

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Jeannette D. Pappas
General Attorney (Manhattan, Group 4)
(Large & Mid-Size Business)

Robert A. Margolies
Internal Revenue Agent, Comm Technology & Med
Field Operations East, CTM
Territory 7-Manhattan-NY, Team 1338 – Manhattan

Martin B. Satz
Program Manager, Comm Technology & Med
Field Operations East, CTM
Territory 7-Manhattan- NY, Team 1338 - Manhattan

from: Debra L. Carlisle
Branch Chief, Branch 5
(Corporate)

Rebecca O. Burch
General Attorney, Branch 5
(Corporate)

subject: Application of section 1032 to TP's characterization of amounts received in connection with a stock purchase agreement.

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer (TP)	=	
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Parent	=	
Counterparty (CP)	=	
Sub1	=	
Date1	=	
Date2	=	
\$ <u>u</u>	=	
\$ <u>v</u>	=	
\$ <u>w</u>	=	
\$ <u>x</u>	=	
\$ <u>y</u>	=	
\$ <u>z</u>	=	
<u>m</u>	=	
<u>n</u>	=	
<u>o</u>	=	
<u>p</u>	=	

ISSUE

Whether payments made to modify a stock purchase agreement that provides for different payment methods can be correctly characterized for federal tax purposes as a payment for the lapse or acquisition of an option, to which section 1032(a) applies?

CONCLUSION

No. The available methods by which the agreement could have been settled are not separate options, and the receipt of cash to forgo one of those methods will not be treated as a lapse or acquisition of an option, to which section 1032(a) would apply.

FACTS¹

Taxpayer (TP), a corporation, is wholly owned by Parent, a publicly traded corporation.² Counterparty (CP) is a foreign corporation. TP and CP formed Sub1 as a joint venture to provide m services. On Date1, TP and CP executed an agreement (the Agreement) that provided CP with the right to sell to TP its Sub1 stock in two tranches during two consecutive exercise periods for a total exercise price (paid by TP to CP) of \$u (the puts); if CP failed to exercise its rights, TP had the right to buy from CP the Sub1 stock in two tranches for a total exercise price of \$y (a price higher than \$u) (the calls).

Under the Agreement, TP had the right to pay the exercise prices of the puts or the calls in cash, TP stock, or a combination of both. If TP chose to use its stock to pay part or all of the exercise price of a put or a call, the TP stock would be valued at its average closing price over a 30-day period that ended before the settlement date. TP had the right to determine whether to settle in cash, TP stock, or a combination of both for a period of up to n days after the 30-day period (the free-look period), which ended before the settlement date. The free-look period allowed TP a potential to deliver a certain number of shares with a market value less than \$u if during the free-look period the value of TP stock declined.

Pursuant to a series of amendments to the Agreement, CP paid a total of \$w to TP. In the first amendment, TP agreed to pay at least \$x of the exercise price of CP's first set of put rights in cash rather than in TP stock. As consideration for the first amendment, CP paid TP \$y for services. In the second amendment, the parties agreed to various terms that did not affect the amount or composition of the puts and calls under the Agreement. In the third amendment, TP agreed to pay the remainder of the exercise price for CP's first and second puts solely in cash and not in TP's stock. Concurrently with the third amendment, CP paid TP \$z for additional TP services, and TP recorded this payment as revenue for financial accounting purposes.

Subsequently, o filed a complaint against TP and a settlement was reached that resolved the complaint. As part of the settlement, TP adjusted its accounting for the

¹ This statement of facts is based on the materials you provided. Additional facts might affect the analysis.

² TP was acquired by Parent after the transactions described. But, Parent continued TP's transactions as a successor-in-interest and we refer to TP for convenience in discussing the Agreements and Amendments.

transaction involving the \$w payment to restate the \$w payment as a reduction in p for Sub1 stock.

In a letter dated Date2, TP's counsel asserted that the methods of payment under the Agreement, which included TP's right to pay the exercise price of \$u of the puts in TP stock, created a put option on TP stock that entitled TP to sell TP stock to CP in exchange for Sub1 stock. TP's counsel advised TP that the \$w payments received were with respect to the lapse or acquisition of that put option. TP's counsel concluded there was substantial authority for taking the position that the \$w payments made by CP to TP could be excluded from TP's income under section 1032(a).

You sought our advice as to whether the conclusion reached by TP's counsel is correct and whether there is support to treat the \$w payment as a reduction of the initial purchase price of \$u.

DISCUSSION

The second sentence of section 1032(a) provides that no gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option, or with respect to a securities future contract (as defined in section 1234B), to buy or sell its stock (including treasury stock).

Generally, an option is a legal contract that gives one person (the holder) the right to buy from or sell to another person (the grantor) specific property at a fixed price within a certain time.³ Generally, when the holder exercises its option, the exercise is treated as the acceptance of an offer made by the grantor to buy or sell the property at the price set forth in the option. An option can be a put or a call option. Typically, the holder of a put option has the right to sell to the grantor of the put option, and the holder of a call option has the right to buy from the grantor of the call option. The holder of a put option is generally treated as accepting the grantor's offer to buy the specific property at the fixed price set forth in the option when the holder exercises the put option. Similarly, the holder of a call option is treated as accepting the grantor's offer to sell the specific property at the fixed price set forth in the option when the holder exercises the call option.

Under the second sentence of section 1032(a), no gain or loss is recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock. TP asserts that the ability to pay the exercise price of \$u of the puts in cash, TP stock, or a combination of both makes TP the holder of a put option to sell its stock to CP for

³ TP cites Saviano v. Comm'r, 80 T.C. 955, 970 (1983), aff'd, 765 F.2d 643 (7th Cir. 1985); Old Harbor Native Corp. v. Comm'r, 104 T.C. 191, 201 (1995); and cases cited therein for the characteristics of options. See also the definition and cases cited in Halle v. Comm'r, 83 F.3d 649, 654 (4th Cir. 1996).

Sub1 stock because the Agreement requires CP to accept TP stock in exchange for Sub1 stock. However, the Agreement only requires CP to accept TP stock in exchange for Sub1 stock as one of three methods for TP to pay CP the exercise price of \$u upon the exercise of CP's put option. CP becomes obligated to transfer Sub1 stock to TP when CP exercises one of its puts, not when TP subsequently decides how to pay the exercise price of the put.

Moreover, the amendments that created CP's obligation to pay TP \$w were amendments with respect to CP's put rights, and not amendments to TP's call rights. Therefore, the \$w payments were not paid for any lapse or acquisition of TP's option to sell its stock, because under CP's put rights, TP did not have an option to sell its stock. Under CP's put rights, TP had an obligation to buy Sub 1 stock. TP's characterization of its right to pay \$u for Sub1 stock in TP stock as an option to sell TP stock is not supported by the Agreement. Thus, contrary to the position taken by TP's counsel, the \$w payments CP paid to TP for TP's agreement to pay \$u in only cash does not relate to an option on TP's stock.

CONCLUSION

We recommend rejecting the TP's application of the second sentence of section 1032(a) to the \$w payments received under the Amendment. Based on the facts submitted, we agree that your position, which asserts the \$w payments were a price reduction for Sub1 stock, is supportable.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-7550 if you have any further questions.