MEMORANDUM
TO: Senior partner
FROM: Team Number ___
DATE: November 11, 2004
SUBJECT: 2004 Law Student Tax Challenge Problem

INTRODUCTION

Mega plans a § 355 spin-off of its subsidiary, iTunes. Mega currently has a compensation plan that annually grants iTunes executives Mega restricted shares and nonqualified options ("options"). The client would like to understand how the spin-off will affect Mega, iTunes, and the executives and whether Mega shares and options may be replaced by iTunes shares and options. Two recalcitrant executives threaten to resign if the division goes forward and demand that their indebtedness under an employee loan program be forgiven.

The current compensation plan and loan program present no obstacles to the § 355 transaction. While the executives who filed 83(b) elections for their restricted stock should do so again if it is replaced, their tax treatment is not affected by the transaction. The entities have some flexibility to replace Mega shares and options with iTunes shares and options, if the change reflects their current economic relationship. In general, iTunes claims deductions for compensation, even if issued by Mega, because the executives perform services only for iTunes. There is some risk that a failure to follow information reporting requirements would cause a forfeiture of those deductions. Mega has ultimate withholding responsibility for employment taxes on the restricted shares and options that it issues. Mega should not forgive the debt under the loan program because the forgiveness will be treated as compensation, and Mega's deductions will likely be limited.

TAX CONSEQUENCES OF COMPENSATION PLAN PRE-SPIN

Executives

Under the current plan, § 83 governs when iTunes executives face compensation income for their receipt of restricted stock and options. When the executives file 83(b) elections for the

restricted stock, they must include into income the fair value of the stock without regard to the vesting restrictions. See I.R.C. § 83(b). Appreciation in the stock is capital gain, the holding period commences at the election, and dividends paid on the restricted stock retain dividend character. Treas. Reg. § 1.83-4(a); Rev. Proc. 83-38, 1983-1 C.B. 773. Executives who have not filed elections include income only when the restricted stock vests. See I.R.C. § 83(a). Dividends declared prior to the lapse of restrictions are characterized as additional compensation income. Treas. Reg. § 1.83-1(a)(1); Rev. Proc. 80-11, 1980-1 C.B. 616. Because the options have no ascertainable fair value, the executives recognize compensation income only when the options are exercised. Treas. Reg. § 1.83-3(a)(2); Comm'r v. Lobue, 351 U.S. 243 (1956).

Mega & iTunes

Neither Mega nor iTunes face gain or loss recognition in connection with the transfer of restricted stock and options to the executives. Regulation § 1.1032-3 triangulates Mega's transfer of property to iTunes executives as a capital contribution to iTunes, which is used to purchase the Mega property at fair value, after which the property is transferred to the executives. Treas. Reg. § 1.83-6(d)(1); Rev. Rul. 2002-1, 2002-1 C.B. 268. This deemed capital contribution and cash purchase occur immediately before the "transfer" of property—that is, when elections are filed, stock vests (for those who did not file elections), or options are exercised. Treas. Reg. § 1.1032-3(b)(1), (2).

Because the executives pay nothing for the restricted shares, the total fair value of those shares is the amount deemed contributed by Mega, which iTunes uses to purchase the shares. See Treas. Reg. § 1.1032-3(3)(ex. 6). However, because the executives do pay a strike price for the options, Mega is deemed to contribute only the difference between the fair value of the stock at exercise and the strike price. Treas. Reg. § 1.1032-3(b)(2) and (e)(ex. 8). The strike price is

deemed paid to iTunes, who in turn distributes the cash to Mega. Treas. Reg. §§ 1.1032-3(d); 1.83-6(d)(1).

TREATMENT OF COMPENSATION PLAN POST-SPIN & OTHER ISSUES

Executives

Durability of 83(b) Elections

If the Mega restricted shares do not convert into iTunes restricted shares, then the earlier 83(b) elections will continue to be effective after the spin-off. Generally, 83(b) elections are ineffective only when made for inappropriate property (for example, options without a readily ascertainable fair value), when a taxpayer secures Service approval to revoke an election under § 83(b)(2), or in the unusual scenario where there is a rescission of § 83(b) property in the same year as the grant. See P.L.R. 9104039 (Oct. 31, 1990) (ruling that elections have no effect after rescission of grant that had an unanticipated negative accounting impact).

If the Mega shares are replaced with iTunes shares, an 83(b) election probably does not need to be filed with respect to the iTunes restricted shares. Nonetheless, because the provision allows for a contrary reading, the executives should again file protective 83(b) elections for the iTunes restricted shares.

Under § 83(g), if there is an exchange of § 83(a) property for other property with "substantially similar" restrictions and §§ 354, 355, 356, or 1036 applies to the exchange, then the exchange is disregarded for purposes of § 83(a). Thus, if the iTunes shares are subject to similar restrictions as the Mega restricted shares, and because § 355 would apply to the exchange, then § 83(g) disregards the exchange, and no additional 83(b) elections would be necessary. See also Treas. Reg. 1.83-1(b)(3).

However, if an 83(b) election takes property out of the § 83(a) setting, then § 83(g) is inapplicable, and an additional election is necessary. In other words, because § 83(g) only applies to property "to which subsection (a)" applies, there is no exchange flexibility for what is

now § 83(b) property. An 83(b) election should not upset the flexibility that § 83(g) affords an exchange of restricted property. Because of the ease of filing an 83(b) election, however, it is best to avoid uncertainty by filing an election for the iTunes restricted shares. The executives have thirty days from the date of transfer in which to file the election; they may also file the election prior to the actual transfer of the iTunes restricted shares. Treas. Reg. § 1.83-2(b).

Mega & iTunes

Replacement of Mega Options

Mega and iTunes may replace old options with new options and get favorable tax consequences if the post-division options reflect the economic terms of the pre-division options. See Rev. Rul. 2002-1, 2002-1 C.B. 268 ("the Ruling"). The client is considering a complete conversion of Mega options into iTunes options. This approach has the benefit of, for example, simplifying withholding obligations. Applying the logic of the Ruling, the Service might approve of issuing only price-adjusted iTunes options because an adjustment would compensate the executives for receiving an interest in a spun-off subsidiary less valuable than an interest in the parent of the consolidated group. However, the guidance on such a transaction is not clear because the Ruling sanctions an arrangement where an employee continues his interest in both distributing and controlled corporations. Therefore, to hew closer to the Ruling, Mega should cancel its old options and, in connection with the spin-off, issue an amount of new Mega and iTunes options that reflects the pre-spin relationship.

When the parent-subsidiary relationship is reflected in the distribution of new options, the Ruling provides that neither Mega nor iTunes will face gain or loss recognition upon exercise of the options. The Ruling applies a relation-back principle that treats a post-spin exercise of distributing (Mega) options as a pre-spin exercise. As discussed above, the exercise of Mega

options does not result in gain or loss recognition to Mega or iTunes. Nor does iTunes face gain recognition upon the exercise of options to acquire its stock because § 1032 applies.

The terms of the options must provide that forfeited options return to the issuer (e.g. Mega options return to Mega) so that § 1032 will apply. See Rev. Rul. 2002-1; Treas. Reg. § 1.1032-3(e)(ex. 7). The facts of the Ruling were that the executive compensation plan had not been adopted in anticipation of the spin-off; the spin-off occurred two years after adoption of the plan. Likewise, so long as the iTunes compensation plan began two years prior to the spin-off, the Service should not argue that it was adopted in anticipation of the spin-off.

To ensure the economic terms are preserved, the total exercise price of pre- and post-spin options should be the same, and the total number of Mega and iTunes shares subject to option should reflect the distribution of iTunes shares. For example, if Mega shareholders receive one iTune share for each Mega share owned, then the number of post-spin iTunes shares subject to option should correspond to the number of Mega shares subject to option pre-spin. The ratio of post-spin exercise prices for Mega and iTunes options should equal the ratio of the fair value of Mega (without its interest in iTunes) to the fair value of iTunes.

Mega and iTunes probably also have similar flexibility with respect to the restricted stock. Although the Ruling specified that none of the employees had made 83(b) elections, it is unclear why that fact would lead to a different result.

Entity's Ability to Claim Deductions and Timing of Deductions

iTunes is entitled to claim the deductions for the restricted shares and options that Mega issued to the iTunes executives. The entity for which services were performed may claim the deduction, even for property that was transferred from the entity's parent. I.R.C. § 83(h); Treas. Reg. §§ 1.83-6(d)(1), -7(a). That restrictions lapse or options are exercised after a spin-off does

not alter the general rule that the service recipient is entitled to the deduction. Rev. Rul. 2002-1, 2002-1 C.B. 268.

However, because of the restricted stock's grant date, iTunes' deductions are deferred. See I.R.C. § 83(h) ("Such deduction shall be allowed for the taxable year of such person in which ends the taxable year in which such amount is included in the gross income of the person who performed such services."). The year delay on these deductions is due to the difference between iTunes' fiscal year, which ends in June, and the executives' calendar year. For example, the executives received restricted shares this March, 2004, and will include the shares as income in December, 2004; assuming, after the spin-off, iTunes has the same tax year as its parent, it may not take the deductions for the shares until June, 2005. To avoid deferrals in the future, iTunes should consider changing the day on which it delivers restricted stock to some time between the end of iTunes' fiscal year and the end of the calendar year.

When the options are exercised, iTunes is entitled to a deduction equal to the spread between the exercise price and the fair value of the underlying shares. Treas. Reg. § 1.83-(7)(a). If the option is exercised between the beginning of the calendar year and the end of iTunes' fiscal year, as explained above, the deduction will be deferred until its following tax year.

Information Reporting Requirements and Potential for Deduction Forfeiture

If Mega or iTunes fails to comply with information reporting requirements, monetary penalties may be applied. See, e.g., I.R.C. §6721, 6722. However, it is unclear whether failure to comply jeopardizes § 83(h) deductions. The Service position, as reflected in the regulations and its preamble, is that a deduction is allowed only if the compensation is actually included in the service provider's income or the employer complies with the safe harbor. See I.R.C. § 83(h); T.D. 8599. If actual inclusion is required, then iTunes should comply with information reporting

because the regulations provide a safe harbor under which the executives would be deemed to have included the compensation if iTunes timely files W-2s. See Treas. Reg. § 1.83-6.

Even if iTunes does not comply with the reporting requirements, its failure to follow the information reporting requirements may not prevent it from taking the deductions. See Robinson v. United States, 335 F.3d 1365 (Fed. Cir. 2003). In Robinson, the court held that the word "included" in § 83(h) means "included as a matter of law." Id. at 1372. The court held that this distinction allowed a service recipient to claim the § 83(h) deductions irrespective of whether or not the employee actually reports the income. Id. at 1373. But see Venture Funding, Ltd. v. Commissioner, 110 T.C. 236 (1998) (holding, under pre-1995 regulations, that either actual inclusion or safe harbor compliance was necessary).

The entities should comply with the safe harbor because the Service has not acquiesced to the Robinson position. Nonetheless, if for some reason they fail to comply with information reporting, Robinson is helpful authority for the position that deductions are not lost.

Appropriate Entity to Remit Employment Taxes

To be clear, employment taxes are owed on the restricted stock and options. The term "wages" is broadly construed under the applicable employment tax provisions. See I.R.C. §§ 3401(a), 3121(a), 3306(b). However, withholding and employment tax is due only when the restricted stock vests or an option is exercised. Rev. Rul. 79-305, 1979-2 C.B. 350; 67-257, 1967-2 C.B. 359.

Although the employer, iTunes, may claim the deductions for the restricted stock and options, "employer" has a different meaning in the context of employment taxes. Because "employer" means the party having control of the payment of the wages, Mega must remit employment taxes even after the spin-off. See Rev. Rul. 81-45, 1981-1 C.B. 483; see also Otte

v. United States, 419 U.S. 43, 51 (1974); STA of Baltimore-ILA Container Royalty Fund v. United States, 621 F.Supp. 1567, 1575 (D. Md. 1985), aff'd 804 F.2d 296 (4th Cir. 1986).

It is unclear how the parties currently handle withholding obligations. The obligations can be handled in at least three ways: (1) Executives make cash payments to Mega representing its withholding obligation; (2) Mega withholds the requisite amount until it has recouped that amount; (3) Mega pays the executives' withholding tax as a bonus, which gives rise to further withholding. Whether or not the property converts in connection with the spin-off, the simplest arrangement is to require the executives to make cash payments to Mega (or iTunes, if there is a conversion). Alternatively, if there is no conversion, the Service probably would respect an arrangement where iTunes agrees with Mega to withhold the proper amount of employment tax. See Rev. Rul. 81-45, 1981-1 C.B. 483 (permitting a subsidiary to withhold the amount for which the parent is liable; however, the Ruling discusses an ongoing parent-subsidiary relationship.) If the employment taxes are not collected, Mega is still liable. See Treas. Reg. § 31.3403-1.

Discharge of Indebtedness Under Employee Loan Program

A discharge of debt will produce compensation income, which likely will be non-deductible to iTunes and heavily taxed to Dum and Duma. See Rev. Rul. 2004-37, 2004-11 I.R.B. 583 (holding that employee recognizes compensation income upon the forgiveness of debt by its employer, after its employer issued the debt so the employee could purchase stock options). Although the ruling only deals with debt issued to buy stock options, we think the same analysis would apply to other expenses as well.

Ruling 2004-37 provides that where a discharge of debt is a medium to provide compensation, § 1001 trumps §108(e)(5), and forgiveness of debt is income rather than an offset of basis. See Treas. Reg. § 1.1001-3. This analysis holds true if the forgiveness of indebtedness

significantly changes the notes' yield. See §1.1001-3(e)(2). Here, as forgiveness would change the face of the notes of over six million dollars in total, it is clear that a discharge significantly changes the yield on the notes. Id. Therefore, the forgiveness would be compensation income taxable to Dum and Duma, and, but for the limitations discussed below, would be deductible to iTunes under § 83(h). See Rev. Rul. 2004-37, 2004-11 I.R.B. 583 (2004); see also Treas. Reg. §1.83-4(c).

If Dum and Duma's debt is discharged, they would each receive over three million dollars of additional income in that tax period. This drastic increase in income probably triggers provisions that limit deductions to Mega and impose additional tax on Dum and Duma. See I.R.C. §§ 162(m), 280G, 4999.

First, Dum and Duma are probably employees under § 162(m) whose remuneration above one million dollars is not deductible to iTunes. iTunes and Mega are or will be public companies under § 162(m)(2); Dum and Duma are likely among the four highest compensated officers for the taxable year in which they would receive this income and thus would be "covered employees." See I.R.C. § 162(m)(3).

Second, in addition to the one million dollar limitation, the deduction also may be limited by the golden parachute rules of § 280G. Dum and Duma would be disqualified individuals who receive a payment contingent on a change in the effective control of the corporation. See I.R.C. § 280G(c). The discharge will be a "parachute payment" if the present value of the discharge is triple their "base amount" (annualized includible compensation over the previous five years). I.R.C. §§ 280G(b)(2), (b)(3), (d)(2). iTunes and Mega would not be entitled to a deduction of any amount higher than the "portion of the base amount allocated to such payment." See I.R.C. § 280G(a), (b)(1). Even if the discharge does not triple their base amount, § 280G may

nonetheless apply if the forgiveness violates a securities law such as Sarbanes-Oxley. See I.R.C. 280G(b)(2)(B).

Third, the Service might argue that the compensation is unreasonable and is not compensation but instead a disguised dividend that is not deductible. See Treas. Reg. §§ 1.162-7, 1.162-8. However, this treatment is more likely in the setting of a closely-held company, and therefore is highly unlikely here.

Because a discharge would likely limit deductions, iTunes should take all steps to ensure the loans are repaid. Dum and Duma may be more receptive to this repayment once informed of the error in the accounting firm opinion. There is a twenty percent additional tax to the recipient of any "excess parachute payment." See I.R.C. § 4999. Hopefully an explanation of the compensation income and additional twenty percent tax will quell Dum and Duma's grumblings about any legal claims against Mega.

CONCLUSION

The issues that caused the client concern do not impede the spin-off. However, there are several steps the parties can take to minimize costs and uncertainty. The entities may replace Mega options, and probably shares, if the replacement reflects the current parent-subsidiary economic relationship. In that event, the executives should file 83(b) elections again. Whether or not shares and options are replaced, iTunes is able to claim the deductions, but Mega is ultimately liable for employment taxes on the property it issues to the executives. iTunes should follow information reporting requirements to ensure it may claim deductions. Finally, Mega should not forgive the debt under the employee loan program.

LAW OFFICES OF TEAM NUMBER ____
Tax Town, ABA State, 10000

Client,
Tax Town, ABA State, 10000
Subject: 2004 Law Student Tax Challenge Problem
Date: November 11, 2004

Dear Maya Dezine:

Based on the information you have given us about the proposed spin-off and existing executive compensation plan, we conclude that the transaction is a good method of attaining the parties' goals. However, there are several steps that the parties can take to reduce uncertainty and prevent adverse consequences.

Dum's and Duma's debt should not be forgiven because it would produce a result adverse to all parties. The executives should file 83(b) elections again to resolve any uncertainty if Mega restricted stock is replaced with iTunes stock. Whether or not shares and options are replaced, iTunes is entitled to the deductions, yet Mega is liable for the employment taxes on the property that it issued to the iTunes executives. Finally, iTunes should comply with information reporting requirements to ensure that it is able to claim deductions for the shares and options that its executives include as compensation.

Forgiveness of Debt to Dum and Duma

You will be relieved to learn that Dum's and Duma's position is untenable, and we anticipate that they will drop their demand once apprised of the tax consequences of debt forgiveness. The forgiveness of debt would likely be treated as excess compensation to Dum and Duma, rather than as basis reduction as they contend. iTunes and Mega should not agree to any reduction in debt because the Service would probably disallow compensation deductions for what it sees as excessive compensation and "excess

parachute payments." Dum and Duma would also be subject to a golden parachute penalty tax of twenty-percent in addition to the standard tax on ordinary income.

Executives' 83(b) Elections

The spin-off does not affect the 83(b) elections that most executives have already filed for their Mega restricted stock. An 83(b) election is rarely "undone." However, if in connection with the spin-off, the Mega restricted stock is replaced with iTunes restricted stock, we advise that the executives file 83(b) elections again. They probably do not need to do so because in certain tax-free scenarios, such as the planned spin-off, § 83(g) allows for an exchange of substantially similar property. Nonetheless, filing an 83(b) election mitigates any uncertainty and is a relatively easy and inexpensive step.

Deductions and Timing

iTunes is able to claim the deductions on the Mega shares and options issued to the iTunes executives because the executives performed services for iTunes. Even though this property was issued by Mega, the general rule is that it is the entity for which services are provided that is entitled to the deduction. The Service recently held that this result occurs even if shares vest or options are exercised after a spin-off.

The timing of iTunes' deductions is governed by the "deferral principle" that it may not claim the deduction before the employee has included the corresponding amount of compensation at the end of his tax year. Because of the difference between the entity's fiscal year and the executives' calendar year, and because of the date on which the shares are issued, iTunes' deductions are currently deferred by a year. Thus, for the stock issued this March, 2004 (for which 83(b) elections were made), iTunes' deduction is deferred

from June, 2004 until June, 2005 because the executives' year will not end until December, 2004. In the future, iTunes should consider delivering restricted stock some time between the end of its fiscal year (June) and the end of the calendar year.

Employment Tax Withholding

Although iTunes is entitled to a deduction for the Mega restricted shares and options issued to its executives, Mega is ultimately liable for the withholding tax due on that property. For purposes of employment taxes such as Social Security, the "employer" is whoever has control over the payments, even if those payments are made to an employee of a subsidiary. To ensure that employment taxes are withheld, the simplest solution is to enter into an agreement (if one does not already exist) obligating the iTunes executives to make cash payments to Mega covering its withholding obligation. If such an agreement is not feasible, iTunes could agree to withhold the amounts.

Information Reporting Requirements

There is currently some conflict between judicial interpretation and the Service position over whether a failure to comply with information reporting requirements results in a forfeiture of deductions. Because of the uncertainty, the best course is to comply with all information reporting requirements.

The Service position, based on Treasury Regulations, is that an employee must either actually include the compensation in his income or, under a safe harbor, the employer may ensure its deduction if it complies with information reporting. In contrast, the Federal Circuit Court of Appeals has held those regulations are invalid. Under its analysis, the intent of Congress was to allow the employer a deduction for the

corresponding amount of compensation that was includible as a matter of law (whether or not actually included) in the employee's income.

Again, the best course is simply to follow the reporting requirements. However, if iTunes does not comply, there is helpful and persuasive legal authority that it should nonetheless be entitled to the deduction for the restricted stock and options.

Conversion of Mega Options into iTunes Options

Mega has flexibility, in connection with the spin-off, to replace some of the Mega options with iTunes options. In a recent Revenue Ruling, the IRS blessed a replacement that occurred in connection with a tax-free spin-off. Because the ruling does not explicitly bless a total conversion of parent options, we recommend that Mega cancel its outstanding options and replace them with new Mega and iTunes options. By structuring the new options to reflect the current economic relationship between Mega and iTunes, Mega and iTunes will face no gain recognition when the options are later exercised.

The principles and reasoning articulated in the ruling lead us to think that Mega probably has similar flexibility with respect to the restricted shares. However, the facts of the ruling were that none of the employees had made 83(b) elections. Because most of the iTunes executives have made elections, the ruling is clearer on an option replacement than it is on a restricted stock replacement.

We hope that we have responded adequately to your concerns. Please feel free to contact us if you have additional questions or would like further explanation.

Sincerely,
TEAM NUMBER ______