Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:HOU:TL-N-5472-99
JDFaucher

date: APR 21 2000

to: Chief, Examination Division, Houston District
Attn: Robert T. Jones, Case Manager, Group 1106 M.S. 4106-HOU
Bernard Falk, Team Coordinator, Group 1106 M.S. 4106-HOU

from: District Counsel
Houston

subject: [redacted]
Taxable Years: [redacted] through [redacted]
Stock Options
EIN: [redacted]

ISSUE

[redacted] has claimed deductions under I.R.C. § 83 for the income element of stock options paid to non-employee directors. Does the Internal Revenue Code allow it to take those deductions?

ANSWER

Yes.

FACTS

The Examination Team working on [redacted]'s income taxes is considering adjustments to income in the following amounts:

Tax Year	Amount
[redacted]	$[redacted]

The adjustments correspond to the discount in stock price received by the outside directors after exercising their stock options each year under the Nonqualified Stock Option Plan for Non-Employee Directors.

[redacted] (b)(5)(DP) [redacted]

(b)(5)(DP)

[redacted].

ANALYSIS

I.R.C. § 83 determines when and to what extent a recipient of a transfer of property exchanged for services must include that transfer in the recipient's gross income.[1] A recipient of such property may elect to include it in income either in the year in which the transfer is made, or in the year in which the recipient's rights to the property vest. I.R.C. § 83(a), (b).

By its plain language, § 83 applies to the transfers of stock at issue here. [redacted] transferred the stock in connection with the performance of services, i.e., the performance of the outside directors' duties. The property (stock) was transferred to the outside directors ("any person other than the person for whom such services are performed [[redacted]]").

Nothing in the general rule limits its application to property transferred within an employer-employee relation. In fact, the language of the statute suggests that its drafters bent over backward to avoid such restrictive language: the "person who performed such services" is much more cumbersome than "employee."

---

[1] The general rule states 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 -

> (a)(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
>
> (a)(2) the amount (if any) paid for such property,

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. . . . " I.R.C. § 83(a).

Under § 83(h), "employers" are allowed to deduct the same amount of income that the recipients included as gross income under § 83(a) and (b). Nothing in this subsection restricts this deduction to the employer-employee relation, however; the word "employer" is only used in the subsection's heading, and the language grants the deduction to " . . . the person for whom were performed the services in connection with which such property was transferred . . ." A subsection heading should not be construed to limit a code subsection further than the actual text. 1 J. Mertens, Law of Federal Income Taxation § 3.45.

We understand that the Examination Division has verified that [redacted] has provided Forms 1099 timely to the outside directors involved in this matter. Thus, [redacted] satisfied the reporting requirement described in Treas. Reg. § 1.83-6(a)(2).

Section 83's legislative history suggests that its drafters wrote it to establish rules for the timing of deductions relating to stock option plans:

> "Both the House bill and the committee amendments provide that a person who receives a beneficial interest in property, such as stock, by reason of his performance of services is to be taxed on the value of the property at the time of receipt unless his interest in the property is subject to a substantial risk of forfeiture." S. Rep. No. 91-552, reprinted in 1969-3 C.B. at 501.

The legislative history notes that under Treasury regulations prior to § 83's enactment, stock donors and recipients claimed similar income and deductions as they do under § 83, just at different times. The timing of those claims, however, gave a more generous treatment to stock option plans than to other deferred compensation arrangements.

In the absence of § 83, [redacted] could still claim this deduction under § 162; the existence of § 83 merely clarifies the deduction's timing. Courts have found the payment of cash salaries to non-employee directors to be deductible business expenses, in some cases using very broad language to arrive at this result. See, e.g., Express Publishing Co. v. Commissioner, 143 F.2d 386 (5th Cir. 1944) (holding Tax Court erred as a matter of law by ignoring service rendered in directors' meetings as a source of a "reasonable allowance for salaries"); Wilshire-La Cienega Gardens v. Riddell, 148 F.Supp. 938 (S.D. Cal. 1956) (allowing deduction of $2,000 for remuneration to non-employee directors). Nothing in the cases or the statute poses a reason to treat a grant of a stock option differently from a cash

payment.

Regulations relating to § 83 assume that any stock option would be given to an employee, an independent contractor, or a beneficiary of such a person. Reg. §§ 1.83-3(f), 1.83-7(a). Examiners at [redacted] have cited these regulations as authority for the proposition that the regulations limit § 83 stock option recipients to those classes of people. (b)(5)(DP) [redacted]

Though they refer exclusively to employees, independent contractors or their beneficiaries, the regulations regarding § 83 do not quite limit the section's applicability to stock options given to those classes of people. Thus, nothing in the regulations would prevent a corporation from granting stock options to some other type of person and claiming the § 83 deduction, so long as the grant follows the rest of the statute. However, it is hard to imagine what other type of person would receive a qualifying stock option; § 83 applies only to property transferred in connection with the performance of services, which comes very close to defining a contractual relationship.

Outside directors perform services for the corporation under a contract. The Nonqualified Stock Option Plan for Non-Employee Directors is part of this contract: it contributes part of their compensation, in return for which the outside directors perform their duties of attending board meetings and overseeing the governance of the corporation. The outside directors perform their services in pursuit of a trade or business subject to a contract. As shown above, they are involved in a § 162 activity.

If the legislative history behind § 83 included some statement of intent to limit its provisions to payments made within the employer-employee relation, there might be some argument that the statute silently adopts that limit. However, there is no such statement of intent. S. Rep. No. 91-552, reprinted in 1969 U.S. Code Cong. & Ad. News 2027, 2150-56; H.R. Rep. 91-413, reprinted in 1969 U.S. Code Cong. & Ad. News 1645, 1733; Staff of Joint Committee on Internal Revenue Taxation, 91st Cong., General Explanation of the Tax Reform Act of 1969 (Comm. Print 1970) 109-113. The reports refer frequently to employers and employees as the general targets of this statute, but nowhere do so in a limiting fashion.[2] The rule was created with

---

[2] The following is an example of how the legislative history refers to employers and employees: "Present law does not contain any specific rules governing the tax treatment of . . .

employer-employee relations in mind, but appears specifically drafted to include more than just those relations.

Some taxpayers have attempted to use the legislative history to support their argument that § 83 should not apply to independent contractors. In at least two cases, taxpayers have advanced the argument that § 83 does not apply to them because Congress intended it to prevent abuses of restricted stock plans in executive employee relations. Cassetta v. Commissioner, T.C. Memo. 1979-384; Cohn v. Commissioner, 73 T.C. 443 (1979). In both cases, the court rejected the argument. 73 T.C. at 446 ("We reject petitioners' argument . . . the language of the section covers the transfer of any property in connection with the performance of services 'to any person other than the person for whom such services are performed. . .'"); T.C. Memo. 1979-384 (language almost identical to that quoted from Cohn).

If anything, the legislative history supports the broadest possible application of § 83: "Congress . . . has clearly expressed the intention that § 83 is to have the broadest application . . . Absent specific provision that a particular transfer is excepted from § 83, this section is applicable. See § 83(e)." Alves v. Commissioner, 79 T.C. 864 (1982).

One of the National Office experts in § 83 matters, Norm Paul, says that he is unaware of any situation in which the Service has argued that a director (outside or otherwise) was not a "person" for purposes of § 83. In this regard, he notes that the plain language of the statute makes it applicable to "any person," and that I.R.C. § 7701(a)(1) defines "person" to include "an individual," and thus, an outside director.

(b)(5)(AWP)

[redacted]

---

arrangements known as restricted stock plans . . . A restricted stock plan, generally, is an arrangement under which an employer transfers stock to one or more of his employees . . . subject to certain restrictions which affect its value." 1969 U.S. Code Cong. & Ad. News at 2150-51. In the "explanation of provisions," the Senate report switches to more inclusive language: " . . . a person who receives a beneficial interest in property, such as stock, by reason of his performance of services . . ."; " . . . the recipient of the beneficial interest . . ." (both at 2152).

(b)(5)(AWP)

[redacted]

Whether the outside directors' compensation is "reasonable" is outside the scope of this memo. However, we do note that the Second, Seventh and Ninth Circuits have adopted the "independent investor" test to determine the reasonableness of managerial compensation. Dexsil Corp. v. Commissioner, 147 F.3d 96 (2nd Cir. 1998); Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999); Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir.). Under this test, compensation is held to be reasonable so long as an independent investor in the company would receive a rate of return at or above the expected rate in spite of the manager's or director's salary. Exacto Spring Corp., 196 F.3d at 839. (b)(5)(AWP) [redacted]

/s/ John D. Faucher
JOHN D. FAUCHER
Attorney