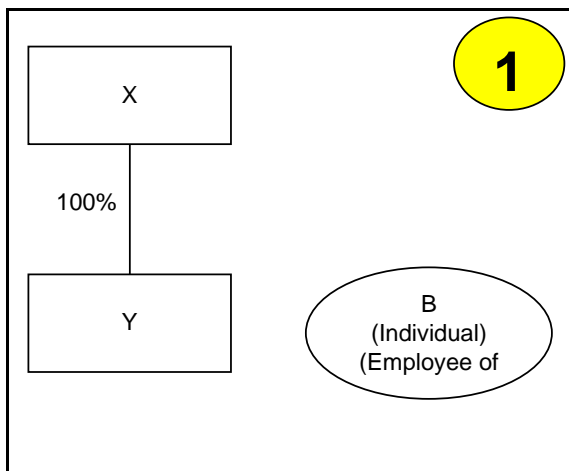
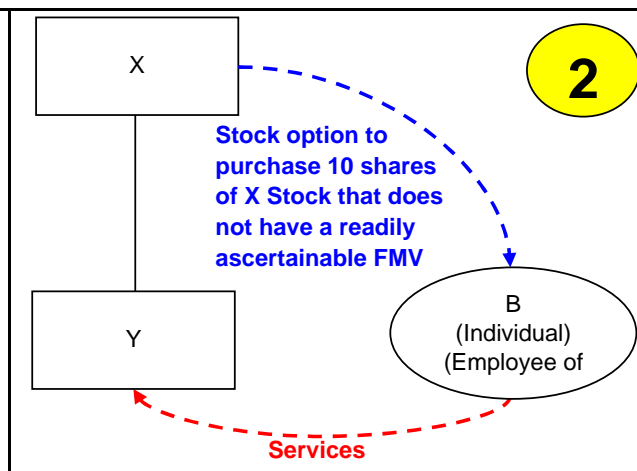


**Parent Stock Option Used As Compensation For Subsidiary Employee**

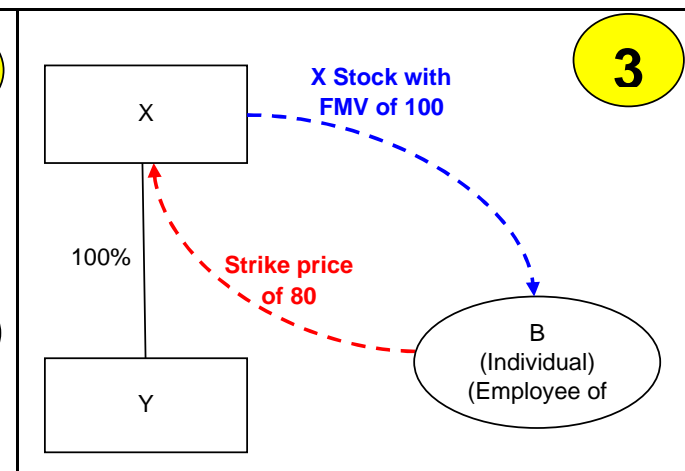
**Initial Structure**



**Issuance of Stock Option (Year 1)**



**Exercise of Stock Options (Year 2)**



X, a corporation, owns all of the outstanding stock of Y corporation. In Year 1, X issues to Y's employee, B, a nonstatutory stock option to purchase 10 shares of X stock as compensation for services provided to Y. The option is exercisable against X and does not have a readily ascertainable fair market value (determined under Reg. 1.83-7(b)) at the time the option is granted. In Year 2, B exercises the option by paying X the strike price of \$80 for the X stock, which then has a fair market value of \$100.

Because the option does not have a readily ascertainable FMV, section 83(a) does not apply to the grant of the option. Section 83 and Reg. 1.1032-3 apply in Year 2 when the option is exercised; thus, no gain or loss is recognized on the deemed disposition of X stock by Y in Year 2. Immediately before Y's deemed disposition of the X stock in Year 2, Y is treated as purchasing the X stock from X for \$100, \$80 of which Y is deemed to have received from B and the remaining \$20 of which is deemed to have been contributed to Y by X. Under section 358, X's basis in its Y stock is increased by \$20.

**Deemed Transfers (Year 2)**

