



## NEW PROPOSED SECTION 1504(a)(5) REGULATION — EFFECT OF SUBSIDIARY'S OPTIONS, WARRANTS, AND CONVERTIBLE DEBENTURES ON SUBSIDIARY'S AFFILIATED GROUP MEMBERSHIP

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*In this article, Levin and Welke analyze and critique the new proposed regulation under code section 1504(a)(5), which determines when options, warrants, convertible debentures, and similar rights on the stock of a subsidiary will be considered exercised for purposes of determining whether the subsidiary is part of an affiliated group.*

*The authors explain the operation of the complex proposed regulation and provide many examples to il-*

*lustrate its operation. They critique a number of vague regulatory phrases (e.g., whether an option is being used "as a device") that are preconditions to safe harbors and exceptions, and that could lead to troublesome audit disputes; they point out several troublesome flaws (e.g., in the definition of "related"); they review one important way in which the proposed regulation is overbroad (treating cash settlement options, SARs, and phantom stock as options); and they analyze one way in which it is too narrow (using the underlying stock's FMV on the exercise date rather than the measurement date to determine qualification for the 100-percent-FMV safe harbor).*

*The authors conclude that, with relatively minor changes, the proposed safe harbors and exceptions will be workable and will permit most legitimate (i.e., non-tax-avoidance) options, warrants, convertible debentures, and similar rights to be treated as options rather than as stock for code section 1504 purposes.*

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### I. INTRODUCTION

P (parent) can file a consolidated federal income tax return with S (subsidiary) only during the period that P's ownership of S stock meets the "80-80 test" of code section 1504(a)(2) (so that P and S are members of the same "affiliated group"), i.e., while P owns both:

- (a) 80 percent or more of S' stock by value and
- (b) stock possessing 80 percent or more of S' voting power.

Hence, P cannot consolidate with S during the period that a third party (hereinafter "X") owns more than 20 percent of S' stock either by value or by vote.<sup>1</sup>

<sup>1</sup>In applying the 80-percent-by-value test, S straight nonvoting preferred stock is ignored (whether held by P or by X), i.e., stock is ignored if it is nonvoting, nonconvertible, and nonparticipating preferred. Code section 1504(a)(4).

A number of tax issues in addition to consolidation also turn on whether S is part of P's "affiliated group." See e.g., code sections 332, 337, and 338.

The 1984 Tax Act granted the IRS broad regulatory power to prescribe when an option, warrant, convertible debenture, or similar instrument or right (hereinafter an "option") held by X to acquire S stock (either to acquire outstanding S stock from P or to acquire newly issued S stock from S) will be treated as exercised (so that X is treated as holding the underlying S stock) in determining whether P's ownership of S stock satisfies the 80-80 test.<sup>2</sup>

**Example (1):** P owns all 79 shares of S' outstanding stock. However, X holds an option<sup>3</sup> to purchase from S 21 shares of newly issued S stock. If the option is treated as exercised, X will be treated as owning 21 percent of S' stock, P's 79-percent ownership of S will not satisfy the 80-80 test, and P will thus not be able to file a consolidated return with S.

**Example (2):** P owns all 100 shares of S' outstanding stock. However, X holds an option to purchase from P 21 of P's 100 S shares. Same issue as in Example (1).

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***Eight years after the 1984 act granted the IRS broad regulatory power, the IRS issued a proposed regulation.***

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In March 1992, eight years after the 1984 act granted the IRS regulatory power, the IRS issued a proposed regulation.<sup>4</sup> Although complicated, unnecessarily vague in several aspects, overbroad in at least one other, and reflecting a near-paranoia that taxpayers may seek to avoid its rules, the proposed regulation contains exceptions and safe harbors for many legitimate (i.e., non-tax-avoidance) options held by X, so that they will not be treated as exercised for code section 1504 purposes.

## II. GENERAL RULE

Where X holds an option to acquire S stock, the option will be treated as exercised (in determining whether P fails code section 1504's 80-percent-by-value test) on any "measurement date" (i.e., generally each date on which the option is either issued, transferred, or materially modified — as described at more length in V below) if on such date the option does not fit

within at least one of the 10 safe harbors and exceptions described in III below.<sup>5</sup>

Where an option meets one of the 10 safe harbors and exceptions, it is not treated as exercised for purposes of the 80-80 test. However, once an option is actually exercised, the stock is treated as outstanding for purposes of the 80-80 test, even if, prior to exercise, the option fell within a safe harbor or an exception. Thus, P can rely on a safe harbor or exception only until the option is actually exercised.

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***Where an option meets one of the 10 safe harbors and exceptions, it is not treated as exercised for purposes of the 80-80 test.***

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## III. SAFE HARBORS AND EXCEPTIONS

An option will not be treated as exercised on a measurement date if it meets at least one of the following 10 safe harbors or exceptions on such date:

1. A stock appreciation right ("SAR"), warrant, option, phantom stock, or similar arrangement issued to an employee, director, or independent contractor as reasonable compensation that is nontransferable (except upon death) as defined in the regulation.<sup>6</sup> An instrument that is transferable in any other circumstance (e.g., on divorce) would apparently not qualify for the safe harbor.

2. An option issued in connection with a loan to a lender "actively and regularly engaged in the business of lending" in connection with a "commercially reasonable" loan.<sup>7</sup>

3. An option exercisable for 24 months or less with an exercise price of at least 90 percent of the stock's FMV on the measurement date.<sup>8</sup> unless there is an arrangement granting to the option holder (prior to exercise) "managerial or economic rights in the issuing corporation that ordinarily would be afforded to owners of the issuing corporation's stock (e.g., voting rights, dividend rights, or rights to proceeds on liquidation)" (hereinafter "stockholder rights"). For purposes of this safe harbor, stockholder rights that arise

<sup>5</sup>The general rule set forth in the proposed regulation is actually worded somewhat differently — it states that an option will be treated as exercised only if the option fails (on a measurement date) to satisfy both of the tests set forth in III(9) and (10) and also fails to satisfy any of the eight safe harbors and exceptions set forth in III(1) through (8). However, we believe that the proposed regulation is easier to understand if the two threshold tests described in III(9) and (10) are re-stated as safe harbors and exceptions, making a total of 10 safe harbors and exceptions.

<sup>6</sup>The safe harbors and exceptions described in 1, 2, 6, 7, and 8 do not, however, apply if the option is used "as a device to avoid the application of section 1504 and [this proposed regulation]," whatever the quoted words mean. See the discussion of this unnecessarily vague phrase in VI(1) below.

<sup>7</sup>See footnote 6.

<sup>8</sup>In the case of an option to sell (i.e., a put option) exercisable for 24 months or less, the option's exercise price must not exceed 110 percent of the stock's FMV.

<sup>2</sup>Code section 1504(a)(5).

<sup>3</sup>Throughout this discussion, the term "option" includes an option, warrant, convertible debenture, or similar instrument or right, as described in IV below.

<sup>4</sup>Prop. Reg. section 1.1504-4.

upon a default under the option or a related agreement are ignored.<sup>9</sup>

An option can qualify for this safe harbor even if it had a life exceeding 24 months at the time the option was first issued, so long as on the measurement date it has a remaining life not exceeding 24 months.

4. An option with an exercise price of at least 100 percent of the underlying stock's FMV on the exercise date,<sup>10</sup> unless there is an arrangement granting stockholder rights to the option holder (prior to exercise), other than those arising on default under the option or a related agreement. Note that this safe harbor (unlike safe harbor 3) measures the exercise price against the stock's FMV at exercise, rather than the stock's FMV at the measurement date.

This safe harbor and the safe harbor described in 5 are very limited. In order to qualify for one of these two safe harbors, the option price must continually track the FMV of the underlying stock as it rises and falls. By definition, an option with a fixed exercise price cannot qualify for one of these two safe harbors, even if the exercise price is in fact greater than the stock's FMV on the particular measurement date.<sup>11</sup>

5. An option with a formula exercise price that is "a bona fide attempt to arrive at fair market value of the underlying stock on the exercise date and is to be applied based on the facts in existence on the exercise date," unless there is an arrangement granting stockholder rights to the option holder (prior to exercise), other than those arising on default under the option or a related agreement.

6. A publicly traded option.<sup>12</sup>

7. A stock purchase agreement in which the buyers and sellers are obligated to close the transaction "subject only to reasonable closing conditions."<sup>13</sup>

8. An escrow, pledge, or other security agreement that is "a typical commercial transaction" and "subject to customary commercial conditions."<sup>14</sup>

9. An option that is not reasonably certain to be exercised, after reviewing all the facts and circumstances, including:

(a) The purchase price of the option "in absolute terms and in relation to the [FMV] of the stock or the [option] exercise price."

(b) Whether the option is in-the-money or out-of-the-money and by how much, both in absolute terms and in proportion to the stock's FMV.

(c) The period of time during which the option can be exercised and any contingency to which exercise is subject (e.g., occurrence of "a public offering" or achievement of "a certain level of earnings").

<sup>9</sup>Query whether stockholder rights continue to be ignored after a default has actually occurred.

<sup>10</sup>In the case of a put option, the option's exercise price must not exceed the stock's FMV on the exercise date.

<sup>11</sup>See VIII(4) for a criticism of the excessively narrow language of safe harbor 4.

<sup>12</sup>See footnote 6.

<sup>13</sup>See footnote 6.

<sup>14</sup>See footnote 6.

(d) Whether the option holder has stockholder rights prior to exercise.

(e) Whether restrictive covenants or similar arrangements limit the issuer's ability to engage in activities (e.g., "payment of dividends or borrowing funds") while the option is outstanding.

In determining reasonable-certainty-of-exercise, all arrangements between the parties are taken into account, including the existence of a call in X's hands and a put in P's hands at similar prices.<sup>15</sup>

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***A questionable example concludes that a 25-percent-in-the-money option is reasonably certain to be exercised although the issuer is losing money.***

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This reasonable-certainty-of-exercise test is obviously subjective, unlike the objective 24-month-90-percent-FMV test (see 3 above). An example in the proposed regulation reaches the questionable conclusion that a three-year option to buy a share of S' stock at a \$30 exercise price per share, granted when S' stock had a \$40 FMV per share (i.e., an option which was 25 percent in the money at grant), is reasonably certain to be exercised even where "S has had substantial losses for five consecutive years" and it is anticipated that S will continue this "earnings history for several more years."<sup>16</sup>

On the other hand, the IRS explanatory release accompanying the proposed regulation<sup>17</sup> states that an option is considered reasonably certain to be exercised "only if a strong probability exists that the option will be exercised" and gives as an example of a situation where there is not such a strong probability, "an option issued at the start-up of a venture, the exercise of which depends on the outcome of true business risks, such as the ultimate success of the venture." This true-business-risks explanation seems at variance with the IRS' contrary conclusion in the example described above that a 25-percent-in-the-money option from a corporation suffering and expected to continue suffering substantial losses is reasonably certain to be exercised.

Because the 24-month-90-percent-FMV safe harbor described in III(3) does not apply if the option's remaining term exceeds 24 months and the safe harbor described in III(4) requires an exercise price not less than 100 percent of the stock's FMV at exercise (not at the measurement date), the only safe harbors or exceptions applicable to a more-than-24-month option with a fixed exercise price that is not publicly traded and not issued to a service provider or lender are the subjective reasonable-certainty-of-exercise exception discussed in this III(9) and the no-substantial-tax-saving exception discussed in III(10).

<sup>15</sup>Prop. Reg. section 1.1504-4(h), examples 5 and 6.

<sup>16</sup>Prop. Reg. section 1.1504-4(h), example 1.

<sup>17</sup>CO-152-84, issued in early March 1992.

10. If the stock underlying the option had actually been transferred to X (instead of transferring to X only an option), no substantial amount of additional federal income tax could be anticipated, i.e., breaking consolidation between P and S by transferring to X actual S stock (rather than an option on S stock) would not be expected to result in substantial additional taxes.<sup>18</sup>

Where P and S are both expected to be profitable corporations with no NOLs or other tax attribute carryforwards, this test would generally be satisfied, because there would be no substantial additional federal income tax if the P-S consolidation were broken by issuing S stock to X instead of an option.

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***The proposed regulation states that an option is not reasonably certain to be exercised where exercise depends on the outcome of true business risks.***

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However, where either P or S is expected to have future losses (or an NOL or other tax attribute carryforward) and the other is expected to have future profits against which the loss or NOL can be used, this test will not be satisfied, unless the tax liability being eliminated or deferred by the P-S consolidated return is not "substantial" in light of all the facts and circumstances, including the absolute amount, the amount relative to overall tax liability, and the timing.

On the other hand, where X would, if it exercised the option, hold sufficient S stock to permit X and S to file a consolidated return (i.e., upon X's exercise of the option, X's ownership of S would meet the 80-80 test), any federal income tax saving that the new X-S consolidated group would realize is taken into account (i.e., subtracted) in determining whether a substantial amount of additional federal income tax could be anticipated if the P-S consolidation is broken.<sup>19</sup>

**Example (3):** P owns all 100 shares of S' stock. P grants X an option to purchase 80 shares, i.e., 80 percent, of S' stock. (Or S grants X an option to purchase 400 newly issued S shares, i.e., 80 percent of the 500 S shares that would be outstanding if X exercised the option.) The parties expect that, for the foreseeable future, (i) P will realize \$100 of taxable income each year, (ii) S will realize \$90 of taxable loss each year, and (iii) X will realize \$90 of taxable income each year.

<sup>18</sup>The proposed regulation, read literally, would treat each option separately for purposes of this III(10) exception, so that an option could fail this exception only if the particular S option being tested plus any S stock actually outstanding in the hands of third parties exceeds 20 percent. See the discussion at VIII(1) regarding several possible cures for this apparent flaw in the proposed regulation.

<sup>19</sup>Any tax cost to the X-S group from consolidation would also be taken into account, for example, if X had expiring NOLs or foreign tax credits that would not be usable because of S' anticipated current year losses. See CO-152-84, the preamble to the proposed regulation.

If X had acquired 80 percent of S' stock outright, the new X-S consolidated group's expected federal income tax saving from using S' loss each year against X's profit each year would be as great as the P-S consolidated group's tax saving if the P-S group had continued. Hence exception 10 would apply, because it could not reasonably be anticipated that there would be a substantial amount of additional federal income tax if X had purchased the underlying S stock instead of an option thereon.

The X-S group's potential tax saving from consolidation is taken into account for purposes of this exception if X (had it exercised the option) would have been able to consolidate with S, whether or not X has an arrangement allowing it to vote the underlying S stock prior to exercise of the option (as described in VII(1)).<sup>20</sup>

#### IV. MEANING OF OPTION

For purposes of the proposed regulation, an option includes (a) a call option, (b) a put option, (c) a warrant, (d) a convertible debt, (e) any other instrument providing for the right to issue or transfer stock, or (f) any other instrument or right permitting the holder to share in the issuing corporation's growth. Each of these is covered whether granted by the issuing corporation (e.g., an option to acquire unissued S stock from S) or by a shareholder (e.g., an option to acquire already outstanding S stock from P).

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***The proposed regulation is overbroad to the extent it treats SARs and the like as options even where the holder has no right to receive S stock.***

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**1. SARs, phantom stock, cash settlement options.** The proposed regulation also clearly includes SARs, phantom stock, cash settlement options, and similar arrangements within the definition of "option."<sup>21</sup> However, the proposed regulation is overbroad to the extent it seeks to treat all SARs, phantom stock, and cash settlement options as "options," even where the holder has no right under the instrument to receive actual S stock. Code section 1504(a)(5) contains the grant of regulatory authority to the IRS with respect to options, warrants, obligations convertible into stock, "and other similar interests." Where there is no circumstance under which the holder of a cash settlement option, an SAR, or phantom stock could transmute his interest into stock (a "non-stock instrument"), it does not appear to be a "similar interest" to an option, warrant, or convertible obligation within the meaning of code section 1504(a)(5).

The proposed regulation states that if no safe harbor or exception is available, the option is treated as "exercised" for purposes of the 80-80 test. Where an option

<sup>20</sup>Prop. Reg. section 1.1504-4(h), example 2.

<sup>21</sup>Prop. Reg. section 1.1504-4(d)(1)(ii) and (d)(2)(v).

is treated as exercised, the proposed regulation does not state that the option itself is treated as stock.<sup>22</sup> Thus, literal application of these rules to a non-stock-instrument should not break affiliation between P and S, because the deemed exercise does not cause the holder to be treated as owning S stock and the option itself is not treated as S stock.

**Example (4):** P owns all 79 shares of S' outstanding stock. Each S share has an FMV of \$100. S grants a 10-year SAR on 21 shares to an executive, X, entitling X to receive on exercise of the SAR at any time within 10 years an amount of cash equal to the FMV of 21 S shares. Assume that no safe harbor is available (e.g., the SAR's FMV exceeds an amount that would be reasonable compensation or the SAR is transferable).

If Prop. Reg. section 1.1504-4(b)(2) applies, the SAR is treated as exercised for purposes of the 80-80 test. However, because X does not have the right to receive S stock on exercise of the SAR, P should continue to satisfy the 80-80 test with respect to S even if the SAR is deemed exercised.

While the literal language of the proposed regulation clearly reaches the result described above for a nonstock instrument, it is not clear that the drafters intended this result. Hence the proposed regulation should be amended to state that an instrument constitutes an "option" only if it grants a holder the right (including a right that is one of several alternatives) on exercise to receive stock. If, on the other hand, the drafters intend an instrument granting a holder the right to receive only cash to be treated as an option that may break affiliation (and cannot be dissuaded from this heretical idea), the proposed regulation should be amended to state that the holder is treated as receiving, on deemed exercise, an amount of S stock equal to the number of S shares used in measuring the holder's rights under the instrument.

**2. Subsidiary tracking stock.** The proposed regulation is completely silent as to whether it applies to subsidiary tracking stock (e.g., P stock with dividend rights based on the earnings of its subsidiary S). Under the literal words of the proposed regulation, subsidiary tracking stock is clearly not an option. First, subsidiary tracking stock clearly does not fall within part (i) of the proposed regulation's definition of "option" as a "call option, warrant, convertible obligation, put option, or any other instrument that provides for the right to issue or transfer stock."<sup>23</sup>

Second, while subsidiary tracking stock may fall within part (ii) of the proposed regulation's definition of "option" as "[a]ny other instrument or right . . . pursuant to which the holder may share in the growth" of S, the proposed regulation excludes from this part of

the definition any instrument or right which is "stock itself."<sup>24</sup>

Third, where an "option" fails all the safe harbors and exceptions, the proposed regulation treats the option as "exercised." However, subsidiary tracking stock cannot be "exercised" by the holder. It is (and clearly remains) P stock with certain rights (e.g., dividends that track S' success or lack thereof) or, if drafted so as to take too many attributes from S' stock, it is (and remains) S stock.<sup>25</sup> But, in any event, there is nothing to exercise.

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### ***Indeed, there is no real reason for the proposed regulation to cover subsidiary tracking stock.***

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Indeed, there is no real reason for the proposed regulation to cover subsidiary tracking stock. Such stock is either P stock (in which case the holder neither owns S stock nor has any right to receive S stock and the P-S affiliation should not be affected) or it is S stock (which will be counted in applying the 80-80 test without regard to the proposed regulation).

## **V. MEASUREMENT DATE**

Each time there is a measurement date with respect to a specific option, the general rule set forth in II above is applied to that option (but not to other options as to which there is then no measurement date) — so that the option is treated as exercised for purposes of code section 1504, unless on such date at least one of the 10 safe harbors and exceptions described in III above applies.

A measurement date for an option is each date on which (a) the option is issued, transferred, or modified,<sup>26</sup> or (b) the terms of the underlying stock are modified. However, a measurement date does not

<sup>24</sup>Prop. Reg. section 1.1504-4(d)(1)(ii).

<sup>25</sup>It has been suggested that subsidiary tracking stock may be analyzed as a joint venture, although such a result seems unlikely absent a change in the code or the regulations. See "New York State Bar Association Report," reprinted at 43 *Tax Law Review* at 70, 72. For a thorough and thoughtful discussion, see Sheffield & St. Clair, "An Abecedarium on Alphabet Stock," 66 *Taxes* 954 (1988).

<sup>26</sup>The proposed regulation apparently takes the questionable position that an option may be "modified" even if its terms are not amended or renegotiated. The proposed regulation treats an automatic change in the terms of an option that occurs pursuant to its original terms as a modification. Prop. Reg. section 1.1504-4(i) (reference in the effective date provisions to measurement date that occurs after 2/28/92 "because of a modification in the terms of the option pursuant to the terms of the option as it existed on [2/28/92]"); Prop. Reg. section 1.1504-4(c)(4)(ii)(D) (stating that a change in the terms of an option under an anti-dilution formula is not a measurement date — an exception that would not be needed unless a formula adjustment pursuant to the existing terms of an option is a modification).

<sup>22</sup>Compare Reg. section 1.1361-1(l)(4)(iii)(A) under which an option may be treated as stock — indeed as a second class of stock — rather than being treated as exercised, for purposes of the S corporation rules. See the discussion in VIII(5) below.

<sup>23</sup>Prop. Reg. section 1.1504-4(d)(1)(i).

occur where any one of the five tests set forth below is satisfied:<sup>27</sup>

1. An issuance or transfer of the option by gift, at death, or between spouses.

2. An issuance or transfer of the option between members of a code section 1504 affiliated group of corporations, i.e., where the transferor and transferee are both members of the same affiliated group under the 80-80 test.

3. An issuance or transfer of the option between persons neither of whom is "related" to the issuing corporation or any member of its affiliated group. For this purpose, "related" generally means a 10-percent stock ownership standard.

**Example (5):** P owns 100 percent of S' stock. X acquires (either from S or from P) an option to purchase S stock. There is no other stock interrelationship between X, S, and any member of S' affiliated group.

The original issuance of the option to X is a measurement date.

Thereafter, X transfers the option to Y. There is no other stock interrelationship between Y, S, or any member of S' affiliated group.

The transfer of the option from X to Y is not a measurement date, subject to the discussion immediately below.

It appears that the drafters of the proposed regulation did not intend to treat the option being transferred from X to Y (or indeed any other option) as exercised in determining whether X or Y is "related" to S. "Related" is defined in the proposed regulation by reference to code section 267(b) (substituting 10 percent for code section 267(b)'s normal 50-percent test), and code section 267(b) very clearly does not contain an option attribution rule (see code section 267(c)).

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***A literal reading of the proposed regulation's definition of 'related' reaches an absurd result where the transferor or transferee is a corporation.***

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The literal language of the proposed regulation does indeed reach this rational result — i.e., the option is not treated as exercised in determining whether X or Y is 10-percent-or-more "related" to S or a member of S' affiliated group — where the transferor (X) and the transferee (Y) are both individuals. However, where either the transferor (X) or the transferee (Y) is a corporation, a literal reading of the proposed regulation appears to treat the option as exercised in determining whether the transferor or transferee corporation is 10-percent-or-more "related" to S. This absurd result follows from code section 267(b)(3), which refers to code

section 267(f), which in turn refers to code section 1563. Code section 1563(e)(1) treats the holder of an option as owning the underlying stock. Discussions with a representative of Treasury confirm that this result was not intended.

**Example (6):** P owns 100 percent of S' stock. X holds an option to acquire 11 percent of S' stock (i.e., 10 percent or more). X sells the option to Y. There is no other stock interrelationship between X, Y, S, and any member of S' affiliated group.

X and Y are each individuals.

Under the proposed regulation, neither X nor Y is "related" to S, because neither X nor Y bears a section 267(b) relationship to S or to any member of S' affiliated group (substituting 10 percent for 50 percent). In making this determination, the option to acquire 11 percent of S' stock (held first by X and then by Y) is not treated as exercised. Hence the transfer of the option from X to Y is not a measurement date.

**Example (7):** Same facts as Example (6), except that X is a corporation.

Under the literal language of the proposed regulation, X is 10-percent-or-more "related" to S because X is treated as owning 11 percent of S' stock by virtue of code section 1563(e)(1). Hence, unless the language of the proposed regulation is corrected, it appears that the transfer of the option from X to Y will be a measurement date.

**Example (8):** Same as Example (6), except that Y is a corporation.

Same result as Example (7), because Y is 10-percent-or-more "related" to S by virtue of code section 1563(e)(1).<sup>28</sup>

4. A modification which does not increase the likelihood that the option will be exercised.

5. A modification pursuant to a reasonable anti-dilution formula.

The exceptions to the definition of "measurement date" are important. Assuming the final regulation fixes the technical glitch described in 3 above that causes a corporate holder of a 10-percent-or-more option to be related to S merely because of the option, the exceptions to "measurement date" will mean that an option issued to a person not "related" to S is generally tested only on issuance, unless (i) the terms of the option are modified, (ii) the option is thereafter transferred to a person related to S, or (iii) a "device" is present.<sup>29</sup>

## VI. ANTI-AVOIDANCE AND OTHER RULES

The proposed regulation contains a number of anti-avoidance rules. The combination of these anti-avoidance rules and the restricted nature of the safe

<sup>27</sup>As noted in VI(1), the exceptions to measurement date do not apply if they are "used as a device to avoid the application of section 1504 and [this proposed regulation]," whatever the quoted words mean.

<sup>28</sup>The proposed regulation also refers to code section 707(b)(1) (substituting 10 percent for 50 percent) in defining "related." However, code section 707(b)(1) is not relevant to the issues discussed in text because it deals with transactions between two related partnerships or transactions between a partnership and a partner thereof.

<sup>29</sup>See VI(1).

harbors seems to reflect an almost paranoid concern that an S somewhere might find a way around the regulation.<sup>30</sup> This section also discusses several special rules (other than the anti-avoidance rules).

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***The proposed regulation's 'device' exception inserts substantial uncertainty which the IRS would presumably defend as producing a valuable in terrorem effect on taxpayers.***

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**1. 'Device' restriction.** Five of the safe harbors described above in III above are not available if the option in question is "used as a device to avoid the application of section 1504 and this [proposed regulation]."<sup>31</sup> A similar device restriction applies to the five exceptions to the definition of measurement date described in V above.<sup>32</sup>

By its terms, the device limitation apparently turns on some form of "bad intent," but the proposed regulation does not suggest any standard for its application. Thus, the device limitation inserts substantial uncertainty into a large number of the safe harbors and exceptions that are otherwise objective or which turn on factors (such as commercial reasonableness) which have at least some objective frame of reference.

The IRS would presumably defend the uncertainty as producing a valuable *in terrorem* effect on taxpayers. However, it is just as likely to give the IRS great discretion on audit and may result in "device" assertions by agents in order to gain bargaining power. Because the proposed regulation offers no standard for determining when a device is present, it will be very difficult for a taxpayer to meet its burden of proof that there was no device.

This uncertainty seems wholly unnecessary in light of the numerous protections already built into the safe harbors and exceptions. For example, in order to come within the safe harbor described in III(1), an option must be issued to a service provider, may not constitute "excessive" compensation, and may not be transferable. It is difficult to conceive of circumstances where an option meeting the requirements of this safe harbor should be excluded as a device. A similar safe harbor under the S corporation one-class-of-stock regulation for options issued to service providers is not restricted by a "device" limitation.<sup>33</sup>

<sup>30</sup>Perhaps this concern is based on the *Woods Investment* decision, holding the IRS to the literal words of the consolidated return investment adjustments (prior to the adoption of code section 1503(e), overruling the decision) and the difficulty the IRS has faced in winning substance-over-form and step-transaction cases.

<sup>31</sup>Prop. Reg. section 1.1504-4(d)(2). The device restriction applies to the safe harbors described in III(1) (certain SARs and other options issued as compensation for services), III(2) (options issued in connection with loans), III(6) (publicly traded options), III(7) (stock purchase agreements), and III(8) (escrows and pledges).

<sup>32</sup>Prop. Reg. section 1.1504-4(c)(4)(ii).

<sup>33</sup>Reg. section 1.1361-1(l)(4)(iii)(B)(2).

**2. Changes in capital structure and intent to change the value of the underlying stock.** If, with a principal purpose of increasing the likelihood that an option will be exercised, it is intended that (i) the capital structure of S be changed, or (ii) the FMV of S' stock altered (by transferring assets to or from S or by other means):

a. the intended change or alteration will be taken into account in determining whether an option is reasonably certain to be exercised;<sup>34</sup>

b. the safe harbors described in III(3), (4) and (5) above will not apply;<sup>35</sup> and

c. if the change or alteration occurs, it will be a measurement date.<sup>36</sup>

Surprisingly, the proposed regulation does not provide that a device is present in such a case.

**3. Related agreements.** The preamble to the proposed regulation states that in applying the 10 safe harbors and exceptions, any "express or implied agreement," whether part of the option or contained in "another agreement," which modifies the terms of the option, is taken into account in determining whether the option meets one or more of the 10 safe harbors and exceptions.<sup>37</sup>

**4. Related or sequential options.** Special rules apply to related or sequential options, defined by the proposed regulation as "one of a series of options issued to the same or related persons."<sup>38</sup> Any options issued to the same person or related persons within a two-year period are presumed to be related or sequential; options issued to the same person or related persons more than two years apart are presumed not to be related or sequential. In each case the presumption may be rebutted.

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***Special rules apply to related or sequential options . . . .***

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A measurement date for any one of a series of related or sequential options is a measurement date for all such options.<sup>39</sup> The safe harbors described in III(3), (4), and (5) apply to an option that is part of a series of related or sequential options only if each option meets at least one of these safe harbors.<sup>40</sup>

**5. Valuation of shares.** The proposed regulation specifically states that in applying the 80-percent-by-value test, "all shares of stock within a single class are

<sup>34</sup>Prop. Reg. section 1.1504-4(g)(1)(ix).

<sup>35</sup>Prop. Reg. section 1.1504-4(g)(2)(iv)(B).

<sup>36</sup>Prop. Reg. section 1.1504-4(c)(4)(iii).

<sup>37</sup>CO-152-84, the IRS explanatory release accompanying the proposed regulation.

<sup>38</sup>Prop. Reg. section 1.1504-4(c)(2).

<sup>39</sup>Prop. Reg. section 1.1504-4(c)(4)(iv).

<sup>40</sup>Prop. Reg. section 1.1504-4(g)(2)(iv)(C).

See VIII(1) for a discussion of an apparent flaw in the treatment of related or sequential options for purposes of the exception discussed in III(10).



considered to have the same value," so that "control premiums and minority and blockage discounts . . . are not to be taken into account."<sup>41</sup>

## VII. EFFECT OF DEEMED EXERCISE

When an option held by X is deemed exercised under the proposed regulation, X is treated as owning the underlying S stock for purposes of code section 1504(a)'s 80-80 test both (i) in determining whether S is a member of P's affiliated group, and also (ii) for purposes of all code sections which incorporate the 80-80 test.<sup>42</sup>

If an option is treated as exercised under the proposed regulation, the optionee (rather than the optionor) is treated as actually owning the option stock for purposes of code section 1504's 80-percent-by-value test (as described above). However, for purposes of the 80-percent-by-vote test, the optionee is treated as owning the option stock only if there is an arrangement allowing the optionee (or a related person) to direct the vote of the underlying stock prior to exercise of the option.<sup>43</sup>

**1. Consolidation.** P and S may file a consolidated return only if P and S are members of the same affiliated group. Thus, if the deemed exercise of an option on S stock breaks affiliation between P and S, P and S may not consolidate. Because the deemed exercise is generally effective for purposes of the 80-percent-by-value test and not for the 80-percent-by-vote test, application of the proposed regulation will generally break affiliation/consolidation between P and S, but will generally not create affiliation/consolidation between X and S.

**Example (9):** P owns all 100 outstanding S shares. P grants X an option to purchase all 100 S shares. The option does not satisfy any of the 10 safe harbors and exceptions and hence it is treated as exercised. The option does not permit X (or a related person) to vote the S shares prior to exercise of the option.

P can no longer consolidate with S once the option is issued, because X is treated as owning 100 percent of S' stock for purposes of the 80-percent-by-value test.

However, X cannot consolidate with S prior to X's exercise of the option, because P is treated as continuing to own all of S' voting power for purposes of the 80-percent-by-vote test.

**Example (10):** Same facts as Example (9), except that P gives X its proxy to vote the S shares while the option is outstanding.

As in Example (9), P cannot consolidate with S. However, X and S can elect to consolidate because the option is considered exercised for purposes of both the 80-percent-by-value and the

80-percent-by-vote test because X has the right to vote the S shares prior to exercise of the option.<sup>44</sup>

**Example (11):** P owns all 90 of S' outstanding Class A common shares. S grants X an option to purchase 10 shares of S' Class B common. If exercised, X's Class B shares will represent 10 percent of the value of S' outstanding stock and 21 percent of its voting power. The option does not satisfy any of the 10 safe harbors and exceptions and hence it is treated as exercised. The option does not permit X (or a related person) to vote the Class B shares prior to exercise of the option.

The option is treated as exercised by X for purposes of the 80-percent-by-value test. Because the Class B shares would represent only 10 percent of the value of S' stock, P and S continue to meet the 80-percent-by-value test even after the deemed exercise.

However, the option is not treated as exercised by X for purposes of the 80-percent-by-vote test. P and S continue to meet the 80-percent-by-vote test even after issuance of the option (although actual exercise of the option by X would mean that P and S no longer meet the 80-percent-by-vote test). Thus, issuance of the option to X does not break the P-S affiliation and P and S may continue to file consolidated returns.

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### ***Application of the proposed regulation will generally break consolidation but will generally not create consolidation.***

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**2. Code sections 332 and 337.** Under code sections 332 and 337, a subsidiary may liquidate tax-free into its parent if the parent owns stock in the subsidiary meeting the 80-80 test. If the proposed regulation breaks affiliation between P and S, the liquidation of S into P would be taxable to both S and P.

**3. Code sections 338 and 338(h)(10).** Z, a corporate purchaser of the stock of S, makes a qualified stock purchase (a "QSP") of S under code section 338 if it purchases an amount of S stock meeting the 80-80 test. Thus, where X holds an option on S stock not meeting any safe harbor or exception, application of the proposed regulation could prevent Z from making a QSP of S' stock and hence prevent the making of a section 338 or a section 338(h)(10) election.

Even where Z makes a QSP of S, Z and P may make a joint election under section 338(h)(10) to treat the purchase of S' stock as a purchase of S' assets only if S was (before the QSP) a member of P's affiliated group and P and S filed a consolidated return. Application of the proposed regulation to break affiliation and hence consolidation between P and S before Z's purchase of

<sup>41</sup>Prop. Reg. section 1.1504-4(b)(2)(iii).

<sup>42</sup>Prop. Reg. section 1.1504-4(a)(1).

<sup>43</sup>Prop. Reg. section 1.1504-4(b)(2)(ii).

<sup>44</sup>In such a case, X and S must consolidate if X is already a member of an affiliated group that previously elected to file a consolidated return. Reg. section 1.1502-75(e); Reg. section 1.1502-76(b)(1).



S' stock would prevent Z and P from jointly making a section 338(h)(10) election.<sup>45</sup> However, the mere execution of a stock purchase agreement between Z and P will not result in a deconsolidation of S prior to the acquisition, provided that it meets the terms of the safe harbor described in III(7) above.

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***Application of the proposed regulation could prevent the making of a section 338 or a section 338(h)(10) election.***

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**4. Other code sections.** A number of other (generally less significant) code provisions also turn on affiliated group status, e.g., the 100-percent dividends received deductions ("DRD") for affiliated group members not electing to file a consolidated return, and the proposed regulation is thus relevant in applying these other code provisions which incorporate by reference code section 1504's affiliated group definition.<sup>46</sup>

**5. Effect outside the 80-80 test.** The proposed regulation does not treat an option as exercised for any purpose of the code other than the affiliated group 80-80 test. For example, an option will not be deemed exercised under the proposed regulation for purposes of satisfying the 12-month holding period for long-term capital gain or the 20-percent-by-vote-and-value test to qualify for the 80-percent (rather than the 70-percent) DRD.

Conversely, the satisfaction of one or more of the 10 safe harbors and exceptions in the proposed regulation (or failure to satisfy any of them) will create "no inference . . . that options will not be treated as stock or as exercised under other provisions of the code or regulations, or other principles of law."<sup>47</sup>

Prior precedents will continue to apply outside the affiliated group area in determining whether (and under what circumstances) an option is treated as exercised or is treated as an equity interest. The preamble to the proposed regulation specifically mentions Rev. Rul. 82-150, 1982-2 C.B. 110 (X treated as the actual owner of stock underlying an option where X purchased the option paying a price for the option equal

to 70 percent of the underlying stock's FMV, and the option exercise price was only 30 percent of the underlying stock's FMV); and Rev. Rul. 83-98, 1983-2 C.B. 40 (convertible note treated as an equity instrument because of the high probability of conversion where the note was worth \$600 at maturity but was convertible into stock currently worth \$1,000). Other precedents suggest that the courts are much less likely than the IRS to recharacterize an option. See, e.g., *Penn-Dixie Steel Corp. v. Commissioner*, 69 T.C. 837 (1978) (court holds that a matching put and call on the stock of a joint venture corporation was not a current sale where the put and call expired at different times); *Victorson v. Commissioner*, 326 F.2d 264 (2d Cir. 1964) (an option to purchase shares at an exercise price equal to 0.2 percent of the underlying stock's FMV at the grant date treated as an option); *Simmons v. Commissioner*, 23 TCM 1423 (1964) (same where exercise price was equal to 0.1 percent of the underlying stock's FMV at the grant date). But see also *Morrison v. Commissioner*, 59 T.C. 248 (1972) (option treated as having a readily ascertainable value at grant where the exercise price was \$1 and the underlying stock's FMV was \$300 at the grant date).

**VIII. OTHER AMBIGUITIES AND ISSUES**

The proposed regulation contains a number of other interpretive ambiguities and issues:

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***Under the no-substantial-tax-savings exception, an option will be treated as exercised only if exercise of that option alone would break affiliation.***

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**1. Application of the proposed regulation to an option on 20-percent-or-less of S' stock.** Under the exception described in III(10), an option is considered exercised only where substantial additional federal income tax would have resulted if the underlying stock had been issued or transferred rather than the option. Under the literal language of the proposed regulation, each option is treated separately for purposes of this exception. As a result, the proposed regulation, read literally, will never treat an option as exercised unless the exercise of that option alone would break affiliation between P and S (in combination with any S stock actually issued to minority shareholders of S).

**Example (12):** P owns all 100 S shares. On 1/1/93, P grants an option to X on 19 S shares. On 1/2/93, P grants an option to Y on 19 additional S shares. On 1/3/93, P grants an option to Z on 19 additional S shares. X, Y, and Z are not related. No safe harbor or exception applies, other than the exception described in III(10). If the proposed regulation were worded more broadly, the exception discussed in III(10) would not apply, because breaking the P-S consolidation would result in substantial additional federal income tax.

As worded, the proposed regulation does not apply to break the affiliation and consolidation

<sup>45</sup>Under current regulations, if Z and P attempt to make a section 338(h)(10) election with respect to S where S is not eligible because S was not a member of P's consolidated group, it appears that Z will have made a regular section 338 election for S (required as part of any section 338(h)(10) election), a potentially expensive result that Z would be unlikely to choose intentionally. Under proposed section 338 regulations (which will not be effective for QSPs occurring before the regulations are finalized), if Z and P attempt to make a section 338(h)(10) election for S and S is ineligible, a regular section 338 election is not considered made for S. Prop. Reg. section 1.338(h)(10)-1(d)(1).

<sup>46</sup>However, the proposed regulation specifically states that it does not apply to code section 382(l)(5) (special bankruptcy rule for NOL corporation) or code section 864 (U.S. taxation of foreign persons).

<sup>47</sup>CO-152-84, the IRS explanatory release accompanying the proposed regulation.

of P and S, because each option (for 19 percent of S' stock) is considered separately and the issuance of the stock underlying any one option would not break P-S consolidation and hence would not result in substantial federal income tax.

Because X, Y, and Z are not related, the options issued to X, Y, and Z are not related or sequential. Thus, the option issued to X has a measurement date on 1/1/93, and not on 1/2/93 or on 1/3/93 when options are issued to Y and Z, respectively. Similarly, the option issued to Y has a measurement date on 1/2/93, and not on 1/3/93 when an option is issued to Z. This is true even if the options are issued to X, Y, and Z as part of one plan.

Because this exception literally applies separately to each option, the result would arguably be the same even if (i) all three options were issued on the same day and therefore had a common measurement date or (ii) all three options were treated as related or sequential.

While the option-by-option rule generally makes sense, the IRS may wish to amend the proposed regulation to treat options together for purposes of the exception described in III(10) in some cases. Several approaches are possible:

a. Options could be considered together if they are related or sequential options. It is hard to believe the drafters did not intend this result. However, the literal language of the proposed regulation does not appear to reach this result.

b. Options could be considered together if they are issued pursuant to a single plan, even though not issued to the same or related persons.

c. Options could be considered together if they have the same measurement date, which would pick up related or sequential options as well, since a measurement date for any one constitutes a measurement date for all under the proposed regulation.

d. Each outstanding option that was not treated as exercised on its most recent measurement date solely because, considered alone, it would not have broken affiliation between P and S if exercised (i.e., each option which failed to meet any safe harbor or exception except III(10) and met the III(10) exception only because, considered alone, it would not have broken the P-S affiliation if exercised), could be treated as exercised for purposes of applying the exception described in III(10) to an option with a later measurement date.

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***An option that is not treated as exercised on one measurement date may be treated as exercised on a subsequent measurement date.***

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2. **Substantial additional taxes under code sections 332 or 338(h)(10).** The proposed regulation does not make clear whether federal income taxes resulting from the failure of a transaction to qualify under code

sections 332 or 338(h)(10) because of the deemed exercise of an option should be counted for purposes of determining whether the exception described in III(10) applies. Presumably the answer is no, since there is no abuse of the benefits of consolidation, but the answer is not clear. Cf. Prop. Reg. section 1.1504-4(e) (last sentence — ignoring, for this purpose, any tax that would be triggered by a sale on the measurement date of the underlying stock pursuant to the option).

3. **Measurement dates and deemed exercise.** An option that is not treated as exercised on one measurement date may be treated as exercised on a subsequent measurement date.<sup>48</sup> It is less clear under the proposed regulation whether an option that is treated as exercised on one measurement date (because it fails to satisfy any one of the 10 safe harbors and exceptions) may be treated as not exercised on a subsequent measurement date (because it then satisfies at least one of the 10 safe harbors or exceptions). This might occur, for example, where the underlying stock's FMV declines from one measurement date to the next so the option is no longer "reasonably certain to be exercised."<sup>49</sup> The proposed regulation should be amended to clarify that an option may cease to be tainted under the deemed exercise rule on a subsequent measurement date.

4. **Expansion of 24-month-90-percent-FMV and 100-percent-FMV safe harbors.** The authors believe that the 24-month-90-percent-FMV safe harbor described in III(3) should be available even if the term of the option exceeds 24 months. This change would make this safe harbor consistent with the 90-percent-of-FMV safe harbor for options contained in the S corporation one-class-of-stock regulation that has no such 24-month time limitation.<sup>50</sup>

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***The 90-percent-FMV safe harbor should be available even if the term exceeds 24 months.***

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If the 24-month limitation is not removed, the authors believe that the safe harbor described in III(4) should be modified to apply to an option if the exercise price of the option is at least 100 percent of the under-

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<sup>48</sup>CO-152-84, the IRS explanatory release accompanying the proposed regulation.

<sup>49</sup>If S was initially included in P's consolidated return, S then ceased to be included because an option on S stock held by X was treated as exercised, and thereafter S again becomes a part of P's affiliated group because the option on S stock held by X ceases to be treated as exercised, then code section 1504 may not permit S to immediately reenter P's consolidated return. Code section 1504(a)(3) requires S (once it has failed the 80-80 test and dropped out of P's consolidated return) to wait five years (or in some circumstances slightly longer) after ceasing to be a part of P's consolidated return before S may again be included in P's consolidated return. Code section 1504(a)(5)(D) waives this waiting period in certain other circumstances. It would be desirable for the proposed regulation to extend this waiver to the situation described in the text.

<sup>50</sup>See Reg. section 1.1361-1(l)(4)(iii)(C).

lying stock's FMV on the measurement date (rather than on the exercise date, as the proposed regulation now requires). Where the exercise price of an option is at least 100 percent of the underlying stock's FMV on the measurement date, there is no built-in incentive to exercise the option. Any future exercise of the option depends wholly on the future success of S' business. The preamble to the proposed regulations indicates that where the exercise of an option turns on business risks, it will not be treated as reasonably certain to be exercised, stating "an option issued at the start-up of a venture, the exercise of which depends on the outcome of true business risks, such as the ultimate success of the venture, generally will be treated as not reasonably certain to be exercised."<sup>51</sup>

Indeed, an option with only a short time until expiration, i.e., less than a 24-month remaining life, which is 10 percent in the money, is highly likely to be exercised within a short time, but is safe harbored under III(3). On the other hand, where an option has more than a 24-month remaining life and is not in the money at all, its exercise *vel non* clearly turns on the future success of S' business, but such an option is not safe harbored under III(4).

**5. Comparison to S corporation one-class-of-stock regulation.** In general, an S corporation may have only one class of stock. A regulation interpreting this requirement treats a "call option, warrant, or similar instrument" as a second class of stock unless it qualifies for one of several safe harbors or exceptions.<sup>52</sup> If no safe harbor or exception applies, the S regulation treats the option itself as stock (indeed as a second class of stock) and does not deem the option to be exercised.

In several significant respects, the S regulation offers more generous safe harbors and exceptions for options than the safe harbors and exceptions under the proposed code section 1504 regulation.

First, the S regulation provides an exception for an option that is not "substantially certain to be exercised." The proposed code section 1504 regulation provides an exception for an option that is not "reasonably certain" to be exercised. The S exception is more generous.

Second, the S regulation creates an additional exception so that even where an option "is substantially certain to be exercised," it will not be treated as stock unless it has "a strike price substantially below the [FMV] of the underlying stock on the date that the . . . option is" tested. There is no similar exception under the proposed code section 1504 regulation.

Third, the S regulation offers safe harbors for an option issued to a lender or a service provider that are similar to the safe harbors provided under the proposed code section 1504 regulation, except that they are not conditioned on the absence of a "device" or bad intent.

<sup>51</sup>CO-152-84.

<sup>52</sup>Reg. section 1.1361-1(l)(4)(iii). The general rule set out in the S corporation regulation is worded somewhat differently — it applies several threshold tests that we prefer to view as safe harbors and exceptions.

Fourth, the S regulation provides a safe harbor for an option where the exercise price is at least 90 percent of the underlying stock's FMV on the date the option is tested. This safe harbor is more generous than the safe harbors described in III(3) and III(4): Unlike III(3), it is not limited to options with a term of 24 months or less, and unlike III(4), it is based on the underlying stock's FMV on the date the option is tested, not on the FMV on the exercise date.

Fifth, the S regulation's option rule does not explicitly treat SARs and other instruments not granting a right to receive stock as options that are subject to being treated as a second class of stock.

There is no reason why the proposed code section 1504 regulation should be more restrictive with respect to options than the S corporation one-class-of-stock regulation. The proposed code section 1504 regulation should therefore be amended to be consistent with the S regulation.

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***The proposed code section 1504 regulation should . . . be amended to be consistent with the S regulation.***

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**6. Convertible obligations.** In the preamble to the proposed regulation, the IRS seeks comments on whether a special safe harbor is needed for convertible obligations. The authors believe that if the safe harbors described in III(3) and (4) are modified as described in 4 above, there would be no need for a special exception or safe harbor for convertible obligations. Convertible obligations would then generally qualify for the safe harbors described in III(2) through (4).

## IX. EFFECTIVE DATE

If adopted, the proposed regulation will apply to all options (even if issued long ago) for each measurement date occurring on or after 2/28/92. Thus, if a pre-2/28/92 option (an "old option") would fail to qualify for any safe harbor or exception, it is desirable to avoid having a post-2/27/92 measurement date.

There are two exceptions to this effective date rule for old options:

First, if an old option is modified pursuant to the terms of the option as it existed on 2/28/92, such modification is not a measurement date.

Second, the release accompanying the proposed regulation states that an old option with no post-2/27/92 measurement date is still subject to general "substance over form principles in determining whether options will be treated as stock or as exercised in appropriate circumstances," citing Rev. Rul. 82-150 and Rev. Rul. 83-98, discussed in VII(5) above.

The proposed regulations should be modified to include the special effective date provisions described in Notice 87-63, 1987-2 C.B. 375. In that notice, the IRS stated that regulations under code section 1504 would not be effective (i) under code section 332 for plans of liquidation adopted on or before the date that code section 1504 regulation was proposed, and (ii) under

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code section 338(d)(3) for purchases made during any 12-month acquisition period beginning on or before the date that code section 1504 regulations were proposed.

### X. CONCLUSION

The proposed regulation is complicated, contains a number of vague phrases as preconditions to safe harbors, exceptions, and tests (e.g., whether an option is being used "as a device to avoid the application of section 1504 and [this proposed regulation]") which could lead to troublesome audit disputes, contains several important flaws (e.g., in the definition of "re-

lated"), is overbroad in at least one respect (treating cash settlement options, SARs, and phantom stock as "options"), and is too narrow in one important respect (making the safe harbor described in III(4) turn on the stock's FMV on the exercise date rather than on the measurement date). However, the proposed safe harbors and exceptions are generally broad enough to permit many legitimate (i.e., non-tax-avoidance) options to be treated as options rather than as stock for code section 1504 purposes. Hence with relatively minor changes, the proposed regulation would be a workable addition to code section 1504.