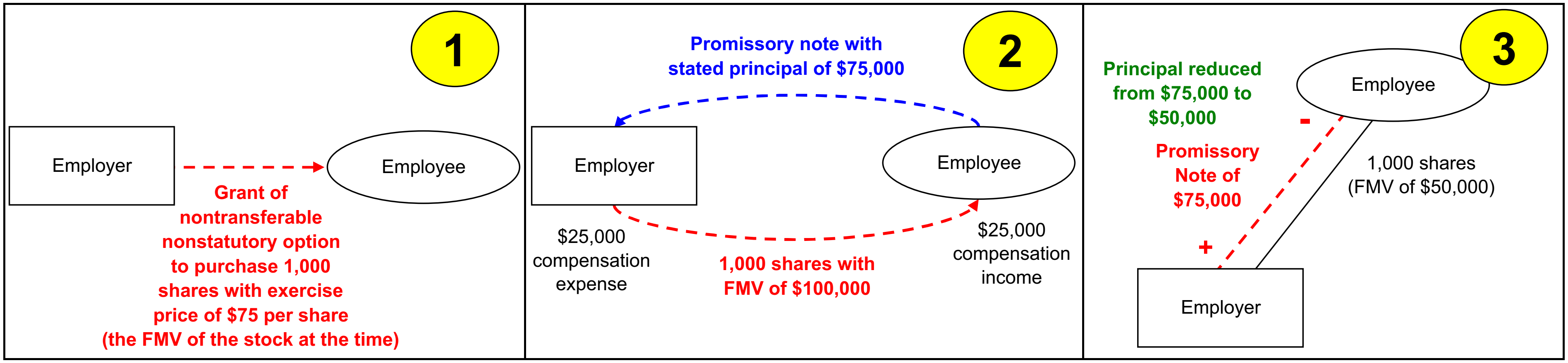
Revenue Ruling 2004-37

Forgiveness of Option Exercise Debt Treated as Compensation

Year 1 - Option Grant | **Jan. 1, Year 2 - Exercise** | **Jan. 1, Year 4 - Principal Reduction**



In Year 1, Employer, a corporation, grants a nontransferable, nonstatutory option to its Employee to purchase 1,000 shares of Employer common stock at an exercise price of $75 per share, the fair market value of a share of Employer stock at the time the option is granted. Employee may exercise the option only during employment with Employer or within 90 days after cessation of employment. On January 1 of Year 2, when the fair market value of 1,000 shares of Employer stock is $100,000, Employee exercises the option and purchases 1,000 shares of Employer stock in exchange for a nontransferable recourse note ("Note") secured by the stock Employee receives on the exercise of the option. The Note has a stated principal amount of $75,000, which is payable at maturity on December 31 of Year 11. The Note also provides for payments of interest on December 31 of each year the Note is outstanding. The interest rate is one-year LIBOR (determined as of January 1 of each year the Note is outstanding) plus 25 basis points. The interest rate on the Note is not less than the appropriate applicable Federal rate (AFR) on the date the Note is issued. The stock is not subject to a substantial risk of forfeiture within the meaning of §83(c).

In Year 2, Employee includes $25,000 as compensation income under section 83(a). Employer reports $25,000 of compensation income on the Form W-2 issued to Employee for Year 2 and claims a corresponding deduction in Year 2 under section 83(h). In Years 2 and 3, Employee makes the required interest payments under the Note. On January 1 of Year 4, the fair market value of the Employer stock has declined to $50,000 and Employer and Employee agree to reduce the stated principal amount of the Note from $75,000 to $50,000. The interest rate on the Note is not modified.

The employee issued a recourse note to his or her employer in satisfaction of the exercise price of an option to acquire the employer's stock. The employer and employee subsequently agreed to reduce the stated principal amount of the note. The employee generally recognizes compensation income under section 83 at the time of the reduction. Thus, under the facts described above, Employee recognizes $25,000 of compensation income on January 1 of Year 4 under Reg. 1.83-4(c). If Employer and Employee instead were, for example, to reduce the interest rate on the Note or change the Note from recourse to nonrecourse, that modification also generally would result in compensation income for Employee. The compensation is wages for purposes of FICA, FUTA, and income tax withholding.