The final Regulations under Section 1032 use a deemed cash purchase model that eliminates much of the difficulty that stems from the Service’s long-standing position that a corporation has a zero basis in its own stock. Nevertheless, some problems remain, particularly if creative tax planners design compensation packages that use the stock of a sister corporation. Other problems may arise from the particularly difficult Proposed Regulations governing the determination of holding periods for partnership interests.

TD 8883, 5/11/00, contains guidance and a partial solution to the potential “zero basis” problem that arises in compensating partnership employees with stock of a corporate partner.¹ Reg. 1.1032-3 provides that no gain or loss is recognized on the immediate disposition of the issuing corporation’s stock or options by the acquiring entity (corporation or partnership) under a plan to acquire money or other property or services. The Regulation also authorizes the corporate partner to increase its tax basis in the partnership, necessary for the corporation to take full advantage of its allocable share of the partnership’s compensation deduction arising from the employee’s recognition of compensation income, even though the corporation recognizes no taxable gain arising from the use of its stock to compensate the employee. Finally, Reg. 1.1032-3 includes favorable treatment for the corporate parent of a corporate partner, with respect to actual cash payments made in connection with the corporate partner’s stock.
During the past two years, the Service also has applied other characterizations to certain compensatory transfers of stock to employees of a partnership in which the corporation is a partner, each having somewhat different tax consequences to the partnership and its partners. Rev. Rul. 99-57, 1999-51 IRB 678, dealt with an actual transfer of stock from the corporate partner to the partnership, and a subsequent delayed transfer by the partnership to its employees. There, the IRS applied an aggregate approach, whereby the corporate partner obtained nonrecognition of gain under Section 1032 with respect to its allocable share of gain under Sections 704(b) and 704(c) arising from the partnership’s transfer of the corporate stock to the employee, while increasing the transferor-corporation’s basis in its partnership interest, again enabling the corporation to make optimal use of its allocable share of the compensation deduction under Section 83(h). The Preamble to TD 8883 confirms that in certain situations where the Regulations do not technically apply to the disposition by a partnership of a corporate partner’s stock, the realized gain allocated to the corporate partner may nonetheless not be recognized pursuant to Rev. Rul. 99-57. This dual relief will facilitate use of corporate partner stock to “incentivize” such employees.

Nevertheless, certain transactions may not fall within the relief of either Reg. 1.1032-3 or Rev. Rul. 99-57. The Preamble declares obsolete an important pro-taxpayer position (based on Rev. Rul. 80-76, 1980-1 CB 15) that apparently covered certain affiliated corporation transfers, and as a result some traps remain in using an affiliated corporation’s stock to compensate partnership and LLC employees. Moreover, it is unclear to what extent the favorable analysis in Rev. Rul. 99-57 will be extended beyond its particular facts.

Thus, uncertainty remains as to the Service’s current position with respect to several permutations of equity-based compensation issued to a partnership’s employees. This article will identify the Service’s current position with respect to 14 variations of equity-based compensation and will highlight the planning opportunities and perils under several typical scenarios that use a corporate partner’s stock or options (or the stock or options of the corporate partner’s parent or other affiliates) to incentivize partnership employees.

BACKGROUND

Unlike partnerships, corporations have a great deal of flexibility in providing key employees with equity-based incentive compensation. Restricted and unrestricted stock plans and nonqualified stock options (NQSOs) allow the employees to earn an ownership stake while the employer obtains valuable tax deductions without recognizing gain on the transfer of its stock, all generally without an expenditure of cash by the employer or the employee.

While partnership employees also may be incentivized with additional ownership interests or options to acquire such interests in their partnerships, these interests are rarely publicly traded or liquid. Moreover, the tax treatment of receiving such partnership
interests or options remains uncertain. Accordingly, partnership employees may be better off (and happier) with NQSOs in, and publicly traded stock of, a corporate partner, whose value is materially affected by the operations of the partnership. The partnership or its partners can obtain valuable compensation deductions generated from such NQSOs and stock without incurring a cash expenditure. Nevertheless, there has been some uncertainty as to whether the tax consequences are less favorable (or, in some circumstances, actually burdensome) to the corporation and, in certain situations, to the other partners.

**Potential tax consequences.** Issues for the partnership’s employee, the corporation, and the other partners include:

- The timing and amount of income recognition by the employee.
- The employee’s ability to obtain capital gains treatment for the appreciation of the equity-based compensation.
- The potential recognition of gain by the corporation with respect to the stock or options used to compensate the partnership’s employees.
- The potential recognition of gain (or loss) by the other partners.
- The timing, amount, and allocation of the partnership’s compensation deduction.
- The partners’ bases in their partnership interests as a limitation on their ability to use their allocated compensation deduction.

Sections 61 and 83 govern the timing and amount of the employee’s income recognition, as well as the timing and amount of the employer-partnership’s compensation deduction. Under these provisions the rules for transfers of stock (restricted and unrestricted) and NQSOs in exchange for services are well defined. The employee’s ability to obtain favorable capital gains treatment is also straightforward—such treatment generally applies to the appreciation that accrues once the employee is treated as the owner of the stock under Section 83.

The answers to the issues involving the tax treatment of the employer-partnership and its partners are far less clear. Does the partnership recognize taxable gain when the corporate partner’s stock or stock options are transferred directly or indirectly to the employee? If gain is recognized, what is the transferor-partnership’s basis in the corporation’s stock, for purposes of determining gain or loss? Under Section 704, is the gain allocated solely to the corporate partner whose stock will be used to compensate the employee (or to fund the exercise of the employee’s NQSOs)? Can the corporate partner avoid recognition of its allocable share of that gain under Section 1032? If the corporation does not recognize the gain under Section 1032, is its basis in its partnership interest nonetheless increased under Section 705, so as to allow the corporation to use its allocable share of the partnership’s compensation deduction? Moreover, does it make a difference:

- Whether the corporate partner’s stock is transferred “directly” (from the corporation to the employee) or “indirectly” (from the corporation to the partnership and from the partnership to the employee)?
If the stock is transferred indirectly, whether the partnership transfers it immediately after its receipt, or instead holds the stock before transferring it to the employee?

If the stock is transferred indirectly, whether it is restricted (subject to a substantial risk of forfeiture) or unrestricted at the time of transfer?

If the stock is transferred indirectly, whether the partnership purchases the stock from the corporation or receives the stock gratis as a capital contribution by the corporate partner?

Whether the stock being transferred is the stock of the corporate partner or instead the corporate partner’s parent corporation (or another affiliated corporation)?

Whether the equity-based compensation consists of stock or instead NQSOs?

If the equity-based compensation consists of NQSOs, whether the order of the steps to be taken in the employee’s acquisition of the stock and payment of the option exercise price will affect the characterization (and consequences) of the transactions for tax purposes?

The 16 examples below illustrate the potential problems and opportunities of equity-based compensation for partnership employees, as well as the impact of Reg. 1.1032-3 and other recent IRS pronouncements.

THE ZERO BASIS PROBLEM

Much of the analysis turns on the different characterizations and consequences of dealing with the zero basis problem. The genesis of the problem was Rev. Rul. 74-503, 1974-2 CB 117, which involved the tax-free transfer of stock of a parent corporation (P) to P’s wholly owned subsidiary (S) pursuant to Section 351. The IRS took the position that P had a zero basis in its own stock and the carryover basis rules of Section 362(a) required S to take a zero basis in the P stock. On the subsequent disposition of the P stock—occurring not “immediately after” S’s receipt of P’s stock—S would recognize taxable gain under Section 1001 equal to the then-current value of the P stock, since S had a zero basis in the property. Although the Service’s zero basis approach was widely criticized, the validity of Rev. Rul. 74-503 has not yet been litigated.

Application of the zero basis approach to partnership compensation planning leads to certain assumptions about the tax consequences if a corporation (A Co.) that is a partner in a partnership (AB) were to transfer its stock directly to a partnership employee (X) in a transaction governed by Section 83. By analogy to Reg. 1.83-6(d), this transaction would be characterized as (1) A Co.’s capital contribution of its stock to AB, followed immediately thereafter by (2) a transfer of such stock by AB to X, for which a deduction may be allowed pursuant to Reg. 1.83-6(a).

If Rev. Rul. 74-503 applied to such a transaction, AB presumably would have a carryover basis of zero in the corporate stock pursuant to Section 723 (the partnership analogue to Section 362(a)), and AB presumably would recognize gain under the second (constructive) step of transferring such property to its employee (X) as payment for
services rendered. Since Section 1032 does not literally apply to transfers by a subsidiary (whether it is a subsidiary partnership or subsidiary corporation) of its parent’s stock, concern has existed that the subsidiary partnership would recognize taxable gain equal to the full value of the stock transferred to the employee. If so, at the partnership level the partnership’s compensation deduction (relating to the corporate partner’s stock transferred to the partnership’s employee) effectively would be offset by the short-term capital gain the partnership would recognize under Section 1001, equal to the difference between the value of the employee’s services (presumably equal to the assumed value of the corporation’s stock on the date of transfer) and the partnership’s basis in the corporate stock (presumably zero).

If gain is recognized by partnership AB under the zero basis approach, what are the consequences to the partners—A Co. and B? The answer may turn on whether the aggregate or entity approach applies. Partnership taxation is a mixture of provisions that treat the partnership as an aggregate of its members or as a separate entity. Under the former, each partner is treated as the owner of an undivided interest in partnership assets and operations. Under the latter, the partnership is treated as a separate entity in which the partners have no direct interest in partnership assets and operations.

If A Co. is deemed to have made a capital contribution of its stock to AB and if the entity approach applies to AB’s subsequent taxable sale or exchange of the A Co. stock, A Co. will be taxed on the full value of its stock, valued at the time of its transfer to X. When a partnership sells property that was contributed with a built-in gain, the portion of the taxable gain realized on the partnership’s sale that is attributable to the built-in gain is allocated to the contributing partner under Section 704(c). Thus, when AB is deemed to transfer A Co. stock to X immediately after its deemed receipt by AB, any gain that AB realized on the deemed stock transfer to X would be allocated to A Co., the contributing partner, under Section 704(c). If the entity theory of partnership taxation is mechanically applied, the partnership’s short-term capital gain would retain its status and characterization, and thus A Co. would recognize short-term capital gain. Subchapter K principles require the income to be characterized at the partnership (not partner) level, and under a pure entity theory the partner must report its allocable share (even if the partner would have recognized no income if the partner had realized the income directly).

Fortunately, the IRS has not mechanically applied the entity approach to cause the corporate partner to recognize gain on the partnership’s taxable sale or exchange of that corporate partner’s stock. Indeed, in dealing with compensatory transactions involving a corporation’s stock, during the past two years the IRS has at various times (and in various circumstances) applied (1) the aggregate approach (as reflected in Rev. Rul. 99-57); (2) the “zero basis/no gain recognition” approach (based on Rev. Rul. 80-76), and (3) the “deemed cash purchase” approach (as described in the Section 1032 Regulations). Unfortunately, these different approaches can have differing tax consequences in certain situations, which leads to some uncertainty for both planning and audit defense purposes.

The Aggregate Approach
In TAM 9822002, a corporate partner was treated as contributing its own stock to a partnership, which was treated as using the stock to acquire business assets. (The TAM did not involve a compensatory transfer by a partnership of its corporate partner’s stock.) TAM 9822002 rejected application of the entity theory and concluded that a partnership is properly treated as an aggregate of its partners for purposes of Section 1032. Therefore, the corporate partner was not required to recognize its distributive share of the partnership’s gain, if any, from the transfer of the corporation’s stock.

Rev. Rul. 99-57 provides relief to certain corporate partners whose own stock is indirectly transferred to an employee of the partnership at some subsequent date. The facts of Rev. Rul. 99-57 are straightforward: C Co., a C corporation, and D, an individual, form partnership CD as equal partners. C Co. contributes 100 shares of its own stock, valued at $100 with a basis of zero, to CD in exchange for its 50% partnership interest. D contributes real estate with a value and adjusted basis of $100 to CD, in exchange for D’s 50% partnership interest. One year later, after the value of the stock has increased to $120, CD transfers 50 shares of C stock to employee E in exchange for services valued at $60.

Rev. Rul. 99-57 concludes that the aggregate approach applies to CD’s realization of gain and C Co.’s nonrecognition of gain with respect to the compensatory transfer of the C stock by CD to E. The analysis is substantially the same as found in TAM 9822002: neither C Co. nor CD recognizes gain on C Co.’s capital contribution of its stock to CD under Section 721(a). CD’s basis in the C stock is zero under Section 723, and C Co.’s basis in its partnership interest in CD is zero under Section 722. When CD subsequently pays E for services with C stock, CD realizes gain measured by the difference between the basis of the C stock (zero) and the value of the services received ($60). CD allocates $50 of this gain to C Co. under Section 704(c), and the remaining $10 pursuant to the CD partnership agreement, i.e., $5 each to C Co. and D.

The Ruling states that if C Co.’s share of the gain from the use of its stock in these transactions was not subject to Section 1032, C could recognize $55 of gain. Section 1032, however, is intended to prevent a corporation from recognizing gain or loss when dealing in its own stock. The Ruling further states that under Sections 704(b) and (c), a corporate partner contributing its own stock generally will be allocated an amount of gain attributable to its stock that corresponds to the economic interest in the stock held by the partnership. Accordingly, use of the aggregate theory of partnerships is appropriate in determining the application of Section 1032 with respect to gain allocated to a corporate partner. Under Section 1032, C Co.’s share of the gain (under Sections 704(c) and (b)) resulting from CD’s transfer of C stock to E will not be subject to income tax.

An important aspect of Rev. Rul. 99-57 is the Service’s confirmation that C Co. increases its basis in its partnership interest in CD under Section 705 by $55. This equals C Co.’s share of the gain resulting from CD’s transfer of the stock to E, thereby
preserving the nonrecognition result of the transaction in accordance with the policy underlying Section 1032.\textsuperscript{11}

Rev. Rul. 99-57 thus provides certain corporate partners with the best of both worlds—nonrecognition of gain on the stock contribution to the partnership and the transfer by the partnership of the corporation’s stock to the partnership employee, along with an increase in basis in the transferor-corporation’s partnership interest, enabling the corporation to make optimal use of its allocable share of the compensation deduction under Section 83(h). The scope of Rev. Rul. 99-57 may be limited, however, to compensatory transfers to partnership employees involving all four of the following factors:

- Indirect transfers of stock, i.e., physically going first to the partnership and from the partnership to the employee.
- Transfers of stock via capital contribution (not sale) from the corporate partner to the partnership.
- Transfers involving the corporate partner’s own stock (\textit{not} stock of the partner’s parent or other affiliated corporations).
- Transfers by the partnership \textit{not} occurring immediately after the partnership’s receipt of the corporate partner’s stock.

Returning to our compensatory transfer example, application of the aggregate approach would result in (1) AB’s realizing gain on the transfer of A Co.’s stock to X, (2) an allocation of all or a portion of such gain to A Co. as mandated by Sections 704(c) and (b), and (3) A Co.’s recognizing no gain by reason of Section 1032. AB and its partners presumably still would obtain the full compensation deduction under Sections 83(h) and 162.\textsuperscript{12}

\textbf{The Zero Basis/No Partnership Gain Recognition Approach}

Even if we assume AB has a zero basis in the A Co. stock, no gain may be recognized at the partnership level (and therefore none of AB’s partners would recognize gain) because Section 83 arguably applies to the transfer. The underlying premise is that the transfer by A Co. of its stock to X is a capital contribution of the A Co. stock to AB under Section 721(a), followed immediately thereafter by AB’s transfer of the A Co. stock to X.\textsuperscript{13}

The conclusion that the partnership itself would recognize no gain on any zero basis stock transferred \textit{directly} by the corporate partner to the partnership’s employee is supported by Rev. Rul. 80-76. In that Ruling, an individual owning stock in corporation P transferred such stock directly to an employee of corporation S, which was controlled by P within the meaning of Section 368(c). The IRS concluded that “because Section 83 applies to the transfer” S does not recognize gain or loss on the transfer of the P stock, but S \textit{is} allowed the Section 83(h) deduction.\textsuperscript{14}
Ltr. Rul. 9822012 was the first ruling to extend the application of certain of the holdings in Rev. Rul. 80-76 to transfers of a corporate partner’s stock to an employee of a partnership. There, corporation C was a general partner in partnership PS, and all shareholders of C were employees of PS. Under C’s NQSO plan, for a ten-year period beginning in 1998 selected employees of PS would be offered nontransferable NQSOs to acquire stock in C. The objective was to retain key employees of PS by offering them an equity stake in C, whose value was directly tied to PS’s performance.

None of the Service’s six specific rulings in Ltr. Rul. 9822012 relating to the NQSO plan explicitly held that PS did not recognize gain or loss on the transfer of the stock from C to the partnership’s employees on exercise of their options. Indeed, the IRS had never ruled in the partnership context as to whether the deemed capital contribution approach of Reg. 1.83-6(d)(1) applies; that Regulation is limited to the transfer of stock by a shareholder of a parent corporation to an employee of that corporation. No published or private ruling had extended relief from the zero basis problem for such equity-based transfers to employees of a partnership.

The letter ruling hinted that PS should not recognize gain; it discussed Rev. Rul. 80-76 and specifically referred to its holdings that (1) “because Section 83 applies,” S (the corporate employer) did not recognize gain or loss on the transfer of the P stock, and (2) S was allowed the Section 83(h) compensation deduction. If Ltr. Rul. 9822012 were read to mean that Rev. Rul. 80-76 applied by analogy and that PS recognized no gain (because Section 83 applied to the transfer), then the Service effectively would be applying the Rev. Rul. 80-76 approach to compensatory transfers of partner stock to partnership employees.

Unfortunately, the zero basis problem—i.e., whether a partnership (like a controlled corporate subsidiary) also avoids recognition of gain or loss on the direct transfer of a corporate partner’s stock to the partnership’s employee—is not resolved by Ltr. Rul. 9822012: No ruling was issued on the topic and the IRS attached the standard caveat that except as specifically provided therein, no opinion was expressed or implied concerning the tax consequences of any other aspect of any transaction or item discussed or referred to in the letter ruling. Ltr. Rul. 9822012 also does not discuss the effect of the stock transfer on the corporate partner’s basis in its partnership interest.

The Service dealt with the partnership zero basis issue for the first time in Ltr. Rul. 9853038. Company C was the parent of company A, which owned a 62% interest in a partnership. Company B owned the remaining 38% partnership interest. Certain employees of A and B and their own corporate subsidiaries were (or would be) transferred to the partnership, and become partnership employees. Those employees who previously were awarded NQSOs retained (or would retain) the NQSOs granted to them under their respective predecessor corporate employers’ stock incentive plans. Additional NQSOs would be granted by B and C to partnership employees in the future.
In Ltr. Rul. 9853038, the IRS cited Rev. Rul. 80-76 and specifically referred to its holdings that (1) “because Section 83 applies,” S (the corporate employer) did not recognize gain or loss on the transfer of the P stock, and (2) S was allowed the Section 83(h) compensation deduction. More important, Ltr. Rul. 9853038 became the first IRS pronouncement to explicitly hold that no gain or loss was recognized by the partnership as the result of the transfer of B or C stock to partnership employees on the exercise of an NQSO. In addition, Ltr. Rul. 9853038 held that a deduction will be allowable under Section 83(h) arising from the transfer of B or C stock to a partnership employee on the exercise of the NQSO, and allowed to the entity that employed the optionee when the NQSO was granted. Thus, for former B or C employees who received NQSOs prior to being transferred to the partnership, the deduction would belong to the former corporate employer. For employees who received their NQSOs after being employed by the partnership, the latter would obtain the Section 83(h) deduction on the exercise of the options.

Not clarified by Ltr. Rul. 9853038 is the effect of the transfer of stock on a corporate partner’s basis in its partnership interest. Section 722 provides that when a partner contributes property to the partnership, the basis of the partner’s interest in the partnership is increased by the adjusted basis of the contributed property. If the corporate transferor has a zero basis in its stock, its basis in its partnership interest does not change (essentially is increased by zero) under this section. The partnership would be able to deduct the compensation element of the stock transfer under Section 83(h), and the deduction presumably would be allocated to the partner or partners bearing the economic risk of such loss. Assuming that the corporate transferor was the sole party to bear the economic risk of loss (e.g., there were no matching capital contributions by the other partners), then presumably the full amount of the loss would be allocable under Section 704(b) to the contributing corporation.

The allocation of the compensation deduction therefore would reduce the transferor corporation’s tax basis in the partnership, pursuant to Section 705; the corporation would obtain no corresponding increase in its tax basis, however, because the partnership has not recognized taxable gain (and, as noted, the deemed capital contribution of the zero basis stock by the corporation to the partnership does not increase its basis, either). As a net result, the corporate transferor would have its outside basis in the partnership interest reduced by the amount of the deduction, and on a subsequent sale of its partnership interest the corporation would recognize taxable gain in such amount.17 Where the transferor corporation’s allocable share of the compensation deduction exceeded the corporation’s basis in its partnership interest, the deduction presumably would be disallowed until the corporation ultimately obtained basis in its partnership interest.18

In the Preamble to REG-106221-98, 9/22/98 (Prop. Regs. 1.83-6(d) and 1.1032-3), the IRS and Treasury indicated Rev. Rul. 80-76 would be rendered obsolete when the Regulations were finalized. The final Regulations declare this to be so,19 and thus neither that Ruling nor Ltr. Ruls. 9822012 and 9853038 appear to retain any vitality. Therefore,
the “zero basis/no partnership gain recognition” approach appears to be a dead letter, from the Service’s viewpoint.

The Deemed Cash Purchase Approach

The tax consequences of a transfer of a corporate partner’s stock directly to a partnership employee also may be analyzed by deeming the partnership to have a cost basis in the corporate partner’s stock equal to its FMV on the date of transfer. As a result, on AB’s deemed transfer of A Co. stock to X, AB would recognize zero gain at the partnership level, and A Co. would recognize zero gain as well.

In the Section 83/1032 Proposed Regulations, the IRS and Treasury applied this deemed cash purchase rationale with respect to certain transfers of a corporation’s stock and stock options received by a subsidiary corporation’s employee, and in Prop. Reg. 1.1032-3(b) stated that “no gain or loss is recognized.” It was unclear under the Proposed Regulations whether the IRS would apply the deemed cash purchase approach with respect to stock of a corporate partner (or a partner’s parent corporation) transferred to a partnership’s employees or service partners, if the other requirements of Prop. Reg. 1.1032-3 were met.

THE FINAL 1032 REGS.

In Reg. 1.1032-3, the IRS extended its deemed cash purchase approach to partnerships. At the public hearing on Prop. Reg. 1.1032-3 held on 1/7/99, the sole witness testifying recommended that the Regulations be expanded to explicitly apply to transfers of stock to a partnership in which the issuing corporation or a subsidiary of the issuing corporation is a partner. Failure to do so allegedly would disadvantage the partnership form of doing business by denying favorable tax treatment for a common compensation arrangement used by corporations and their subsidiaries’ employees. In response, IRS and Treasury officials pointed out that TAM 9822002 seemed to provide even broader relief than that in Prop. Reg. 1.1032-3, insofar as the Proposed Regulation is limited to zero basis situations involving immediate transfers, whereas the TAM’s aggregate approach is not so limited (as discussed above).

The final Section 1032 Regulations extend the deemed cash purchase approach to partnerships in two important respects—transfers to partnerships, and combinations of transfers.

**Transfers to partnerships.** Under Reg. 1.1032-3(a), an acquiring partnership’s disposition of the stock of the issuing corporation is treated in the same manner as an acquiring corporation’s disposition of stock, thereby creating a cost (equals FMV) basis for the partnership (rather than a zero basis) in the corporate stock pursuant to Section 1012.

**Combinations of transfers.** The Regulations now apply to transactions in which the stock of the issuing corporation is obtained indirectly by the acquiring entity in any
combination of exchanges under Sections 721 (i.e., capital contributions of stock to a partnership) and 351 (transfers to controlled corporations).\textsuperscript{23}

This is illustrated by Reg. 1.1032-3(e), Example 3, as follows: X, a corporation, owns all of the stock of Y corporation. Y is a partner in partnership Z. Z reaches an agreement with C, an individual, to acquire a truck from C in exchange for ten shares of X stock with an FMV of $100. To effectuate Z’s agreement with C, X transfers to Y the X stock in a transaction in which, but for Reg. 1.1032-3, the basis of the X stock in the hands of Y would be determined with respect to X’s basis in the X stock under Section 362(a). Y immediately transfers the X stock to Z in a transaction in which, but for Reg. 1.1032-3, Z’s basis of the X stock would be determined under Section 723. Z immediately transfers the X stock to C to acquire the truck.

In this example, no gain or loss is recognized on the disposition of the X stock by Z. Immediately before Z’s disposition of the X stock, Z is treated as purchasing the X stock from X for $100 of cash indirectly contributed to Z by X through an intermediate corporation, Y. Because Z is deemed to have made a cash purchase of the X stock for $100, Z is deemed to have a $100 basis in the X stock, rather than zero.\textsuperscript{24} Thus, rather than recognize $100 of gain (as would follow if Z had a zero basis in the X stock), Z recognizes zero gain (the example actually says “no gain or loss is recognized” by Z) on receiving a truck with a value of $100.

**Additional Guidance**

The final Regulations also provide guidance on several matters involving the cash purchase approach as they apply to both corporations and partnerships.

**Immediate transfer.** The requirement of an “immediate transfer” to the service provider was the subject of comments on the Proposed Regulations. The final Regulations apply only if, pursuant to a plan to acquire money, other property, or services, all four of the following conditions (“the four requirements”) are met:

1. The acquiring entity acquires stock of the issuing corporation directly or indirectly from the issuing corporation in a transaction in which, but for Reg. 1.1032-3, the basis of the stock of the issuing corporation in the hands of the acquiring entity would be determined, in whole or in part, with respect to the issuing corporation’s basis in its own stock under Section 362(a) or Section 723; provided, however, that in the case of an indirect acquisition by the acquiring entity, the transfers of issuing corporation stock through intermediate entities occur immediately after one another.\textsuperscript{25}

2. The acquiring entity immediately transfers the stock of the issuing corporation to acquire money or other property (from a person other than an entity from which the stock was directly or indirectly acquired).
3. The party receiving stock of the issuing corporation in the exchange specified in paragraph 2 from the acquiring entity does not receive a substituted basis in the stock of the issuing corporation within the meaning of Section 7701(a)(42).

4. The issuing corporation stock is not exchanged for stock of the issuing corporation.

Several commentators on the Proposed Regulations requested that “immediately” be explicitly defined; some suggested that the requirement be replaced with a transactional approach, requiring only that the stock be disposed of “pursuant to a plan of acquisition.” The IRS concluded that the immediacy requirement should not be waived or construed to permit the acquiring entity to hold issuing corporation stock for a period of time during which the value of the stock could fluctuate. The Preamble to TD 8883 indicates that where the acquiring entity’s ownership of the issuing corporation stock is “more than transitory,” the deemed cash purchase model should not be allowed, and presumably the dreaded zero basis result would occur. Thus, the final Regulations retain the immediacy requirement without further exception.

Compensatory stock options. Commentators also asked how Prop. Reg. 1.1032-3 would apply to a compensatory stock option without a readily ascertainable FMV. Pursuant to Section 83(e)(3) and Reg. 1.83-7(a), the grant of such option is effectively treated as an open transaction. Prop. Reg. 1.1032-3(d) provided that the rules of Prop. Reg. 1.1032-3 apply to an option issued by a corporation to buy or sell its own stock in the same manner as the Proposed Regulation applied to the stock of an issuing corporation. Commentators were concerned whether Prop. Reg. 1.1032-3 would apply to such options.

In response, the final Regulations add an example to confirm that Reg. 1.1032-3 does not apply to such options. Rather, when the option is exercised, Sections 83(a) and (b) apply to the transfer of stock pursuant to the exercise. If all of the requirements of Reg. 1.1032-3 are met, those Regulations apply to determine the treatment accorded the issuing corporation and the acquiring entity on transfer of the issuing corporation stock to the employee.26

Increase in basis of acquiring entity. Prop. Reg. 1.1032-3 did not explicitly deal with the basis adjustments that logically should follow when a deemed capital contribution occurs. Reg. 1.1032-3(b)(1) states that Sections 358 and 722 and the Regulations thereunder may apply in determining the issuing corporation’s adjustment to basis in the acquiring entity (or, if necessary, in determining the adjustment to basis in intermediate entities).

Actual payment for issuing corporation stock. Under this model, the acquiring entity is deemed to have purchased the issuing corporation stock from the issuing corporation for FMV with cash contributed to the acquiring entity by the issuing corporation. Commentators requested clarification of the tax consequences where the
acquiring entity or another party makes an actual payment to the issuing corporation for issuing corporation stock, expressing concern as to whether any or all of the amounts actually paid to the issuing corporation would be treated as a distribution by the acquiring entity to the issuing corporation.

The Preamble to TD 8883 supplies the following example: Assume that the issuing corporation, which owns all the stock of the acquiring corporation, transfers an option for issuing corporation stock to an employee of the acquiring corporation. When one share of issuing corporation stock has an FMV of $100, that employee exercises the option to acquire one share and pays a strike price of $80 to the issuing corporation. The acquiring corporation pays some or all of the “spread” of $20 to the issuing corporation. The Preamble states that an actual payment to the issuing corporation for its stock should not be taxed as a distribution with respect to acquiring corporation stock.

Accordingly, Reg. 1.1032-3(b)(2) provides that the cash deemed contributed by the issuing corporation to the acquiring entity in the cash purchase model is the difference between the FMV of the issuing corporation stock and the FMV of the money or other property received by the issuing corporation as payment from the employee or the acquiring entity.27 As discussed further below, this clarification is important to corporate partners that transfer bargain stock or stock options to employees of their partnerships.

INCENTIVE COMPENSATION TECHNIQUES

The impact of Reg. 1.1032-3 on various types of compensation strategies will be explored below in 14 examples. These examples are summarized in Exhibit 1 on pages 96-97.

Corporate Partner’s Stock Transferred to Partnership

Using the stock of a corporate partner or member is the most direct approach to incentivizing employees of a partnership or LLC. Several permutations raise the zero basis issue. The first example involves an immediate “indirect” transfer of a corporate partner’s own stock (i.e., transferred first via a capital contribution by the corporation to the partnership, and immediately thereafter to the employee).

EXAMPLE 1: X is an employee of partnership (or LLC) AB, an accrual-method, calendar-year entity whose equal partners (or members) are A Co. and B. A Co. and B currently have a zero basis in their respective partnership interests in AB. AB does not currently have surplus cash. X wishes to receive $100,000 of additional compensation on an after-tax basis, in the form of 1,000 shares of A Co. stock (currently worth $100 per share). X is in the top federal and state marginal tax brackets, and must receive $200,000 of compensation on a pre-tax basis to net $100,000 after tax. Therefore, if AB is to pay X $200,000, A Co. and B must each ante up $100,000. Thus, on 8/1/00 A Co. transfers A Co. stock worth $100,000 and B transfers $100,000 cash to AB. AB immediately transfers the cash and the A Co. stock to X when the stock’s value is still $100,000. (For
all variations of this fact pattern, below, assume that X’s handshake deal with AB calls for 1,000 shares of stock plus $100,000 in cash, regardless of the value of the stock when payment is made.)

Pursuant to Section 83(a), X will recognize compensation income equal to the FMV of the A Co. stock (i.e., $100,000) on his receipt of the stock on 8/1/00, plus the $100,000 cash. AB will be entitled to a corresponding $100,000 deduction pursuant to Section 83(h), plus the $100,000 cash payment.

Will gain be realized by AB on 8/1/00 when it transfers the A Co. stock to X, and will A Co. be liable for taxes on such gain? Under Reg. 1.83-6(d), but for Reg. 1.1032-3, the transfer of A Co. stock by A Co. to AB would be treated as a contribution of the A Co. stock by A Co. to the capital of AB, and immediately thereafter a transfer of the A Co. stock by AB to X. But for Reg. 1.1032-3, the basis of the A Co. stock in the hands of AB would be determined under Section 723, and presumably would be a zero basis pursuant to Rev. Rul. 74-503.

Under the deemed cash purchase approach, AB would clearly obtain a cost basis in the A Co. stock under Section 1012 (and thus AB will not recognize gain or loss on its transfer of the stock to X, because AB would be deemed to have a basis equal to the FMV of the stock). The four requirements of Reg. 1.1032-3(c) are met here. Therefore, under Reg. 1.1032-3(b)(1) no gain or loss is recognized on the disposition of the A Co. stock by AB. Immediately before AB’s disposition of the A Co. stock, AB is treated as purchasing the A Co. stock from A Co. for $100,000 of cash deemed contributed to AB by A Co. Under Section 722, A Co.’s basis in its AB partnership interest is increased by $100,000.

This result under the deemed cash purchase approach is substantially the same as would occur under Rev. Rul. 99-57, i.e., no gain recognized by A Co., and a basis step-up for its interest in AB. Certain potential differences as to the tangential tax consequences of applying the aggregate approach of Rev. Rul. 99-57 and the deemed cash purchase approach remain. The Preamble to TD 8883 indicates that the overlap of the two approaches is governed by the deemed cash purchase approach.

Corporate Partner’s Stock Transferred Directly to Employee

Instead of the indirect transfer of the corporate partner’s stock (i.e., first to the partnership and then to the partnership’s employee) illustrated above, what are the tax consequences if the corporate partner directly transfers the stock to the partnership’s employee?

Example 2: The facts are the same as in Example 1, except A Co. transfers its stock directly to X on 8/1/00.
X again will recognize compensation of $200,000 (the $100,000 FMV of the A Co. stock under Section 83(a), plus the $100,000 cash) on 8/1/00. AB will be entitled to a corresponding $200,000 compensation deduction at such time, even though AB itself does not actually make any payment or transfer of the stock to X. The deduction will be allocated equally ($100,000) to A Co. and B.

Will gain be realized by AB on 8/1/00 with respect to the stock transfer, and if so, will A Co. be liable for taxes on such gain? Under Reg. 1.83-6(d), but for Reg. 1.1032-3, the transfer of A Co. stock by A Co. to X would be treated as a contribution of the A Co. stock by A Co. to the capital of AB, and immediately thereafter, a transfer of the A Co. stock by AB to X. The basis of the A Co. stock in the hands of AB would be determined with respect to A Co.’s basis in the A Co. stock under Section 362(a) (presumably zero). But the four requirements of Reg. 1.1032-3 again would be met here, even though the issuing corporation (A Co.) is actually transferring its stock directly to X, in exchange for services. Therefore, pursuant to Reg. 1.1032-3, no gain or loss is recognized on the deemed disposition of the A Co. stock by AB. Immediately before AB’s deemed disposition of the A Co. stock, AB is treated as purchasing the A Co. stock from A Co. for $100,000 of cash contributed to AB by A Co. Under Section 723, AB’s basis in its A Co. stock is increased by $100,000. Similarly, A Co. will obtain a step-up in basis (for its deemed contribution of cash to AB) in its AB partnership interest under Section 722.

Corporate Partner’s Stock Transferred by Shareholder Directly to Employee

What are the tax consequences if a shareholder of the corporate partner transfers stock of the corporate partner to the partnership’s employee?

EXAMPLE 3: The facts are the same as in Example 2, except that SH, the majority shareholder of A Co., transfers 1,000 shares of A Co. stock with an FMV of $100 per share (and having a basis to SH of $10 per share) directly to X on 8/1/00.

X again will recognize compensation of $200,000 (the $100,000 FMV of the A Co. stock under Section 83(a), plus the $100,000 of cash) on 8/1/00. AB will be entitled to a corresponding compensation deduction at that time under Sections 83(h) and 162.

Will gain be realized by AB on 8/1/00 with respect to the stock transfer, and if so, will A Co. be liable for taxes on such gain? The transfer meets the four requirements of Reg. 1.1032-3(c). SH will be treated as making a nondeductible contribution of the 1,000 A Co. shares to the capital of A Co., and she will not recognize gain or loss as a result of this transfer. SH must allocate her $10,000 basis (1,000 shares at $10 per share) in the transferred shares to her remaining shares of A Co. stock.
AB recognizes no gain or loss on the deemed disposition of the A Co. stock by AB.\textsuperscript{34} Immediately before AB’s disposition of the A Co. stock, AB is treated as purchasing the A Co. stock from A Co. for $100,000 of cash contributed by A Co. to AB.\textsuperscript{35} Under Section 722, A Co.’s basis in its AB partnership interest is increased by $100,000.\textsuperscript{36}

**Delayed Transfer**

The two preceding examples involve direct and indirect transfers of a corporate partner’s own stock immediately to the employee. What are the consequences if instead there is a delayed “indirect” transfer of the corporate partner’s stock (i.e., transferred first via a capital contribution to the partnership, and some time later to the employee), with the stock appreciating in value while held by the partnership?

**EXAMPLE 4:** The facts are the same as in Example 1, except that before X renders his services to AB, it is agreed that AB will not transfer the 1,000 shares of A Co. stock to X until 8/1/01. (AB will retain any dividends paid by A Co. during the interim; such dividends will not be subsequently turned over to X.\textsuperscript{37}) The stock is not subject to a substantial risk of forfeiture. When AB actually transfers the 1,000 A Co. shares (and cash) to X on 8/1/01, the value of those shares has increased to $130,000.

X, a cash-method taxpayer, does not recognize taxable income on entering into the agreement or rendering the services. Pursuant to Section 83(a), X will recognize $130,000 of compensation income (the FMV of the A Co. stock) on his receipt of the stock on 8/1/01, plus the $100,000 cash. Pursuant to Section 83(h), AB will be entitled to a corresponding $230,000 compensation deduction in accordance with AB’s normal method of accounting, in conformity with Sections 446 and 461.

Will gain be recognized by AB on 8/1/01 when it transfers the A Co. stock to X, and if so, how is the gain allocated between AB’s partners? The deemed cash purchase model of Reg. 1.1032-3 would not apply in Example 4 because the A Co. stock was not immediately transferred by the partnership to the employee. Thus, AB will realize $130,000 of gain.

Fortunately, the Service most likely will apply the aggregate approach as used in Rev. Rul. 99-57 to effectively eliminate A Co.’s share of the gain. Pursuant to that Ruling, A Co. will recognize gain of $115,000 on the transfer of the A Co. stock to X, i.e., $100,000 pursuant to Section 704(c) (the pre-contribution or “built-in” gain as of 8/1/00) plus $15,000 pursuant to Section 704(b) (50% of the $30,000 post-contribution appreciation in the A Co. stock). B will recognize the remaining $15,000 of Section 704(b) gain. Application of the aggregate approach in Example 4 results in A Co. recognizing no portion of its allocable share of the gain by reason of Section 1032.

Also under Section 704(b), A Co. and B each would be allocated $115,000 (i.e., 50%) of AB’s $230,000 compensation deduction ($130,000 under Section 83(a) plus the
$100,000 cash compensation paid to X). Will A Co. have sufficient tax basis to use its allocable share of the compensation deduction? Under Rev. Rul. 99-57, A Co. would increase its basis in its partnership interest in AB under Section 705 by $115,000, A Co.’s share of the gain resulting from AB’s transfer of the stock to X (even though A Co. recognizes no gain under Section 1032). In that event, A Co. will have sufficient tax basis to use its share of the compensation deduction.

Does Rev. Rul. 99-57 apply here? It clearly should. Example 4 is factually similar to the Ruling, except that AB is an existing partnership and A Co. is not contributing its stock to AB as its initial capital contribution in exchange for A Co.’s partnership interest in AB. This distinction makes no difference; in all relevant regards, Example 4 conforms with the specific fact situation in Rev. Rul. 99-57, i.e., (1) A Co. physically transfers its stock to the partnership, which then transfers the stock to the employee, (2) A Co. transfers its stock via a capital contribution (not a sale) to the partnership, (3) the transfer in question is of A Co.’s own stock (not that of A Co.’s parent or affiliated corporation), and (4) the partnership’s transfer of the A Co. stock to its employee does not occur immediately after the partnership’s receipt of such stock.

While application of Rev. Rul. 99-57’s aggregate approach provides A Co. with the optimum tax result, the same cannot be said for B. The IRS likely would rule that B recognizes short-term capital gain of $15,000 in Example 4 (i.e., B’s share of the post-contribution appreciation) under Section 704(b).

There are some tangential differences between the nonrecognition of gain by AB under the deemed cash purchase approach of Reg. 1.1032-3 and the aggregate approach of Rev. Rul. 99-57. It appears that AB recognizes gross income under the aggregate approach, whereas no gross income is recognized at the partnership level under the deemed cost purchase approach. For purposes of whether the six-year assessment period governs by reason of a corporate partner’s omission of more than 25% of the gross income stated in the corporation’s return pursuant to Section 6501(e), the corporation’s gross income includes its distributive share of the gross income of the partnership. Gross income is also relevant for purposes of several other Code sections.

**Actual Cash Purchase/Decrease in Value**

The above analysis deals with stock that appreciates in value while in the hands of the partnership. What are the consequences if instead the partnership’s basis in the corporate partner’s stock exceeds the value of the stock on the date the stock is transferred to the partnership’s employee?

**Example 5:** The facts are the same as in Example 4, except that (1) A Co. contributes $100,000 cash (rather than its stock) to AB, (2) on 8/1/00 AB uses that cash to purchase A stock on the open market for $100,000, and (3) on 8/1/01, the A stock is worth $70,000 when transferred by AB to X.
Pursuant to Section 83(a), X will recognize $70,000 of compensation income (the FMV of the A Co. stock) on his receipt of the shares on 8/1/01, plus the $100,000 cash. AB will be entitled to a corresponding $70,000 compensation deduction with respect to the stock transfer pursuant to Section 83(h), plus the $100,000 cash payment to X. The $170,000 deduction will be allocated between A Co. and B equally under Section 704(b).

Will AB recognize a $30,000 loss on 8/1/01 when it transfers the A Co. stock to X, and if so, how is it allocated between AB’s partners? AB will realize the loss on the date of the transfer, because its $100,000 basis in the A Co. stock exceeds the stock’s value ($70,000) on that date. The loss will be allocated equally (i.e., $15,000 each) between A Co. and B under Section 704(b).

The deemed cash purchase model of Reg. 1.1032-3, which otherwise might give AB a $100,000 cost basis in the A Co. stock—and thereby permit a loss to be recognized—will not apply because (as in Example 4) the A Co. stock is not immediately transferred to X.

Will Rev. Rul. 99-57’s aggregate approach apply, and if so, with what result? If aggregate treatment does not apply in Example 5, AB selectively could recognize losses and not gains on the A Co. stock and pass through the benefit of A Co.’s share of those losses to A Co., thus circumventing the principles of Section 1032.

It is highly likely that the IRS will apply the aggregate approach used in Rev. Rul. 99-57 to disallow A Co.’s recognition of its $15,000 loss. Although Example 5 is factually distinguishable from Rev. Rul. 99-57 in that the stock in the Ruling is acquired by capital contribution (not by purchase from a third party), the Ruling explicitly states that a similar aggregate approach analysis would apply to a transaction in which a corporate partner is allocated a loss from a transaction involving the disposition of the corporate partner’s stock held by the partnership.

Would A Co.’s basis in its partnership interest in AB be reduced by the nonrecognized $15,000 loss? That result should follow (presumably) under Section 705 in accordance with the analysis in Rev. Rul. 99-57. This would preserve the nonrecognition result of the transaction in line with the policy of Section 1032 (just as A Co.’s basis was increased in Example 4 under Section 705 for A’s share of the gain not recognized under Section 1032).

Corporate Partner’s Restricted Stock

Employers often issue to their employees restricted or nonvested stock, i.e., stock subject to a substantial risk of forfeiture. What are the tax consequences if the partnership employee is not immediately vested in the corporate partner’s stock received in return for services to be rendered to the partnership? Does the analysis differ if, in the event of forfeiture, the stock reverts to the corporation or instead reverts to the partnership?
**EXAMPLE 6:** The facts are the same as in Example 4, except the A Co. shares are transferred by AB to X on 8/1/00 subject to substantial risk of forfeiture until 8/1/01. A Co. retains the reversionary interest in the A Co. stock in the event that X forfeits his right to the stock. X does not make a Section 83(b) election to recognize income immediately. He remains employed by AB on 8/1/01, when the A Co. shares vest. On that date, when the shares are worth $120,000, the $100,000 cash compensation is paid by AB to X.

Pursuant to Section 83, the transaction should be characterized as a deemed transfer by A Co. of its stock to AB on 8/1/01, when the stock vests, and (immediately thereafter) a deemed transfer by AB of the A Co. stock to X on that date, rather than the date the restricted stock was actually transferred (i.e., 8/1/00). Under that characterization, neither A Co. nor AB will recognize gain or loss on the deemed transfer on 8/1/01 of A Co.’s stock to AB, pursuant to Section 721. By operation of Section 83, X will recognize $120,000 of ordinary compensation on 8/1/01 with respect to the A Co. stock he has received, when he becomes vested in those shares, plus the $100,000 cash payment. Pursuant to Section 83(h), AB will obtain a corresponding compensation deduction on its 2001 Form 1065 for $120,000, plus the $100,000 cash payment. Depending on the economic arrangement between partners A Co. and B, the $220,000 compensation deduction will be allocated either $120,000 to A Co. and $100,000 to B, or $110,000 each to A Co. and B.

The key issues are (1) whether AB recognizes gain or loss on its deemed transfer of the A Co. stock to X, (2) if so, how is the gain allocated between the partners, (3) whether A Co. avoids recognition of its allocable share of the gain, and (4) whether A Co. obtains a basis step-up in its partnership interest, regardless of whether A Co. recognizes gain.

But for Reg. 1.1032-3, the basis of the A Co. stock in the hands of AB would be determined with respect to A Co.’s basis in the A Co. stock under Section 362(a), i.e., presumably a zero basis. Reg. 1.1032-3 will apply, however, even though the vesting does not occur until one year after the transfer of the restricted stock. In Example 6, immediately before AB’s disposition of the A Co. stock, AB is treated as purchasing A Co.’s stock from A Co. for $120,000 (the FMV of the shares at the time the stock vests) with cash contributed to AB by A Co. Therefore, AB will recognize no gain or loss (since its $120,000 basis in the A Co. stock equals the value of X’s services, for purposes of Section 1001) at the vesting date. Moreover, under Section 722, A Co.’s basis in its AB partnership interest is increased by $120,000.

The same result should follow if A Co. issued the restricted stock directly to X, rather than first transferring the shares to AB (which then would transfer the shares to X).

**Partnership has reversionary interest.** Are the tax consequences different if the corporate partner does not retain the reversionary interest in its restricted stock?
EXAMPLE 7: The facts are the same as in Example 6, except AB (rather than A Co.) will receive the reversionary interest in the A Co. stock in the event X forfeits the right to the stock. On 8/1/01, the stock vests.

As in Example 6, the transaction should be characterized under Section 83 as a deemed transfer by A Co. of its stock to AB on 8/1/01, when the stock vests, and immediately thereafter a deemed transfer by AB of the A Co. stock to X on that date. Under that characterization, neither A Co. nor AB would recognize gain or loss on the first leg of the transaction, i.e., the deemed transfer of A Co.’s stock to AB, pursuant to Section 721. By operation of Section 83, X will recognize $120,000 of ordinary compensation when the A Co. shares vest on 8/1/01, plus the $100,000 cash payment. AB again will obtain a corresponding deduction on its 2001 Form 1065 for $120,000, pursuant to Section 83(h), plus the $100,000 cash payment.

The key issues again are (1) whether AB recognizes gain or loss on its deemed transfer of the A Co. stock to X, (2) if so, how is the gain allocated between the partners, (3) whether A Co. avoids recognition of its allocable share of the gain, and (4) whether A Co. obtains a basis step-up in its partnership interest, regardless of whether A Co. recognizes gain.

Unlike Example 6, the deemed cash purchase model of Reg. 1.1032-3 will not apply to AB’s deemed disposition of the A Co. shares in Example 7. The Regulation states (without explanation) that AB is not deemed to have transferred the A Co. stock to X immediately after receiving the stock from A Co. According to the Service, the tax consequences to AB on the deemed disposition of the A Co. stock are governed by Reg. 1.83-6(b). Presumably AB would realize gain equal to the value of the A Co. stock ($120,000) at the time the stock vests, pursuant to Reg. 1.83-6(b).

How would this gain be allocated between the partners? Because the cash purchase model of Reg. 1.1032-3 does not apply, the aggregate approach of Rev. Rul. 99-57 apparently becomes operative (as discussed above). The realized gain allocated to A Co. under that Ruling will be protected by Section 1032; B’s allocable gain (if any) will not be so protected. But what will be A Co.’s and B’s respective shares of the gain in Example 7? Reg. 1.1032-3 does not deal with partnership gain allocations. Section 704 generally would require the precontribution gain to be allocated to A Co. under Section 704(c), and the post-contribution appreciation to be allocated between A Co. and B (to reflect the economics of their business deal) pursuant to Section 704(b). In Example 7, the threshold question for determining the respective amounts of precontribution and post-contribution gain under Section 704 is, “When is A Co. deemed to make the contribution of its stock to AB for tax purposes—at the date the shares are physically transferred by A Co. to X (8/1/00) or at the time the shares vest (8/1/01)?” Under Reg. 1.83-1(a)(1), the transfer to X does not occur for tax purposes until vesting occurs (in the absence of a Section 83(b) election), and under Reg. 1.1032-3 the shares would be deemed purchased by AB at that date (8/1/01). But Reg. 1.1032-3 does not apply in
Example 7, as described above; indeed, Reg. 1.1032-3(e), Example 7(ii) states that AB is not deemed to have transferred the A Co. stock to X “immediately after” receiving the stock from A Co. This implies that AB received the stock at an earlier date—presumably when A Co. first granted the restricted stock to X on 8/1/00. As the FMV of the A Co. stock was $100,000 on 8/1/00, there would be $100,000 of precontribution gain allocated under Section 704(c) to A Co. and $20,000 of post-contribution gain allocated under Section 704(b) in equal amounts ($10,000 to A Co. and $10,000 to B). Under Rev. Rul. 99-57, A Co. would recognize no gain. B will recognize $10,000 of gain in this example.

**Corporate Partner’s Stock Options**

Does the zero basis analysis change if options to purchase the corporate partner’s stock, rather than the stock itself, are the subject of the employees’ incentive plan?

**EXAMPLE 8:** The facts are the same as in Example 4, except that on 8/1/00 A Co. grants NQSOs to X that are nontransferable and do not have a readily ascertainable FMV. The NQSOs are exercisable on 8/1/01 by X’s payment of $50,000 cash directly to A Co. At issuance, the options are in-the-money, i.e., worth $25,000. On 8/1/01, X exercises the options and pays the exercise price, when the options have a value of $100,000 and the A Co. stock is worth $150,000. AB transfers $100,000 cash (contributed by B to AB) to X on 8/1/01.

The grant by A Co. of an NQSO to X will not cause him to have a taxable event. On X’s exercise of the NQSO on 8/1/01, X will receive ordinary compensation income of $100,000, i.e., the FMV of the stock on the date of the exercise ($150,000) less the exercise price ($50,000), plus the $100,000 cash paid to him. AB will be entitled to a deduction in the same amount at that time.

Will AB recognize gain or loss on its deemed transfer of the A Co. stock to X? Since the four requirements of Reg. 1.1032-3 are met in Example 8, the Section 1032 Regulations apply to determine the treatment of the issuing corporation (A Co.) and the acquiring entity (AB) on transfer of the issuing corporation’s stock to the employee. Because Section 83(a) does not apply to the grant of the option, Reg. 1.1032-3(d) also does not apply to the grant of the option. Section 83 and Reg. 1.1032-3 apply in 2001, when the option is exercised; thus, no gain or loss is recognized on the deemed disposition of A Co. stock by AB in 2001. Immediately before AB’s deemed disposition of the A Co. stock in 2001, AB is treated as purchasing the A Co. stock from A Co. for $150,000, $50,000 of which AB is deemed to have received from X (on exercise of the option) and the remaining $100,000 of which is deemed to have been cash contributed to AB by A Co. A Co.’s basis in AB will increase by $100,000 pursuant to Section 722.

The option exercise and payment arrangements could be characterized in at least four different ways for federal tax purposes, each having potentially differing consequences. The approach taken in Reg. 1.1032-3 reflects the Service’s determination
that an actual cash payment to the issuing corporation for issuing its stock should not be treated as a distribution by the acquiring entity to the issuing corporation, contrary to Reg. 1.83-6(d)(1). In a partnership or LLC, such a distribution arguably would have been treated as a current distribution (i.e., a Section 731(a) draw), reducing the corporate partner’s tax basis in its partnership interest. If the distribution exceeded the corporate partner’s basis, gain would be immediately recognized pursuant to Section 731(a)(1). If the distribution did not exceed the corporate partner’s basis, the reduction in basis would increase the corporation’s gain (or decrease its loss) on ultimate disposition of its partnership interest in AB. In a corporate setting, the distribution by the acquiring corporation could constitute a taxable redemption or dividend; to avoid such a harsh result, the Preamble to TD 8883 clarifies that the actual payment merely reduces the deemed capital contribution, thereby integrating such payments into the deemed cash purchase model.

Although neither the final Regulations themselves nor the Preamble cites any authority for the particular option exercise characterization used in Reg. 1.1032-3(e), Example 8, support can be found in Anderson, 67 TC 522 (1976), aff’d per cur. 583 F.2d 953, 42 AFTR2d 78-5876 (CA-7, 1978). In that case, a parent corporation granted options to employees of its subsidiary corporation to buy the parent’s corporate stock at a fixed (option) price. The employees exercised some of the options. At issue was whether the “spread” between the option price and the FMV of the option stock on the date of exercise was chargeable against the E&P of the (subsidiary) employer corporation rather than the issuing parent. The Tax Court concluded that the employer corporation would be entitled to a deduction for this spread when the option was exercised, even though the stock was that of the parent. The court reached this result by using the following “analogy of what is deemed to happen”:

Although neither the final Regulations themselves nor the Preamble cites any authority for the particular option exercise characterization used in Reg. 1.1032-3(e), Example 8, support can be found in Anderson, 67 TC 522 (1976), aff’d per cur. 583 F.2d 953, 42 AFTR2d 78-5876 (CA-7, 1978). In that case, a parent corporation granted options to employees of its subsidiary corporation to buy the parent’s corporate stock at a fixed (option) price. The employees exercised some of the options. At issue was whether the “spread” between the option price and the FMV of the option stock on the date of exercise was chargeable against the E&P of the (subsidiary) employer corporation rather than the issuing parent. The Tax Court concluded that the employer corporation would be entitled to a deduction for this spread when the option was exercised, even though the stock was that of the parent. The court reached this result by using the following “analogy of what is deemed to happen”:
I. The parent corporation is deemed to have transferred to the subsidiary-employer cash equal to the spread between the option price and the FMV of the stock at the date of exercise. This cash represents a contribution of capital by the parent and permits an increase in the parent’s basis in the subsidiary’s stock.

II. The subsidiary is deemed to purchase the parent’s stock needed to distribute to the employees with the cash received from the parent plus the subsidiary’s own funds in an amount equal to the option price. As a result of this transaction, the parent realizes no income pursuant to Section 1032, and the subsidiary has a basis in the parent’s stock equal to its FMV (the purchase price).

III. The subsidiary is deemed to transfer the parent stock to its employees in return for services plus the option price. The employees would include in their income the spread under Section 83, and the subsidiary would have a deduction under Section 162 in the same amount.

The primary difference between the Anderson characterization and Reg. 1.1032-3(e), Example 8 is that in Anderson the subsidiary is deemed to use its own funds in an amount equal to the option price, rather than having been deemed to receive that cash from the employee prior to paying the option price. The difference should have no operative effect for tax purposes.

How, if at all, is the analysis affected if the option exercise price is payable by the employee to the partnership, rather than to the issuing corporation, and the partnership then remits the option price to the issuer corporation? Returning to our Example 8, if X tendered the $50,000 exercise price to AB and AB immediately paid A Co. $50,000, Reg. 1.1032-3 still would apply, as the four requirements again would be met. Immediately before AB’s deemed disposition of the A Co. stock in 2001, AB will be treated as purchasing the A Co. stock from A Co. on 8/1/01 for $150,000, $50,000 of which AB actually received (and is not merely deemed to have received) from X and the remaining $100,000 of which is deemed to have been cash contributed to AB by A Co. Thus, AB will recognize no gain on its deemed transfer of the A Co. stock to X in this situation; the actual payment merely reduces the deemed capital contribution. A Co.’s basis again will increase by $100,000 pursuant to Section 722.

Finally, what will be the consequences if the option price is payable to the partnership but the partnership does not remit the option proceeds to the issuing corporation? Returning to the facts in the immediately preceding paragraph, assume that A Co. has physically transferred its NQSOs to AB (as a capital contribution) and on 8/1/00 AB granted the options to X, with the option exercisable on 8/1/01 and the option price payable to AB (not A Co.). On exercise, X tenders the $50,000 option price to AB, which retains the payment. The four requirements again will be met; AB again will be treated as purchasing the A Co. stock on 8/1/01 for $150,000, none of which is treated as being deemed paid by AB to A Co., and all $150,000 of which will be treated as a cash contribution by A Co. to AB (thereby increasing A Co.’s basis in AB by $150,000 pursuant to Section 722). AB again will recognize no gain on its deemed transfer of the A Co. stock to X.

Stock of the Corporate Partner’s Parent
In many situations, the corporate partner itself may be a subsidiary and the partnership’s employee will prefer to receive stock of the corporation that is the parent of the corporate partner (rather than the corporate partner’s own stock) because the parent’s stock is publicly traded. Frequently an operating company (for whom the employee previously worked) creates a special-purpose subsidiary corporation (for non-tax purposes) to act as the corporate partner, and neither the parent nor the employee would want the partnership’s employee to receive the stock of such a subsidiary corporation. What are the tax consequences if the stock transferred to the employee is stock of the corporate partner’s parent corporation?

**Direct transfer.** What are the consequences if the stock of the corporate partner’s parent is transferred directly to the partnership’s employee?

**EXAMPLE 9:** The facts are the same as in Example 2 except that A Co.’s parent (P Co.) rather than A Co. transfers its stock directly to X on 8/1/00. P Co. and A Co. do not file consolidated tax returns.

X again will recognize compensation of $200,000 (the $100,000 FMV of the P Co. stock under Section 83(a), plus the $100,000 cash) on 8/1/00. AB will be entitled to a corresponding deduction at such time under Sections 83(h) and 162.

Will gain be realized by AB on 8/1/00 with respect to the stock transfer, and if so, will A Co. be liable for taxes on such gain? As in Example 2, the stock transfer (actually made directly from P Co. to X) arguably should be treated for federal income tax purposes as (1) a fictitious or deemed transfer (i.e., a capital contribution) by P Co. of its stock to its subsidiary, A Co., followed by (2) a deemed capital contribution by A Co. of the P Co. stock to AB, followed by (3) a deemed transfer (payment for services) by AB of the P Co. stock to X. So viewed, AB again would realize gain equal to the value of the P Co. stock at the time of its transfer to X, pursuant to Reg. 1.83-6(b). A Co. would be allocated the $100,000 gain under Section 704(c) and would not be protected from gain recognition under the aggregate approach of Rev. Rul. 99-57, because Section 1032 would not apply to A Co. with respect to gain on its parent’s stock. Under the aggregate approach, AB will realize $100,000 of gain, all allocated to A Co. under Section 704(c).

Fortunately, the final Section 1032 Regulations extend the deemed cash purchase model to the direct transfer of stock in our Example 9, and no gain or loss will be recognized on the disposition of the P Co. stock by AB. Immediately before AB’s disposition of the P Co. stock, AB is treated as purchasing the P Co. stock from P Co. for $100,000 of cash indirectly contributed to AB by P Co. through its intermediate (subsidiary) corporation, A Co. Under Section 722, A Co.’s basis in its AB partnership interest is increased by $100,000, and under Section 358 P Co.’s basis in its A Co. stock is increased by $100,000.57

Would the same result occur if, immediately after P Co.’s transfer of its stock to X, P Co. did not own stock of A Co. that constituted “control” within the meaning of Section 368(c)? Prior to the final Regulations, uncertainty existed as to whether a deemed capital contribution could occur pursuant to Reg. 1.83-6 and Rev. Rul. 80-76 where the transferor of the property did
not have control as defined in Section 368(c). The Preamble to TD 8883 states that the Regulations have been expanded to apply to transactions in which the stock of the issuing corporation is obtained indirectly by the acquiring entity in any combination of exchanges under Sections 721 and 351. In our Example 9, P Co.’s stock is not obtained indirectly under Section 351, which only applies in connection with transfers of property to a controlled corporation (the 80% requirement under Section 368(c)). Technically, the deemed capital contribution of cash by P Co. to A Co. (P’s less-than-wholly owned subsidiary) apparently would constitute a tax-free capital contribution under Section 118, but not under Section 351.

Notwithstanding the language in the Preamble that Section 351 (and thereby the control test of Section 368(c)) be satisfied, the actual language of the final Regulations is broader. Reg. 1.1032-3(c)(1) requires the acquiring entity to obtain the stock of the issuing corporation directly or indirectly in a transaction in which, but for this Regulation, the basis of the stock of the issuing corporation in the hands of the acquiring entity would be determined, in whole or in part, with respect to the issuing corporation’s basis in the issuing corporation’s stock under Section 362(a) or 723. Section 362(a) applies not only to Section 351 transfers (described in Section 362(a)(1)) but also to capital contributions described in Section 362(a)(2). Thus, a capital contribution to the acquiring corporation that falls short of Section 351 will nonetheless meet the requirement of Reg. 1.1032-3(c)(1); therefore, it is not necessary for P Co. in our Example 9 to own stock of A Co. that constitutes control under Section 368(c).

**Indirect transfer.** Would the analysis be different if the stock of the corporate partner’s parent were not transferred directly to the partnership’s employee?

**EXAMPLE 10:** The facts are the same as in Example 1, except that X covets the stock of P Co., A Co.’s parent. Thus, P Co. transfers its stock to A Co., A Co. transfers the P Co. stock to AB, and AB transfers the P Co. stock to X, all on 8/1/00.

Once again, the question is whether AB will realize gain on 8/1/00 when it transfers the P Co. stock to X, and if so, will A Co. recognize its allocable share of that gain? Unless the deemed cash purchase approach applies, the series of stock transfers (treated for federal income tax purposes as the capital contribution by P Co. of its stock to its subsidiary, A Co.; the capital contribution by A Co. of the P Co. stock to AB, and the compensatory transfer by AB of the P Co. stock to X) again would result in AB’s realization of gain of $100,000 on 8/1/00, and A Co. would be allocated all of that gain under Section 704(c). Unlike Example 1, the aggregate approach of Rev. Rul. 99-57 gives A Co. no protection from gain, because the nonrecognition rule of Section 1032 does not apply to a subsidiary corporation’s gain on its parent’s stock.

Fortunately, AB’s and A Co.’s gain recognition should be zero under Reg. 1.1032-3. The transactions should be treated as if, immediately before AB transferred the P Co. stock to its employee, AB purchased the stock from P Co., the issuing corporation, for FMV with cash contributed first by P Co. to A Co. and then by A Co. to AB. This characterization has the additional benefits of increasing, in an amount equal to the FMV of the P Co. stock, (1) P Co.’s basis in the A Co. stock owned by P Co. and (2) A Co.’s outside basis in its AB partnership interest.
The results in Examples 9 and 10 are identical if the deemed cash purchase approach applies, whether the P Co. stock is transferred directly or indirectly to X. This is consistent with the potential applicability of Reg. 1.1032-3(c)(1), which includes in its scope acquisitions of stock of the issuing corporation made “directly or indirectly” from the issuing corporation by the acquiring corporation.

**Delayed transfer.** Will the corporate partner recognize taxable gain if its parent’s stock is transferred indirectly to the partnership’s employee, *not* immediately after it is received by the partnership?

**EXAMPLE 11:** The facts are the same as in Example 10, except AB transfers the P Co. stock to X on 8/1/01 when the value of the P Co. shares has increased to $130,000.

As in Example 4, X will recognize $230,000 of compensation income on 8/1/01, i.e., $130,000 on his receipt of the P Co. stock pursuant to Section 83(a) plus the $100,000 cash paid to him. AB will be entitled to a corresponding $130,000 compensation deduction under Section 83(h) for the FMV of the P Co. stock on 8/1/01, and $100,000 for the cash payment.

Will gain be realized by AB on 8/1/01 when it transfers the P Co. stock to X, and if so, will A Co. recognize its allocable share of that gain? As discussed below, neither the deemed cash purchase approach of Reg. 1.1032-3 nor the aggregate approach of Rev. Rul. 99-57 will prevent A Co. from recognizing gain in this example.

Under current law, A Co. apparently will take a zero basis in the P Co. stock it receives via a capital contribution from P Co., pursuant to Rev. Rul. 74-503. On A Co.’s contribution of the P Co. stock to AB on 8/1/00, AB apparently also will take a zero basis in the stock, pursuant to Section 723.

If applicable, the deemed cash purchase approach would provide AB with a basis of $100,000, i.e., the value of the P Co. stock when transferred by A Co. to AB on 8/1/00. That model, however, will *not* apply in Example 11 because AB (the acquiring entity) does not immediately retransfer the stock of P Co. (the issuing corporation) for X’s current and future services; rather, AB retains the stock for one year (until 8/1/01) before it finally transfers the shares to X. Thus, the “immediate transfer” requirement of Reg. 1.1032-3(c)(2) is not met. Accordingly, when AB transfers the P Co. stock to X on 8/1/01, AB will realize $130,000 of gain, pursuant to Reg. 1.83-6(b) and Rev. Rul. 99-57. The gain will be allocated $115,000 to A Co. and $15,000 to B, under Section 704.

Pursuant to Reg. 1.83-6(b), AB recognizes gain on the transfer of appreciated property as compensation for services. Under Rev. Rul. 99-57’s aggregate approach, A Co. would not have recognized any portion of the $115,000 gain, as A Co. would be protected by Section 1032. That section, however, does *not* apply to prevent a subsidiary corporation from recognizing gain (or loss) on transfers of its parent’s stock. Thus, Rev. Rul. 99-57 will not prevent A Co. from recognizing gain of $115,000 (thereby effectively offsetting A Co.’s ($115,000) allocable compensation deduction) on AB’s transfer of the P Co. stock to X.
Can a position be taken under Reg. 1.1032-3 that the deemed cash purchase model nonetheless applies, so that AB has a $100,000 (not zero) basis, by viewing A Co. (not AB) as the “acquiring entity” for purposes of Reg. 1.1032-3(c)(1), with the “plan” being for A Co. to acquire its AB partnership interest (rather than to acquire X’s services) in exchange for the P Co. stock? Three of the four requirements of Reg. 1.1032-3(c) would seem to be met. Nevertheless, the fourth requirement, i.e., that the party receiving the stock (here, AB) must not receive a substituted basis in the stock of the issuing corporation (P Co.) within the meaning of Section 7701(a)(42), is not met. Since AB would take a carryover basis from A Co. in the P Co. stock pursuant to Section 723, the P Co. stock would be “transferred basis property” as defined in Section 7701(a)(43). AB would receive a substituted basis in the P Co. stock within the meaning of Section 7701(a)(42). Reg. 1.1032-3 would not apply to the P Co. to A Co. to AB transfers, and therefore AB would not obtain a deemed cash purchase basis in the P Co. stock under the final Regulations. Accordingly, neither Reg. 1.1032-3 nor Rev. Rul. 99-57 will prevent A Co. from recognizing gain of $115,000 in Example 11 on AB’s subsequent transfer of the P Co. stock to X.

Because A Co. will recognize $115,000 of gain as its allocable share of AB’s gain, A Co.’s basis in AB will increase by $115,000, pursuant to Section 705(a)(1)(A). P Co.’s basis in A Co. will not increase, however, because Reg. 1.1032-3 does not apply here to create a deemed cash contribution by P Co. to A Co. (thereby increasing basis under Section 358). Instead, the transaction would not be recharacterized from its form and would be treated as a stock contribution by P Co. to A Co. Pursuant to Rev. Rul. 74-503, P Co. presumably has a zero basis in its own stock and therefore, on the stock’s transfer to A Co., P Co. technically would obtain an increase of zero in its basis in A Co., pursuant to Section 358.

**Actual Cash Purchase of Parent’s Stock**

If the parent corporation receives an actual cash payment for its stock, will the parent be treated as having received a distribution from its subsidiary (the corporate partner) taxable under Sections 301 or 302?

**Example 12:** P Co. is the parent of A Co., which is an equal partner (along with individual B) in AB. X is an employee of AB. AB wishes to incentivize X by offering him the opportunity to buy $100,000 worth of P Co. stock for the reduced price of $80,000. To keep A Co. and B equal partners, B contributes $10,000 in cash to AB, and AB pays the $10,000 to P Co. as partial payment for the P Co. stock when X pays $80,000 to P Co. All events occur on 8/1/00.

A preliminary question is whether AB realizes gain on 8/1/00 when the P Co. stock is transferred to X for a bargain purchase price. Reg. 1.1032-3 should apply to the transaction since AB is acquiring X’s services in exchange, in part, for the stock of a corporation (P Co.), see Reg. 1.1032-3(a), and the four requirements of Reg. 1.1032-3(c) are met. Immediately before AB’s deemed disposition of the P Co. stock to X, AB is treated as purchasing the P Co. stock for $100,000, $80,000 of which AB is deemed to have received from X, $10,000 of which originated with AB (i.e., the $10,000 cash contributed to AB by B), and $10,000 of which is deemed to have been contributed to AB by A Co. and, in turn, which is deemed to have been contributed to
A Co. by P Co. Since AB is treated as purchasing the P Co. stock for its FMV, AB recognizes no gain or loss on its deemed disposition of the P Co. stock to X. Moreover, P Co.’s basis in its A Co. stock will increase by P’s deemed cash contribution of $10,000 pursuant to Section 358, and A Co.’s basis in its AB partnership interest will increase by $10,000 pursuant to Section 722.

A related question is whether all or any part of the $90,000 cash received by P Co. (i.e., the $10,000 actually paid by AB and the $80,000 paid by X) should be taxed as a distribution by A Co. with respect to P Co. Commentators requested clarification in the final Regulations of the tax consequences where the acquiring corporation or another party makes an actual payment to the issuing corporation for issuing corporation stock. Specifically, concern was expressed as to whether any or all of the amounts actually paid to the issuing corporation are treated as a distribution by the acquiring corporation to the issuing corporation. If so, the distribution will be a deemed dividend under Section 301, with potentially adverse federal, state and local tax consequences.

The Preamble states that the Treasury and IRS do not believe that an actual payment to the issuing corporation for issuing corporation stock should be taxed as a distribution with respect to acquiring corporation stock. Accordingly, Reg. 1.1032-3(b)(2) provides that the cash deemed contributed by the issuing corporation to the acquiring corporation in the cash purchase model is the difference between the FMV of the issuing corporation stock and the FMV of the money or other property received by the issuing corporation as payment. The Preamble states that payment for this purpose is payment “from the employee or the acquiring corporation” (emphasis added). Reg. 1.1032-3(e), Example 5(ii) provides that payments from both the employee and the acquiring corporation count for this purpose, thereby reducing the issuing corporation’s deemed capital contribution.

Thus, Reg. 1.1032-3 overrides Reg. 1.83-6(d)(1)’s characterization of cash received by the parent corporation as being a deemed distribution under Section 302, and A Co. would not be deemed to make a dividend-type distribution to P Co. in Example 12.

Parent’s Restricted Stock

What happens if the corporate partner’s parent issues restricted stock to the partnership’s employees?

EXAMPLE 13: The facts are the same as in Example 6, except that on 8/1/00 P Co. (rather than A Co.) transfers the restricted stock to X, and P Co. (rather than A Co.) retains the reversionary interest in the P Co. stock in the event X forfeits his right to the stock.

The analysis should be similar to that in Example 6. Having again not made a Section 83(b) election, X will recognize compensation income on 8/1/01 when the stock vests. Pursuant to Section 83, the transaction should be characterized as deemed transfers of the P Co. stock on 8/1/01 by P Co. to A Co., by A Co. to AB, and by AB to X, respectively, rather than the date the restricted stock was actually transferred (8/1/00). Under this characterization, P Co., A Co., and AB will not recognize gain or loss on the successive deemed transfers of the P Co. stock, pursuant to Sections 118, 351, and 721. By operation of Section 83, X will recognize $120,000
of ordinary compensation with respect to the P Co. stock he has received, on 8/1/01 when he becomes vested in those shares, plus the $100,000 cash payment. As described in Example 6, the $220,000 compensation deduction will be allocated between A Co. and B.

Also as described in Example 6, Reg. 1.1032-3 should apply, to prevent recognition of gain or loss by AB. The partnership will be treated as purchasing P Co.’s stock from P Co. for $120,000 (the FMV of the P Co. shares at the time the stock vests), with cash deemed contributed by P Co. to A Co. and then by A Co. to AB. Therefore, AB will recognize no gain or loss at the vesting date, and under Sections 358 and 722 P Co.’s basis in A Co. and A Co.’s basis in its AB partnership interest, respectively, will be increased by $120,000.

This result should follow if P Co. issued the restricted stock directly to X, rather than first transferring the shares to A Co. and then A Co. transferring them to AB, which then transferred the P Co. shares to X. 70

Parent’s Stock Options

What consequences follow if the parent corporation of the corporate partner issues options to the partnership’s employees to purchase the parent corporation’s stock?

EXAMPLE 14: The facts are the same as in Example 8, except that on 8/1/00 P Co. (rather than A Co.) transfers the NQSOs to X.

The analysis should be similar to that in Example 8. P Co.’s grant of the option to X will not be a taxable event. When X exercises the NQSO on 8/1/01, he again will receive compensation income of $200,000 (i.e., the $100,000 spread on the stock on the date of exercise plus the $100,000 cash paid to him). AB will be entitled to a $200,000 deduction at that time. 71

AB will not recognize gain or loss on its deemed transfer of the options or the P Co. stock to X, because the four requirements in Reg. 1.1032-3(c) will be satisfied. Immediately before AB’s deemed disposition of the P Co. stock in 2001, AB will be treated as purchasing the P Co. stock from P Co. for $150,000 cash, $50,000 of which AB is deemed to have received from X (on exercise of the option) and the remaining $100,000 of which is deemed to have been contributed by P Co. (the issuing corporation) to A Co. and by A Co. to AB. 72

As a result of the deemed capital contributions, P Co. will increase its basis in its A Co. stock by $100,000 pursuant to Section 358 and A Co. will increase its basis in its AB interest by $100,000 pursuant to Section 722. 73

UNANSWERED QUESTIONS

Despite the issuance of the final Regulations, several zero basis issues still remain. They arise from both the procedural context in which IRS has indicated it will eliminate prior, potentially conflicting guidance, and the substantive context of the tax rules affecting in-kind employee compensation.
Interim Transfers of Partnership Interests Before Stock Vests

Some interesting questions arise with respect to transfers of a corporate partner’s stock that are subject to vesting, where the partnership employee does not make a valid Section 83(b) election.

What would be the consequences in Example 6 if A Co. sold its AB partnership interest to C, a third party, at any time between 8/2/00 and 7/31/01? In Example 6, A Co.’s actual transfer of stock on 8/1/00 is disregarded for income tax purposes, and A Co. is not treated as making the deemed capital contribution to AB until 8/1/01, when the stock vests. Assume A Co. sold its interest in AB for $110,000 on 12/31/00. Would A Co. be able to include the value of the A Co. stock (previously physically transferred to X on 8/1/00) in its basis, for purposes of determining gain or loss on the disposition of its partnership interest? If not, A Co. presumably would have no basis in its partnership interest, and would recognize $110,000 of gain on 12/31/00. If so, when the stock vests in X on 8/1/01 would A Co. then be deemed to contribute the stock to the partnership, consistent with principles of Section 83? If so, what are the tax consequences to AB and A Co., which at that time (8/1/01) is no longer a partner in AB for tax purposes? Has AB received a nonpartner capital contribution, which the Service would treat as a taxable event not protected by Section 721(a) or the judicially developed nonshareholder capital contribution doctrine? If AB recognizes gain on that transfer, to whom is the gain allocated—C? B? both? Would A Co. also recognize gain, since (under the Service’s view) it also is not protected by either Section 721 (being a nonpartner on 8/1/01) or the capital contribution doctrine? Such a result seems both inappropriate and inequitable. In any event, would A Co. then recognize a loss on 8/1/01, when it transferred its stock to X? Would that loss relate back to the 12/31/00 sale under the Arrowsmith doctrine, and thus retain the character of the sale (presumably being a capital loss)? Or would it be an ordinary loss? If so, would the loss be limited to A Co.’s basis in its own stock? And would not the IRS say that basis is zero, under Rev. Rul. 74-503? A discussion of potential approaches and solutions to this problem can be found in our prior article. The cash purchase model contained in the final Regulations does not affect the analysis.

Circular Cash Transactions

In appropriate situations, a corporate partner (or the partner’s parent, when it is the parent’s stock that is to be transferred to the partnership’s employee) may contribute cash rather than stock to the partnership. The partnership in turn may use that cash to purchase the stock, either on the open market (as in Example 5) or from the issuing corporation itself. Does such an actual cash purchase create a cost basis in the stock in the partnership’s hands? A quarter-century ago, your author suggested in this JOURNAL (in an analogous corporate setting) that if the form of the transaction is respected, this cash purchase should succeed in eradicating the zero basis result.

Rev. Rul. 70-305, 1970-1 CB 169, suggests that a subsidiary corporation can obtain a non-zero (apparently cost) basis when it purchases its parent’s stock on the open market; its later sale to outside interests resulted in recognition of gain or loss. Additional support for recognizing the cost basis approach is found in GCM 39452, 5/30/85, and related Ltr. Rul. 8550022. In the
GCM, an international finance subsidiary was held to have acquired a basis equal to the purchase price of the shares of its parent that it acquired from the parent for cash. The ruling reasons that the subsidiary’s basis is the cost paid, pursuant to Section 1012 and Reg. 1.1012-1(a). The source of the cash is not disclosed, but neither the GCM nor the letter ruling bars the parent from providing the cash, perhaps even in a recent transaction.

A cost basis result appropriately would permit form to control over substance, and would allow taxpayers to circumvent the zero basis problem. Nonetheless, the step-transaction or substance-over-form (recharacterization) doctrines might be applied to disregard AB’s cash purchase from A Co. and again treat the actual stock transfer from A Co. to AB as a capital contribution of the stock (not cash) under Section 721 and a corresponding carryover basis of zero for the A Co. stock under Section 723. It is less likely that these recharacterization doctrines could be successfully applied by the Service where the A Co. stock is purchased by AB from a third party or with cash generated from AB’s own operations (rather than from a cash infusion from A Co.).

The deemed cash purchase approach of Reg. 1.1032-3 at first glance supports the creation of a cost basis in the stock held by the partnership. If the IRS can construct a deemed cash purchase, it logically follows that taxpayers can partake of self-help to create an actual cash purchase. But the deemed cash purchase in Reg. 1.1032-3 exists only with respect to immediate retransfers by AB of A Co.’s stock to X; the Regulation would not apply where AB does not dispose of the parent corporation’s stock immediately after receiving it.

**Impact on Holding Period for Partnership Interests**

The deemed cash purchase model may have the unanticipated consequence of converting a substantial portion of a corporate partner’s long-term capital gain or loss on sale of its partnership interest into short-term gain or loss. This can be relevant whether the corporate partner is an S corporation or a C corporation.

In Prop. Reg. 1.1223-3(a)(1), IRS has taken the position that the holding period of a partnership interest will be divided if a partner acquires portions of an interest at different times. The holding period of a portion of a partnership interest is determined based on a fraction of which the numerator is the FMV of the portion of the partnership interest to which the holding period relates (determined immediately after the acquisition), and the denominator is the FMV of the entire partnership interest. Significantly, under the Proposed Regulations a partner’s holding period in a partnership interest is affected by contributions to the partnership.

The Proposed Regulations (which were not finalized as of the time this article went to print) take the position that proportionate additional capital contributions require computation of a divided holding period in a partnership interest. As a result of each partner’s additional contribution, under the proposal each partner has a new holding period in the portion of the partner’s interest that is attributable to the contribution. Thus, under Prop. Reg. 1.1223-3, IRS would characterize A Co. as having a multiple holding period in AB under a blended approach, with the long-term and short-term components being based on the respective values of the portion of interests A Co. is deemed to have acquired at different times.
Suppose (1) A Co. acquired its partnership interest in AB in 1998, (2) the value of A Co.’s partnership interest on 8/1/00 is $300,000, and (3) on that date A Co. makes a capital contribution to AB of $100,000. Under the Proposed Regulations, A Co.’s new holding period in its partnership interest attributable to its 8/1/00 capital contribution is 25% of A Co.’s partnership interest ($100,000/$400,000), and A Co.’s holding period for the 1998 portion of its partnership interest is 75%. If A Co. were to sell its partnership interest at any time prior to 8/1/01, A Co.’s gain (or loss) arising from the sale would be allocated 75% as long-term capital gain and 25% as short-term capital gain.

Returning to our examples, if A Co. transfers (directly or indirectly) $100,000 of its stock to AB’s employee X, Reg. 1.1032-3(b)(1) will characterize that transfer as a deemed capital contribution of cash by A Co. to AB (followed by AB’s purchase of A Co. stock with such cash). If the IRS finalizes Prop. Reg. 1.1223-3 without substantial change, A Co.’s direct transfer of its stock to X may cause a material portion of the gain or loss it recognizes on a subsequent sale of its partnership interest in AB to become short-term.

The negative aspect of the interrelationship of the deemed cash purchase model under Reg. 1.1032-3 and the Service’s partnership interest holding period Proposed Regulations becomes even more extreme when A Co. issues to X nontransferable A Co. stock subject to a substantial risk of forfeiture, and X does not make the Section 83(b) election. X therefore does not become the owner of the property for income tax purposes until the stock vests, pursuant to Section 83(a). Moreover, pursuant to Reg. 1.1032-3, the deemed cash purchase model does not operate until such time as vesting occurs, i.e., there is no deemed cash capital contribution by A Co. until the moment of vesting. Based on the analysis above, A Co. would take a short-term holding period with respect to its partnership interest in AB, to the extent of the value of such stock, even though (1) A Co. may have issued the restricted stock to X several years earlier and (2) the value of the stock may have increased substantially in the interim, resulting in a much greater proportion of the total value of A’s partnership interest being deemed to have a short-term holding period.

This absurd result is not due to an inherent flaw in Reg. 1.1032-3. Rather, it reflects the highly dubious position taken in Prop. Reg. 1.1223-3 that capital contributions by existing partners in an ongoing partnership affect the contributing partners’ holding period for their partnership interests.86 The same unanticipated holding period consequences will occur on the exercise of compensatory options issued (directly or indirectly) by A Co. to X.

Stock of the Corporate Partner’s Affiliates

The Regulations do not deal with a transfer of the stock of a corporation affiliated with (but not the direct or indirect owner of) the corporate partner. Suppose that P Co., A Co.’s parent, also owns a majority block of SisterCo, a corporation that conducts business with AB and whose success is intermingled with AB’s success. To incentivize X, AB’s employee, A Co. causes SisterCo to transfer SisterCo stock directly to X. Will AB or its partners recognize gain in this situation?
Neither Reg. 1.1032-3 nor the Preamble contemplate other than a parent-subsidiary situation. In this hypothetical, it is A Co.’s sister corporation whose stock is being transferred. As SisterCo is not itself a partner in AB, if the deemed cash purchase model of Reg. 1.1032-3 does not apply the transfer of SisterCo stock to X is likely to be characterized as (1) a dividend-type distribution by SisterCo of its stock to P Co., (2) P Co.’s capital contribution of the SisterCo shares to A Co. (P Co.’s subsidiary),

(3) A Co.’s capital contribution of the SisterCo shares to AB, and (4) a transfer by AB of the SisterCo shares to X, as compensation for services.

If the deemed cash purchase model does apply, the transfer of SisterCo stock might be recharacterized as (1) a deemed cash dividend by SisterCo to P Co., equal to the FMV of the SisterCo shares, (2) P Co.’s cash contribution to A Co. of the same amount, (3) A Co.’s cash contribution to AB, (4) AB’s cash purchase of the SisterCo stock from SisterCo, and (5) AB’s transfer of the SisterCo stock to X as compensation.

Would Reg. 1.1032-3 apply in this situation? At first glance the transaction seems to fall within the scope of the Regulations, which provide rules for certain transactions in which, inter alia, a partnership (AB) acquires services in exchange, in whole or in part, for stock of a corporation, as stated in Reg. 1.1032-3(a). Nevertheless, the first of the four requirements in Reg. 1.1032-3(c) is that the acquiring entity (here, AB) acquire stock of the issuing corporation (SisterCo) in a transaction in which, but for Reg. 1.1032-3, the basis of SisterCo’s stock in the hands of AB would be determined, in whole or in part, with respect to SisterCo’s basis in its stock under Sections 362(a) or 723. Under the Service’s zero basis approach, SisterCo has a zero basis in its own stock. But the deemed dividend-type distribution of SisterCo’s shares to P Co. (step 1, above) would not result in P Co. having a zero basis in the SisterCo stock; instead, P Co. presumably would take an FMV basis pursuant to Section 301(d). P Co.’s basis in the SisterCo stock would then become A Co.’s basis in those shares pursuant to Section 362(a) when they are deemed contributed by P Co. to A Co., and in turn such basis would become AB’s basis in A Co.’s deemed contribution of the SisterCo shares to AB (pursuant to step 3, above) under Section 723—a deemed double drop-down. Thus, the basis of SisterCo’s stock in the hands of AB would not be determined, in whole or in part, with respect to SisterCo’s (presumed zero) basis in its own stock, the four requirements would not be met, and Reg. 1.1032-3 would not apply. Therefore, Reg. 1.1032-3 would not provide nonrecognition treatment to AB on the transfer of the SisterCo stock to AB’s employee. Rev. Rul. 99-57 also would not provide nonrecognition treatment to A Co. on its allocable share of such gain recognized by AB, as Section 1032 applies only to protect a corporation with respect to nonrecognition of gain on the transfer of its own stock (as discussed in Example 9, above).

The failure of Reg. 1.1032-3 and Rev. Rul. 99-57 to apply to these facts should be of little practical concern. Since P Co. would take an FMV basis in the SisterCo stock under Section 301(d), and AB would take the same basis on the deemed double drop-down under steps 2 and 3, above, the amount of gain recognized should be zero when SisterCo in fact transfers its shares to X.

The Partnership Holds Other Stock of the Issuer
The Regulations do not deal with a situation where the acquiring entity already owns stock of the issuing corporation. Will a compensatory transaction to which Reg. 1.1032-3 applies nonetheless result in gain (or loss) recognition because of the operation of the stock basis allocation rules applicable when a shareholder disposes of only a portion of his stockholdings?

**Example 15:** The facts are the same as in Example 1, except that in 1998, in an unrelated transaction, A Co. transferred to AB 1,000 shares of A Co. stock, as a capital contribution pursuant to Section 721, to provide AB with net worth and thereby improve AB’s credit rating.

AB would have a zero basis in the 1,000 shares of A Co. stock received in 1998 pursuant to the Service’s position in Rev. Rul. 74-503. Reg. 1.1032-3 would not provide AB with an FMV basis in such stock since there was no “immediate transfer” by AB of these A Co. shares to anyone. When A Co. transfers the 1,000 shares of its stock directly to X on 8/1/00, A Co. is deemed to transfer its stock to AB, followed by AB’s deemed transfer of them to X, under Reg. 1.83-6(d). At that moment, AB is deemed to have an FMV basis of $100,000 in those 1,000 shares, pursuant to the second sentence of Reg. 1.1032-3(b)(1). Under the basis allocation rules, when a shareholder (here, AB) owns blocks of stock in the same corporation purchased at different times for different prices, and the shareholder can identify the specific shares being sold, the shareholder may compute its gain or loss either by reference to the basis of the shares actually transferred through specific identification or the first-in, first-out (FIFO) method. Absent adequate identification of the lot from which the stock was sold, the basis of the stock sold is the basis of the first stock of the particular company acquired by the taxpayer. If AB does not specifically identify the A Co. shares transferred to X, under the FIFO rule AB’s basis in the 1,000 A Co. shares that it is deemed to have transferred to X under Reg. 1.83-6(d) would be zero (i.e., the basis of the 1998 shares acquired by AB). As the value of X’s services for income tax purposes is deemed to be $100,000 (i.e., the value of the stock X receives as taxable compensation), AB would appear to recognize the $100,000 difference as gain, pursuant to Reg. 1.83-6(b).

Nevertheless, the first sentence of Reg. 1.1032-3(b)(1) unequivocally states that in “a transaction to which this section applies, no gain or loss is recognized on the disposition of the issuing corporation’s stock by the acquiring entity.” The Regulation does not say that recognition of gain of zero occurs; rather, it characterizes any transaction meeting the four requirements of Reg. 1.1032-3 as being a nonrecognition transaction. The Preambles to both the proposed and final Section 1032 Regulations reiterate that no gain or loss is recognized. Thus, it appears that, for purpose of disposition of stock for property or services that meet the four requirements of Reg. 1.1032-3, the acquiring entity will recognize no gain or loss even if its basis in the transferred stock would be less than the stock’s FMV under the stock basis rules described above.

If this analysis is correct, it appears that AB thereafter would have a basis of $100,000 in its remaining A Co. stock (i.e., the shares it actually owned since 1998), thereby eliminating the zero basis taint on those shares that existed pursuant to Rev. Rul. 74-503. Nothing in Reg. 1.1032-3 indicates that such a result was intended, and the combination of nonrecognition of gain
(on A Co.’s direct transfer of the shares to X) plus a basis step-up for the A Co. shares held by AB since 1998 seems to be an improper result.

Stock Options Exercisable Against the Partnership

Examples 8 and 14, above, involve options granted by the issuing corporation (A Co. and P Co., respectively) directly to AB’s employee, X. If X’s option instead was exercisable against the acquiring entity (AB), would the deemed cash purchase model still apply to eliminate AB’s recognition of gain when X exercised the option?

EXAMPLE 16: The facts are the same as in Example 8, except that AB (rather than A Co.) grants X the NQSOs to acquire A Co. stock. A Co. agrees to issue the option stock to AB. A Co. transfers its stock to AB at the time of AB’s option grant to X, in order to provide X with greater assurance that the A Co. stock will be available on X’s option exercise and payment of the option price to AB. If the option lapses, AB will retain the stock, to fund future option grants.

The Regulations do not provide an example involving options exercisable against the acquiring entity—apparently with good reason. In this scenario, AB most likely will recognize gain and Reg. 1.1032-3 will not apply. AB received the stock from A Co. at the time of the option grant, not its exercise. Section 83 and Reg. 1.1032-3 apply when the option is exercised, not at grant.\(^9^1\) Pursuant to the second of the four requirements, the acquiring entity (AB) must transfer the stock of the issuing corporation (A Co.) immediately after its receipt. Here, AB receives the stock on 8/1/00 but does not transfer the stock to X until 8/1/01. Therefore, Reg. 1.1032-3 will not apply, and AB will recognize gain on its disposition of the A Co. stock.

If A Co. did not transfer its stock to AB until X exercised his NQSOs granted by AB (and tendered payment of the exercise price to AB), would Reg. 1.1032-3 apply so as to prevent gain recognition by AB? The “immediate transfer” requirement of Reg. 1.1032-3(c)(2) would be met, unlike the situation in Example 16. Some commentators, however, questioned the application of the Proposed Regulations’ deemed cash purchase model to an option to buy issuing corporation stock from the acquiring entity. Clarification was requested as to whether the option must be exercisable for stock of the issuing corporation in order to be subject to the Proposed Regulations.\(^9^2\) Unfortunately, final Reg. 1.1032-3(d) adopts verbatim the proposed language.\(^9^3\) Moreover, the example added in the final Regulations, which deals with a compensatory grant and exercise of an option, involves a direct grant by (and exercise against) the issuing corporation to the employee of the acquiring entity.\(^9^4\) The Preamble to TD 8883 also does not answer this question.\(^9^5\)

CONCLUSION

Reg. 1.1032-3 provides needed and favorable answers to certain questions of basis and gain arising from compensatory transfers of a corporate partner’s stock and options to a partnership employee. Combined with the Regulation’s express approval of the Service’s aggregate approach in Rev. Rul. 99-57, practitioners can be confident that in most properly structured compensatory transactions the corporate partner will not recognize gain but nonetheless will obtain a step-up in the basis of its partnership interest under Section 705.
Neither the deemed cash purchase approach of Reg. 1.1032-3 nor the aggregate approach of Rev. Rul. 99-57, however, will prevent recognition of gain by the other partners, if the stock of the corporate partner is actually transferred to the partnership prior to transfer to the employee and there is post-contribution appreciation during the interim, as Examples 4 and 7 illustrate. Moreover, all the partners (including the corporate partner) may recognize taxable gain (or loss) where Reg. 1.1032-3 does not apply, as Example 11 illustrates.

The Rev. Rul. 80-76 approach, as applied in Ltr. Ruls. 9822012 and 9853038, would support nonrecognition by the partnership of any gain—including post-contribution appreciation—so that none of the partners pays taxes on (pre- or post-contribution) gain on the corporation’s stock. Furthermore, the Rev. Rul. 80-76 approach would even protect the partnership and its partners in situations such as Example 11, i.e., where stock of the corporate partner’s parent (or other affiliated) corporation is the subject of the compensatory transfer. But the Rev. Rul. 80-76 approach is (or will be) no longer available, pursuant to its obsolescence as announced in the Preamble to TD 8883.

Thus, in situations like Example 11, where Rev. Rul. 80-76 would have applied to provide nonrecognition, but neither Rev. Rul. 99-57 nor the final Regulations would apply, revocation of Rev. Rul. 80-76 will result in gain recognition where none previously existed, with the amount of gain being equal to the value of the stock transferred, under the zero basis approach. This is a most undesirable result and a new trap.

Nonetheless, Reg. 1.1032-3 is a major step in the right direction. It is far better to have this guidance than to wait another 25 years for Godot to bring taxpayers a global solution to the zero basis problem.96

The broader picture demonstrates that the IRS takes a band-aid approach to the zero basis problem. A thoughtful commentator has observed that the Service’s zero basis position in Rev. Rul. 74-503 has not in practice halted transactions involving stock. To overcome the Ruling, taxpayers sometimes have tried self-help solutions, including formalistic circular cash transactions that optimistically avoid step transaction and substance-over-form attacks. Those taxpayers have relied on the maxim that a formal solution is sufficient to avoid a technical problem. The Service’s zero basis position, however, still will ensnare some taxpayers.97

As we suggested in the February 2000 article in The Journal, problems involving zero basis could be eliminated by a relatively simple legislative fix that provides that a corporation’s basis in its stock is the FMV of that stock.98 In the Preamble to TD 8883, the IRS and Treasury raise two concerns about an FMV basis solution: the administrative burden of valuing stock that is not publicly traded (while recognizing the potential for the stock to be overvalued), and the facilitation of selective loss recognition99 (which already exists for parent corporation stock purchased for cash from a third party or on the open market by the subsidiary). The Service’s band-aid approach to the zero basis problem100 does not cover all the potential wounds created by the Service’s zero basis position. A legislative fix remains appropriate, before the IRS runs out of band-aids.
ENDNOTES

1 As in previous articles, for purposes of this article references to “partners” include members of LLCs as well as partners in both limited and general partnerships, and references to “partnerships” include LLCs and limited and general partnerships. See Banoff, “Rev. Rul. 99-57 Expands Partnership Use of Corporate Partner Equity as Compensation,” 92 JTAX 87 (February 2000); Banoff, “Use of Corporate Partner Stock and Options to Compensate Service Partners—Parts 1 and 2,” 89 JTAX 343 (December 1998) and 90 JTAX 26 (January 1999).

2 See Banoff, JTAX February 2000, supra note 1. Because the problems and issues arising under the Section 1032 Regulations are the same as those arising under Rev. Rul. 99-57, 1999-51 IRB 678, some of the discussion in the earlier article is perforce repeated herein.

3 As to the consequences of using corporate stock to compensate service partners, see Banoff, JTAX December 1998 and January 1999, supra note 1.

4 See, e.g., Banoff, “Status of Service Partners Remains Unclear Despite Eighth Circuit’s Reversal in Campbell,” 75 JTAX 268 (November 1991). In Notice 2000-29, 2000-23 IRB 1241, IRS requested input as to the tax consequences to the recipient of the partnership interest as well as the partnership on the exercise of an option to acquire partnership interests issued in compensatory and noncompensatory transactions.


6 See FSA 199941033. The Service’s Examination Division had taken the position that a domestic subsidiary corporation recognized gain under two alternative zero basis analyses, in connection with the transfer of the parent’s stock to the subsidiary’s employees on their exercise of NQSOs for the parent’s stock. The Appeals Division agreed with the analysis that the subsidiary was required to recognize gain equal to the sum of (1) what the employees paid for the stock less the subsidiary’s adjusted basis (zero), plus (2) the subsidiary’s compensation expense (i.e., the excess of the FMV of the parent’s stock on the dates of exercise over what the employees paid for the stock). The IRS Assistant Chief Counsel (EP/EO) responded in the FSA, however, that the Service’s position (pending finalization of Reg. 1.1032-3) was that no gain or loss was recognizable by the subsidiary.

7 Compare Reg. 1.83-6(b), which states that except as provided in Section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor’s basis in the property.

8 Technically, AB would tack A Co.’s holding period, under Section 1223(2). Presumably, A Co. could have no holding period in its own stock, so AB would have nothing to tack. Therefore, AB’s holding period in the A Co. stock would start on its receipt of the A Co. stock,
and AB would have only a short-term holding period at the time of its transfer of the A Co. stock to X.

9 IRS reasoned in TAM 9822002 that the purpose of Section 1032 is to prevent a corporation from recognizing taxable gain or deductible loss on the receipt of money or other property in exchange for its own stock. In a sale (or other taxable transfer) by a partnership of its corporate partner’s stock, treatment of the partnership as an entity could result in the partnership recognizing taxable gain or deductible loss on the disposition of the corporate partner’s stock, thereby frustrating the purpose of Section 1032. Thus, a partnership is properly treated as an aggregate of its partners for purposes of applying Section 1032. The TAM, along with Ltr. Rul. 9822012, discussed in more detail in the text, below, was analyzed in Banoff, “New Rulings Expand Partnership Use of Corporate Partner Stock and Options as Compensation,” 89 JTAX 92 (August 1998). That article predated the issuance of Prop. Reg. 1.1032-3.

10 All of the gain allocated by the partnership to the corporate partner in TAM 9822002 was allocated pursuant to Section 704(c). Rev. Rul. 99-57 correctly extends the nonrecognition treatment of Section 1032 to C Co.’s allocable share of post-contribution gain.

11 The Ruling further states that a similar analysis (including a reduction in a corporate partner’s basis) would apply to a transaction in which the corporate partner is allocated a loss.

12 Under Section 83(h), the service recipient is allowed a compensation deduction under Section 162, equal to the amount included in the service provider’s gross income under Section 83(a). No deduction is allowed under Section 83(h), however, to the extent the transfer of property constitutes a capital expenditure, an item of deferred expense, or an amount properly includable in the value of inventory items. For purposes of this article, it is assumed that the services rendered by the partnership’s employee are not of the type that would preclude an immediate deduction by the partnership.


14 Rev. Rul. 80-76, 1980-1 CB 15, holding 4. This result is hereinafter referred to as “the Rev. Rul. 80-76 approach.” As to the underlying rationales for the Service’s analysis in Rev. Rul. 80-76, see GCM 38176, 11/26/79; Banoff, JTAX August 1998, supra note 9, pages 95-96 and fns. 18-21. The IRS reportedly has not applied the rationale of Rev. Rul. 80-76 (at least for advance ruling purposes) if A Co. does not transfer its stock directly to X. See Banoff, JTAX February 2000, supra note 1, page 100 and fn. 38.

15 See “Treatment of Options Granted to Employees Later Transferred to a Partnership,” 90 JTAX 186 (March 1999). The same transactions are also the subject of three other identical rulings. Ltr. Ruls. 9903036, 9903037 and 9904039. See “Issuing Corporate Partners May Deduct Options on Exercise by Partnership Employees,” 90 JTAX 251 (April 1999).

16 Although not entirely free from doubt, it appears that the employer-partnership in Ltr. Rul. 9853038 will not grant the NQSOs to, or receive the option exercise payments from, the
employees who receive the options granted by B or C; rather, this appears to be a “direct” grant and transfer from the companies to the partnership’s employees.

17 In situations involving NQSOs, the tax basis consequences also were draconian. The partnership employee’s payment of the option’s exercise price could be treated as though the employee paid the money into the partnership and then the partnership made the cash distributions to the corporate partner, by analogy to the treatment under Reg. 1.83-6 with respect to stock option payments by employees of the corporation’s subsidiary. This will no longer be the result for NQSOs transferred after 5/16/00. See Reg. 1.1032-3(e), Example 8(ii).

18 Section 704(d); Reg. 1.704-1(d)(1).

19 See the Preamble to TD 8883, “Status of Rev. Rul. 80-76.” Query whether Rev. Rul. 80-76 retains any vitality (e.g., as constituting authority to avert penalties for substantial underpayment of taxes or return preparer penalties under Sections 6662(b) and 6694) during the period between the issuance of Reg. 1.1032-3 on 5/16/00 and a formal revocation of the Ruling (which had not occurred at the time this article was submitted for publication). FSA 199941033, supra note 6, implies that something more than a declaration of obsolescence may be required (“until Rev. Rul. 80-76 is revoked, it remains the Service’s position on the issue in question” (emphasis added)).

20 See Prop. Regs. 1.83-6(d) and 1.83-3(b). Transfers of stock held for any period of time would not meet the “immediately” requirement of Prop. Reg. 1.1032-3(c)(3), and thus would not come within the ambit of Prop. Reg. 1.1032-3.

21 Testimony of Michael J. Hosler, Senior Tax Counsel—Federal Income Tax, Marathon Oil Company.

22 Comment of Philip Levine, IRS Assistant Chief Counsel (Corporate). An immediate retransfer was required by the Proposed Regulation to eliminate the opportunity for selective loss recognition.

23 See the Preamble to TD 8883, “Applicability of the Final Regulations in the Partnership Context.”

24 This derives from the second sentence of Reg. 1.1032-3(b)(1): “The transaction is treated as if, immediately before the acquiring entity disposes of the stock of the issuing corporation, the acquiring entity purchased the issuing corporation’s stock from the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation (or if necessary, through intermediate corporations or partnerships).”

25 The proviso was added by a retroactive correction to TD 8883. According to Ann. 2000-57, 2000-28 IRB 115, as originally published TD 8883 “contains an error which may prove to be misleading and is in need of clarification.” Absent the clarification, taxpayers could avoid the zero basis consequence so long as the last in a chain of transfers of corporate stock was received.
immediately before the stock was transferred for property or services in a taxable transaction (even if an intermediate entity had held the stock for some time).

26 Reg. 1.1032-3(e), Example 8. See notes 52-53, infra, and the accompanying text.

27 See notes 65-68, infra, and the accompanying text.

28 The Rev. Rul. 99-57 aggregate approach assumes an allocation of realized gain to the corporate partner under Section 704(c); the Section 1032 Regulations’ deemed cash purchase approach assumes no gain or loss realization (or allocation thereof), because the partnership will be deemed to have a basis equal to the FMV of the stock.

29 Citing Rev. Rul. 99-57, the Preamble states: “In certain situations where the recast of the final regulations does not apply to the disposition by a partnership of a corporate partner’s stock..., realized gain or loss that is allocated to that corporate partner may nonetheless not be recognized pursuant to Section 1032.” Preamble to TD 8883, “Applicability of the Final Regulations in the Partnership Context.”

30 Section 83(h); Rev. Rul. 80-76; Ltr. Rul. 9853038.

31 Reg. 1.1032-3(e), Example 4(i).

32 Reg. 1.1032-3(e), Example 4(ii).

33 See Reg. 1.1032-3(e), Example 9(ii), citing Fink, 483 U.S. 89, 60 AFTR2d 87-5054 (1987).

34 Reg. 1.1032-3(e), Example 9(ii).

35 Id.

36 Reg. 1.1032-3(b)(1).

37 Any dividend income received by AB on A Co. stock and any interest income earned by AB on B’s cash contribution while held for the period 8/1/00 to 8/1/01 are disregarded for all purposes of this article.

38 Insofar as A Co. did not purchase its interest in AB from a third party and AB did not own A Co. stock when A Co. acquired its interest, Notice 99-57, 1999-51 IRB 692, issued in conjunction with Rev. Rul. 99-57, will not be applicable to deny A Co. its basis step-up in its partnership interest in AB with respect to A Co.’s allocable share of the gain that is not recognized under Section 1032.

39 Section 702(c); Reg. 1.702-1(c)(2).
See, e.g., Sections 856, 931, 6012(a); Regs. 1.856-3(g), 1.884-1(d)(3)(i), 1.6654-2(d)(2). See Banoff, JTAX August 1998, supra note 9, page 99, fn. 36.

Cf. Rev. Rul. 80-189, 1980-2 CB 106; Rev. Rul. 70-305, 1970-1 CB 169. None of the Code’s nonrecognition of loss provisions would apply. Cf. Sections 267, 707(b), and 1091. Would AB similarly obtain a $100,000 basis in the A Co. stock if it purchased the stock on 8/1/00 from A Co. itself? See the text, below, under “Unanswered Questions—Circular Cash Transactions.”

Cf. Rev. Rul. 96-10, 1996-1 CB 138, holding that disallowed losses under Section 267(a)(1) or 707(b) nonetheless reduce a partner’s basis under Section 705(a)(2)(B); see H. Rep’t No. 1337, 83d Cong., 2d Sess. A225 (1954); S. Rep’t No. 1622, 83d Cong., 2d Sess. 384 (1954) (requiring a partner’s share of nondeductible expenditures to be deducted from the partner’s basis in order to prevent that amount from giving rise to a loss to the partner on a sale or redemption of the partner’s interest in the partnership).

Cf. Reg. 1.83-6(d)(1); see Reg. 1.1032-3(e), Example 6(i). The premise of Section 83 is that effective ownership of the property remains with the transferor until all substantial risks of forfeiture have expired. Until then, Reg. 1.83-1(a)(1) provides that the transferor is “regarded as the owner of the property.” In our Example 6, A Co. remains the owner of the property (its stock) until the substantial risk of forfeiture ends. Not until that time is there a constructive transfer of the A Co. stock to AB and from AB to X.

Cf. Reg. 1.1032-3(e), Example 6(ii), which involves a subsidiary corporation; the analysis presumably should be the same for a subsidiary partnership (such as AB), as the Preamble states the general proposition that the final Regulations treat an acquiring partnership’s disposition of stock of the issuing corporation in the same manner as an acquiring corporation’s disposition of such stock.


Compare Reg. 1.1032-3(e), Example 6(i).

Cf. Reg. 1.1032-3(e), Example 7(ii). The Preamble to TD 8883 states that the two types of reversionary interests (in Reg. 1.1032-3, Examples 6 and 7) were included in the examples “to indicate ownership of the stock for tax purposes.” Perhaps this means that AB (as owner of the reversionary interest) is treated as the owner from the moment A Co. transfers the stock to X until the stock vests; prior to vesting X cannot be treated as the owner of the stock under Section 83 and Reg. 1.83-1(a)(1), and A Co. cannot be treated as the owner either—as of the date A Co. transfers the shares to X, it no longer has a current or reversionary interest or the benefits and burdens of ownership of the A Co. shares, and therefore should not be treated as the owner for tax purposes. If neither X nor A Co. can be treated as the owner as of 8/1/00, then AB must be the owner starting at that time; since AB is not deemed to transfer the A Co. stock until 8/1/01 when it vests in X, AB fails the “immediate transfer” element of the four requirements and Reg. 1.1032-3 cannot apply in our Example 7.
Reg. 1.1032-3(e), Example 7(ii).

Section 83(e); Reg. 1.83-7(a).

Section 83(a); Reg. 1.83-7. Under the facts in our Example 8, X should be able to avoid constructive receipt and immediate taxation at the time of grant, even though the option is granted at a substantial discount. See O’Neill and Schenck, “Using Discount Options as Executive Compensation,” 72 JTAX 348 (June 1990).

Section 83(h); Reg. 1.83-6(a); Ltr. Ruls. 9822012 and 9853038. See “Issuing Corporate Partners May Deduct Options on Exercise by Partnership Employees,” supra note 15.

Reg. 1.1032-3(e), Example 8(ii).

Id.

The characterizations that come to mind are: (1) as (a) a transfer of the stock from the corporation to the partnership, (b) a transfer of the stock from the partnership to the employee in exchange for the employee’s payment to the partnership of the exercise price, and (c) a cash distribution of the exercise price by the partnership to its corporate partner; (2) as (a) a transfer of cash from the corporation to the partnership equal to the FMV of the stock, (b) a cash purchase of stock (for the same amount) by the partnership from the corporation, (c) a transfer of the stock by the partnership to its employee in exchange for the employee’s payment (equal to the exercise price), and (d) a cash distribution from the partnership to the corporation of an amount equal to the exercise price; (3) as (a) a transfer of cash from the corporation to the partnership equal to the FMV of the stock, (b) a transfer of cash (equal to the value of the stock minus the exercise price) by the partnership to the employee, (c) use of that cash by the employee to purchase some shares directly from the corporation (at full FMV), (d) payment of the remaining cash by the partnership to the corporation, to purchase the remaining shares from the corporation (at full FMV), (e) transfer of those remaining shares from the partnership to the employee, for an actual payment by the employee to the partnership equal to the exercise price of the stock, and (f) a distribution (draw) of cash from the partnership to the corporation; and (4) as (a) a transfer of cash from the corporation to the partnership equal to the FMV of the stock minus the exercise price, (b) a transfer of that cash by the partnership to the employee, and (c) a purchase of the stock from the corporation by the employee (by the employee’s payment of cash to the corporation equal to the FMV of the stock, with the employee using his own cash equal to the sum of the exercise price and the cash received from the partnership in (b) above to pay the difference).

The special rule for actual payment for stock of the issuing corporation, in Reg. 1.1032-3(b)(2), applies “if the issuing corporation receives money or other property in payment for its stock,” apparently without limitation as to the identity of the payor. Moreover, the Preamble to TD 8883 specifically refers to payment coming from either the employee or the acquiring entity.

Cf. Reg. 1.1032-3(e), Example 8(ii).

Reg. 1.1032-3(e), Example 3(ii).
That is, the ownership of stock having at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of all other classes of the corporation’s stock.

Some commentators were concerned that the Service’s favorable holding in Rev. Rul. 80-76 would be extended only where the parent owned 80% or more of its corporate subsidiary (in light of the reference in that Ruling to the parent’s having “control” as defined in Section 368(c)). In fact, nothing in Section 83 or the Regulations thereunder differentiates between 80%-owned and less-substantially owned subsidiaries. One commentator urged the IRS, when finalizing Prop. Reg. 1.1032-3, to clarify that the rules are equally applicable to a subsidiary corporation owned less than 80% by the transferor-partner. Alas, Reg. 1.1032-3 contains no such explicit clarification.

Query whether it would be sufficient to merely have the last leg of the transfer, i.e., a deemed contribution (of the P Co. stock) from A Co. to AB, qualify under Section 723, regardless of meeting the requirement of Section 362(a) with respect to the transfer from P Co. to A Co.

Rev. Rul. 70-305, supra note 41.

See Reg. 1.1032-3(c)(1) (the “potential Section 362(a) or 723 applicability” requirement), Reg. 1.1032-3(c)(2) (the “immediate re-transfer” requirement), and Reg. 1.1032-3(c)(4) (the “no exchange for issuing corporation stock” requirement).

Reg. 1.1032-3(c)(3).

See Sections 7701(a)(42)(A) and (a)(43).

Reg. 1.1032-3(e), Example 5(ii).

Id.; Reg. 1.1032-3(b)(1).

Reg. 1.83-6(d)(1) provides, in substance, that if a shareholder (e.g., “Parent”) of a corporation (“Subsidiary”), transfers property to an employee of Subsidiary, any money or property paid by the employee to Parent for the property is considered paid to Subsidiary and transferred immediately thereafter by Subsidiary to Parent “as a distribution to which Section 302 applies.” Commentators pointed out that this will result in dividend treatment (to the extent of Subsidiary’s E&P) under Section 301 for such transactions, with potentially adverse, unanticipated consequences (e.g., if Subsidiary is a foreign corporation, the deemed dividend would bring foreign income and foreign tax credits into Parent’s U.S. tax return; and Parent may incur state and local taxes where dividends are subject to tax).

The Preamble to TD 8883 states that Reg. 1.83-6 is currently under study, and a cross-reference to Reg. 1.1032-3 has been added to Reg. 1.83-6(d) indicating that “the mechanics of section 1.1032-3, rather than the mechanics of section 1.83-6(d), apply to a corporate
shareholder’s transfer of its own stock to any person in consideration of services performed for another entity where the conditions of the final [Section 1032] regulations are satisfied.”

69 See notes 49-51, supra.

70 Compare Reg. 1.1032-3(e), Example 6(i).

71 See notes 49-51, supra.

72 Cf. Reg. 1.1032-3(e), Example 8(ii). Although that example contains only a single deemed capital contribution (i.e., from the issuing corporation to the acquiring entity), Reg. 1.1032-3(b)(1) extends the deemed cash purchase model to include deemed cash capital contributions through intermediate corporations.

73 Regs. 1.1032-3(b)(1) and 1.1032-3(e), Example 3(ii).


76 Might A Co. be protected by Section 1032? That nonrecognition provision applies to the receipt of money or other property in exchange for stock. A nonpartner capital contribution does not actually or constructively result in the receipt of anything by the contributor, and thus Section 1032 appears inapplicable.

77 See Banoff, JTAX February 2000, supra note 1, pages 107-108.

78 See Banoff, JTAX February 1975, supra note 5, page 98. Also see Shop Talk, “More on Transfer of Zero Basis in Stock to ESOP,” 64 JTAX 320 (May 1986). Respected commentators have subsequently endorsed the parent’s sale of its stock to its subsidiary as creating a cost basis for the stock. See, e.g., Walter, “The Issuer’s Own Stock—Section 1032, Section 304 and Beyond,” 68 Taxes 906 (December 1990); Schler, “Exploring the Boundaries of Section 1032,” 49 Tax Lawyer 543 (Spring 1996).

79 A similar result was reached in Ltr. Ruls. 8234081 and 8321111, not mentioned in the Service’s 1985 pronouncements. Nevertheless, there are indications the IRS would not permit basis to be so created by the partnership, given that the Service denied a corporate subsidiary’s attempt to create an FMV basis in parent stock. Serota, “Employee Benefits Considerations in Joint Ventures,” ABA Center for CLE, National Institute, Employee Benefits in Mergers and Acquisitions (4/24-25/97).

80 One of several variants would be for AB to purchase the A Co. stock from A Co. for AB’s note of $100,000; at a decent interval thereafter A Co. could contribute $100,000 cash to the capital of AB, which AB then would use to repay the debt.
Moreover, the Preamble to REG-106221-98, 9/22/98 (the Section 1032 Proposed Regulations) warned against taxpayers using self-help to overcome the zero basis problem: “No inference is intended regarding whether circular cash flows would be respected apart from this regulation [1.1032-3]. Similarly, no inference is intended with respect to other methods of avoiding gain on the acquiring corporation’s use of the issuing corporation’s stock.”

In general, an S corporation’s net long-term and net short-term capital gains and losses retain their character (and long-term or short-term holding period) in the hands of the S corporation’s shareholders; Section 1366(a). Ownership of the corporation’s stock by a partnership or LLC for longer than a transitory period would cause the corporation to lose its S status; Section 1361(b)(1)(B) and Reg. 1.1361-1(e)(1). Nevertheless, a partnership may own S corporation stock momentarily, in connection with other transactions, without threatening its S status. Cf. Ltr. Rul. 8926016. Under the cash purchase model, the corporate partner’s stock would be owned (or deemed owned) by AB only for a transitory period; to qualify under Reg. 1.1032-3 for the deemed cash purchase approach, AB must “immediately transfer” the shares to X (the third party).

Prop. Reg. 1.1223-3(b).

Prop. Regs. 1.1223-3(d)(1) and 1.1223-3(e), Example 3.

Prop. Reg. 1.1223-3(e), Example 3.

See Banoff, “Planning for Partnership Interest Transfers Under New Holding Period Prop. Regs.,” 91 JTAX 202 (October 1999). Under the Section 1223 Proposed Regulations, this illogical result also applies where all the existing partners make capital contributions proportionate to their interests in the partnership! See Prop. Reg. 1.1223-3(e), Example 3.

These first two steps amount to a triangular distribution, whose characterization for tax purposes (as a deemed dividend and capital contribution) is found in analogous situations. See, e.g., Rev. Rul. 78-83, 1978-1 CB 79; Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, Sixth Edition (Warren, Gorham & Lamont, 1994), ¶ 8.05[10], and cases cited therein.

See note 24, supra.


In so doing, Reg. 1.1032-3 differs from the Service’s sole other zero basis solution using the deemed cash purchase model, i.e., Reg. 1.1502-13(f)(6)(ii) (which uses the model to create FMV basis but contains no nonrecognition rule or statement akin to the first sentence of Reg. 1.1032-3(b)(1)). Where the requirements of Reg. 1.1502-13(f)(6)(ii) are satisfied, that Regulation provides that “[i]f a member, M, would otherwise recognize gain ... M is treated as purchasing the P stock from P for fair market value with cash contributed....” Such a characterization is consistent with recognizing gain of zero.
Reg. 1.1032-3(e), Example 8(ii).

See ABA Section of Taxation, “Comments on Proposed Regulations § 1.1032-3” (12/14/98), page 6, reprinted in 56 Highlights & Documents 41 (1/4/99).

To wit, that the rules of Reg. 1.1032-3 apply to an option issued by a corporation to buy or sell its own stock in the same manner as the rules of the Regulation apply to the stock of an issuing corporation.

Reg. 1.1032-3(e), Example 8(i).

The Preamble does not directly respond to the question whether Reg. 1.1032-3 applies if the acquiring entity issues the NQSO. The Preamble provides that if all of the requirements of Reg. 1.1032-3 are met, the Regulations apply to determine the treatment accorded the issuing corporation and the acquiring corporation on transfer of the issuing corporation stock to the employee.


See Schler, note 78, supra.


The Preamble states: “If the acquiring corporation could receive the stock at a fair market value basis and hold on to it, then if the value of the stock decreased, the subsidiary could sell the stock and recognize a loss. The Treasury and the IRS believe that it is inappropriate to issue regulations facilitating selective loss recognition.”

The IRS adopted a similar cash purchase model to substantially eliminate the zero basis problem for a consolidated subsidiary using its parent’s stock but adopted a different, “over the top” approach to solve the zero basis problem for a nonconsolidated subsidiary using its parent’s stock in a nontaxable reorganization. Compare Regs. 1.1502-13(f)(6)(ii) and 1.1032-2.

Practice Notes

A key aspect of the Section 1032 Regulations is the requirement for an “immediate transfer” of the stock of the corporate partner (or its parent) to the employee of the partnership. Any delay, which might allow for appreciation or depreciation in the value of the stock, upsets the application of the deemed cash purchase model, and will result in unpleasant tax consequences for the partnership and its partners.
<table>
<thead>
<tr>
<th>Example No.</th>
<th>Property Transferred by or for A Co.</th>
<th>Type of Transfer</th>
<th>Date of Transfer from A Co. to AB</th>
<th>Date of Transfer from AB to X</th>
<th>Value of Stock on 8/1/00</th>
<th>Subsequent Value of Stock</th>
<th>Consequences to AB</th>
<th>Consequences to A Co.</th>
<th>Consequences to B</th>
<th>Consequences to X</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>A Co. stock</td>
<td>Indirect</td>
<td>8/1/00</td>
<td>8/1/00</td>
<td>$100,000</td>
<td>$100,000 (8/1/00)</td>
<td>No gain or loss recognized; $200,000 deduction in 2000</td>
<td>No gain or loss recognized; A Co.’s basis in its AB interest increases $100,000; $100,000 deduction in 2000</td>
<td>No gain or loss recognized; $100,000 deduction in 2000</td>
<td>$200,000 income in 2000</td>
</tr>
<tr>
<td>2</td>
<td>A Co. stock</td>
<td>Direct</td>
<td>8/1/00</td>
<td>8/1/00</td>
<td>$100,000</td>
<td>$100,000 (8/1/00)</td>
<td>No gain or loss recognized; $200,000 deduction in 2000</td>
<td>No gain or loss recognized; A Co.’s basis in AB increases $100,000; $100,000 deduction in 2000</td>
<td>No gain or loss recognized; $100,000 deduction in 2000</td>
<td>$200,000 income in 2000</td>
</tr>
<tr>
<td>3</td>
<td>A Co. stock</td>
<td>Direct</td>
<td>8/1/00</td>
<td>8/1/00</td>
<td>$100,000</td>
<td>$100,000 (8/1/00)</td>
<td>No gain or loss recognized; $200,000 deduction in 2000</td>
<td>No gain or loss recognized; A Co.’s basis in AB increases $100,000; $100,000 deduction in 2000</td>
<td>No gain or loss recognized; $100,000 deduction in 2000</td>
<td>$200,000 income in 2000</td>
</tr>
<tr>
<td>4</td>
<td>A Co. stock</td>
<td>Indirect</td>
<td>8/1/00</td>
<td>8/1/01</td>
<td>$100,000</td>
<td>$130,000 (8/1/01)</td>
<td>$130,000 STCG in 2001; $230,000 deduction in 2001</td>
<td>$115,000 STCG in 2001 (not recognized); A Co.’s basis in AB increases $115,000; $115,000 deduction in 2001</td>
<td>$15,000 STCG in 2001; $115,000 deduction in 2001</td>
<td>$230,000 income in 2001</td>
</tr>
</tbody>
</table>

1/ All examples assume B makes a cash contribution to AB and AB pays such cash to X as additional compensation.

2/ “Indirect” means stock is transferred from A Co. to AB and AB to X; “direct” means stock is actually transferred from A Co. directly to X.

3/ Transfer is from SH, A Co.’s majority shareholder, directly to X. (SH must allocate her basis in the transferred shares in her remaining shares of A Co. stock.)

4/ Per Rev. Rul. 99-57 and Section 705.
<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Date</th>
<th>Basis</th>
<th>STCL</th>
<th>STCG</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>Cash</td>
<td>8/1/00</td>
<td>8/1/01</td>
<td>$100,000</td>
<td>$70,000</td>
<td>$30,000 STCL in 2001; $170,000 deduction in 2001; $15,000 STCL in 2001 (not recognized); A Co.’s basis in AB reduced by $15,000; $85,000 deduction in 2001; $170,000 income in 2001</td>
</tr>
<tr>
<td>6</td>
<td>A Co. stock</td>
<td>8/1/01</td>
<td>8/1/01</td>
<td>$100,000</td>
<td>$120,000</td>
<td>No gain or loss recognized; A Co.’s basis in AB increases $120,000; $120,000 or $110,000 deduction in 2001; $220,000 income in 2001</td>
</tr>
<tr>
<td>7</td>
<td>A Co. stock</td>
<td>8/1/01</td>
<td>8/1/01</td>
<td>$100,000</td>
<td>$120,000</td>
<td>$120,000 STCG in 2001; $220,000 deduction in 2001; $110,000 STCG in 2001 (not recognized); A Co.’s basis in AB increases $120,000; $120,000 or $110,000 deduction in 2001; $220,000 income in 2001</td>
</tr>
</tbody>
</table>

5/ Shares are transferred 8/1/00 from A Co. to AB and AB to X, but are subject to risk of forfeiture until 8/1/01, when they vest. No Section 83(b) election by X. In the event of forfeiture, the shares revert to A Co.

6/ Same as fn. 5, above, except any forfeited shares revert to AB (not A Co.).

7/ The NQSOs are granted 8/1/00. The NQSOs are exercised, and the shares are transferred to X when X pays the option price, on 8/1/01. “Date of transfer” as reflected here is the date the shares are transferred.
| Example No. | Property Transferred by or for A Co. | Type of Transfer | Date of Transfer from A Co. to AB | Date of Transfer from AB to X | Value of Stock on 8/1/00 | Subsequent Value of Stock | Consequences to AB | Consequences to A Co. | Consequences to B | Consequences to X |
|------------|-------------------------------------|-----------------|----------------------------------|-------------------------------|------------------------|-------------------------|---------------------|-----------------------|----------------|----------------|----------------|
| 8          | A Co. NQSOs                          | Direct          | 8/1/01                           | 8/1/01                        | $25,000 (options' value) | $100,000 (8/1/01)      | No gain or loss recognized; $200,000 deduction in 2001 | No gain or loss recognized; A Co.'s basis in AB increases $100,000; $100,000 deduction in 2001 | No gain or loss recognized; $100,000 deduction in 2001 | $200,000 income in 2001 |
| 9          | P Co. stock                          | Direct          | 8/1/00                           | 8/1/00                        | $100,000 (8/1/00)       | $100,000 (8/1/00)      | No gain or loss recognized; $200,000 deduction in 2000 | No gain or loss recognized by A Co. (or P Co.); A Co.'s basis in AB (and P Co.'s basis in A Co.) increases $100,000; $100,000 deduction in 2000 | No gain or loss recognized; $100,000 deduction in 2000 | $200,000 income in 2000 |
| 10         | P Co. stock                          | Indirect        | 8/1/00                           | 8/1/00                        | $100,000 (8/1/00)       | $100,000 (8/1/00)      | No gain or loss recognized; $200,000 deduction in 2000 | No gain or loss recognized by A Co. (or P Co.); A Co.'s basis in AB (and P Co.'s basis in A Co.) increases $100,000; $100,000 deduction in 2000 | No gain or loss recognized; $100,000 deduction in 2000 | $200,000 income in 2000 |
| 11         | P Co. stock                          | Indirect        | 8/1/00                           | 8/1/01                        | $100,000 (8/1/01)       | $130,000 (8/1/01)      | $130,000 STCG in 2001; $230,000 deduction in 2001 | $115,000 STCG in 2001 (recognized by A Co.); A Co.'s basis in AB increases $115,000 (but P Co.'s basis in A Co. does not increase); $115,000 deduction in 2001 | $15,000 STCG in 2001; $115,000 deduction in 2001 | $230,000 income in 2001 |

8/ Shares are transferred 8/1/00 from P Co. to A Co., A Co. to AB and AB to X, but are subject to risk of forfeiture until 8/1/01, when they vest. No Section 83(b) election by X. In the event of forfeiture, the shares revert to P Co.
<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Date/Length</th>
<th>Description</th>
<th>Date/Length</th>
<th>Description</th>
<th>Date/Length</th>
<th>Description</th>
<th>Date/Length</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>P Co. stock (bargain purchase)</td>
<td>Direct 8/1/00</td>
<td>$20,000 (purchase discount)</td>
<td>$20,000 (purchase discount) (8/1/00)</td>
<td>No gain or loss recognized; $20,000 deduction in 2000</td>
<td>No gain or loss recognized by A Co. (or P Co.); A Co.'s basis in AB (and P Co.'s basis in A Co.) increases $10,000; $10,000 deduction in 2000</td>
<td>No gain or loss recognized; $10,000 deduction in 2000</td>
<td>$20,000 income in 2000</td>
</tr>
<tr>
<td>13</td>
<td>P Co. stock</td>
<td>Indirect 8/1/01</td>
<td>$100,000</td>
<td>$120,000 (8/1/01)</td>
<td>No gain or loss recognized; $220,000 deduction in 2001</td>
<td>No gain or loss recognized; A Co.'s basis in AB (and P Co.'s basis in A Co.) increases $120,000; $120,000 or $110,000 deduction in 2001</td>
<td>No gain or loss recognized; $100,000 or $110,000 deduction in 2001</td>
<td>$220,000 income in 2001</td>
</tr>
<tr>
<td>14</td>
<td>P Co. NQSOs</td>
<td>Direct 8/1/01</td>
<td>$25,000 (options' value)</td>
<td>$100,000 (8/1/01)</td>
<td>No gain or loss recognized; $200,000 deduction in 2001</td>
<td>No gain or loss recognized by A Co. (or P Co.); A Co.'s basis in AB (and P Co.'s basis in A Co.) increases $100,000; $100,000 deduction in 2001</td>
<td>No gain or loss recognized; $100,000 deduction in 2001</td>
<td>$200,000 income in 2001</td>
</tr>
</tbody>
</table>