Amounts Paid by Acquiring Corporation to Purchase Options Are Deductible by Target

by Robert W. Wood • San Francisco

The Service has recently considered in technical advice (Technical Advice Memorandum 9438001) the amount and identity of deductions for outstanding employee incentives in the context of a tender offer. As part of a successful tender offer, the acquiring corporation (Acquirer) purchased incentive stock options (ISOs), nonstatutory stock options (NSOs), and stock appreciation rights (SARs) that were previously granted to various employees and directors of the corporation that was the subject of the tender offer (Target).

The ISOs were granted to employees under a plan designed to meet the requirements of section 422. ISOs granted under the plan could not be transferred except by will or by the laws of descent and distribution. The NSOs were granted to directors under a plan that also prohibited transfer except by will or the laws of descent and distribution.

The SARs were granted by letter permitting the employee, on exercise, to receive the difference between the fair market value (FMV) of the Target's stock at the time of exercise and an exercise price recited in the grant letter, multiplied by a number of reference shares, which was also recited in the grant letter. To the extent the SAR had not been exercised, it would terminate at the time the grantee's employment with the Target

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ceased for any reason other than the employee's death. The SARs were not transferable except by will or by the laws of descent and distribution.

On its last tax return, the Target deducted the amounts paid by the Acquirer to the employees and directors for their options and SARs. After initially disallowing the deduction, the Service ruled in technical advice that the Target is entitled to deduct the amounts paid by the Acquirer to purchase the outstanding ISOs, NSOs, and SARs in accordance with the Target's method of accounting.

Employee Tax Hit

The Service noted that the ISOs were transferred by the grantees to the Acquirer. Since this transfer violated the prohibition against transfer under Section 422, the options ceased to be ISOs, and Section 421 could not apply. At that point section 83(a) and 83(b) applied to the transfer of money when the options (originally ISOs) were disposed of. Consequently, the grantees of the NSOs were required to include in gross income in the tax year of the transfer the excess of the amount received on the transfer of the options to Acquirer over the amount, if any, paid for them.

Assuming the NSOs did not have a readily ascertainable FMV at the time of grant, they were not subject to Section 83 at that time. However, Section 83(a) and 83(b) applied to the transfer of money when they were disposed of. Consequently, the grantees of the NSOs were required to include in their gross income in the tax year of the transfer the excess of the amount received on the transfer of the options to the Acquirer over any amount paid for them.

Finally, the Service noted that the recipient would be entitled to a deduction for the amount includable as compensation in the gross income of the service provider under Section 83, but only to the extent the amount satisfies the requirements of Section 162 or 212 and the applicable regulations. IRC §83(h); Reg. §1.83-6. Accordingly, the Target, as the service provider, was entitled to deduct the amounts includable in the income of the grantees.

SAR Treatment.

The Service determined that the transfer of the SARs to the Acquirer resulted in a transfer of cash to the grantees just as if they had exercised the SARs and received cash from the Target. The Target was therefore entitled to deduct the amounts paid by the Acquirer to purchase the SARs. The Service cited Rev. Rul. 73-146, 1973-1 C.B. 61, and Rev. Rul. 80-300, 1980-2 C.B. 165, in support of its conclusions. ■

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