S. 1017 (1999); United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994), cert. denied, 513 U.S. 1190 (1995); Goldstein v. Commissioner, 364 F.2d 734, 740-741 (2d Cir. 1966), aff'g 44 T.C. 284 (1965), cert. denied, 385 U.S. 1005 (1967).

Whether a transaction lacks economic substance hinges on all of the facts and circumstances surrounding the transaction. No single factor will be determinative. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). Whether a court will respect the taxpayer's characterization of the transaction depends on whether there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. See ACM Partnership v. Commissioner, supra; Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990), aff'g Sturm v. Commissioner, T.C. Memo. 1987-625; Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999), aff'd 254 F.3d 1313 (11th Cir. 2001).

An evaluation of whether these stock option transactions lack economic substance requires separate, but interrelated, inquiries: (1) a subjective inquiry into whether the transaction was carried out for a valid business purpose; and (2) an inquiry into the objective economic effect of the transaction. ACM Partnership, 157 F.3d at 247-248; Casebeer, 909 F. 2d at 1363; Kirchman v. Commissioner, 862 F.2d 1486, 1490, 1491 (11th Cir. 1989).

To satisfy the business purpose inquiry, the transaction must be "rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and . . . economic situation." ACM Partnership, T.C. Memo. 1997-115, aff'd. in relevant part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); See Kirchman, supra, at 1490-1491. A valid entity will be disregarded if its creation is nothing more than an artificial device to obtain a tax benefit. Gregory v. Helvering, 293 U.S. 465 (1935).

To satisfy the objective economic inquiry, the transaction must appreciably affect the taxpayer's beneficial interest, absent tax benefits. Knetsch v. United States, 364 U.S. 361, 366 (1960); ACM Partnership, 157 F.3d at 248. Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. See Knetsch, supra. Modest or inconsequential profits relative to substantial tax benefits are insufficient to imbue an otherwise questionable transaction with economic substance. ACM Partnership, 157

F.3d at 258; Sheldon v. Commissioner, 94 T.C. 738, 767-768 (1990). In conducting this economic review, it is appropriate to focus on the taxpayer's calculations at the outset of the transaction. ACM Partnership, 157 F.3d at 257.

In conducting these inquiries into the taxpayer's business purpose and beneficial interest, it is not determinative whether a controlling statute requires such inquiry. Rather, the issue is whether Congress intended to sanction a particular transaction regardless of its economic substance. Saba Partnership v. Commissioner, T.C. Memo. 1999-359; DeMartino v. Commissioner, 862 F.2d 400 (2d Cir. 1988); See Knetsch v. United States, 364 U.S. 361, 369 (1960).

In ACM Partnership, T.C. Memo. 1997-115, the Tax Court found that the taxpayer wanted to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. The Tax Court further stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transactions lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. Id. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions where the Service is able to show that the facts, when viewed as a whole, have no economic substance.

In Nicole Rose Corp. v. Commissioner, 117 T.C. 328 (2001), the Tax Court found that the purpose of the taxpayer's transfers of interests in computer equipment leases was to create substantial tax deductions. The Court noted that prior to the transactions, the taxpayer was not an ongoing business, that it never had any genuine obligation with respect to the leasebacks, that the interests creating the tax deduction were held less than a day, and that the transactions merely created a circular flow of funds with respect to the lender of the funds. The large deductions offset any tax cost associated with the transactions. Because the claimed tax benefits provided the only credible explanation for the taxpayer's actions, the Court held that the transactions lacked a business purpose and economic substance.

The following factors in Notice 2003-47 transactions tend to support a finding that the transactions lack economic substance. Often the entity was created only to facilitate a purported sale of the options, and thus the creation of the entity has no business purpose. The executive was the owner of the options prior to the creation of the entity and retained ownership and control through his interest in the entity and that of close family relations. These relatives often have nothing more than a nominal interest and may not be contributing capital or any service to the related entity. Often the options are virtually the only assets of the entity that has no other business activity. The obligation is unfunded and unsecured and may likely be abandoned over time. The economic effect of the transaction is to enable the executive to pick up the relatively minimal amount of interest income received from the obligation (which may be largely offset by the corresponding interest deduction of the entity in which the executive holds a significant interest), defer the large amount of income he would have reported upon

exercise of the options and sale of the acquired stock or vesting of the restricted stock, and obtain the flow through deduction of the related entity's interest payment.

A finding that there is no economic substance to the transactions would eliminate the purported delay or avoidance of compensation income and gain recognition generated by the Notice 2003-47 transaction.

Substance Over Form and Sham Doctrines

A transaction which exalts form over substance solely to obtain tax benefits will not be recognized. Although the form of a transaction may comply with the Internal Revenue Code, it will not be given effect where it has no business purpose and operates as a device to conceal the true character of a transaction. Andantech v. Commissioner, T.C. Memo. 2002-97, aff'd in part and remanded in part, 331 F.3d 972 (D.C. Cir. 2003). "A transaction is a sham if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions. DeMartino v. Commissioner, 862 F.2d 400 (2d Cir. 1988). Courts will not construe a statute to permit sham transactions. Knetsch v. United States, 364 U.S. 361 (1960); United States v. Wexler, 31 F.3d 117 (3rd Cir. 1994), cert. denied, 513 U.S. 1190 (1995) (a sham transaction will not be recognized and, therefore, cannot be the basis for a deduction). A transaction that fails to create a genuine obligation would "…exalt artifice above reality and … deprive the statutory provision in question of all serious purpose." Gregory v. Helvering, 293 U.S. 465, 470 (1935).

In Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), the taxpayer borrowed funds at a 4% interest rate to purchase assets with a return rate of less than 2%. The court found that the loans were not shams due to their recourse nature and the fact that the funds were borrowed at arm's length from independent financial institutions. However, the court went on to find that the transactions lacked economic substance because of their unfavorable interest rate and anticipated economic loss. The court, therefore, disallowed the interest deductions created by the loans.

Courts have held that a non-binding debt obligation may be a sham for tax purposes even if it is valid under local laws. United States v. Wexler, 31 F.3d 117 (3d Cir. 1994); See Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985). Further, even though a valid entity may be created, if it is devoid of purpose other than to gain a tax benefit, it may not be recognized. Gregory v. Helvering, 293 U.S. 465, 470 (1935).

The sale of the compensatory stock options to a closely-held, related entity in exchange for an unfunded, unsecured deferred payment obligation is highly relevant to a determination as to whether the transfer of the options and the obligation were shams.

Step Transaction Doctrine

Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated

and focused toward a particular result. See Andantech v. Commissioner, T.C. Memo. 2002-97. Courts have applied three alternative tests in deciding whether the step transaction doctrine should be invoked in a particular situation; namely, (1) if at the time the first step was entered into, there was a binding commitment to undertake the later step (binding commitment test),[10] (2) if separate steps constitute prearranged parts of a single transaction intended to reach an end result (end result test), or (3) if separate steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the series of steps (interdependence test). See Penrod v. Commissioner, 88 T.C. 1415, 1428-1430 (1987). More than one test might be appropriate under any given set of circumstances; however, the circumstances need satisfy only one of the tests in order for the step transaction doctrine to operate. Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1527-1528 (10th Cir. 1991) (finding end result test inappropriate but applying the step transaction doctrine using the interdependence test). For a detailed discussion of the three alternative tests applied in deciding whether the step transaction doctrine should be invoked in a particular situation, see Andantech v. Commissioner, supra.

The existence of business purposes or economic effects does not preclude the application of the doctrine:

> Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some non-tax business purpose for engaging in a series of transactional steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine.

True v. United States, 190 F.3d 1165, 1177 (10th Cir. 1999). See also Associated Wholesale Grocers v. United States, 927 F.2d 1517 (1991).

In order to collapse a transaction under the step transaction doctrine, the government must have a logically plausible alternative explanation that accounts for all the results of the transaction. Thus, the step transaction doctrine permits a particular step in a transaction to be disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid United States taxes. Del Commercial Props., Inc. v. Commissioner, 251 F.3d 210, 213-214 (D.C. Cir. 2001), aff'g T.C. Memo. 1999-411, cert. denied, 534 U.S. 1104 (2002);

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[10] The purpose of the binding commitment test is to promote certainty in tax planning; it is the most rigorous limitation of the step transaction doctrine. It is seldom used and is applicable only where a substantial period of time has passed between the steps that are subject to scrutiny. Thus, generally it is not an appropriate test to apply to transactions that fall entirely within a single tax year and so will generally not be the preferred test in the cases at issue here. See, e.g., Andantech v. Commissioner, T.C. Memo. 2002-97; Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1522 n. 6 (10th Cir. 1991) (rejecting use of the binding commitment test because the case did not involve a series of transactions spanning several years).

See also Penrod v. Commissioner, supra at 1428-1430. Tracinda Corp. v. Commissioner, 111 T.C. 315, 327 (1998). The explanation may combine steps, however, courts have generally declined to apply the doctrine where the Government's explanation would invent new steps. See Esmark, Inc. & Affiliated Cos. v. Commissioner, 90 T.C. 171, 196 (1988), aff'd without published opinion 886 F.2d 1318 (7th Cir. 1989). "Useful as the step transaction doctrine may be . . . it cannot generate events which never took place just so an additional tax liability might be asserted." Grove v. Commissioner, 490 F.2d 241, 247-248 (2d Cir. 1973), aff'g T.C. Memo. 1972-98 (quoting Sheppard v. United States, 176 Ct. Cl. 244; 361 F.2d 972, 978 (1966)).

In determining whether to apply the step transaction doctrine, look to whether the interdependence test and/or end result test could be used to disregard the related person and treat the stock options as having been exercised and sold by the executive directly. This argument will depend on the particular facts of the case. To direct a challenge under the step transaction doctrine some considerations should include (but not be limited to) the following: whether only the executive's assets were used to fund the related person or whether there were other investors, whether the executive was the only individual who could benefit or lose from the transactions, whether there was any business justification to having the related person act as an intermediary for the exercise and sale of the options.

8. Will the deferred payment obligation be recognized as valid debt?

Generally, for federal income tax purposes, a loan is defined as an enforceable obligation arising from a debtor-creditor relationship to pay a fixed or determinable sum of money. Goldstein v. Commissioner, T.C. Memo. 1980-273. No debt exists without a legal and enforceable obligation to repay. Courts look to various independent factors to determine if there is "a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship." Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973), acq. 1974-2 C.B. 3.

Whether a debtor-creditor relationship exists is determined by examining the subjective intent of the parties and all relevant objective facts and circumstances pertinent to the transaction. No one factor is determinative. See Hardman v. U.S., 827 F.2d 1409 (9th Cir. 1987); Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968); Gilbert v. Commissioner, 262 F.2d 512 (2d Cir.), cert. denied, 359 U.S. 1002 (1959). Factors examined by the courts include whether: (1) the promise to repay was evidenced by a note or other form of indebtedness; (2) interest was charged; (3) there is a fixed schedule for repayments; (4) security or other collateral was given to insure repayment; (5) there is a written loan agreement; (6) a demand for repayment was made; (7) the parties' records reflect the transaction as a loan; (8) repayments were made; and (9) the borrower was not insolvent at the time the advance was made. Goldstein v. Commissioner, supra. However, the circuit court to which the case could be appealed will be relevant because each circuit has established its own debt/equity

factors. Thus, in determining whether the obligation is valid debt, the circuit to which the case could be appealed is a relevant factor.

Courts will subject a debt instrument to greater scrutiny where a close or family relationship exists between the debtor and creditor. Clark v. Commissioner, 18 T.C. 780, 783 (1952), aff'd., 205 F.2d 353 (2d Cir. 1953). Courts may excuse the absence of certain formalities when such close relationships exist. Litton Business Systems, Inc., supra at 377 (citing American Processing & Sales Co. v. United States, 178 Ct. Cl. 353, 371 F.2d 842 (Ct. Cl. 1967))(other citations omitted). However, the mere presence of significant objective indicia of indebtedness between related parties may not demonstrate a bona fide debt. In Fin Hay Realty Co., supra at 697, the court had to decide whether funds paid by shareholders of a closely held corporation were contributions to capital or loans. The court commented that "…all the formal indicia of an obligation were meticulously made to appear. The corporation, however, was the complete creature of the two shareholders who had the power to create whatever appearance would be of tax benefit to them despite the economic reality of the transaction."

Another factor to consider is whether the related person could have obtained the alleged debt on similar terms from an independent creditor. Litton Business Systems, Inc. v. Commissioner, supra at 379. Further, in Donisi v. Commissioner, T.C. Memo. 1967-62, aff'd, 405 F.2d 481 (6th Cir. 1968), one factor the court noted was that the transferor did not take readily available measures to ensure repayment, such as obtaining collateral for his loans.

In Georgiou v. Commissioner, T.C. Memo. 1995-546, the court noted that there were objective indicia of indebtedness but determined there was no bona fide debt because there was no indication that the shareholder intended to enforce the debt through his closely held corporation. Similarly, courts have found "where 'the same persons occupy both sides of the bargaining table,' the form of a transaction 'does not necessarily correspond to the intrinsic economic nature of the transaction'". Geftman v. Commissioner, 154 F.3d 61, 75 (3d Cir. 1998) (citing Fin Hay Realty, supra, at 697).

Most of the Notice 2003-47 transactions will have obligations which meet all the formal requirements of a bona fide debt. However, failures to conform with the terms of a note, such as a failure to make any interest payments or the periodic acceleration of principal, or the complete repayment after a long period without repayments, will impact on whether the obligation will be respected by the court. See Geftman v. Commissioner, supra at 71 (citing Gilbert v. Commissioner, 74 T.C. 60 (1980)). Similarly, the presence or absence of the other factors discussed above would determine whether the obligation is valid debt.

A finding that the obligation did not constitute valid debt will raise various issues depending on the specific facts and circumstances of the case, including issues of how the transfer of the stock options or restricted stock will be treated for purposes of subchapter K and the gift tax provisions of the Code.

9. Where the transaction is in whole or in part a sham or lacks economic substance, will the legal expenses or fees paid or incurred to create the transaction be deductible under sections 162, 165, or 212?[11]

Case law has generally precluded the deduction of out-of-pocket costs of investing in a sham transaction. In Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 279 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002), the court applied the sham transaction doctrine to disregard the transactions and then turned to the issue of whether administrative fees paid to the scheme's executive were deductible. Those fees constituted expenses of the taxpayer that contributed to the overall "out-of-pocket" economic loss suffered by the taxpayer as a result of its investment in the sham transaction. The court summarily disallowed these fees, stating that, "[t]hey were incurred in connection with, and were an integral part of, a sham transaction and, as a result, are not deductible." Winn-Dixie Stores, Inc., 113 T.C. at 294. Thus, under this reasoning, if a transaction is determined to be a sham transaction, a taxpayer would not be entitled to any expenses incurred in connection therewith, even though those expenses reflected actual economic losses.

Similarly, in United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994) cert. denied, 513 U.S. 1190 (1995), the Third Circuit stated, "Where a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes. Deductions for expenses resulting from such transactions are not permitted." (Internal citations omitted).

In several instances, individual tax shelter investors argued that they were entitled to deduct their "out-of-pocket" expenses on the basis that they suffered a theft loss pursuant to section 165. The courts concluded that cash "investments" in limited partnerships designed to secure tax benefits are not theft losses. See, e.g., Viehweg v. Commissioner, 90 T.C. 1248 (1988); Marine v. Commissioner, 92 T.C. 958 (1989), aff'd, 921 F.2d 280 (9th Cir. 1991), cert. denied, 502 U.S. 819 (1991). The rationale is that the investors received what they bargained for – a tax shelter. See Marine, 92 T.C. at 978.

Other expenses, such as interest deductions on loans incurred in a transaction lacking economic substance, have not always been disallowed by the courts. There have been instances in which a court allowed an interest deduction on a loan that was part of a transaction that lacked economic substance. In Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 96 (4th Cir. 1985), the court allowed the taxpayer to deduct interest, finding that, although the transaction lacked economic substance, the taxpayer

[11] This discussion assumes that one of the Service's arguments is that the transaction is a sham or otherwise a shelter with a primary tax-avoidance motive. Additional analysis of the deductibility of fees and other out-of-pocket expenses may be necessary if, in a given situation, the intended tax benefits are denied based on a "neutral" ground—that is, without a finding of tax-avoidance intent.

was still obligated to make payments on the recourse note. The court in ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), cert. denied, 526 U.S. 1017 (1999), also allowed the taxpayer to deduct interest. There, the court found that the taxpayer had actual economic losses associated with the notes and held that the notes were not the "centerpiece" but were "separable from the sham aspects of the underlying transaction." ACM Partnership, 157 F.2d at 262.

Nonetheless, a number of cases have disallowed interest deductions where they were an integral part of a transaction found to lack economic substance. See Wexler v. United States, 31 F.3d 117, 125-26 (3d Cir. 1994), cert. denied, 513 U.S. 1190 (1995); Sheldon v. Commissioner, 94 T.C. 738 (1990); Saba Partnership v. Commissioner, T.C. Memo. 1999-359; Seykota v. Commissioner, T.C. Memo. 1991-541; Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967).

Sham transactions do not give rise to valid deductions or losses - even for the taxpayer's out-of-pocket cash investment. The only circumstances where some courts have permitted deductions related to sham transactions are where the deductions were attributable to separable economically substantive elements that were not the principal tax benefit of the underlying sham transactions.

In the case of an individual or passthrough entity, there is a related alternative basis for disallowing shelter-related fees and similar costs. To be deductible under provisions such as § 162, 165, or 212, an individual taxpayer must have a bona fide, primary profit motive independent of tax consequences. See Agro Science Co. v. Commissioner, 934 F.2d 573, 576 (5th Cir. 1991), cert. denied, 502 U.S. 907 (1991); Brown v. United States, 396 F.2d 459 (Ct. Cl. 1968); Price v. Commissioner, 88 T.C. 860, 886 (1987). These requirements apply to partnerships at the entity level, determining the entity's motives by looking to those of its controlling individuals. See Brannen v. Commissioner, 78 T.C. 471, 505 (1982), aff'd, 722 F.2d 695 (11th Cir. 1984).

In the Notice 2003-47 transactions, the fees vary depending on the executive and whether the transaction uses nonvested options, vested options with little spread, or restricted stock. Although the fees are most often paid and deducted by the related entity, they may also be deducted by the executive, the employer, or all three parties. The Service should, therefore, examine all three parties' returns and disallow any claimed fees. It is likely that a court would uphold this decision upon a finding that the transaction is a sham or otherwise primarily motivated by tax avoidance. Moreover, the obligations are an integral and necessary element of these transactions since they are the tool used to defer the executive's income. Therefore, any interest deductions claimed on a related entity's return should also be disallowed.

10. Do the disclosure provisions of § 1.6011-4 apply to Notice 2003-47 transactions that were entered into prior to the release of Notice 2003-47?

In general, § 1.6011-4 requires a taxpayer who participates in a reportable transaction to file a disclosure statement. See § 1.6011-4(a). A reportable transaction includes a listed transaction, which is a transaction that is the same as or substantially similar to one of the types of transactions that the Service has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction. See § 1.6011-4(b)(1) and (2).

Notice 2003-47 identifies certain transactions, and any transaction that is substantially similar to the transactions described in the notice, as "listed transactions" for purposes of § 1.6011-4(b)(2). Under Notice 2003-47, transactions in which an individual purports to sell or otherwise dispose of an option described in section 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. The sale or disposition of substantially nonvested stock to a related person in exchange for an amount that includes any deferred payment of money or property is a substantially similar transaction.

The regulations under § 1.6011-4 were first issued on February 28, 2000, as temporary regulations. These regulations were then modified and finalized. A separate determination must be made as to whether each transaction is subject to the disclosure rules under § 1.6011-4 based on the date the taxpayer entered into the transaction and which version of the regulations or temporary regulations was in effect at that time. Generally, however, the disclosure rules applicable to individuals, trusts, partnerships, and S corporations under § 1.6011-4 will apply if the individual, trust, partnership, or S corporation entered into the transaction on or after January 1, 2001, and the transaction was not reported on a tax return of the individual, trust, partnership, or S corporation that was filed on or before June 14, 2002. See § 1.6011-4T(g) (TD 9000, 67 FR 41324).

Thus, for all Notice 2003-47 transactions entered into by individuals, trusts, partnerships, or S corporations before January 1, 2001, there is no disclosure requirement under § 1.6011-4. For those transactions entered into on or after January 1, 2001, for which the transaction was reported on a return filed by June 14, 2002, there is also no disclosure requirement under § 1.6011-4. However, if the transaction is entered into on or after January 1, 2001, and the transaction was not reported on a return filed on or before June 14, 2002, the individual, trust, partnership, or S corporation is subject to the disclosure rules under § 1.6011-4 or § 1.6011-4T, as applicable. Those regulations also provide rules applicable for transactions that are subsequently identified as listed transactions.

Whether a taxpayer discloses the transaction to the Service in accordance with Notice 2003-47 is a factor that may affect the application of penalties in item 11.

11. Should the Service assert the negligence or disregard of rules or regulations or the substantial understatement of income tax provisions of section 6662 against a taxpayer for engaging in a Notice 2003-47 transaction?

The Accuracy-Related Penalty

Section 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment[12] attributable to, among other things: (1) negligence or disregard of rules or regulations, or (2) any substantial understatement of income tax. Section 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40 percent in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (for example, negligence and substantial understatement of income tax). See DHL Corp. v. Commissioner, T.C. Memo. 1998-461, aff'd in part and rev'd on other grounds, remanded by 285 F.3d 1210 (9th Cir. 2002), where the Service alternatively determined that either the 40-percent accuracy-related penalty attributable to a gross valuation misstatement penalty under section 6662(h) or the 20-percent accuracy-related penalty attributable to negligence was applicable. The accuracy-related penalty provided by section 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under section 6663. See Section 6662(b).

Negligence

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See Section 6662(c) and § 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'g, 43 T.C. 168 (1964). Section 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances.

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Code, regulations, revenue rulings or notices issued by the Service and published in the Internal Revenue Bulletin. See § 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of notice or revenue ruling. In this case, the transaction did not become listed until July 3, 2003, pursuant to Notice 2003-47, 2003-

[12] For purposes of Section 6662, the term "underpayment" is generally the amount by which the taxpayer's correct tax is greater than the tax reported on the return. See Section 6664(a).

30 I.R.B. 1. Accordingly, a return filed after July 3, 2003 that fails to include income due to a Notice 2003-47 transaction will have taken a position contrary to a rule.

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of an underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations)[13] and (2) in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation. This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. See § 1.6662-3(c)(1). Further, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. See § 1.6662-3(b)(2).[14]

With respect to negligence, the ability to exclude income based upon a "sale" of the compensatory option to an entity made up entirely of immediate family members, where the option is exchanged for a long-term unsecured note, would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. This is especially true where no third parties were involved, and where the transaction occurred strictly through participation by the executive as a representative of both himself and the related person. Accordingly, negligence is strongly indicated unless the executive demonstrates that he or she made a reasonable attempt to ascertain the correctness of the income exclusion. Where the executive can point to an independent analysis of the tax consequences of the transaction, or even his or her own considered analysis where the executive has sufficient knowledge to reasonably believe he or she can conduct such analysis, the executive may have made a reasonable attempt to ascertain the correctness of the income exclusion. However, executives who point solely to the opinions of the promoter of the transaction, or a law firm or similar entity associated with the promoter for purposes of the transaction, should not be viewed as having made a reasonable attempt to ascertain the correctness of the income exclusion.

Because the executive's position with respect to Notice 2003-47 transactions does not involve a direct challenge to the validity of a particular rule or regulation (other than Notice 2003-47), it generally will be difficult to assert that the executive has disregarded rules or regulations for purposes of asserting the penalty for returns filed before July 2, 2003. However, for returns filed on or after July 2, 2003, the failure to include income due to a Notice 2003-47 transaction would directly disregard the position set forth in the Notice, and accordingly serve as a basis for asserting penalties.

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[13] For transactions listed in Notice 2003-47 and entered into after December 31, 2002, taxpayers must also disclose the transaction as required by § 1.6011-4 (or §1.6011-4T), as applicable, to avoid a penalty for positions contrary to a regulation on grounds of adequate disclosure.

[14] For transactions entered into after December 31, 2002, the listing of a transaction precludes a taxpayer from defending against a penalty for disregarding the notice on the ground that the taxpayer's position has a realistic possibility of being sustained on its merits. See § 1.6662-3(b)(2).

Substantial Understatement

A substantial understatement of income tax exists for a taxable year if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. See Section 6662(d)(1). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment or (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed on the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. See Section 6662(d)(2)(B).

In the case of items of taxpayers, other than corporations,[15] attributable to tax shelters exception (2), above, does not apply and exception (1) applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment. See Section 6662(d)(2)(C)(i). In this case, the transfer or sale of compensatory options or restricted stock to related persons fits within the definition of a tax shelter[16] for the seller of the option. Thus, no reduction in the understatement will be available unless there was substantial authority for the tax treatment of the item and the executive reasonably believed that it was more likely than not the proper treatment.

There is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. See § 1.6662-4(d)(3). Although as discussed above, the executive may point to some authority for their position, the weight of that authority is not substantial in relation to the weight of authorities supporting contrary treatment. Executives have pointed to no authority directly supporting either the claim that this type of transaction should be treated as an arm's-length transaction or that the receipt of a deferred payment obligation under the circumstances of the transaction should result in the deferral of compensation income. Furthermore, in the context of the regulations, the executives' position is problematic on its face. The treatment of the "sale" of a compensatory option to a related person as an arm's length transaction for purposes of § 1.83-7 based solely upon the valuation of the option, rather than the facts and circumstances surrounding the transaction, including its terms, when the compensatory option was not taxed at grant under the same regulations because it did not have a readily ascertainable fair market value, renders meaningless the readily ascertainable fair market value standard. Rather, the executives' analysis reflects the strategic use of sentences in certain authorities which, when taken in context, should be seen as reflecting the conclusion that the transfer of a compensatory option in exchange

[15] There is no ground to assert the accuracy-related penalty against the corporations participating in the transaction listed in Notice 2003-47 on the grounds of substantial understatement of income tax because corporations do not use the transaction to reduce their income tax.

[16] The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. See Section 6662(d)(2)(C)(iii).

for cash or other property results in compensation income, and not the broader propositions concluded by the executives. Similarly, the conclusion with respect to the deferral based upon the deferred payment obligation is problematic. Although the language of § 1.83-3(e) refers to an unfunded and unsecured promise to pay money or property in the future, it is evident when taken in the context that this reference refers to promises to pay in relation to the contract to perform services, and not the use of a third-party's promise as a substitute for the service recipient's obligation to pay the service provider. A contrary position would allow any employer to transfer an unsecured note from any third party in complete payment for the employee's services without any tax consequences to the employee. The Service's position in Revenue Ruling 69-50 explicitly supports the proposition that a third-party obligation received as a payment for services results in the immediate recognition of income. Although executives may point to the Tax Court's decision in Childs, that decision never explicitly addressed the issue and only through inference can any contrary conclusion be reached.

Even if there were substantial authority, the executive must have reasonably believed that the tax treatment of the item was more likely than not the proper treatment. A taxpayer is considered to have reasonably believed that the tax treatment of an item is more likely than not the proper tax treatment if the taxpayer analyzes the pertinent facts and authorities and, based on his or her independent analysis, reasonably concludes in good faith, that there is a greater than 50 percent chance that the tax treatment of the item will be upheld if challenged by the Service. The taxpayer may also reasonably rely, in good faith, on the opinion of a professional tax advisor. The opinion must clearly state that, based on the advisor's analysis of the facts and authorities, the advisor concludes that there is a greater than 50 percent chance that the tax treatment will be upheld if the Service challenged the position. See § 1.6662-4(g)(4)(i)(A), (B). Moreover, if the taxpayer is relying on tax advice to establish reasonable belief, the taxpayer must also meet the requirements generally applicable to relying on advice to establish good faith and reasonable cause. See § 1.6662-4(ii). As discussed more fully below, this standard will rarely be met where the advice relied upon consists of the opinion of the promoter of the transaction.

The Reasonable Cause Exception

The accuracy-related penalty does not apply to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. See Section 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case by case basis, taking into account all pertinent facts and circumstances. See § 1.6664-4(b)(1). All relevant facts, including the nature of the investment, the complexity of the tax issues, issues of independence of a tax advisor, and the sophistication of the taxpayer must be developed to determine whether there was reasonable cause and good faith. Generally, the most important factor is the extent of the taxpayer's effort to assess his proper tax liability. Id. See also Larson v. Commissioner, T.C. Memo. 2002-95.

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reliance on professional advice, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Id. In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account. See § 1.6664-4(b)(1).

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative weight of such purposes), for entering into a transaction and for structuring a transaction in a particular manner. A taxpayer will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or should know, to be relevant to the proper tax treatment of an item. See § 1.6664-4(c)(1)(i).

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. See § 1.6664-4(c)(1)(i). Accordingly, Compliance should evaluate the accuracy of critical assumptions contained in any opinion letter.

Further, where a tax benefit depends on non-tax factors, the taxpayer also has a duty to investigate such underlying factors. The taxpayer cannot simply rely on statements by another person, such as a promoter. See Novinger v. Commissioner, T.C. Memo. 1991-289 (taxpayer could not avoid the negligence penalty merely because his professional advisor had read the prospectus and had advised the taxpayer that the underlying investment was feasible from a tax perspective, assuming the facts presented were true). Moreover, if the tax advisor is not versed in these non-tax factors, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000) (taxpayer's reliance on tax advisor was not reasonable given the cautionary language in offering memoranda and the tax advisor's lack of adequate knowledge to evaluate essential aspects of underlying investment); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990) (reliance on tax advice not reasonable where taxpayer did not consult experts with respect to the bona fides of the financial aspects of the investment); Goldman v. Commissioner, 39 F.3d 402 (2d Cir. 1994) (taxpayer's reliance on accountant's advice to invest in a partnership engaged in oil and gas was not reasonable where accountant lacked industry knowledge); Collins v. Commissioner, 857 F.2d 1383 (9th Cir. 1988) (penalties upheld where advisor "knew nothing firsthand" about the venture).

Reliance on tax advice may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of the federal tax law. See § 1.6664-4(c)(1). For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate a section 6662(a) accuracy-related penalty, the Tax Court in Neonatology Associates P.A. v. Commissioner, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002), stated that the taxpayer has to satisfy the following three-prong test: (1) the advisor was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer gave to the advisor the necessary and accurate information, and (3) the taxpayer actually relied in good faith on the advisor's judgment.

Generally, if a taxpayer is unwilling to produce a copy of its opinion letter, the taxpayer should not be relieved from penalty consideration. Moreover, an opinion letter prepared by a promoter should not be accorded significant weight. Neonatology Associates v. Commissioner, 115 T.C. 43 (2000), aff'd, 299 F.3d 221 (3rd Cir. 2002) (while good faith reliance on professional advice may establish reasonable cause, "reliance may be unreasonable when it is placed upon insiders, executives, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about."). In addition, if the taxpayer did not receive the opinion letter until after the return was filed, the taxpayer could not have reasonably relied on the opinion and thus, should not be relieved from penalties.

On December 30, 2003, Treasury and the Service amended the section 6664 regulations to provide that the failure to disclose a reportable transaction, on Form 8886, "Reportable Transaction Disclosure Statement," is a strong indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to a reportable transaction, as defined under section 6011. See § 1.6664-4(e). While this amendment applies to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003, the logic of this provision applies to reportable transactions occurring prior to that effective date. Failure to comply with the disclosure provisions of the law is a strong indication of bad faith.

These compensatory stock option transactions are being promoted by tax professionals. However, considering the sophistication of the taxpayers, the amount of money involved, and the general circumstances of promoted transactions, it is unlikely that the reasonable cause exception is applicable in these cases, even when the taxpayer has an opinion letter where the opinion letter is prepared by the promoter or provided as part of the promoter's offering materials.