Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:TL-N-37-00
[redacted]

date: January 19, 2000

to: Chief, Examination Division, [redacted] District
Attn: Case Manager [redacted], Examination Branch 8, Group 1109
Attn: Revenue Agent [redacted]

from: District Counsel, [redacted] District

subject: **LO: [redacted] Stock Options**
Consolidated Group Parent Txp.: [redacted]
Cycle: [redacted] & [redacted]; Adjustment only in [redacted] (January 31, [redacted]
Address: [redacted]
EIN [redacted]
Group entity for the adjustment: [redacted]
EIN [redacted]
POA: None.

Non-Docketed Large Case Opinion: over $10M.[1]

This is in response to the request for an opinion, which you made during our meeting of January 4, 2000. We have concluded that the taxpayer is not entitled to the claimed deduction. The facts, the discussion, the legal analysis, and the specific issues considered are set forth below.

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[1]This opinion is that of District Counsel, [redacted] District. It has been issued prior to being reviewed in the national office, as it is based on what we consider to be well-established legal authority or precedent. However, a copy of this opinion is being sent to the national office for coordination purposes, and for their review and/or assistance as they may deem it appropriate. If the national office suggests or recommends any changes or modifications, you will be informed and this opinion will be modified accordingly to bring it in conformance with the national office's views. This will be done orally or by a formal supplementary or superseding opinion, where this is appropriate, necessary or helpful. Unless you are informed otherwise, you should consider this opinion to be final.

Issue

1. Whether the taxpayer[2] can take an ordinary and necessary business expense under I.R.C. §162, in the amount of $[redacted] for the taxable year ended January 31, [redacted], for [redacted]'s exercise of non-statutory stock[3] options.

Answer: No. The stock options were "paid" by [redacted] to its employee, [redacted]. They were **not paid by** the legally separate taxpayer [redacted]. There is no evidence as to what specific services [redacted] performed that would substantiate that the stock options were [redacted]'s **and not** [redacted]'s ordinary and necessary business expenses. There is no mention in any of the documents produced by the taxpayer (that are contemporaneous with the [redacted] granting of the option or the [redacted] equitable adjustment (substitution) of [redacted] stock for [redacted] stock, or anywhere else) that would support an inference that [redacted] granted the [redacted] stock options on behalf of [redacted], rather than for itself. There is nothing to substantiate taxpayer's allegation that the options were granted to [redacted] for services that proximately and directly benefited [redacted], rather than [redacted].

2. Whether [redacted] is entitled to the deduction.

Answer: Although [redacted] is not the taxpayer under your examination, we understand that another district may be examining that taxpayer. As set forth in the "Discussion, Legal Analysis and Opinion" section of this opinion, the facts suggest that [redacted] may be entitled to the deduction that [redacted] is claiming. You should share this opinion with the [redacted] examination team.

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[2]The taxpayer is the [redacted] consolidated return group. The deduction is being claimed by group member [redacted]. The payor shown in the Form 1099-MISC issued to [redacted], for $[redacted], is "[redacted]." The Form 1099-MISC lists the payor's EIN as [redacted], the same EIN that [redacted] now uses. Therefore, apparently [redacted] is [redacted]. A copy of the Form 1099-MISC is enclosed as Exhibit 3.

[3]The fact that the options are nonstatutory stock options is not at issue. The term "nonstatutory option" is a "catch-all" designation for options that do not meet the requirements for statutory options under I.R.C. §421 or that are granted under a plan (or offering) that does not qualify. See Treas. Reg. §1.83-7(a).

Facts and comments re: documentary evidence

[redacted] (the "Executive") served as the Chairman of the Board of Directors and Chief Executive Officer of [redacted], a Delaware corporation ("[redacted]")[4] pursuant to an Employment Agreement, by and between [redacted] and the Executive, effective as of [redacted] (the "[redacted] Employment Agreement"). A copy of the [redacted] Employment Agreement is enclosed as Exhibit 1.

The [redacted] Employment Agreement gave [redacted] the right to participate in [redacted]'s [redacted] Incentive Plan (the "[redacted] Incentive Plan") and to receive (i) [redacted] shares ([redacted]% of fully diluted Common Shares on the Effective Date (the "Restricted Shares") of the Company's common stock, par value $[redacted] per share (the "Common Shares") and (ii) options covering [redacted] Common Shares ([redacted]% of fully diluted Common Shares on the Effective Date ("Options"). See, pg. 2, ¶ 5.(c), of enclosed Exhibit 1. A copy of [redacted] Incentive Plan is enclosed as Exhibit 2.[5]

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[4]At some unspecified time, [redacted] changed its name to [redacted]. This office does not have any of the details as to how this came about, i.e., whether it was a simple name change, did a represent a merger of [redacted] into its wholly-owned [redacted] subsidiary, or did it represent something else altogether? What appears to be true, and what we are assuming to be true for purposes of this opinion, is that the taxpayer which is claiming the stock option deduction at issue, [redacted] and its consolidated return group parent, [redacted], are different corporations. [redacted] (now known as [redacted]) is neither [redacted] nor [redacted].

[5]The taxpayer represents that, in addition, [redacted] served as Chairman of the Board [of Directors] of [redacted] and [redacted], but the taxpayer does not provide any details regarding when he actually served, fees paid to [redacted] to compensate him for these services, or how these fees were inadequate. The taxpayer, then, makes the self-serving allegation that the [stock] options to purchase [redacted] stock "was in recognition of [redacted]'s services rendered to [redacted], [redacted] and [redacted]." That the options were granted for services performed to any entity other than [redacted] is a totally self-serving allegation, unsupported by any documentation. The documents we possess show the options as an integral part of the compensation being paid to [redacted] by [redacted]. There is no evidence that the options were paid to [redacted] for providing services for anyone other than

The "Share Option Agreement Under The [redacted] Incentive Plan" (the "[redacted] Share Option Agreement") is consistent with [redacted]'s employment agreement with [redacted]. It provides the terms for the vesting of the stock options. A material fact is that the [redacted] Share Option Agreement is only between [redacted] and [redacted]. Other entities and, in particular, the [redacted] entities, are neither parties to the agreement nor mentioned or referred to in the agreement, in any way. A copy of the "Share Option Agreement Under [redacted] Incentive Plan" is enclosed as Exhibit 4.

According to the taxpayer[6], in [redacted] and another corporation, named "[redacted]," were wholly owned [redacted] subsidiaries. Taxpayer represents that [redacted] was a pure holding company and that [redacted] spent a significant amount of time overseeing the day to day operations of [redacted]'s subsidiaries, [redacted] and [redacted]. See Facts section, at pgs. 1-2 of "IRS Protest Prepared Pursuant to IRS Publication 5," which is enclosed as Exhibit 5.[7] At all times, [redacted]

[redacted]. In addition, as [redacted] wholly-owned its subsidiaries, [redacted] and [redacted], [redacted] would be expected to perform substantial fiduciary duties on [redacted]'s behalf that would pertain to any of [redacted]'s subsidiaries, including [redacted] and [redacted]. The fact that there are intercompany transactions between a parent corporation and its subsidiaries and that the parent's CEO and Chairman is personally involved does not mean that options expressly granted by the parent as part of the parent's employment contract with its CEO/Chairman represent compensation paid by the subsidiaries. There is no legal or logical reason to pierce the corporate veils at issue. See IRS Protest. (Ex. 5).

[6]The Examiners have not challenged this representation.

[7]Logically this "[redacted]" an [redacted] subsidiary, was a different corporation from [redacted] in [redacted]. At some unknown time subsequent thereto, [redacted] apparently, changed its name to "[redacted]". The specifics of how this occurred (for example, it may have represented a simple name change or it may have represented a merger of [redacted] into its subsidiary [redacted], with [redacted] surviving, or it may have represented something else altogether) is not known to this office. It would be worthwhile for Examination to try to determine the particulars behind this name change, as ultimately the Service's case rests on a factual finding that [redacted]'s stock options were granted

[redacted] has received all of his W-2 compensation from [redacted]. There have been no payroll payments made to [redacted] from the [redacted] subsidiary, [redacted], nor from the taxpayer, [redacted], or any of the [redacted] consolidated return group affiliates.

A new Employment Agreement, effective as of [redacted], was entered into by and among [redacted], [redacted], and [redacted]. A copy of this new Employment Agreement is enclosed as Exhibit 6. A material feature is that said Employment Agreement is between [redacted], [redacted], and [redacted]. [redacted] is not a party. Another material feature is that it was, apparently, intended to contain its own stock option grant. However, the details concerning any such grant are left blank in the copy of the new Agreement provided to this office. See Ex. 6, pgs. 3-4, ¶ 5.(d), and Ex. 6, Annex B.[8]

On or about [redacted], [redacted] entities were, reportedly, split off in an alleged I.R.C. §355 type transaction. As part of the then upcoming split off of [redacted] from the [redacted] group, [redacted]'s stock options to buy [redacted] stock had to be adjusted. Economically this makes sense because, prior to the spin off, [redacted]'s options to buy [redacted] shares represented an option to buy the value represented by those shares, which included [redacted]'s share ownership of the

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for his services to [redacted] thru [redacted], and were not paid by another entity (i.e., by [redacted] for services provided to [redacted]). Even in the absence of totally clear facts, some facts remain clear, namely, that, there is no evidence that [redacted] was employed by [redacted] (there is no employment contract for non-director services between [redacted] and [redacted]), that the stock options originated in the employment agreement between [redacted] and [redacted], to which [redacted] is not a party, and not in an employment agreement between [redacted] and [redacted], and that, [redacted]'s titles, [redacted]'s CEO, President, and Chairman, strongly suggest that he would be concerned with the operations of all of [redacted]'s wholly-owned subsidiaries, including [redacted], as part **of his** [redacted] **duties.** There is no evidence that the non-director services, if any, performed by [redacted] for [redacted], at its premises or otherwise, were anything other than what would be expected of him as [redacted]'s highest level employee.

[8]The language "Solely in connection with the performance of services by the Executive **pursuant to this Agreement [EMPHASIS ADDED]**, suggests that this is a new stock option separate and apart and, thus, immaterial to the [redacted] stock option at issue in this opinion. See Ex. 6, pg. 3,¶ 5.(d).

[redacted] companies. After the spin-off, the [redacted] shares would no longer include the net value of the [redacted] assets that were spun off. Therefore, to maintain [redacted]'s former [redacted] stock option value, something had to be done. Accordingly, in [redacted] [redacted] was granted [redacted] stock options to maintain his claim in net value of the [redacted] assets that were transferred to [redacted]. As a matter of fact, the [redacted] adjustment whereby [redacted] acquired the stock option rights in [redacted] is a mechanical equitable adjustment, to maintain the former value of his [redacted] stock rights. It does not represent in any sense a stock option granted for services to [redacted].[9]

The "DISTRIBUTION AGREEMENT dated as of [redacted] between [redacted] and [redacted]," enclosed as Exhibit 7, in relevant part, explains the equitable adjustment, as follows:

> "Section 7.2 [redacted] Employee Stock Options.
>
> (a) [redacted] acknowledges that [redacted] was granted on [redacted] pursuant to the [redacted] Incentive Plan (the "[redacted] Incentive Plan") options to purchase an aggregate of [redacted] shares of [redacted] Common Stock and that, pursuant to the Employment Agreement between [redacted] and [redacted] dated as of [redacted], [redacted] of such options became vested and the remainder of such options were cancelled. [redacted] further acknowledges that, in accordance with the terms of the [redacted] Incentive Plan, an equitable adjustment for the Distribution will be made through the issuance of options to purchase a like number of shares of [redacted] Common Stock, such grant to be effective as of the Distribution Date. The terms of such options, including the exercise price thereof, shall be approved by the Boards of Directors of [redacted] and [redacted]. See Ex. 7, pg. 24, § 7.2(a), 'DISTRIBUTION AGREEMENT

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[9]In its protest the taxpayer admits that "...the purpose of this grant, at the time of the spin-off, was not to grant additional options or value to [redacted], but to maintain [redacted]'s economic interest in the [redacted] and [redacted] group in effect just prior to the spin-off." See Ex. 5, pg. 2 next to last paragraph.

dated as of [redacted] between [redacted] and [redacted]."

To further effect the substitution of [redacted] stock options for [redacted] stock options, a new Stock Option Agreement was entered into effective as of [redacted]. This new Stock Option Agreement was entered by and between [redacted], the taxpayer at issue in this opinion, and [redacted] (the "Optionee"). A copy of this new Stock Option Agreement is enclosed as Exhibit 8.

Enclosed as Exhibit 9 is a United States Securities and Exchange Commission Schedule 13D, filed by [redacted] where he reports the stock option transactions at issue. It is consistent with the facts as set forth in this opinion. There is no no disclosure made in said document that helps the taxpayer show that the stock options were received for services performed for [redacted], rather than for [redacted].

The rest of the evidence in this case consists of the following. (1) A copy of the [redacted], Board of Directors Minutes, enclosed as Exhibit 10. Its only apparent significance is that it shows [redacted] to be a director of [redacted] after the spin-off. There is no reference to the stock options at issue; (2) An "Acknowledgment of Exercise Price" dated [redacted], enclosed as Exhibit 11, of no apparent significance to the determination of the deduction at issue (3) A communication entitled "Secondary Public Offering of Common Stock" dated [redacted], enclosed as Exhibit 12, also of no apparent significance to the determination of the legal question at issue; (4) A "Cross Receipt" dated [redacted], enclosed as Exhibit 13, also of no apparent significance to the issue; and (5) A copy of the [redacted] Meeting of Board of Directors Minutes dated [redacted], enclosed as Exhibit 14. It ratifies the exercise price for the former [redacted] options, and makes clear that the equitable adjustment (substitution of [redacted] stock for [redacted] stock) were the equivalent of customary anti-dilution adjustments. See Ex. 14, [redacted] Meeting of Board of Directors Minutes dated [redacted], pgs. 3-4, Section entitled "Ratify Exercise Price for Former [redacted] Options."

[redacted], [redacted] was spun off from [redacted] as of [redacted]. [redacted] exercised the [redacted] options on [redacted], at which time, [redacted] also sold the stock and paid the exercise price to [redacted]. Specifically, [redacted] sold the [redacted] shares of [redacted] common stock (the equitable adjustment

representing a substitution for the [redacted] stock option value spun-off) for $[redacted], remitting $[redacted] to [redacted] for the exercise price. See Form 886A, "Notice of Proposed Adjustment,", "Facts" section, at pg. 1, which is enclosed as Exhibit 15. "[redacted]" [redacted] issued a [redacted] Form 1099-MISC to [redacted] showing $[redacted] in box 7 as "Nonemployee compensation." [redacted] was an affiliate of the [redacted]. consolidated return group for the year ended [redacted]. The group claimed the $[redacted] deduction for the year ended [redacted]. The Examination Division, [redacted] District has disallowed the deduction. We concur with the determination of the Examination Division, [redacted] District, for the reasons that follow.

Discussion, Legal Analysis and Opinion

You have asked us to address the question of whether [redacted] is entitled to a deduction for the cost of the stock options at issue. Although, you have not asked us whether [redacted] is entitled to a deduction for the cost of the stock options, this question must also be addressed. According to the [redacted] Examiner, a different group of examiners, apparently, in another district, is examining [redacted]. This raises in our mind the possibility that [redacted] has already taken a deduction for the very same costs that [redacted] is deducting, in which case the Service may be facing double deductions. Another possibility is that [redacted] is entitled to the deduction and has not taken it yet Finally, the deduction may not be allowable, to either party, for other reasons, which have not been considered.

The facts that we know suggest that the stock option costs may be deductible, but deductible by [redacted], and not by [redacted]. Therefore, you must share this opinion with the [redacted] Examination Team, to ensure that consideration of whether the deduction is allowable to [redacted] takes place. The Service should be consistent in both examinations.

Whether [redacted] is entitled to deduct the costs depends on whether the stock options were granted to [redacted] to compensate him for services for [redacted]'s proximate and direct benefit. See Young & Rubicam Inc. v. United States, 410 F.2d 1233, 187 Ct. Cl. 635, 23 AFTR 2d 69-1385, 69-1 USTC ¶ 9404 (1969). For example, a corporation was permitted to deduct the salary of its president even though most of his time was spent in the service of a new company formed to publish the corporation's newspaper. The Ninth Circuit specifically disagreed with the theory that one corporation cannot deduct managerial services which it has agreed to render and has rendered to another corporation for no other reason than to

increase its dividends from the other corporation. See Daily Journal Co. v. Commissioner, 135 F2d 687, 31 AFTR 46, 43-1 USTC ¶ 9427 (9th Cir. 1943).

If the payments had been made by [redacted] for Services to [redacted], generally [redacted] would not be entitled to the deduction. Where corporations make payments to their own officers or employees for services rendered to related corporations, the payments are not deductible unless a direct benefit to the payor corporation through specific activity of the employee is demonstrated. For example, a corporation can not deduct payments to its officers for services to its subsidiaries [See Great Island Holding Corp. v. Commissioner, 5 T.C. 150, acq.; R.J. Reynolds Tobacco Co. v. United States, 149 F. Supp. 889, 138 Ct. Cl. 1, 50 AFTR 2187, 57-1 USTC ¶ 9555 (1957), cert. denied, 355 U.S. 893, 2 L Ed 2d 191 (1957); Columbian Rope Co. v. Commissioner, 42 T.C. 800 (1964); Transamerica Corp. v. United States, 7 Cl. Ct. 119, 55 AFTR 2d 85-599, 85-1 USTC ¶ 9120 (1984)]; for services to related corporations [See E.B. & A.C. Whiting Co. v. Commissioner, 10 T.C. 102, acq.]; for services rendered to a joint venture consisting of the payor corporation and another company where the officer-payee was not acting as the payor's agent in rendering services to the joint venture [See Cropland Chemical Corp. v. Commissioner, 75 T.C. 288 (1981) , affd. 665 F2d 1050 (1981) (unpublished)]; a corporation could not deduct a payment to officers that was provided to make up for inadequate salaries paid to the same officers by a related corporation [Amco Investment Co. v. Commissioner, PH TCM ¶ 45092, 4 CCH TCM 307 (1945)]; and, a corporation could not deduct payments made for the services of a watchman it employed to guard the property of another corporation in which it was the principal stockholder. See Coosa Land Co. v. Commissioner, 29 BTA 389 (1933).

We now concern ourselves with answering the specific question which you have asked from us, namely, whether the deduction is allowable to [redacted]. **We conclude that it is not.**

An option to buy stock at a bargain price may be granted by an employer to an employee, as part of a compensation package. The tax consequences depend on whether the option is "statutory" or "nonstatutory." The fact that the options that are the subject of this opinion are "nonstatutory options" is not in issue.

When an employee, or an independent contractor, is granted a compensatory stock option to which I.R.C. §421 does not apply, i.e., a "nonstatutory option," the tax consequences of the grant or exercise of the option are determined under I.R.C. §83. I.R.C. §83 governs the tax consequences of compensation with property. Treas. Reg. §1.83-7(a). A "nonstatutory option" is taxed to an employee at its grant, but only if it has a readily ascertainable

fair market value at that time. If the value at grant is not ascertainable, the option is taxed at the time it is exercised, or, if earlier, when the option property becomes transferable or no longer subject to a substantial risk of forfeiture. The employer has a corresponding compensation deduction.

As noted, employers are entitled to compensation expense deductions in connection with nonstatutory options. If an employee has compensation income through the grant or exercise of a nonstatutory option, the employer is entitled to a deduction under the rules that apply to the transfer of property for the performance of services. The employer's deduction is allowable for the tax year in which the employee includes in income the compensation attributable to the compensatory property. I.R.C. §83(h).

At all relevant times, [redacted] was the Chief Executive Officer, President, and Chairman of the Board of Directors of [redacted] later known as [redacted]. He was not an employee of [redacted]. Please note that the Form 1099-MISC filed by [redacted] lists the payment to [redacted] as "Nonemployee compensation." (Ex. 3).

[redacted], allegedly, performed services for [redacted], but this does not mean that these services are outside [redacted]'s ordinary duties **as an employee of** [redacted]. Performing such services is to be expected of the CEO, President, and Chairman of [redacted], after all [redacted] was [redacted]'s wholly-owned subsidiary until it was spun-off in [redacted]. Time devoted by top executives of a parent corporation in general supervision of a subsidiary's operations is an ordinary and necessary expense of conducting and managing the **parent's** business. See Columbian Rope Company v. Commissioner, 42 T.C. 800 (1964), acq. 1965-2 C.B. 4 (1965).

In addition as a [redacted] board member, [redacted] would perform director services for [redacted] for which, presumably, he would have been independently compensated in the form of director's fees.

It needs to be noted that taxpayer's protest (Exhibit 5) fails to allege any specific services performed by [redacted] for [redacted]. All we know for a fact is that, he was a [redacted] director. Stated another way, the taxpayer has not established with any particularity or with any details or supporting documentation, the exact nature or extent of [redacted]'s director and non-director services, which he allegedly performed for [redacted]. We only know that [redacted] was a [redacted] director; and that he attended, at least two, Board of Directors meetings. But, presumably, he was compensated for this with director's fees, not with stock options.

It is also important to note that the Service has not been provided with any specific evidence to support the bare allegation that [redacted] was conducting the day to day operations of [redacted] up to the time of the [redacted] settlement option granting date, or at anytime. Even if he was, the Service has not been provided with any documentation to support taxpayer's allegation that the stock options were **intended** to compensate [redacted] for services for [redacted], rather than services for [redacted]. Taxpayer's self-serving conclusory allegations are not proof that any of the [redacted] stock options represented payment by or on behalf of anyone other than [redacted] for [redacted].

In this case, the taxpayer does not question the fact that the stock options were granted by [redacted]. [redacted] was definitely [redacted]'s employer. [redacted] at the time the options were granted by [redacted], but not at the time the options were exercised by [redacted] ([redacted]), was an [redacted] subsidiary. Although [redacted] was a Director of [redacted] he was not an employee of [redacted]; at least, not a "payroll" employee. The only employment agreements are between [redacted] and [redacted]. We are unaware of any agreements between [redacted] and [redacted]. Even more important, the stock options at issue were granted **to fulfill** the terms of [redacted]'s **employment agreement with** [redacted] not pursuant to any employment agreement between [redacted] and [redacted]

Further, there is no mention in any documents that have been brought to our attention to support taxpayer's allegation that these options were granted, at least in part, for [redacted]'s services to [redacted]. What the evidence shows is that [redacted] was [redacted]'s employee, that the employment agreement between [redacted] and [redacted] provided for the stock options, that [redacted] ensured that the value of the stock options was preserved after the spin-off by substituting [redacted] stock for the value spun-off to [redacted], and that [redacted] followed [redacted]'s compensatory plan. There is not an iota of evidence that [redacted] was granted the stock options for services for anyone other than [redacted], or that [redacted] provided anything to [redacted]. All that [redacted] did was turn over to [redacted] an amount equivalent to the value of his stock option to buy [redacted] stock. This value had been transferred by [redacted] to [redacted] during the spin-off, in the form of a transfer of assets. The fact that some of the [redacted] assets had been converted into [redacted] group assets without consideration from [redacted] to [redacted], necessarily, meant that [redacted]'s remainder stock value was lessened pro tanto. It also meant that [redacted] had to be made whole by [redacted] for the former value of his [redacted] stock options, which became assets in [redacted]'s hands. The fact that [redacted] chose to reimburse [redacted] by granting an equitable adjustment (an option to [redacted] to buy [redacted] shares) rather than pay him in cash for the diminution of the value of his [redacted]

stock option as a result of the spin-off, or to make distribution of property in kind to [redacted] in lieu of an equitable adjustment, is immaterial to the origin of [redacted]'s stock option rights. [redacted]'s acquired his stock option as compensation for services performed for [redacted], not [redacted]. [redacted] is the one entitled to the deduction, if anyone is.

To summarize, we believe that the real payor in this case was [redacted]. We believe that there is no evidence to support a conclusion that the stock options were granted to compensate for services performed for the benefit of [redacted], not [redacted]. Finally, even assuming arguendo that [redacted] and not [redacted] was the payor, a taxpayer, (here [redacted] for argument purposes), who undertakes to pay the obligations of another taxpayer, (here [redacted]), may not deduct those payments as ordinary and necessary business expenses. See Interstate Transit Lines v. Commissioner, 319 U.S. 590, 87 L Ed 1607, 30 AFTR 1310, 43-1 USTC ¶ 9486 (1943), reh denied, 320 U.S. 809, 88 L Ed 489 (1943); Deputy v. Du Pont, 308 U.S. 488, 84 L Ed 416, 40-1 USTC ¶ 9161 (1940).

Private Rulings have no precedential authority, but are, nevertheless, of practical use as examples of Service logic. The Service has stated in a private ruling that when property is transferred in connection with the performance of services, the party for whom the services were performed (in our view [redacted] and not [redacted]) is the one entitled to a deduction equal to the amount includible in income by the provider of the services (here [redacted]), regardless of who (whether [redacted] or [redacted]) **actually** transfers the property. Therefore, a corporation (B) which was acquired by another corporation (A) in a statutory merger was entitled to a compensation deduction where the stockholder (X) who controlled B before the merger offered key employees of B (by then a wholly-owned subsidiary of A) an option to buy preferred stock of A (which X was entitled to under the merger plan), and the employees exercised the options at a bargain price. B's deduction was equal to the total amount included in gross income of the employees (the difference between the option price and the f.m.v. of the stock). See IRS Letter Ruling 7838003.

Letter Ruling 9743048, July 30, 1997 [July 30, 1997 CCH IRS Letter Rulings Report No. 1078, 10-29-97; IRS REF: Symbol: CC:EBEO:4-PLR-100663-97] is even clearer, for the proposition that [redacted] and not [redacted] is the one that would be entitled to a deduction in this case, as the facts of that ruling closely track the facts of the instant [redacted] case. The ruling dealt with the tax consequences resulting from the exercise of certain nonstatutory options to acquire Company C stock by employees of Company A and Company B.

Company A wholly-owned Company B. In year X, Company A formed another first-tier subsidiary, Company C, by transferring to it the stock of its wholly-owned subsidiary, Company D. Company C was then split off in a transaction qualifying as a "D" reorganization followed by a distribution described in I.R.C. §355. Immediately after the transaction, Company A did not own any of the stock of Company C.

As part of the split-off, some of the nonstatutory options to acquire Company A stock previously granted to employees of Company A and B for services performed for those companies were (or were be) converted into nonstatutory options for Company C shares. None of the options in question had readily ascertainable f.m.v. when they were granted.

As in the instant [redacted] situation, the employees of Company A and Company B would exercise the Company C options (if at all) by paying the exercise price directly to Company C, and Company C would transfer its shares directly to those employees. Based on the facts, the Letter Ruling ruled, in pertinent part, that the amounts includible in the gross incomes of the **employees of Company A or Company B** as a result of **their exercise of the nonstatutory options for Company C shares** were **deductible by the employer corporation (Company A or Company B**, as applicable) under I.R.C. §83(h) and the regulations issued thereunder. Therefore, this ruling is exactly on point, for the proposition that the stock options, at issue in our instant case, are deductible (if at all) **by** [redacted] **the employer** and **not by** [redacted].

Conclusion

This concludes our legal opinion. We are closing our legal file with respect to this particular question. As noted before, the opinion will be supplemented, if necessary, to account for any national office recommendations or modifications that may be made. If you have any questions, please contact the undersigned at (312) 886-9225, extension 308.

RICHARD A. WITKOWSKI
District Counsel

By: Rogelio A. Villageliu
ROGELIO A. VILLAGELIU
Special Litigation Assistant

Attachments (one set to Examination for their convenience and two sets to DOM:FS. None to other distributees).

1. "Employment Agreement", effective as of [redacted], by and between the [redacted] and [redacted] (the "Prior Employment Agreement")(Ex. 1).

2. "[redacted] Incentive Plan." (Ex. 2).

3. [redacted] Form 1099-MISC. (Ex. 3).

4. Share Option Agreement Under [redacted] Incentive Plan. (Ex. 4).

5. "IRS Protest Prepared Pursuant to IRS Publication 5." (Ex. 5).

6. "Employment Agreement" [redacted] among [redacted] [redacted], and [redacted]. (Ex.6).

7. "Distribution Agreement," [redacted], between [redacted] and [redacted] (Ex. 7).

8. Cover ltr., [redacted], and Stock Option Agreement. (Ex. 8).

9. US Securities and Exchange Commission, Schedule 13 D. (Ex. 9).

10. [redacted] Bd. Meeting Minutes, [redacted]. (Ex. 10).

11. Memorandum, [redacted], from [redacted] to [redacted]. with Acknowledgment of Exercise Price. (Ex. 11).

12. [redacted] Ltr. re. Secondary Public Common Stock Offering. (Ex. 12).

13. Cross Receipt, [redacted]. (Ex. 13).

14. [redacted], Bd. Meeting Minutes, [redacted]. (Ex. 14).

15. Notice of Proposed Adjustment. (Ex. 15).

16. Response to Protest.

CC:District Counsel, [redacted] District

CC:Assistant Regional Counsel (Large Case), [redacted]

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CC:DOM:FS (2 copies)

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