

Part I

Section 83.--Property Transferred in Connection with Performance of Services

26 C.F.R. 1.83-4: Special rules.
(Also §§ 108, 3121, 3306, 3401, 1.1001-3)

Rev. Rul. 2004-37

ISSUE

If an employee issued a recourse note to his or her employer in satisfaction of the exercise price of an option to acquire the employer's stock and the employer and employee subsequently agree to reduce the stated principal amount of the note, does the employee recognize compensation income under § 83 of the Internal Revenue Code?

FACTS

In Year 1, Employer, a corporation, grants a nontransferable, nonstatutory option to its Employee to purchase 1,000 shares of Employer common stock at an exercise price of \$75 per share, the fair market value of a share of Employer stock at the time the option is granted. Employee may exercise the option only during employment with Employer or within 90 days after cessation of employment.

On January 1 of Year 2, when the fair market value of 1,000 shares of Employer stock is \$100,000, Employee exercises the option and purchases 1,000 shares of Employer stock in exchange for a nontransferable recourse note ("Note") secured by the stock Employee receives on the exercise of the option. The Note has a stated principal amount of \$75,000, which is payable at maturity on December 31 of Year 11.

The Note also provides for payments of interest on December 31 of each year the Note is outstanding. The interest rate is one-year LIBOR (determined as of January 1 of each year the Note is outstanding) plus 25 basis points. The interest rate on the Note is not less than the appropriate applicable Federal rate (AFR) on the date the Note is issued. The stock is not subject to a substantial risk of forfeiture within the meaning of § 83(c).

In Year 2, Employee includes \$25,000 as compensation income under § 83(a). Employer reports \$25,000 of compensation income on the Form W-2 issued to Employee for Year 2 and claims a corresponding deduction in Year 2 under § 83(h).

In Years 2 and 3, Employee makes the required interest payments under the Note. On January 1 of Year 4, the fair market value of the Employer stock has declined to \$50,000 and Employer and Employee agree to reduce the stated principal amount of the Note from \$75,000 to \$50,000. The interest rate on the Note is not less than the appropriate AFR on the date the Note is modified.

LAW

Section 83(a) provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of the property at the first time that the rights to the property are either transferable or not subject to a substantial risk of forfeiture ("substantially vested"), whichever occurs earlier, over the amount paid for the property is included in the gross income of the service provider in the first taxable year in which the rights to the property are substantially vested.

Section 83(e)(3) provides that § 83 does not apply to the transfer of an option without a readily ascertainable fair market value.

Section 83(h) provides that, in the case of a transfer of property to which § 83 applies, the person for whom were performed the services in connection with which the property was transferred is allowed a deduction in an amount equal to the amount

included under § 83(a), (b), or (d)(2) in the gross income of the person who performed the services. Such 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 1.83-3(a)(1) of the Income Tax Regulations provides that a "transfer" of property occurs when a person acquires a beneficial ownership interest in the property. A person acquires a beneficial ownership interest in property when he or she has been transferred both the right to share in an increase in the value of the property and the obligation to share in the risk of loss in its value. Whether a transfer has in fact occurred is based on all the facts and circumstances.

Section 1.83-3(g) provides that the term "amount paid" refers to the value of any money or property paid for the transfer of property to which § 83 applies. For this purpose, value does not include any stated or unstated interest.

Section 1.83-4(c) provides that, if an indebtedness that has been treated as an "amount paid" for purposes of § 83 is subsequently cancelled, forgiven, or satisfied for an amount less than the amount of such indebtedness, the amount that is not, in fact, paid is includible in the gross income of the service provider for the taxable year in which such cancellation, forgiveness, or satisfaction occurs.

Section 1.83-7(a) provides that the grant of a nonqualified stock option is taxable to the extent that the option has a readily ascertainable fair market value, determined in accordance with § 1.83-7(b). Under § 1.83-7(b), an option that is not traded on an established market does not have a readily ascertainable value at the time of grant unless certain specific conditions are all satisfied (including the option being transferable, the option not being subject to a condition that has a significant effect on the fair market value of the option, and the fair market value of the option privilege being readily ascertainable). Under § 1.83-7(a), if the option does not have a readily ascertainable value at the time of grant, §§ 83(a) and 83(b) apply at such time as the

option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time.

Section 61(a)(12) provides that, in general, gross income includes income from the discharge of indebtedness.

Section 108(a)(1)(B) provides an exclusion from gross income for any amount that would be includible in gross income by reason of the discharge of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent.

Under § 108(e)(5), for solvent and non-bankrupt taxpayers, if debt owed by a purchaser to a seller is reduced, the reduction is a purchase price adjustment and not income from discharge of indebtedness. Under § 108(e)(5)(C), § 108(e)(5) only applies to reductions that, but for the application of § 108(e)(5), would be treated as income to the purchaser from the discharge of indebtedness.

Not every indebtedness that is cancelled results in the debtor realizing gross income by reason of discharge of indebtedness within the meaning of §§ 61(a)(12) and 108(a). “Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment, rather than under the debt discharge rules.” S. Rep. No. 1035, 96th Cong., 2d Sess. 8 n.6 (1980), 1980-2 C.B. 620, 624 n.6.

Section 1.1001-3 provides rules to determine whether a modification of the terms of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. If the modification results in an exchange, the adequacy of the interest rate on the modified debt instrument generally is retested under the applicable Code section, such as § 483.

Under § 1.1001-3(b), a modification of a debt instrument results in an exchange for purposes of § 1.1001-1(a) if the modification is significant. Under § 1.1001-3(c), a modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties,

or otherwise.

Section 1.1001-3(e) provides rules for determining whether a modification is "significant." Under § 1.1001-3(e)(2), a change in the yield of a debt instrument is a significant modification if the yield computed under § 1.1001-3(e)(2)(iii) varies from the annual yield on the unmodified debt instrument (determined as of the date of the modification) by more than the greater of 1/4 of one percent (25 basis points) or 5 percent of the annual yield of the unmodified debt instrument (.05 x annual yield).

Sections 3101 and 3111 impose Federal Insurance Contributions Act (FICA) taxes on "wages," as that term is defined in § 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 both on the employer under § 3111(a) and (b) and on the employee under § 3101(a) and (b). Section 3102(a) provides that the employee portion of FICA tax must be collected by the employer of the taxpayer by deducting the amount of the tax from the wages as and when paid. Section 31.3102(a)-1(a) of the Employment Tax Regulations provides that the employer is required to collect the tax, notwithstanding that wages are paid in something other than money. The term "wages" is defined in § 3121(a) 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 3121(b) defines "employment" for FICA purposes as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

Rules similar to the FICA rules apply with respect to Federal Unemployment Tax Act (FUTA) tax under §§ 3301, 3306(b), and 3306(c).

Section 3402(a), relating to income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon these wages a tax determined in accordance with prescribed tables or computational procedures. Section

3401(a) provides that “wages” for income tax withholding purposes means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions. Under § 31.3402(a)-1(c), an employer is required to deduct and withhold income tax notwithstanding that the wages are paid in something other than money (for example, wages paid in stock or bonds) and to pay over the tax in money. 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(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. Sections 31.3121(a)-1(i), 31.3306(b)-1(i), and 31.3401(a)-1(a)(5) 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.

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 ruling holds that, under § 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 the fair market value of the stock at the time the risk lapses is wages for purposes of §§ 3121(a), 3306(b), and 3401(a).

ANALYSIS

Under § 1.83-7(b), the option granted to Employee did not have a readily ascertainable fair market value at the time of grant. Therefore, § 83 applies when the

option is exercised and stock is transferred to Employee.

Employee acquired beneficial ownership of the shares of Employer stock in Year 2 because, at that time, Employee acquired both the right to enjoy any increase in the value of the shares and the risk of a decline in the value of the shares. Accordingly, for purposes of § 83, the shares were transferred to Employee in Year 2. Employee's Note, with an issue price of \$75,000, constituted the amount paid by Employee for the shares under § 1.83-3(g) in Year 2. Employee included \$25,000 in gross income under § 83(a) in Year 2, the excess of the fair market value of Employer stock at the time of transfer over the amount paid.

Under § 1.83-4(c), if an indebtedness that has been treated as an "amount paid" for purposes of § 83 is subsequently cancelled, forgiven, or satisfied for an amount less than the amount of such indebtedness, the amount that is not, in fact, paid is includible in the gross income of the service provider for the taxable year in which such cancellation, forgiveness, or satisfaction occurs. Thus, if the reduction of the stated principal amount of the Note is a cancellation, forgiveness, or satisfaction of the indebtedness for an amount less than the amount of such indebtedness, the reduction of the stated principal amount is a medium for payment of compensation by Employer to Employee, and any income resulting from the reduction is not income to Employee from the discharge of indebtedness subject to the provisions of section 108. Accordingly, the tax consequences of the reduction are governed by § 83 and § 1.83-4(c), and not by § 108(a)(1)(B) or § 108(e)(5).

Whether the reduction of the stated principal amount of the Note is a cancellation, forgiveness, or satisfaction for an amount less than the amount of the Note, and, thus, whether an amount is includible in income under § 1.83-4(c), is determined in accordance with § 1.1001-3. Under § 1.1001-3(e)(2), if a modification to the stated principal amount of a note produces a significant change in the note's yield, the modification is significant. A significant modification results in an exchange of the

unmodified note for the modified note, which, depending on the issue price of the modified note and the adjusted issue price of the unmodified note, may have tax consequences for both the issuer and holder of the note.

In this case, the reduction in the stated principal amount of the Note is a significant modification under § 1.1001-3(e)(2). As a result, there is an exchange of the unmodified Note for the modified Note between Employee and Employer and a satisfaction of the original indebtedness. Under § 1.83-4(c), the amount that is not, in fact, paid, and thus the amount includible as compensation by Employee, is the excess of the adjusted issue price of the unmodified Note over the issue price of the modified Note.

The modified Note has adequate stated interest under § 483. Under § 1273(b)(4), the modified Note has an issue price of \$50,000. The adjusted issue price of the unmodified Note is \$75,000. See § 1.1275-1(b). As a result, under § 1.83-4(c), Employee recognizes compensation income of \$25,000 (the excess of the adjusted issue price of the unmodified Note (\$75,000) over the issue price of the modified Note (\$50,000)). This amount is recognized in Year 4, the taxable year in which the modification occurred.

HOLDING

If an employee issued a recourse note to his or her employer in satisfaction of the exercise price of an option to acquire the employer's stock and the employer and employee subsequently agree to reduce the stated principal amount of the note, the employee generally recognizes compensation income under § 83 at the time of the reduction. Thus, under the facts described above, Employee recognizes \$25,000 of compensation income on January 1 of Year 4 under § 1.83-4(c). If Employer and Employee instead were, for example, to reduce the interest rate on the Note or change the Note from recourse to nonrecourse, that modification also generally would result in

compensation income for Employee.

In addition, the compensation is wages for purposes of FICA, FUTA, and income tax withholding.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Jean M. Casey of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Rebecca Asta of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding § 83, contact Ms. Casey at (202) 622-6030 and for further information regarding § 1.1001-3, contact Ms. Asta at (202) 622-3940 (not toll-free calls).