IX. MATERIALS RELATING TO SALE OF OPTIONS TAX SHELTER

AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

Sale of Executive Options Technique – Advantages and Disadvantages
(Privileged Information – Do Not Disseminate)

Associated Advantages of Using the Sale of Executive Options Technique

Executive

1. The executive gets the opportunity to diversify his/her portfolio without having an immediate tax payment due from exercising the options.

2. The executive keeps approximately 80% of the benefits from deferring associated taxes for 15 years.

3. Income from the options is "locked-in" at the sale price.

4. The technique does not have to be reported to the IRS as a tax shelter.

5. The downside risk is limited as Arthur Andersen's opinion letter should eliminate tax penalties imposed by the IRS for disallowing the technique.

Enron

1. Enron may generate goodwill from its top executive staff for introducing such a large potential benefit to its executives.

2. The technique helps serve as an NOL tax refresher for Enron.

Associated Disadvantages of Using the Sale of Executive Options Technique

Executive

1. The executive must pay Arthur Andersen the entire fee by the time the technique is implemented while the benefits will accrue over 15 years.

2. The executive must capitalize the Limited Partnership with non-personal assets in value approximately equal to 10% of the sale price of the options.

3. If the value of the Limited Partnership portfolio drops by a significant amount, then the Limited Partnership could have trouble repaying the "promise to pay" back to the executive. However, this debt must be repaid. In the case of executive death, the debt must be repaid to his/her estate.

4. If tax rates change significantly over the next 15 years, the value of the benefit could be significantly lessened.

Enron

1. Could potentially, significantly reduce executive ownership in Enron. ?

2. Enron must wait until the executive claims income in order to receive the compensation tax deduction for the option. If all goes as planned, Enron will postpone its tax benefit for 15 years.

3. If the executive leaves Enron within the next 15 years, Enron will require some sort of procedure to receive its tax deduction when principal is repaid to the executive from the Limited Partnership.

4. Enron will require guidance from Arthur Andersen as the executive's tax advisor to operationalize manually overriding the payroll system to legally keep income off of the executive's W-2 statement.

5. How will Enron's role in letting Arthur Andersen show the technique to executives be perceived by tax and legal authorities? Enron would prefer not to have involvement.

EC 000770978

Discuss

Sale of Executive Options Technique
(Privileged Information – Do Not Disseminate)

Steps Involved in the Transaction

I. The Executive forms a Limited Partnership (LP) with family ownership approximately as follows:

Executive	79% Limited Partner (also General Partner)
Executive Spouse	18% Limited Partner (also General Partner)
Children	3% Limited Partners

Maintain beneficial ownership (indirect

Executive makes a capital contribution to the LP roughly equal to 10% of the value of the options that will be sold to the LP.

Capitalization should be comprised of non-personal assets.

II. Executive sells options to the LP for an amount equal to the appraised value of the options.

Discuss w/ Mary – cannot be unvested

Generally, nonqualified options will be used (vested ~~or unvested~~).

LP gives to the executive, an unfunded, unsecured, 15 year, balloon promise to pay with a marketable interest rate which is payable yearly. The principal is to be repaid in 15 years.

All income to be recognized concerning the options will now be fixed at the option sale price.

Income recognition is deferred until principal is repaid (15 year principal repayment defers the taxable recognition of income for 15 years). An amortizing debt would recognize income incrementally as the principal is returned to the lender.

Employee income recognition and Enron compensation expense recognition, for tax purposes, must occur at the same time. This means that Enron will not be able to receive a tax deduction for the options (or portions of them) unless the principal on the note (or portions of it) is repaid.

(sale -- for value; occ, insider maintains control/beneficial ownership (he has sold to himself, in effect.)

III. While the partnership may exercise the options within the time frame permitted under the relevant option plan, most partnerships exercise the options and sell the underlying shares immediately. – Note.

Effect of Transaction on Executive

- Can ~~but~~ rely on S-8
- Must report sale by P/S as sale by insider (or family P/S).

Cash

Initial outflow of 10% of the transferred asset value to fund the LP.

The executive must expend the greater of $150,000 or 20% of the NPV of the deferred benefit as compensation to Arthur Andersen.

The executive will receive interest payments annually from the LP. For tax purposes, the amount is reduced by the amount of the pass through interest expense by the LP.

Income

The executive will defer the income from the sale of the options until principal is received.

EC 000770979

It is recommended that the LP exercise the options immediately after the sale transaction. If the options are exercised immediately after the sale, then the net effect of an IRS disallowed deduction would be to accelerate taxes due from a 15 year deferral period to present. AA's "more likely than not" opinion is intended to shield the executive from penalties for understating income should the transaction be challenged.

Enron must override the payroll system at exercise. Since all income will be deferred, override is necessary to ensure that no income will be attributable to the executive from exercise.

Income is also recognized by the executive for interest received on the note receivable. This is partialy offset by the interest expense passed through by the LP.

SEC Reporting

No additional SEC reporting is required.

Discuss - When P/S exercises option, Ken Lay files a Form 4.

Effect of Transaction on LP

Cash

The LP will have an initial capitalization of approximately 10% of the transaction value.

The LP will take possession of the stock options and simultaneously exercise the options.

Will be reported on Ken Lay's Form 4. (i.e., he maintains beneficial ownership -- not a "gift" to family member.

Income

Interest payments will be an interest expense to the LP while the investment income will be income.

Both interest expense and investment income will be passed through to the partners of the LP.

16a-13 Transaction - Without change in pecuniary interest Exempt from Sec 16

SEC Reporting

Upon sale, Form 4 (Family Controlled Entity) is filed by Enron while S-8 should continue to suffice.

? Filed by Ken Lay (not Enron, not Family Controlled Entity)

Effect of Transaction on Enron

Cash

Upon exercise, Enron will recieve the strike price times the number of options exercised.

Since Enron is allowed a compensation expense deduction as the executive recognizes income, a compensation expense (and corresponding the tax deduction) will be taken when principal is returned. This has an effect of reducing cash flow (vis-à-vis a normal exercise) in the year of exercise if Enron is in a positive NOL situation.

is loss of deduction for 15 year. Value in excess of $60,000?

If the sale of options transaction is disallowed by the Service, Enron will be allowed an accelerated compensation expense deduction for the income related to the exercise of the options.

Income

As mentioned above, a slight decrease in the tax deduction will effect a small decrease in net income.

EC 000770980

Tax

The transaction has the net effect of increasing tax expense in the year of exercise and decreasing the expense when principal is returned.

If the deferral transaction does not work, all income from exercise will be accelerated to the date of exercise allowing Enron a corresponding immediate deduction.

Accounting

must be immaterial

For Financial Accounting purposes, the net effect of the transaction is a small indirect reduction in net income through a lower tax deduction in the year of exercise.

Discuss w/ Cauley ~~This is~~ ENE is not a party to this so no proxy disclosure

The deferred tax asset will be maintained on Enron's books without an NPV adjustment.

SEC Reporting

Upon sale, Form 4 (Family Controlled Entity) is filed by Enron while S-8 should continue to suffice.

Ken Lay

Other

This transaction could be put in place by an executive without approval by Enron, however proper approval may be warranted as Enron's involvement may require overriding the payroll systems concerning W-2 income recognition.

But — ENE is not a party (Proxy issue)

There is a small chance that an equity analyst could figure out the transaction.

Enron Plan Allowance for the Transaction

Arthur Andersen requires that plan documents permit "transfers" for the transaction to be permitted. The 1991 Plan currently has that language with the 1994 plan to contain that language beginning August 2000.

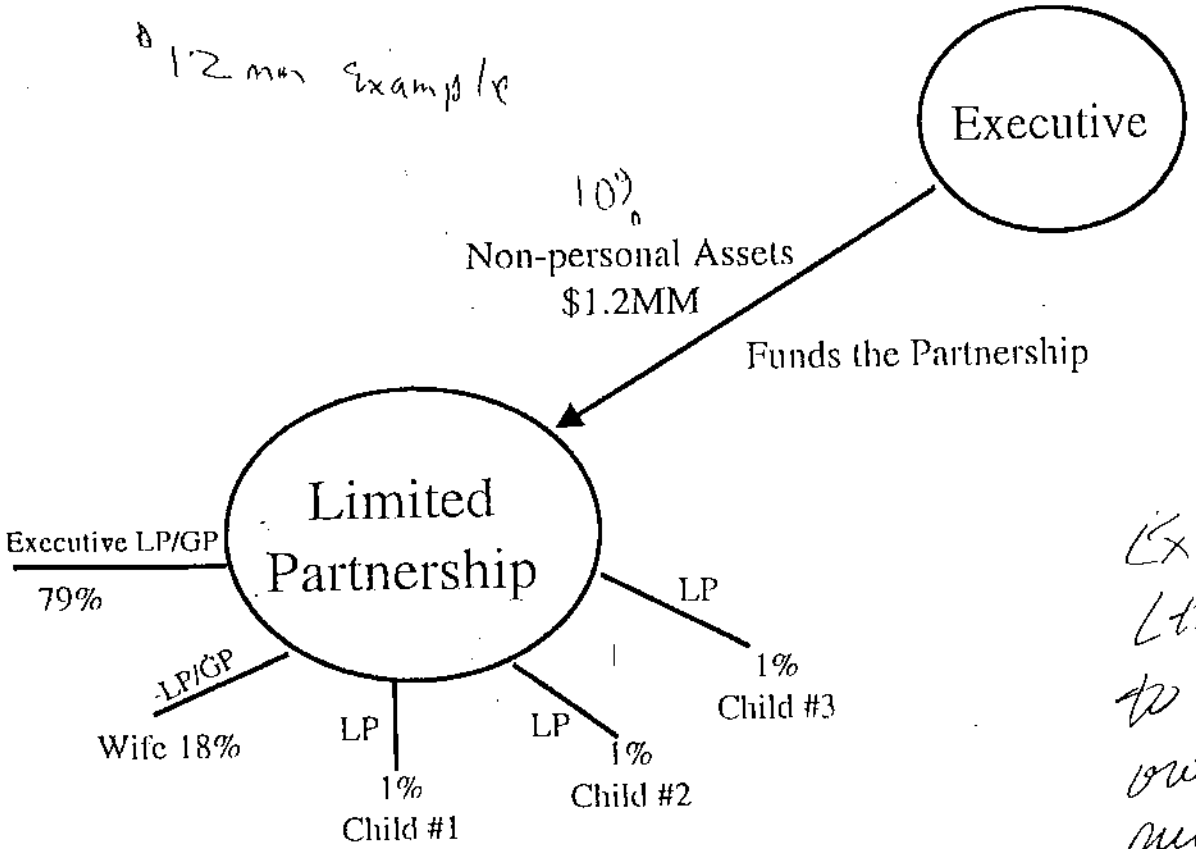
Does Plan provide for "sales". I thought what was contemplated was "gifts" (transfers to family members) Have Pat Machin look at this.)

Should be limited # of executives that get grants for from '94 Plan

EC 000770981

CALL MARY JOYCE

$1.2 mm Example



Executive "controls" Ltd. P/S (i.e. continues to be the "beneficial owner for Section 16 purposes). Stays on Form 4 (i.e. not a "gift" to family members).

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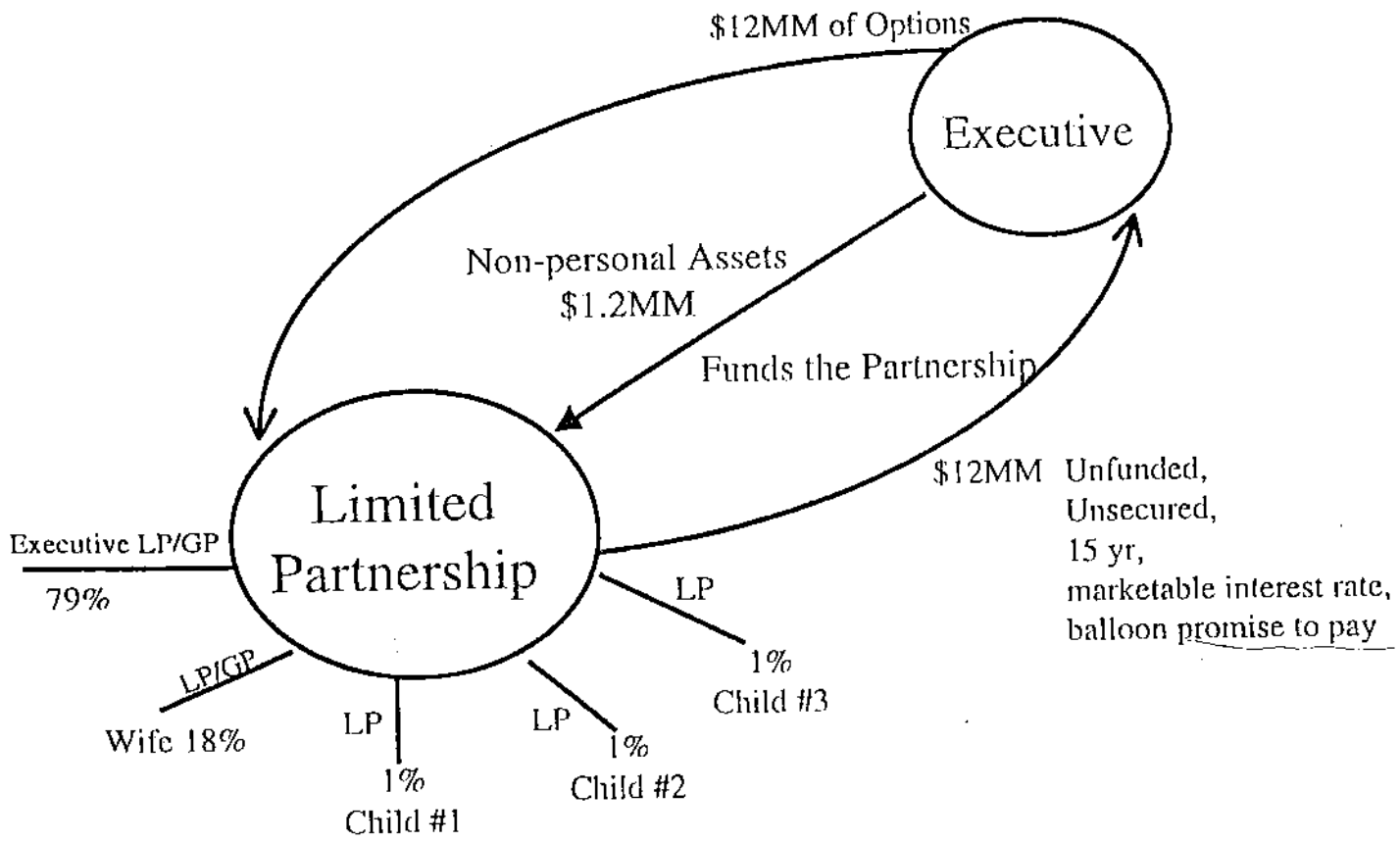

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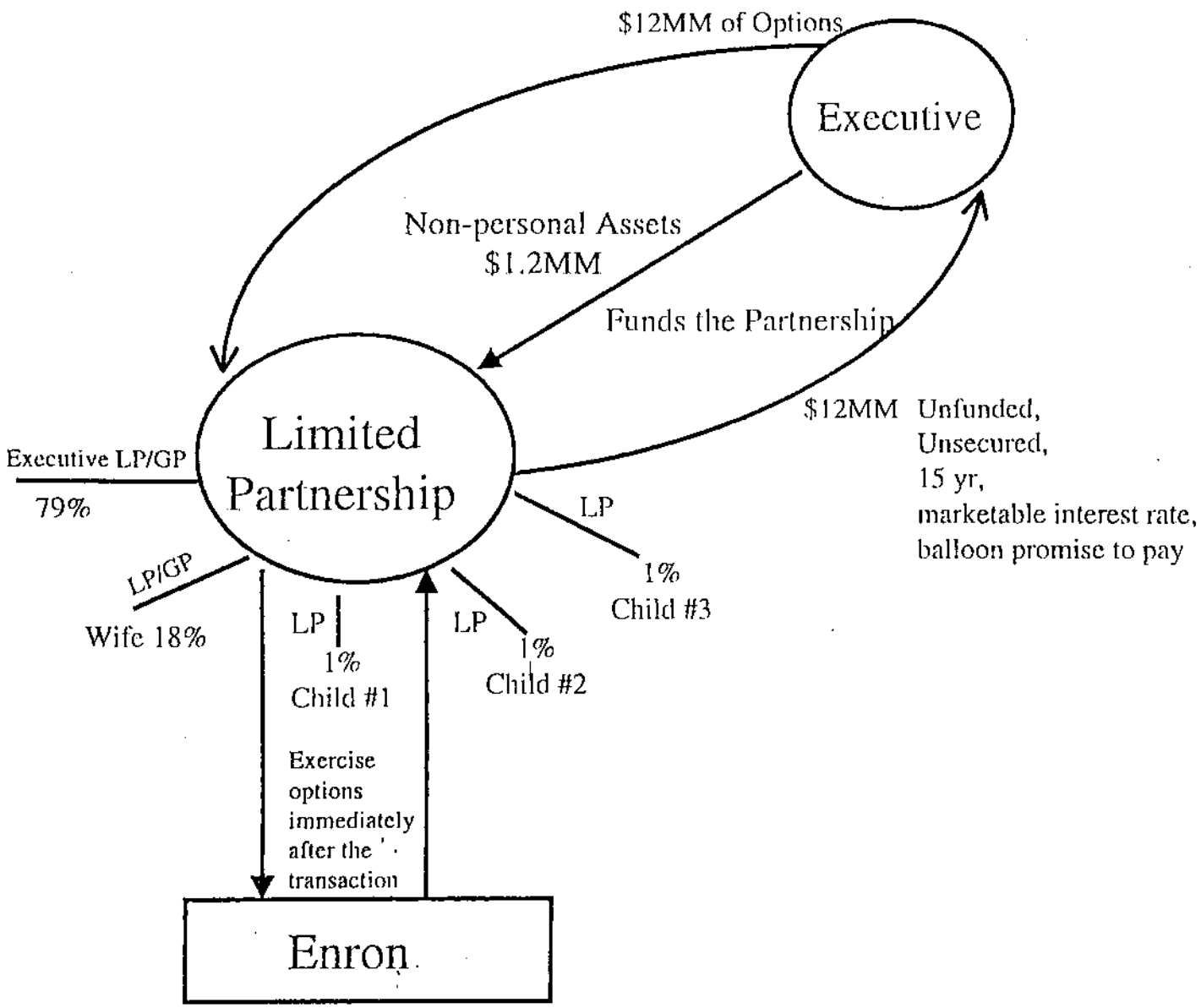

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_____, 1999

PRIVILEGED AND CONFIDENTIAL

Mr.
Address
City, State Zip

Dear Client:

You have requested us to review certain transactions as described herein in connection with the sale of certain of your ABC, Inc., nonqualified stock options to Client Partnership, a Delaware limited partnership, and to provide our opinion to you regarding certain federal income tax issues as stated herein relating to such transactions. We have done so and are communicating our conclusions and our opinions herein.

In analyzing the authorities relevant to the potential tax issues outlined in opinions 1 through 7 below, we have applied the standards of "substantial authority" and "more likely than not," as used in section 6662(d)(2) of the Internal Revenue Code of 1986 (hereinafter the "Internal Revenue Code" or "Code" or "I.R.C.") and Treasury Regulation (hereinafter "Treas. Reg.") § 1.6662-4(d). Based upon our analysis, subject to the various qualifications set forth herein, we have concluded that there is substantial authority for the indicated tax treatment of the issues and opinions discussed herein, and we also believe the indicated treatment of such issues is more likely than not proper.

The opinions expressed herein are based on the facts and assumptions you have provided to us as discussed below under the heading "Facts and Assumptions," and you have represented to us that we have been provided all material facts relating to the transactions described therein and that you concur with the assumptions stated therein. Any misstatement of a material fact or omission of any fact that may be material or any amendment or change in any of the facts referred to may require a modification of all or a part of our opinions. We have no responsibility to update this opinion for events, transactions, or circumstances occurring after the date of issuance of this opinion.

The opinions expressed herein are based upon our interpretation of the Internal Revenue Code and income tax regulations promulgated thereunder as interpreted by court decisions and by rulings and procedures issued by the Internal Revenue Service (the "Service") as of the date of

this letter. When, in this letter, we express an opinion on your position, we mean that if the Service were to assert a contrary position, your position, if properly presented to a court, is more likely than not to ultimately prevail. The opinions expressed herein are not binding on the Service, and there can be no assurance that the Service will not take a position contrary to the opinions expressed herein.

The opinions expressed herein reflect our assessment of the probable outcome of litigation and other adversarial proceedings based on the merits of the issues. However, it is important to note that litigation and other adversarial proceedings are frequently decided on the basis of such matters as negotiation and pragmatism. Furthermore, in recent years, courts of law have exhibited a willingness to interpret prior authorities, as well as to develop new theories, to reach a conclusion that will maximize tax revenues. We have not considered the effect of such negotiation, pragmatism or judicial bias in our assessment of the outcome of such potential litigation or other adversarial proceedings.

These opinions reflect what we regard to be the material income tax effects as described therein; nevertheless, they are opinions only and, therefore, should not be taken as an assurance of the ultimate tax treatment.

In our review of the authorities stated herein, we have accorded weight to each authority in accordance with the provisions of Treas. Reg. § 1.6662-4(d)(3)(ii) and (iii). Accordingly, we have given more weight to more recent revenue rulings, private letter rulings, general counsel memorandum, or actions on decisions than to older ones. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. We have given more weight to authority decided under the particular Code section in question than to authority decided under analogous Code sections. In addition, we have accorded weight to the relevant authorities in accordance with the methodology outlined in Treas. Reg. § 1.6662-4(d)(3). We have relied upon the following sources in our analysis: the Code; case law; legislative regulations; final regulations; temporary regulations; proposed regulations; revenue rulings; private letter rulings; technical advice memoranda; and congressional intent as reflected in committee reports.

The opinions expressed herein would have to be reevaluated if, after their issuance, there are any new judicial developments or changes in the Internal Revenue Code, the regulations and published rulings issued thereunder or the current administrative rulings. We have not considered any nonincome tax or state or local income tax consequences and, therefore, do not express any opinion regarding the treatment that would be given the transactions discussed below by the applicable authorities on any nonincome tax or any state or local tax issues. We also express no opinion on nonfederal income tax issues such as personal property transactions, securities law matters, etc.

These opinions are solely for your benefit and are not intended to be relied upon by anyone other than you. We assume no responsibility for tax consequences to the other parties to the transactions. Instead, the other parties should consult and rely upon the advice of their own counsel, accountant or other advisor. Except to the extent expressly permitted hereby, and without the prior written consent of Arthur Andersen LLP, this letter may not be quoted in whole or in part or otherwise referred to in any documents or delivered to any other person or entity, other than a disclosure to a taxing authority in the event of a penalty assertion by such authority.

FACTS AND ASSUMPTIONS

The factual circumstances and the assumptions upon which we base the opinions expressed herein are described below.

You were granted certain nonstatutory stock options ("options") under the terms of an Option to Purchase Shares ("Option Agreement") dated April 1, 1996. These options were granted to you in connection with your performance of services to ABC Industries, Inc ("ABC"). Because these options had no ascertainable fair market value at date of grant, they were not included in your gross income at the time of grant pursuant to I.R.C. § 83. Originally, the option agreement granted to you the right, privilege and option to purchase 49,830 shares of the voting common stock of ABC and 448,470 shares of the nonvoting common stock of ABC at an exercise price of $2.05 per share. The options were exercisable in whole or in part at any time after April 1, 1996, but no later than March 31, 2001. Subsequent adjustments were made to the Option Agreement due to stock splits, a June 1997 initial public offering and amendments to the Option Agreement as authorized by ABC's Board of Directors. Most recently, on March 25, 1999, the Option Agreement was amended, making them transferable to "members of the immediate family of [you] (or entities controlled by [you] and/or such family members), for or without consideration, to the extent vested." On April 9, 1999, the options represented the right, privilege and option to purchase 199,320 shares of common stock of ABC at $5.125 each, no later than March 31, 2001. From the time of grant until the time of the sale, all of the options granted on April 1, 1996, were vested in you, and none had been exercised or transferred.

On April 9, 1999, you and your family established Client Partnership ("Client P/S"), a Delaware limited partnership, with $200,000 cash contributed 80% ($160,000) by you, 18% ($36,000) by your wife, Client Wife, and 1% ($2,000) by each of your two sons, Client Child #1 and Client Child #2. Your 80% initial partnership interest consists of a 1% general partnership interest and a 79% limited partnership interest. Client Wife's 18% initial partnership interest consists of a 1% general partnership interest and a 17% limited partnership interest. The 1% initial partnership interest held by each of your sons is a 1% limited partnership interest.

For estate planning and other reasons, you sold the ABC options described above to Client P/S under a Stock Option Purchase Agreement ("Purchase Agreement") dated April 13, 1999, in

exchange for an unfunded and unsecured promissory obligation to pay the purchase price in a lump sum on April 13, 2014. The contract price is for the fair market value of the stock options at the date of sale. The Purchase Agreement stated a total purchase price for the options of $2,248,578.75, which was subject to an adjustment clause whereby the stated purchase price would be replaced by the value subsequently determined by an independent appraisal conducted by Arthur Andersen. The subsequent appraisal of these options by Arthur Andersen was performed using the Black-Scholes model for valuing stock options in accordance with Rev. Proc. 98-34, I.R.B. 1998-18, which provides rules for valuing stock options for transfer tax purposes. The independent appraisal determined the value of each option to be $10.11, for a total value of $2,014,756. Thus, the adjusted purchase price of the options is $2,014,756. The Purchase Agreement also provided for the accrual of interest on the outstanding unpaid principal amount at the rate of 8% per year until paid in full. All accrued but unpaid interest is required to be paid on each anniversary of the Purchase Agreement until the principal amount and all accrued but unpaid interest is paid in full. According to the Purchase Agreement, the stated interest rate was also subject to adjustment based on the results of an independent appraisal to by performed by Arthur Andersen. While the appraisal has yet to be finalized as of the date of the issuance of this letter, it has been represented that the interest rate will be such that the promissory obligation had a fair market value equal to the purchased options ($2,014,756) at the time the Purchase Agreement was executed. Under the terms of the Purchase Agreement, you may not transfer, assign or pledge your receivable. As described above, the terms of the Purchase Agreement were designed to be comparable to similar commercial transactions.

To meet its repayment obligations under the Purchase Agreement, Client P/S will segregate and earmark assets to be used for this purpose. However, because the promissory obligation is unsecured, these funds are subject to the claims of general creditors in the event of bankruptcy. As noted above, Client P/S had assets of $200,000 cash prior to this sale, or approximately 10% of the fair market value of the purchased options. Pursuant to the Partnership Agreement, Client P/S may not make distributions to its partners (other than tax distributions) without your prior consent.

Thus, as of the date of the issuance of this letter, Client P/S L.P. is the owner of the options. As owner, Client P/S has absolute discretion in determining whether to exercise or hold the options. As consideration for your sale of these options, you received a promissory obligation, structured as a balloon obligation, under which you will receive annual interest payments with the balance due April 13, 2014.

ISSUES

1. Will Client P/S be respected as a valid partnership for federal income tax purposes?
2. Will your sale of options to Client P/S be respected as a valid sale between two separate taxable entities?
3. Will the Assignment of Income Doctrine apply to your sale of options to Client P/S?
4. Does the sale of the options to Client P/S qualify as an "arm's length transaction" for purposes of I.R.C. § 83?
5. For purposes of I.R.C. § 83, if nonqualified stock options are disposed of in an "arm's length transaction," are there any tax consequences to you upon the subsequent exercise of the options by Client P/S?
6. Does the receipt of an unfunded unsecured contractual promise to pay in exchange for the options constitute the receipt of "property," such that ordinary income must be recognized under I.R.C. § 83?
7. What are the tax consequences to ABC upon your arm's length sale of options to Client P/S?

SUMMARY OF OPINIONS

Based on the analysis set forth below and the assumptions and representations referred to herein, it is our opinion that (a) the following positions are "more likely than not" proper and (b) you would "more likely than not" prevail if these positions are challenged by the IRS. These positions are as follows:

1. Client P/S will more likely than not be recognized as a valid partnership for federal income tax purposes.
2. Your sale of ABC options to Client P/S will more likely than not be respected as a valid sale between two separate and distinct taxable entities.
3. The Assignment of Income Doctrine more likely than not does not apply to your sale of options to Client P/S.
4. A disposition of nonqualified options at fair market value under commercially reasonable terms more likely than not satisfies the arm's length standard of I.R.C. § 83.
5. Once nonqualified options are disposed of at arm's length under I.R.C. § 83, thereby triggering the realization of ordinary income, any subsequent exercise of the options by Client P/S more likely than not does not invoke the re-application of I.R.C. § 83.
6. Your receipt of Client P/S's unfunded and unsecured promise to pay the appraised value for the options plus interest more likely than not will not constitute "the receipt of property" for purposes of I.R.C. § 83. As a result, recognition of compensatory ordinary income should more likely than not be delayed until you receive principal payments under this promissory obligation.
7. It is more likely than not proper that the timing and amount of ABC's deduction for compensation paid correspond to the timing and amount of compensation included in your gross income.

TECHNICAL ANALYSIS

1. Client P/S will more likely than not be recognized as a valid partnership for federal income tax purposes.

Generally, the most important factor in determining the existence of a partnership for tax purposes is the intent of the parties. In the leading case of Commissioner v. Culbertson, 337 U.S. 733, 742 (1949), the Supreme Court stated that a partnership exists for tax purposes when "considering all the facts - the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent - the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." See also Carriage Square, Inc. 69 T.C. 119 (1977); Hubert M. Luna, 42 T.C. 1067 (1964); Clem Moore, 46 T.C.M. 473 (1983).

You, your wife, and your sons have clearly evidenced an intention to join together in the present conduct of an enterprise by forming Client P/S pursuant to Delaware state law. Client P/S will hold title to all investment assets and will conduct its operations in the name of Client Partnership Control of Client P/S, its assets and the income generated by the partnership will be in the hands of the general partners. Client P/S has true and substantial economic substance, having been capitalized with initial contributions totaling $200,000, and thus should not be considered a "mere shell." Additionally, Client P/S's income and losses will be shared jointly among the partners pursuant to the terms of the Partnership Agreement.

Client P/S's classification as a partnership for federal tax purposes is not affected by the fact that the partnership is engaged primarily in investment activities, rather than an active trade or business. The "check-the-box" regulations provide that an entity can qualify as a partnership if the entity carries on a "trade, business, *financial operation*, or venture." Treas. Reg. § 301.7701-1(a)(2) (emphasis added). The final partnership anti-abuse regulation provides additional evidence that an organization formed solely for investment purposes can be a partnership for federal tax purposes. This regulation provides that Subchapter K is intended to permit taxpayers "to conduct joint business (*including investment*) activities." Treas. Reg. § 1.701-2)(a) (emphasis added). In addition, Example 5 of the anti-abuse regulation treats a partnership as a bona fide partnership, even though the partnership is engaged solely in investment activities. See Treas. Reg. § 1.701-2(d) (Example 5). Finally, I.R.C. § 761(a) provides that an unincorporated entity that is availed of for investment purposes only (and not for the active conduct of a business) can elect not to be treated as a partnership for federal tax purposes.

Implicit in the ability of such an entity to elect out of partnership classification is the concept that an entity formed solely for investment purposes can qualify as a partnership for federal tax purposes. Based on these authorities, Client P/S will more likely than not be classified as a partnership for federal tax purposes.

2. Your sale of ABC options to Client P/S will more likely than not be respected as a valid sale between two separate and distinct taxable entities.

In exchange for capital contributions, you, your wife and your children received partnership units of Client P/S. As of the date of this letter, the ownership of Client P/S is as follows:

Client	80%	L.P./G.P.
Client Wife	18%	L.P./G.P.
Client Child #1	1%	L.P
Client Child #2	1%	L.P.

From the time you were granted your ABC options until the date you sold them to Client P/S, you owned the options in your individual capacity. Because the sale of the options was to an entity in which you own 80%, the Service could potentially argue that the sale should not be respected under legal doctrines such as the "sham transaction doctrine" or "substance over form."

In Frank Lyon v. U.S., 435 U.S. 561 (1978), the Supreme Court commented on the substance over form principle explaining,

> The Court has looked to the objective economic realities of a transaction, rather than to the particular form the parties employed. The Court has never regarded "the simple expedient drawing up of papers," as controlling for tax purposes when the objective economic realities are to the contrary. In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal rigid documents are not rigidly binding. Nor is the parties' desire to achieve a particular tax result necessarily relevant.

Id.

In Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992), two entities, a partnership and a corporation, were owned by the same individuals possessing the same ownership percentages in both entities. The stated purpose of the partnership was the acquisition of property for investment. The corporation had been formed for the purpose of developing and selling land. The partnership purchased approximately 270 acres of land, and later sold the property to the

corporation in exchange for a promissory note. The corporation later sold the property to third parties. The issue centered around whether the proceeds from the partnership's sale of the property to the corporation represented capital gain or ordinary income. The Service argued that in light of the activities between the two entities, the partnership was really in the business of selling land and should report the gain from the sale to the corporation as ordinary. Id. at 528. In addressing the issue, the court examined the substance rather than the form of the transaction. The court explained that the corporation was not a sham because there were valid business purposes for the partners to form the corporation, most significantly insulation from unlimited liability. Id. at 533-34. Additionally, the court stated that the transaction appeared to be arm's length and all business and legal formalities had been observed. Finally, the court noted that the partnership purchased the property as an investment, thereby assuming the risk that the land would depreciate. In light of these factors and agency principles, the court held the partnership was entitled to capital gain treatment. Implicit in this holding was a determination that the partnership and the corporation were two separate and distinct entities, and a sale between the two should be respected.

Several provisions of the Code recognize that sales between related parties may be valid transactions. For example, under Subchapter K of the Code, Treas. Reg. § 1.707-1(a) addresses transactions between partners and partnerships, such as a sale of property to a partnership. Additionally, Treas. Reg. § 1.721.1(a) clearly provides that "rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it." However, the regulation notes that in all transactions, "the substance of the transaction will govern, rather than its form." Subchapter K contains several provisions that specifically address potentially abusive transactions between related parties. For example, a loss from a sale or exchange of property between a partnership and a partner who owns a more than 50% interest in the capital or profits of the partnership is not recognized for tax purposes under I.R.C. § 707(b)(1)(A). Similarly, the installment sale provisions under I.R.C. § 453 recognize that related parties may enter into valid sale transactions and may recognize any resulting gain under the installment method of accounting. Rather than invalidating related party sales, these provisions provide specific rules limiting the use of the installment method in potentially abusive scenarios. For example, by providing rules governing second dispositions by related persons, I.R.C. § 453(e) implicitly allows related party sales.

In challenging the validity of the sale, the Service could possibly assert that the sale was in reality a contribution of capital to Client P/S. Contributions of capital are governed by I.R.C. § 721, while sales from a partner to a partnership are governed by I.R.C. § 707. In Davis v. Commissioner, 29 T.C.M. 749 (1970), the taxpayer transferred land to a joint venture in which the court determined he was a partner. The partnership agreement provided that he would be paid for the property with the first available funds, and payment would not depend on the success or failure of the project. The court focused on the form of the transaction, specifically

that the other 50% partner would have been required to provide the purchase price if the venture was unable to pay. The court held that the transaction was a sale governed by I.R.C. § 707. See also Oliver v. Comm'r., 13 T.C.M. 67 (1954) (rejecting taxpayer's characterization as sale); Otay v. Comm'r., 70 T.C. 312 (1978) (discussing factors supporting sale).

Similar issues have arisen in the context of contributions to corporations under I.R.C. § 351. In Sun Properties v. U.S., 220 F.2d 171 (5th Cir. 1955), the taxpayer sold a piece of property to a corporation of which he was the sole shareholder. The district court held that sale was not arm's length and recharacterized the transaction as a contribution to capital. The Fifth Circuit reversed, holding that the transaction was a sale despite the non-arm's length nature and the lack of business purpose for the sale. The court stated that a transaction should not be disregarded simply because it was not arm's length, and found no evidence that it was a capital contribution. See also Brown v. Comm'r., 27 T.C. 27 (1956), Hardwick v. Comm'r., 33 B.T.A. 249 (1935).

As discussed elsewhere in this opinion, your sale to Client P/S more likely than not was an arm's length transaction. Similarly, you and Client P/S have observed all formalities of a sale. Moreover, Client P/S has other assets to support the purchase of the options. Under the facts and circumstances surrounding your sale, the Service will more likely than not respect your sale of options to Client P/S as a valid sale between two separate taxable entities.

3. The Assignment of Income Doctrine more likely than not does not apply to your sale of options to Client P/S.

The assignment of income doctrine is generally applied when a taxpayer has attempted to transfer property to another, but either wholly or partially failed to do so. The doctrine has a basis in both case and statutory law. Under the traditional rule first set forth by the Supreme Court in Lucas v. Earl, 281 U.S. 111 (1930), income must be taxed to the person who earns it, and income may not be avoided by assignment to another. The Lucas Court explained,

> the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Lucas v. Earl, 281 U.S. 111, 115 (1930).

In Lucas v. Earl, the taxpayer attorney contracted with his wife for the two of them to take ownership as joint tenants in all property that they had at the time of contracting, as well as all

after-acquired property. Id. at 114. The issue involved whether the taxpayer could be taxed on the whole of the attorney fees he had earned even though half of such property was immediately distributable to his spouse. As the above quoted language of Justice Holmes indicates, the Court held that the entire amount was taxable as ordinary income to the taxpayer. Unfortunately, the Court did not elaborate on the factors it utilized to draw its conclusion.

As the doctrine developed, other courts had the opportunity to explore the application of the doctrine. For example, in Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962), the court commented on the factors that should be considered in applying the doctrine. The case involved a sole proprietor subcontractor who assigned all his business assets, including his right to receive additional compensation for services rendered that was in disputed litigation at the time of transfer. The taxpayer was the majority shareholder of the corporation to which the claim to compensation was liquidated. The court discussed the following four factors in examining whether the doctrine was applicable:

1. At the time of the transfer, was the claim uncertain, doubtful and contingent,
2. Was the transfer an arm's length transaction,
3. Did the transfer have a business purpose, and
4. Was the transfer full, complete, final and definite.

Jones v. Comm'r., 306 F.2d 292 (5th Cir. 1962).

The Jones Court admitted the difficulty of arriving at a concrete set of determining factors, and the somewhat inconsistent approach courts have taken in applying the doctrine. The court stated that "'drawing the line is a recurrent difficulty in these fields of law when differences in degree produce ultimate differences in kind.' Nevertheless, there are distinct and identifiable principles which have been developed in tax jurisprudence which serve to guide the courts." Jones v. Comm'r., 306 F.2d 292 (5th Cir. 1962) (quoting Harrison v. Schaffner, 312 U.S. 579 (1941)).

The Jones Court continued by explaining the importance of a full and complete transfer. The court discussed two cases which ultimately had differing results, but which both focused primarily on the control the transferor retained over the transferred asset or income right. Id. In Blair v. Commissioner, 300 U.S. 5 (1937), the beneficiary of a trust assigned specific amounts of annual trust income to his children. In rejecting the application of the doctrine, the court noted that the taxpayer retained no control over the share of income that he had assigned. Id. Under this analysis, the transfer was viewed to have been full and complete, with the income derived from the transferred interest taxed to the transferee. In contrast, the Jones court cited in Harrison v. Schaffner, 312 U.S. 579 (1941), in which the court required income recognition under the assignment of income doctrine where the taxpayer transferred a one-year interest in the income stream of a trust to her daughter. Because the taxpayer had not relinquished the

property in any real sense, she was required to recognize ordinary income. Id.

Although the Jones Court also cited the arm's length nature of a transaction as a relevant consideration, the court did not greatly elaborate on what satisfies this requirement, merely stating,

> Where there is an arm's length assignment of income rights for a *valuable consideration*, it is clear that the assignor realizes only the amount of the consideration received, Rhodes v. Commissioner, 43 B.T.A. 780 (1941) affirmed 131 F.2d 50 (6th Cir. 1942), and the assignee is taxable for receipts in excess of this amount. See Blair v. Commissioner, 300 U.S. 5 (1937).

Jones v. Comm'r., 306 F.2d 292 (5th Cir. 1962), citing Harrison v. Schaffner, 312 U.S. 579 (1941) (emphasis added). The significance of the above quoted language is that it indicates the doctrine will not apply in situations where the transfer is arm's length and for full and adequate consideration.

The Jones court also examined the business purpose of the transfer. The court relied on Burnet v. Leininger, 285 U.S. 136 (1932), in which a law firm partner assigned the future income from his partnership to his wife. The Jones Court stated that the taxpayer in Burnet was like taxpayers in many other cases in which there had actually been a gift of the asset because no business purpose could be found for the transfer. However, Mr. Jones was deemed to have met the business purpose test because he himself desired to sell to help alleviate his insolvency. Jones v. Comm'r., 306 F.2d 292 (5th Cir. 1962).

Although the authorities discussed above place a great deal of importance on the control the transferor retained over the transferred assets, these authorities dealt with gratuitous assignments. Courts have clearly made a distinction between the doctrine's application to gratuitous transfers and to arm's length transfers for full and adequate consideration. For example, in Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973), the taxpayer sold a right to future dividends to his son. The taxpayer reported the proceeds from the sale to his son as ordinary income. The business purpose for this sale was to accelerate the ordinary income recognition in order to take advantage of interest expenses incurred during the tax year. The Service asserted the son's receipt of the dividends was taxable to the taxpayer under assignment of income principles. The Sixth Circuit rejected this argument, holding that where good and sufficient consideration is received for the bona fide transfer of income rights, the transferors are taxable on that consideration and not on the transferees' receipt of the transferred income. Id. at 869. See also Pounds v. U.S., 372 F.2d 342, 348 (2d. Cir. 1967) (holding once assignment of rights in real estate commissions passed from the hands of the assignor, they lost their character as compensation and became instead an investment by the

taxpayer/assignee); PLR 9533008 (similar). Similarly, in Cotlow v. Commissioner., 228 F.2d 186 (2d Cir. 1955), the Second Circuit distinguished gratuitous transfers from arm's length transfers for valuable consideration. According to the Cotlow Court, "where there is an arm's length assignment of income rights for valuable consideration, it is clear that the assignor realizes only the amount of the consideration received ... and the assignee is taxable for receipts in excess of this amount." Id.

Your sale of ABC options to Client P/S was for their independently appraised fair market value. As discussed elsewhere in this opinion, the sale to Client P/S was more likely than not at arm's length. Although you retained partial control over the transferred assets by serving as a general partner of Client P/S, this control was substantially limited by your wife's position as an additional general partner of Client P/S. After your sale of the options to Client P/S for their appraised fair market value, you no longer have unilateral control over the assets. You have transferred your entire equitable interest in the options to Client P/S. Thus, Client P/S possesses all rights associated with the options, including the right to exercise or hold them indefinitely. The risk that the value of the Options will decrease or increase is completely borne by Client P/S. Additionally, you will ultimately recognize and report the proceeds from the sale as compensatory ordinary income. Under these circumstances, the assignment of income doctrine more likely than not will have no application to your transaction.

4. A disposition of nonqualified options at fair market value under commercially reasonable terms more likely than not satisfies the arm's length standard of I.R.C. § 83.

I.R.C. § 83 is the exclusive I.R.C. section governing the taxation of property, including stock options, transferred to an employee or independent contractor in connection with the performance of services. The section provides that the person who performed such services shall include in his gross income in the first taxable year in which his rights are transferable or not subject to substantial risk of forfeiture, the excess of the fair market value of such property at that time over the amount paid for such property. I.R.C. § 83(a). If the property is sold or otherwise disposed of in an arm's length transaction before the rights in the property become transferable or not subject to substantial risk of forfeiture, income is recognized at that point in an amount equal to the consideration received from the sale. Id.

Treasury Regulation § 1.83-7(a) provides further guidance on the application of I.R.C. § 83 with respect to nonqualified stock options granted to service providers. In general, for purposes of I.R.C. § 83, the value of an option is not readily ascertainable unless the option is actively traded on an established market. Treas. Reg. § 1.83-7(b). If the option does not have a readily ascertainable fair market value at the time of the grant, I.R.C. §§ 83(a) and 83(b) will apply with respect to the options when the options are exercised or otherwise disposed of, even though

they may have a readily ascertainable value prior to their exercise or disposition. If the options are exercised, the employee or independent contractor recognizes ordinary income in accordance with I.R.C. § 83(a). However, if the options are sold or otherwise disposed of before exercise in an arm's length transaction, the regulations provide that "sections 83(a) and 83(b) apply to the transfer of money or other property received [from their disposition] in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to the exercise of the option." Id. Thus, if the options are disposed of in an arm's length transaction, that disposition triggers the application of I.R.C. § 83 with respect to the consideration received in exchange for the options. If the sale or disposition is not at arm's length, I.R.C. § 83 will continue to apply with respect to the options. In such a situation, exercise of the options by the transferee will trigger compensation income to the transferor under I.R.C. § 83. Treas. Reg. § 1.83-7(a). See, e.g. PLR 199927002, PLR 9713012.

From the above discussion, it is clear that the tax consequences of your sale to Client P/S hinge on whether the transaction was arm's length. Neither the regulations nor the legislative history of I.R.C. § 83 provide any guidance on what constitutes an arm's length transaction.[1] Although the courts have not addressed the specific issue, existing authority appears to recognize that an arm's length transaction is possible between related parties for purposes of I.R.C. § 83. Moreover, no authority can be located which holds or implies that transactions between related parties per se violate I.R.C. § 83's arm's length standard. In describing the amount of compensation required to be recognized under I.R.C. § 83, the Code and regulations repeatedly use the phrase "fair market value." A fair market value transfer appears to be an implicit concept imbedded in the common understanding of what constitutes an arm's length transaction. See Bagley v. Comm'r, 85 T.C. 663, 673 n.17 (1985) (explaining, in dicta, that I.R.C. §83's "arm's length requirement is intended to assure that the statutory scheme is not circumvented by means of a disposition for less than fair market value"). Yet Treas. Reg. § 1.83-7, in dealing with the taxation of options, uses the term "arm's length transaction." Despite the plausible interpretation of the arm's length requirement in Bagley, standard statutory construction may lead to the conclusion that the arm's length standard requires more than a mere fair market value disposition.

a. Related parties and the "arm's length" standard

The statutory and regulatory ambiguity leaves open the issue of whether a transaction between related parties may satisfy the arm's length standard. Although the regulations under I.R.C. § 83 do not directly address the issue, no authority can be found precluding related party transactions from satisfying the arm's length standard. Moreover, the terminology used in the regulations suggests the drafters of I.R.C. § 83 did not intend to prohibit such a transaction. For example, in discussing the effect of a transfer of non-vested property subject to I.R.C. § 83, Treas. Reg. § 1.83(b) uses the more general term "third party," rather than another phrase, such as an "unrelated third party." By analogy, I.R.C. § 267, which covers losses, expenses and

interest, specifically states that losses between "related taxpayers" are disallowed. However, I.R.C. § 83-1(a) does not state that the sale of non-vested property must be to an unrelated party, rather it simply requires a sale to a "third party." There is no requirement in the statute or the related committee reports for any additional standard beyond "arm's length." If the drafters intended the relationship between the transferor and transferee to be controlling, the regulations would have likely reflected this intention.

While the court has never directly ruled on this issue in the context of I.R.C. § 83, existing authority strongly implies that a transaction between related parties may satisfy the arm's length standard. For example, in Pagel v. Commissioner, 91 T.C. 200 (1988), aff'd, 90-2 U.S.T.C. ¶ 50,347 (8th Cir. 1990), a corporation received compensatory warrants to purchase stock in exchange for underwriting services rendered to the issuer. The corporation later sold the warrants to its sole shareholder for $314,900, characterizing the gain as a capital gain. The IRS contended that the income recognized on the sale should be ordinary income under I.R.C. § 83 and Treas. Reg. § 1.83-7(a) since the warrant was compensation from underwriting services provided by taxpayer. The Tax Court and the Eighth Circuit Court of Appeals upheld the IRS's position, finding the corporation's arm's length disposition triggered ordinary income under Treas. Reg. § 1.83-7(a). In finding that Treas. Reg. § 1.83-7(a) was applicable, the court accepted the party's stipulation that the transaction was arm's length and stated,

> [a]lthough the transaction was between petitioner and its sole shareholder, neither petitioner nor respondent has suggested that the sales price of $314,900 was other than the fair market value of the warrant or that the sale of the warrant was other than an arm's length transaction. We therefore find that petitioner's sale of the warrant... was an arm's length transaction executed at the fair market value of the warrant.

Id. at 210.

In Pagel, the court acknowledged the fact that the compensatory warrants were sold to a related party, but did not find that this precluded an arm's length transaction. The court had the opportunity to challenge the parties' stipulation that the transaction was arm's length but did not. The court's acceptance of the parties' stipulation supports the position that it is possible to have an arm's length transaction for purposes of I.R.C. § 83 between related parties. The court's opinion was similarly unaffected by the fact that a related party, the shareholder, ended up holding the warrants after the disposition. The court could have ruled as a matter of law that a sale between related parties was per se not an arm's length transaction, or could have taken issue with the value as fair market value. Neither issue was raised or discussed by either party in the case. Instead, the court focused on whether the related party shareholder paid fair market value for the warrant. Implicit in the approach used in Pagel is an analysis focusing on whether the seller received value equivalent to what would have been received had the buyer been an independent party.

The Service similarly indicated that a transfer between related parties does not preclude arm's length treatment in Private Letter Ruling 9421013. This ruling involved a taxpayer's receipt of compensatory stock options from a corporate employer. The taxpayer later sought to transfer the options to her son, and requested a ruling as to the son's basis in the underlying stock upon the future exercise of the options. The Service ruled that "provided that the [son] acquires the Options in a transaction not at arm's length," his stock basis would be increased by the amount the parent includes in her gross income at exercise date. The clear implication from this ruling is that a transfer between parent and child could be arm's length.

The Tax Court has also indicated that transactions between related parties do not preclude arm's length treatment in contexts other than I.R.C. § 83. For example, in Zachry v. Commissioner, 49 T.C. 73 (1967), the corporate taxpayer sold preferred stock to a related company for cash, and recognized no gain or loss under I.R.C. § 1032. The Service asserted that the transaction was a sham and did not qualify as a § 1032 exchange of stock for property. Instead, the Service characterized the transfer as one of several "interrelated steps in a single transaction" subject to I.R.C. § 351. Id. at 81. The Tax Court rejected the Service's argument, finding the transaction was a "normal arm's length purchase." Id. The court further stated "[i]t is true that there was a sale between related parties, but that in itself does not destroy its validity." Id.

In each of these authorities the court or the Service had the opportunity to challenge the transactions on grounds that the related party status precluded an arm's length transaction, yet they failed to do so. In light of these authorities, the fact that a transaction involves a sale to a related-party more likely than not does not prevent the disposition from being arm's length.

b. Commercially reasonable

In light of the lack of authoritative guidance specifically addressing what the phrase "arm's length" means in the context of I.R.C. § 83, I.R.C. § 482 may provide some guidance. I.R.C. § 482 grants the Service authority to allocate income and deductions among commonly controlled organizations as necessary to prevent the evasion of taxes or to clearly reflect income. Although the types of transactions governed by I.R.C. § 482 can be readily distinguished from those governed by I.R.C. § 83, the regulations under I.R.C. § 482 provides insight into the meaning of the arm's length standard. Treasury Regulation § 1.482-1(b)(1) provides the general rule:

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at *arm's length* with an uncontrolled taxpayer. A controlled transaction meets the *arm's length* standard if the results of the transaction are consistent with the results that would have

> been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).

Treas. Reg. § 1.482-1(b)(1) (emphasis added).

Thus, if this general rule of I.R.C. § 482 can be applied in the context of I.R.C. § 83,[2] the sale of options to a related party should be viewed as arm's length if the "results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." Treas. Reg. § 1.482-1(b)(1). Applying this language, it appears that if unrelated parties would enter into a particular transaction, and if related parties also enter into the same transaction on the same or comparable terms, the related party transaction will be respected as being at arm's length.

The regulations continue by pointing out that "because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances." Id. Thus, it appears that absent an identical transaction, the application of I.R.C. § 482 would require a comparison of the your transaction with comparable transactions. In general, this is done by comparing factors that could influence prices or profits in arm's length dealings. Treas. Reg. § 1.482-1(d)(1). Under these regulations, the comparability factors include:

- Functional analysis
- Contractual terms
- Risks
- Economic conditions
- Property or services.

Thus, under I.R.C. § 482, the Service may apply these factors to reasonably allocate income and deductions between two commonly controlled entities as if the transaction between related entities were conducted at arm's length. Because it is often rare or impracticable to identify identical transactions, similar factors are commonly applied by qualified appraisers in ascertaining the fair market value of businesses, real estate, notes, etc. Thus, absent using an identical transaction to determine the arm's length nature of a transaction, it would appear that I.R.C. § 482 supports the proposition that such a determination could be made with reference to a qualified appraisal. Essentially, an analysis under the comparability factors of I.R.C. § 482 employs a standard of commercial reasonableness. Although I.R.C. § 83 specifically references neither I.R.C. § 482 nor the phrase "commercially reasonable," without further guidance from the Service or the courts, there appears to be no other reasonable interpretation of what this phrase represents.

Under a commercially reasonable analysis, one method to verify the arm's length nature of the transaction is to determine whether the terms of the obligation are similar to terms that would

be offered by commercial lenders to unrelated borrowers. This would include a comparison of such terms as interest rates charged, collateral requirements, payment schedules and the term of the loan. If the terms of a loan between related parties are consistent with terms available to the borrower from commercial lending institutions, the transaction should arguably be characterized as arm's length. Thus, as expounded upon above, any relationship between the borrower and the lender more likely than not should be irrelevant.

In the context of valuing promissory notes for estate tax purposes, the Service and courts have examined a number of factors. I.R.C. § 2031 provides that both secured and unsecured obligations and receivables have an estate tax value equal to the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes a lower value or proves that the notes are worthless. Treas. Reg. § 20.2031-4. Generally, the factors examined by courts in valuing promissory obligations include payment terms, collateral, interest rate, financial security of the obligor and whether the obligation is recourse or nonrecourse. These should provide some guidance as to what may constitute commercially reasonable terms. For example, in Estate of Berkman v. Commissioner, 38 T.C.M. 183 (1979), the taxpayer died holding several promissory notes representing loans made to his daughter and son-in-law. The term of each note was 20 years, with interest at 6% per annum, payable monthly. No payment was due on the principal until the maturity of the note, at which time the full balance of the principal was due. Interest had been paid monthly on each note from date of execution. Additionally, none of the notes were secured. During the seven-year period during which the loans were made, the taxpayers could have obtained a loan from a commercial lending institution. The prime interest rate for bank loans during this period ranged from 6.25% to 9.75%. The taxpayer's executor valued the five notes at 50% of face value plus interest accrued at date of death for estate tax purposes. The Service issued a notice of deficiency, asserting that the notes had a fair market value equal to their face amount. In finding for the taxpayer, the court cited Treas. Reg. § 20.2031-4 and noted the interest rate on all five notes was below the prime rate of interest. The court stated "[t]aking into account this low rate of interest, together with the lack of security and the considerable length of time until maturity, we conclude that these notes are includable in the decedent's gross estate at their fair market value and not their face amount." Id.

In the context of gift tax, the court has held that if a note carries the I.R.C. § 7872 Applicable Federal Rate (AFR), the transaction will be considered arm's length, and no gift tax will be imposed on the transaction. In Frazee v. Commissioner, 98 T.C. 554 (1992), the taxpayers sold a piece of improved real estate to their children in exchange for a promissory note bearing a below market interest rate. The court noted the sweeping scope of I.R.C. § 7872, stating "[i]n contrast to sections 483 and 1274, the language and legislative history of section 7872 make it clear that it is to apply for gift tax purposes. See sec. 7872(d)(2). The coverage of section 7872 ... provide[s] comprehensive treatment of below-market loans for income and gift tax purposes." 98 T.C. at 589. In determining whether the rate used created taxable gifts, the Tax Court explained that "[u]nder section 7872, a below the market loan is recharacterized as an arm's

length transaction in which the lender is treated as transferring to the borrower on the date the loan is made the excess of the issue price of the loan over the present value of all the principal and interests payments due under the loan." Id. at 588. The Tax Court further stated that "[b]y enacting section 7872, Congress indicated that virtually all gift transactions involving the transfer of money or property would be valued using the current applicable federal rate. Sec. 7872(f)(2)(B). In doing so, Congress displaced the traditional fair market methodology of valuation of below market loans by substituting a discounting methodology." Id. at 589. By adopting a discounting methodology, Congress effectively eliminated the need to evaluate the collateral, net worth, cash flow or other characteristics of the issuer of a note in order to determine the note's fair market value. Thus, for gift tax purposes, if the loan had been at the Applicable Federal Rate, I.R.C. § 7872 would deem the note to be worth its face amount, regardless of other information concerning the note's issuer or the note's terms. Although the fact that a note carries the I.R.C. § 7872 interest rate does not establish that the note is arm's length, Frazee clearly indicates the importance the courts and the Service place on interest rates. In your transaction, regardless of whether the arm's length standard has been met, there is no taxable gift to Client P/S because the interest rate at least equals the I.R.C. § 7872 rate. This interest rate should be another factor to strengthen the arm's length nature of the transaction. It could easily be inferred that the Congressional intent behind I.R.C. § 7872 was to deem every loan bearing a rate of interest at least equal to the Applicable Federal Rate as worth its face bly equivalent to an arm's length loan for all income tax purposes, including I.R.C. § 83.

c. Conclusion

As discussed above, neither the courts nor the Service have indicated that transfers between related parties prevent them from being arm's length. Thus, the relationship of the third party should be technically irrelevant; however, as a practical matter, the Service scrutinizes more closely related party transactions. The authorities discussed above, as well as the use of the phrase "arm's length" elsewhere in the Code, imply that the issue of whether a transaction is arm's length depends primarily on whether the terms of the transaction are commercially reasonable.

In your sale of ABC options to Client P/S, the terms of the transaction appear to be commercially reasonable. First, a qualified independent appraiser has determined or will determine that the market value of the promissory obligation is equal to its face value. Second, the terms of the obligation call for market interest payments (such interest rate being at least equal to the Applicable Federal Rate) to be made at least annually. Third, the obligation contains an acceleration clause allowing Client P/S to accelerate payments on the obligation at any time prior to expiration of the stated term. Fourth, although the obligation will not be secured, the lender should be adequately protected in the event of default because the sales agreement precludes Client P/S from making distributions other than to meet its partners' tax

obligations. This provision mirrors comparable security arrangements often required by commercial lending institutions, and thus, helps to ensure that Client P/S retains assets adequate to meet its obligation. Partnership property is essentially reserved to repay the promissory obligation, albeit subject to claims of general creditors in bankruptcy. Fifth, Client P/S has other assets that provide you (as the seller) some protection from downside risk in the case the partnership's assets drop in value. The $200,000 of cash (or approximately 10% of the value of the options sold to Client P/S) with which you and your family initially funded the partnership provide this protection. Finally, Client P/S's exposure to other contingent liabilities is likely to be minimal due to the fact that it is primarily engaged in investing and will have few, if any, creditors other than you (as the obligee). There are many real estate and other financial loans which have less stringent terms and conditions with much greater risk. Therefore, in light of these factors and the fact that the obligation has a fair market value equal to its face value, the promissory obligation appears to be commercially reasonable. Therefore, your disposition of the options to Client P/S will more likely than not satisfy the arm's length standard of I.R.C. § 83 and the regulations thereunder.

5. Once nonqualified options are disposed of at arm's length under I.R.C. § 83, thereby triggering the realization of ordinary income, any subsequent exercise of the options by Client P/S more likely than not does not invoke the re-application of I.R.C. § 83.

Although stock options may not have a readily ascertainable fair market value at the time of grant, the terms of the options may still allow for transferability. If the employee granted such options disposes of the options before exercise, the tax consequences to the employee depend on whether the disposition was arm's length or non-arm's length. The rules governing these types of dispositions of stock options mirror the general rules of I.R.C. § 83(a) regarding dispositions of restricted property before the compensation element has been triggered.

I.R.C. § 83(a) provides a general rule deferring the taxation of property transferred in connection with the performance of services until the property becomes transferable or is no longer subject to a substantial risk of forfeiture. The theory behind I.R.C. § 83 is that the fair market value of property received in connection with the performance of services is taxed as compensation as soon as the employee's rights with respect to the property are sufficiently clear and the property is readily valued. With respect to stock options, this generally occurs once the options are exercised or are sold in an arm's length transaction. Under I.R.C. § 83, if property which is transferable and not subject to substantial risk of forfeiture is granted in connection with the performance of services, I.R.C. § 83 will apply at the time of the grant. For example, if an executive is granted shares of stock in connection with the performance of services which are not subject to substantial risk of forfeiture, are fully transferable, and have a readily ascertainable fair market value, I.R.C. § 83(a) would apply to tax the stock as compensation at the time of the grant. I.R.C. § 83(a)(2). If the executive continued to hold the stock after I.R.C. §

83 has triggered taxation, the stock would be treated as a capital asset. If the executive later sold the stock, I.R.C. § 83 would have no further application. Id. I.R.C. § 83(a) clearly reflects that Congress did not intend that the statute operate to tax property more than once by stating "the preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to substantial risk of forfeiture." Id.

The regulations under I.R.C. § 83 are drafted to emphasize the fact that the section will not apply more than once. For example, Treas. Reg. § 1.83-1(b), which specifically addresses the taxation of substantially non-vested property received pursuant to the performance of services, provides that if substantially non-vested property is sold subsequent to its receipt in an arm's length transaction, while still substantially non-vested, the person who performs such services shall realize compensation in an amount equal to the excess of the amount realized from such sale or other disposition over the amount paid for the property. Subparagraph (1) of this regulation continues by stating that I.R.C. § 83(a) shall thereafter cease to apply with respect to such transferred property. Treas. Reg. § 1.83-1(b)(1). The impact of the regulation is that once I.R.C. § 83 applies to the transfer of property and income has been realized under I.R.C. § 83 with respect to the full value of the property, subsequent gain associated with that property from the exercise of the options by the transferee is no longer subject to I.R.C. § 83(a). While not explicitly stated in the regulations, this reasoning should apply equally to vested stock options.

Treasury Regulation § 1.83-7(a), which explains the operation of I.R.C. § 83 in the context of nonqualified stock options, states that if an option is sold or otherwise disposed of in an arm's length transaction, I.R.C. § 83(a) and (b) will apply to the transfer. Although Treas. Reg. § 1.83-7(a) does not specifically state that I.R.C. § 83 will no longer apply to stock options following an arm's length disposition, the regulation suggests such treatment by referencing I.R.C. § 83(a) and (b). This reference to I.R.C. § 83(a) is significant because, as noted above, I.R.C. § 83 clearly indicates that the section will no longer apply following an arm's length disposition. If this were not the case, Treas. Reg. § 1.83-7(a) would operate to tax the options at the time of the arm's length disposition and again upon their subsequent exercise. This result would be contrary to Congress's intent expressed in the statutory language of I.R.C. § 83.

In your arm's length sale of options to Client P/S, income realization under I.R.C. § 83 more likely than not occurs at the time the options are sold. Because compensation will be realized at the point of this arm's length sale, I.R.C. § 83 more likely than not no longer applies to the options in the hands of the transferee, Client P/S. Therefore, when Client P/S ultimately exercises the options, the exercise of the options more likely than not will not trigger further taxation under I.R.C. § 83.

6. Client P/S's unfunded and unsecured promise to pay the appraised value for the options plus interest more likely than not will not constitute "property" for purposes of I.R.C. § 83. As a result, it is more likely than not proper that compensatory ordinary income should not

be recognized until principal payments are received under this promissory obligation.

a. "Property" under I.R.C. § 83

Treasury Regulation § 1.83-7(a) governs the taxation of nonqualified stock options. The regulation provides that if the option is sold or otherwise disposed of in an arm's length transaction, I.R.C. §§ 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as I.R.C. §§ 83(a) and 83(b) would have applied to the exercise of the option. To the extent the seller of the options receives cash or property from the sale of the options, such proceeds would be taxed as compensatory ordinary income under the principles of I.R.C. § 83. The theory behind Treas. Reg. § 1.83-7(a) is that once the options have been disposed and the special deferral treatment of stock options is no longer applicable, the proceeds from the sale should be taxed under the general rules of I.R.C. § 83.

The term "property" takes on a specific meaning for purposes of I.R.C. § 83. Treasury Regulation § 1.83-3(e) defines property for purposes of I.R.C. § 83 as "real and personal property *other than* either money or an unfunded and unsecured promise to pay money or property in the future." (emphasis added). Property also includes "a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." This definition of property creates a distinction between the treatment of a bare contract right to receive future payment, and a secured right to payment represented by evidence of indebtedness.

Prior to the enactment of I.R.C. § 83, authorities addressing the issue of when to tax property transferred in connection with the performance of services applied the well-established principles of actual and constructive receipt. The potential application of the constructive receipt doctrine to your transaction will be discussed later in this opinion. The results reached under this approach were similar to those reached under I.R.C. § 83 in that they distinguish between bare contractual rights to receive payments and rights secured by evidence of indebtedness. Because I.R.C. § 83's definition of property continues to reflect this distinction and there is little authority interpreting the meaning of "unfunded and unsecured" in the context of I.R.C. § 83, these pre - I.R.C. § 83 authorities appear relevant in determining what is meant by this phrase.

In Rev. Rul. 71-419, 1971-2 C.B. 220, the Service applied these principles to a company's deferred compensation plan. Under the plan, at the end of each year the corporation's board of directors could elect to defer the receipt of all or part of their annual director fees for the following year. The deferred amounts were credited to a separate corporate memorandum account and earned interest until distributions began. If the director stepped down from his position and became an employee, officer, or affiliate with any competing business, the entire balance of his deferred

fees would be paid to him. Upon death of the director, the balance of his deferred fees would be paid to his estate. The Service noted that the deferred funds held pursuant to the plan were unsecured and unfunded. Because the corporation was "under a merely contractual obligation to make the payments when due," the director was not required to include the deferred amounts in his gross income until they were paid or otherwise made available to him.

In Rev. Rul. 60-31, 1960-1 C.B. 174,[3] the Service discussed the general rule for determining the taxable year of inclusion. Although issued prior to the enactment of I.R.C. § 83, the Service has cited this ruling in numerous Private Letter Rulings dealing with I.R.C. § 83's application to deferred compensation arrangements. See PLR 9612027, PLR 9218037, PLR 9149024. Situation (1) of this ruling involved a deferred compensation arrangement between a taxpayer and corporation. The employment contract established an annual salary and additional compensation of 10x dollars each year. The additional compensation was deferred and credited each year to a reserve bookkeeping account on the corporate books. The terms of the agreement specified that the corporation was under a contractual obligation to make the deferred payments in accordance with the plan. In the event of the taxpayer's death, the deferred amounts would be paid to the taxpayer's family in annual installments beginning in the calendar year after the taxpayer's death. Applying the doctrine of constructive receipt of income, the Service found that the additional compensation under the employment contract was not includable in taxpayer's gross income until the installment payments were received.

I.R.C. § 83 does not define or offer any further guidance on what constitutes an "unfunded and unsecured promise to pay. " The regulation's definition of property implies that for a contractual obligation to be treated as I.R.C. § 83 property, the obligation must be either funded or secured. In Childs v. Commissioner, 103 T.C. 634 (1994), the Tax Court considered whether amounts receivable under an annuity contract were "property" within the meaning of I.R.C. § 83 by first examining whether they were funded and then whether they were secured. The plaintiffs in Childs were three attorneys who were entitled to receive attorney's fees as part of a structured settlement. The structured settlement was to be paid by an annuity purchased by the defendant's insurance company. The insurance company retained ownership of the annuities, and had the power to change the beneficiaries. Additionally, the annuities specifically provided that the attorneys' rights were those of general creditors. After examining the provisions and funding of the structured settlement arrangement, the court determined that the payments were not "property" within the definition of I.R.C. § 83. Id. at 653. Although funding may occur where no further action is required of the obligor for the trust or insurance proceeds to be distributable to the beneficiary, funding has not occurred if the trust or annuity policy is subject to the rights of general creditors of the obligor. Id. at 651. The Childs court agreed with the taxpayer's position that the settlement payments were unsecured because the beneficiaries of the annuity policies were not granted a security interest in the property that would be used to pay the obligations. The Childs court noted "[i]t is well settled that a simple guarantee does not make a promise secured, since by definition a guarantee is merely itself a promise to pay." Id. at

652. Because the amounts receivable under the settlement were neither funded nor secured, the court determined I.R.C. § 83 was inapplicable.

This distinction was also evident in Revenue Procedure 92-64, issued by the Service in 1992, which provided a model rabbi trust to serve as a safe harbor in drafting deferred compensation arrangements. If a trust is drafted to mirror the model trust, the employee benefiting from the payments to the trust will not be in constructive receipt of income or incur an economic benefit solely on account of the adoption or maintenance of the trust. One key provision of the model trust provides that the trust assets are "subject to the claims of Company's creditors in the event of Company's Insolvency... until paid to Plan participants and their beneficiaries." Generally, amounts received under a deferred compensation plan modeled according to these provisions will not constitute property for purposes of I.R.C. § 83.

The Service has consistently applied the I.R.C. § 83 definition of property in numerous Private Letter Rulings. The majority of these rulings have addressed the issue in the context of deferred compensation plans. For example, in Private Letter Ruling 8642045, a Company adopted a stock option plan which provided for a grant of non-qualified stock options and stock appreciation rights ("SAR's") to employees. The options and SAR's granted under the plan were not transferable by the employee other than by will or the laws of descent and distribution. If a participant exercised his stock option, the SAR entitled him to receive the number of shares of stock having an aggregate fair market value on the date of exercise equal to the amount by which the fair market value of a share exceeds the option price per share, times the number of shares subject to the option. Applying the I.R.C. § 83 definition of property, the Service determined the SAR was an unfunded and unsecured promise to pay money or property in the future. Therefore, it was not property for purposes of I.R.C. § 83.

In Private Letter Ruling 8727028, the Service determined amounts placed in irrevocable trust accounts to fund deferred compensation for the benefit of key employees was not I.R.C. § 83 property. Although the funds were segregated in an irrevocable trust, the funds were still subject to the claims of creditors in the event of bankruptcy. The Service concluded that this risk constituted a substantial risk of forfeiture, and the assets were not I.R.C. § 83 property.

In Private Letter Ruling 9540033, the Service examined a deferred compensation plan established by an insurance company. Under the plan, selected insurance agents were able to accumulate benefits for later distribution, generally retirement. Each agent made an annual election to defer all or a portion of his compensation. The obligation of the insurance company to make future benefit payments was unfunded and unsecured. The rights of the plan participants to receive future payments were those of unsecured, general creditors. After citing the Treas. Reg. § 1.83-3(e) definition of property and discussing the economic benefit doctrine, the Service ruled that neither the crediting of salary deferrals under the plan nor the crediting of earnings under the plan constituted property to participating employees under I.R.C. § 83 or the

regulations.

These authorities clearly establish that an obligation is "unfunded and unsecured" if the funds intended to be used to satisfy the obligation are subject to the claims of creditors in bankruptcy proceedings. In consideration for your sale of the options, you received a contractual right to receive future payment. The Partnership has segregated and earmarked assets that will be used to meet its repayment obligation to you. Although these assets are earmarked and segregated, they still remain subject to the claims of the Partnership's creditors in the event of bankruptcy. The segregation of funds will merely provide you with a greater level of assurance of repayment than a naked promise to pay would provide. Because your contractual rights to future payment from the sale of the options constitute an "unfunded and unsecured promise to pay money in the future," this right more likely than not does not rise to the status of property for purposes of I.R.C. § 83.

Since the promissory obligation is not considered property for purposes of I.R.C. § 83, the question becomes how should it be taxed under I.R.C. § 83. Many of the previously cited authorities make it clear, regardless of the arm's length nature of a transaction, that the mere receipt of an unfunded and unsecured promise to pay does not rise to the level of property requiring immediate taxation. See, e.g. PLR 9540033, PLR 8642045. Instead, ordinary income is recognized as payments are made on the promissory obligation. While the authorities cited above involve a promissory obligation of an employer rather than a third party, there is no special rule limiting this provision to employers. In fact, the theoretical support for not requiring immediate taxation upon the receipt of an unfunded and unsecured promise to pay applies equally should the promissor be a third party or an employer. Therefore, the receipt of an unfunded, unsecured promise to pay made by a non-employer more likely than not does not have a different treatment than if it was made by an employer. Since you will not receive any money or property at the time your options are sold, the transaction more likely than not will not result in immediate taxation. Instead, you will more likely than not recognize compensation in accordance with I.R.C. § 83(a) upon the future receipt of property or cash as principal payments are made under the terms of the promissory obligation.

b. Income recognition under doctrine of constructive receipt

Although, as discussed above, your recognition of income from the sale will more likely than not be delayed until property is received under the promissory obligation in accordance with I.R.C. § 83, the Service could potentially argue for immediate recognition under the doctrine of constructive receipt. Under Treas. Reg. § 1.451-2(a), cash basis taxpayers must include amounts constructively received in gross income. Treas. Reg. § 1.451-2(a). If the Service prevailed in asserting this theory, you would be required to currently recognize the amounts due under the promissory obligation in gross income.

In Private Letter Ruling 9639016 the IRS stated that the courts have determined that the

following conditions are necessary to tax an amount under the doctrine of constructive receipt: (1) the amount must be due; (2) the amount must be appropriated on the books of the obligor; (3) the obligor must be willing to pay; (4) the obligor must be solvent and able to pay; and (5) the obligee must have knowledge of the foregoing facts. In essence, the obligee's demand for payment must be the only thing that would be necessary for payment; the taxpayer *must* be entitled to present possession. See Robinson v. Comm'r., 44 T.C. 20 (1965); Basila v. Comm'r., 36 T.C. 111 (1961) acq., 1962-1 C.B. 3; Oates v. Comm'r., 18 T.C. 570 (1952), aff'd, 207 F.2d 711 (7th Cir. 1953); Veit v. Comm'r., 8 T.C. 809 (1947), acq., 1947-2 C.B. 4.

In your case, the Purchase Agreement clearly states that the amount due under the contract is not due until 2014, so the first criterion is not met. Also, the third criterion is missing since there is no evidence that Client P/S is willing to accelerate payment. Additionally, Treas. Reg. § 1.451-2(a) requires that, in order for there to be constructive receipt, income must be "otherwise available to the taxpayer so that he can draw upon it at any time..." In your case, you have no call on any assets owned by Client P/S. The contractual obligation for payment does not mature until year 2014. Until then, as the holder of the obligation, you have no ability to force or demand payment. Under the terms of the contract, Client P/S could decide to prepay the contract, but that is not your decision – it's the Partnership's. Additionally, you cannot assign your contract rights to a third party. As previously discussed in this opinion, amounts that are unfunded and unsecured are generally not treated as constructively received. See, e.g., PLR 954003, PLR 8728028, PLR 8642045. Client P/S's obligation to you is clearly unfunded and unsecured. Thus, under the above cited authorities, you do not appear to be in constructive receipt of the money due under the obligations.

In arguing the doctrine of constructive receipt, the Service could focus on your role as general partner. As general partners of Client P/S, you and your wife Client Wife control the management decisions of the partnership. The Service could potentially assert that in light of your control and ownership relating to Client P/S, you are in constructive receipt of "property." Treasury Regulation § 1.451-2(a) provides that income is not constructively received if the "taxpayer's *control* of its receipt is subject to substantial limitations or restrictions." (emphasis added). Analysis of the relevant authority in this area indicates that your ownership does not rise to a sufficient level to result in constructive receipt.

This general rule has been held to apply in deferred compensation cases between an employee and a controlled entity. In Basila v. Commissioner., 36 T.C. 111 (1961), petitioner was president, general manager and principal shareholder of a company. His employment contract with the company provided for a bonus to be determined at the end of each fiscal year, October 31, and to be paid to him on January 4 of the following year. The IRS argued that petitioner constructively received the bonus in October. Petitioner contended that the contract under which he was to receive the bonus provided that it was not due and payable until January; that the amount was not set aside for his unrestricted use; and that, albeit he had the power to write

checks on company funds, he did not have the right to do so in October because of the contract. The court agreed, pointing out the fact that a company president, even if a majority shareholder, did not have the power to dispose of company assets inconsistent with company contracts. Id.

Basila is distinguishable from Haack v. Commissioner, 41 T.C.M. 708, TC Memo 1981-13, which also addressed the issue of constructive receipt and deferred payments of bonuses in a controlled entity setting. In Haack, the Tax Court held that no substantial restriction existed upon petitioner's right to receive bonuses on the dates of authorization. The only restriction identified by petitioner was a "long-standing custom" to pay the bonuses in the following year. This custom, however, was started only 3 years prior to the tax years in issue and the court did not think it could reasonably be characterized as a substantial restriction preventing petitioner from demanding his bonus in the earlier year. In fact, the taxpayer served as the corporation's majority shareholder, president, treasurer and director, and thus decided when and for how long to defer payment. Unlike the facts in Basila, where the contractual obligations were determined before the income was earned, in Haack, there was no contractual arrangement entered into before earning the bonus that required the company to defer payment until the subsequent year. As a result, the court held that the deferral was solely within the control of the employee/president and was therefore constructively received. Id.

In your case, you and your wife, Client Wife, as general partners control Client P/S. That was also the case on the transaction date. You and your wife negotiated a sales contract that does not require payment until the year 2014 and does not provide funding or security for that contract in the meantime. Under the terms of the Partnership Agreement, any act taken by a general partner requires action of general partners holding more than 50% of the aggregate capital account balances held by all general partners. Thus, you do not have the unilateral ability to control the business operations of Client P/S. Furthermore, the terms of the Stock Option Purchase Agreement do not authorize Client P/S to accelerate payment of the balloon obligation. Under the circumstances, you do not have unfettered discretion – even today – to take control of the assets of Client P/S or to accelerate the contract payments, nor is it in the best interests of the Partnership to do so. Thus, the Service would more likely than not fail in asserting that you have constructively received amounts under the promissory obligation.

7. It is more likely than not proper that the timing and amount of ABC's deduction for compensation paid correspond to the timing and amount of compensation included in your gross income.

I.R.C. § 83(h) governs an employer's deduction for the compensatory income generated by the application of I.R.C. § 83(a). The amount of deduction to which the employer is entitled is equal to the amount included as compensation in the gross income of the employee under I.R.C. §

83(a). Treasury Regulation § 1.83-6(a) limits this amount by incorporating the requirements of I.R.C. §§ 162 and 212. The regulation only allows a deduction in the employer's taxable year in which or with which ends the employee's taxable year in which the income was included. Thus, it would appear that this regulation overrides the general rules for both accrual and cash method taxpayers. Under former Treas. Reg. § 1.83-6, an employer was required to withhold upon the amount of compensation generated by I.R.C. § 83(a) in order to claim a deduction. This requirement was deleted from the regulation by a 1995 amendment. See T.D. 8599, 1995-2 CB 12. The amended regulation allows a deduction equal to the amount included in the employee's gross income. If the employer timely complies with the reporting requirements of I.R.C. §§ 6041 and 6041A, the regulations state that the compensation amounts will be deemed included in employee's gross income. Thus, the employer will be entitled to a deduction provided it complies with the applicable Form W-2 or Form 1099 reporting requirements under I.R.C. § 6041 or § 6041A.

Thus, the timing and amount of ABC's deduction for compensation paid is tied to the timing and amount of compensation included in your gross income. Because you more likely than not are not required to include the compensation in your gross income until principal payments are actually received under the promise to pay, the deduction by ABC more likely than not is delayed until that time.

RESTRICTIONS APPLICABLE TO THIS OPINION LETTER

We are rendering this Opinion Letter with respect to all issues solely for your benefit under I.R.C. § 7525. Accordingly: (i) we consider this Opinion Letter to be a confidential communication which may not be furnished, reproduced, distributed or disclosed to anyone other than, in the event of a penalty assertion, a taxing authority, without our prior written consent, (ii) this Opinion Letter is rendered solely for your information and for assistance to you in connection with the above described transaction, and may not be relied upon by any person other than you, or for any other purpose without our prior written consent, (iii) this Opinion Letter is rendered as of the date hereof, and we undertake no, and hereby disclaim any, obligation to advise you of any changes or any new developments which might affect any matters or opinions set forth herein, and (iv) this Opinion Letter is limited to the matters stated herein and no opinions may be inferred or implied beyond the matters expressly stated herein.

Very truly yours,

ARTHUR ANDERSEN LLP

By

Although the Code and the regulations are silent as to what constitutes an arm's length transaction, several Private Letter Rulings have held that a *gift* of a stock options to a related party is not an arm's length transaction. SeePLR 10002702 , PLR 9713012.

[1] Reg. §1.482-1(a)(3) specifically limits a taxpayer's ability to affirmatively apply §482. This restriction does not appear to limit the use of the §482 regulations as a guide in applying the concept of arm's length transaction under §83.
[2] Rev. Rul. 60-31 was modified by Rev. Rul. 64-279, 1964-2 C.B. 100 and Rev. Rul. 70-435, 1970-2 C.B. 100. However, these modifications do not effect the above cited portion of Rev. Rul. 60-31.