

INTERNAL REVENUE SERVICE

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February 14, 2000

LEGEND:

Company =

Plan =

X =

Dear

This is in reply to your letter of October 5, 1999, in which a ruling is requested that Incentive Stock Options granted under the Plan are options described in section 422 of the Internal Revenue Code.

The facts submitted are that Company's board of directors will adopt the Plan, its shareholders will vote to approve the Plan within 12 months after it is adopted, and the Plan will become effective as of the date that it is adopted. Both statutory and nonstatutory options for Company shares may be granted under the Plan, and the maximum number of such shares that may be purchased through the exercise of those options is 400,000.

Under the Plan, only Employees of Company and Employees of Affiliated Companies may be granted an "Incentive Stock Option" ("ISO"), which is defined as "an option described in section 422(b) of the Code." For the purpose of granting ISOs, the term "Employee" is defined as "an individual described in section 3401(c) of the Code and the Treasury Regulations thereunder." It is represented that an Employee will not be granted an ISO if, at the time the option is granted, the Employee owns stock possessing more than ten percent of the total combined voting power or value of all classes of stock of Company or of a "parent corporation" or a "subsidiary corporation," as defined, respectively, in sections 424(e) and 424(f) of the Code. The continuance of the employment status of ISO recipients will be determined under the rules of section 1.421-7(h)(2) of the Income Tax Regulations. The term "Affiliated Company" is defined as "a 'parent corporation' of Company or a 'subsidiary corporation' of Company as defined, respectively, in sections 424(e) and 424(f) of the Code."

Under the Plan, options may only be granted within five years from the date that the Plan is adopted and are not exercisable after the expiration of 10 years from their Date of Grant. For ISOs, the "Date of Grant" of the option is defined as "the date that the Selected Participant signs the corresponding Option Agreement," and the Exercise Price of all options granted under the Plan is defined as "the last closing price for the Share, on the X stock exchange, on the date proceeding the Date of Grant." Options granted under the Plan are not assignable or transferable by the optionee other than by will or by the laws of descent and distribution and are exercisable during the optionee's lifetime only by the optionee.

On an option's Exercise Date, individuals purchasing shares must (among other things) pay the option's Exercise Price in full. After the Exercise Date, the shares purchased through the exercise of options will be issued to the purchaser "as quickly as is reasonably possible." Upon issuance of the shares, shareholders will have substantially all of the rights of ownership of such shares, including voting rights, dividend rights and liquidation rights.

In pertinent portion, section 421(a) of the Code provides that, if a share of stock is transferred to an individual in a transfer in which the requirements of section 422(a) are met, no income shall result to the individual at the time of the transfer, no deduction under section 162 shall be allowable at any time to the employer corporation with respect to the share transferred, and no amount other than the price paid under the option shall be considered as received by the employer corporation for the share transferred.

Under section 421(b), if the transfer of a share of stock to an individual pursuant to his exercise of an option would otherwise meet the requirements of section 422(a) except that there is a failure to meet the holding period requirements of section 422(a)(1) (there is a "disqualifying disposition"), then any increase in the income of such individual or deduction from the income of his or her employer corporation for the taxable year in which such exercise occurred attributable to such disposition is treated as an increase in income or a deduction from income in the taxable year of such individual or of such employer corporation in which such disposition occurred.

Section 422(a) of the Code provides that section 421(a) will apply to the transfer of a share of stock to an individual pursuant to the exercise of an "incentive stock option" if (1) no disposition of the stock is made by the individual within two years after the date of grant of the option nor within one year after the transfer of such share to the optionee, and (2) at all times during the period beginning with the date that the option is granted and ending 3 months before the date of its exercise, the optionee remains an employee of the granting corporation, a parent or subsidiary corporation of such corporation, or a corporation (or parent or subsidiary corporation of such corporation) issuing or assuming a stock option in a transaction to which section 424(a) applies.

Section 422(b) of the Code defines an "incentive stock option" as an option that meets the requirements set forth in paragraphs (1) through (6) of that section. For purposes of these determinations, section 424(e) of the Code defines "parent corporation" as any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations (other than the employer corporation) owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain. Section 424(f) defines "subsidiary corporation" as any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

Section 1.421-7(c)(1) of the regulations provides, in part, that, for purposes of sections 421 and 422 of the Code, the words "the date of the granting of the option" and "the time such option is granted" (and similar phrases) refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. For purposes of determining when an option is granted, a corporation "completes corporate action," within the meaning of section 1.421-7(c)(1) of the regulations, when, pursuant to the terms of its offer, the number of shares of stock that may be purchased is fixed and determinable, and the minimum exercise price of the option has been specified. If an offer to sell stock does not designate a fixed and determinable maximum number of shares that an employee may purchase and a minimum exercise price for the option, corporate action has not been completed. See Revenue Ruling 68-317, 1968-1 C.B. 186, and Revenue Ruling 70-358, 1970-2 C.B. 96, both of which are clarified by Revenue Ruling 73-223, 1973-1 C.B. 206.

Under section 83(a), if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property, determined on the first day that the transferee's rights in the property are not subject to a substantial risk of forfeiture, over the amount paid for the property is included in the service provider's gross income for the taxable year which includes that day. However, under section 83(e), section 83 does not apply to a transaction to which section 421 of the Code applies. Rather, the rules of section 83 govern the tax consequences resulting from disqualifying dispositions of stock to the extent that section 421 does not apply. See section 1.422A-1(b) of the Proposed Income Tax Regulations.

Applying the above law to the information submitted, we rule as follows:

- (1) The Plan will be a plan described in section 422(b)(1) of the Code; and
- (2) Provided that the requirements of sections 422(a)(1) and (2) of the Code are satisfied, Employees granted Incentive Stock Options under the Plan will not be

required to recognize income under section 83 of the Code upon the grant or exercise of those options. In qualification of the foregoing, to the extent that the aggregate fair market value of stock with respect to which ISOs are exercisable for the first time by an optionee during any calendar year (under all plans of Company, its parent, and its subsidiaries) exceeds \$100,000, such options will be treated as nonstatutory options taxed under the rules of section 83. See section 422(d).

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 particular, we specifically note that no opinion is expressed regarding: (1) "deviations" made pursuant to Article 6.3.2(i) of the Plan and section 5 of the Option Agreement; (2) "extensions" of the Option Exercise Period made under Article 7.2 of the Plan; (3) "alterations" made under Article 10.2 of the Plan and section 7 of the Option Agreement; (4) "decisions" made under Article 10.3 of the Plan and section 8 of the Option Agreement; (5) actions taken under Article 11.1 of the Plan and section 10 of the Option Agreement; (6) the federal employment tax consequences of any aspects the transaction; or (7) section 13 of the Option Agreement. Also, please note that, if the Plan is amended, the above rulings may not remain in effect. Finally, please note the above rulings are conditioned upon Company's board of directors adopting the Plan and upon Company's shareholders voting to approve the Plan within 12 months after it is adopted.

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.

A copy of this letter should be attached to Company's federal income tax return for the year in which the Plan is implemented. A copy is enclosed for that purpose.

Sincerely yours,

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