Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply to:

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Date:

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LEGEND:

Company =

Parent =

This is in reply to a letter dated May 13, 1999, submitted on behalf of Company by its authorized representative, in which a ruling is requested that the failure to adjust the terms of certain statutory options to take into account a reverse stock split will not result in a "modification" of those options, as that term is defined in section 424(h) of the Internal Revenue Code.

The facts submitted are that Parent declared a large special dividend and simultaneously effected a reverse stock split of its shares. The total dollar amount of the special dividend was approximately equal to the proceeds from Parent's sale of certain of its businesses. The only reason for the reverse stock split was to maintain the value of Parent shares following the special dividend. Specifically, the size of the reverse stock split was designed so that its effect on the price of Parent shares would almost exactly offset the dividend's effect on that price. It was impossible for either event to have happened without the other.

After the reverse stock split, every shareholder of Parent owned Parent in exactly the same proportion that he or she owned Parent prior to the transactions. It is submitted that these results are the same as those that would have arisen if, instead of declaring a special dividend and a effecting a reverse stock split, Parent had caused a pro rata redemption of the percentage of Parent shares equal to the percentage of the special dividend.

At various times prior to the transactions described above, employees of Company and its United States subsidiary corporations were granted options under an "employee stock purchase plan" and incentive stock options ("ISOs") for Parent shares

("the options"). The options contained typical anti-dilution provisions which, subject to the administrating committees' discretion, required that they be adjusted to reflect stock splits and reverse stock splits.

The committees administering the option plans, in view of the unique circumstances involved and their determination that the transaction as a whole was tantamount to a pro rata redemption, decided that no adjustments would be made to the options to reflect the reverse stock split, and they based that decision on their interpretation of the plans. Specifically, the committees concluded that the overriding purpose of the anti-dilution provisions was to keep the optionees whole, and that adjustments to the options to reflect the reverse stock split, if not accompanied by adjustments to reflect the special dividend, would be contrary to that purpose.

Section 424(h) of the Code and the regulations thereunder provide the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a statutory option. Under section 1.425-1(e)(2) of the regulations, any modification, extension, or renewal of the terms of an option to purchase stock is considered as the granting of a new option.

Under section 1.425-1(e)(5)(i), the time or date when an option is modified, extended, or renewed is determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option that are provided in section 1.421-7(c). For purposes of sections 421 through 424, the term "modification" means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change which provides more favorable terms for the payment for the stock purchased under the option, is a modification. Where an option is amended solely to increase the number of shares subject to the option, the increase is not considered to be a modification of the option, but is treated as the grant of a new option for the additional shares.

A change in the number or price of the shares of stock subject to an option merely to reflect a stock dividend, or stock split-up, is not a modification of the option. Se section 1.425-1(e)(5)(ii)(a). Under section 1.425-1(e)(5)(ii)(b), a change in the number or price of the shares of stock subject to an option to reflect a "corporate transaction" (as defined in section 1.425-1(a)(1)(ii)) is not a modification of the option provided that (i) the excess of the aggregate fair market value (determined immediately after such corporate transaction) of the shares subject to the option immediately after such change over the aggregate new option price of such shares is not more than the

excess of the aggregate fair market value of the shares subject to the option immediately before the transaction over the aggregate former option price of such shares; and (ii) the option after the change does not give the employee additional benefits that he did not have before the change. Additionally, the ratio of the option price immediately after the change to the fair market value of the stock subject to the option immediately after the corporate transaction must not be more favorable to the optionee on a share-by-share comparison than the ratio of the old option price to the fair market value of the stock subject to the option immediately before such a transaction. A reduction in the option price of an option, other than as specifically authorized in section 1.425-1(e), is a modification of such option.

Applying the above law to the information submitted, given the fact that, in substance, the above-described transactions were tantamount to a pro rata redemption of Parent shares, we conclude that the failure to make adjustments to the options in the present case simply conforms the plans to their original intent and to the original understanding of the affected optionees. In contrast, making the adjustments would cause unintended results. In this regard, we note that this is not a situation where the plan provisions in question were specifically designed to adversely affect the employees, as was the case in Revenue Ruling 71-166, 1971-1 C.B. 135. Accordingly we have concluded that by failing to adjust the options to reflect the reverse stock split, Parent did not made a "modification" of the options, as defined in section 424(h) of the Code and the regulations thereunder.

Except as ruled above, no opinion is expressed regarding the federal tax consequences of the transaction described above under any provision of the Internal Revenue Code. In this regard, please note that we specifically express no opinion regarding the status of any of the referenced plans under sections 422 and 423 of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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A copy of this letter should be attached to Company's federal income tax return for its taxable year during which the reverse stock split occurred. A copy is enclosed for that purpose.

Sincerely yours,

Robert B. Misner

ROBERT B. MISNER
Assistant Chief, Branch 4
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)

Enclosures: 2
Copy of this letter
Copy for section 6110 purposes

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