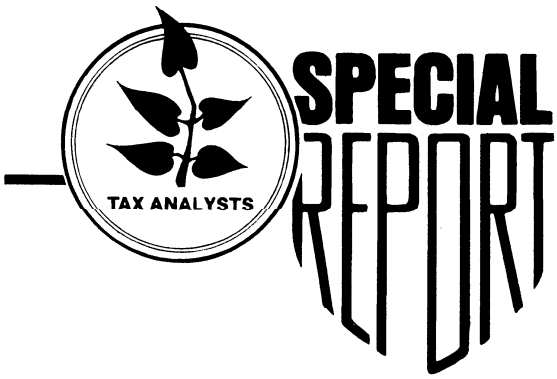


FINAL SECTION 1504(a)(5) REGULATION — EFFECT OF SUBSIDIARY'S OPTIONS, WARRANTS, AND CONVERTIBLE DEBENTURES ON SUBSIDIARY'S AFFILIATED GROUP MEMBERSHIP

by Jack S. Levin, Patrick C. Gallagher, and William R. Welke

Jack S. Levin is a senior partner and Patrick C. Gallagher and William R. Welke are partners in the law firm of Kirkland & Ellis. This article is part of a soon-to-be-published update to a seven-volume set of books entitled Mergers, Acquisitions and Leveraged Buyouts, by Martin D. Ginsburg and Jack S. Levin.

The authors thank Martin D. Ginsburg, professor at Georgetown University Law Center and counsel to Fried, Frank, Harris, Shriver & Jacobson, for his assistance in the preparation of this article.

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

The final regulation, which was issued in December 1992, substantially amends the March 1992 proposed version of the regulation. According to the authors, the final regulation, by addressing many of the ambiguities and other concerns that marred the proposed version of the regulation, yields a welcome and substantial improvement.

The authors explain the operation of the complex regulation and provide many examples to illustrate its operation. They critique various aspects of the regulation, including ambiguities in the treatment of (i) preferred stock with a fixed mandatory redemption date that does not qualify for the straight preferred safe harbor of section 1504(a)(4), and (ii) instruments that are options in form but are viewed as stock under general tax principles.

The authors conclude that, subject to relatively minor exceptions, the final regulation, through greater clarity and relatively generous safe harbors and exceptions (including a significant reduction of the circumstances in which an option transfer will trigger a "measurement date"), is broad enough to exempt in a clear manner most legitimate (i.e., non-tax-avoidance) transactions involving options, warrants, convertible debentures, and similar rights, so that such rights will not be treated as exercised for section 1504 purposes.

TABLE OF CONTENTS

I. INTRODUCTION

A parent corporation ("P") can file a consolidated federal income tax return with its subsidiary ("S") only during the period that P's ownership of S stock meets the "80-80 test" of section 1504(a)(2) (so that P and S are members of the same "affiliated group"). P's ownership of S meets the 80-80 test only if P (or other members of its affiliated group) owns:

(a) S stock with a fair market value ("FMV") of at least 80 percent of the FMV of all S's outstanding stock (the "80-percent-by-value test") and

(b) S stock possessing at least 80 percent of the total combined voting power of outstanding S stock (the "80-percent-by-vote test").

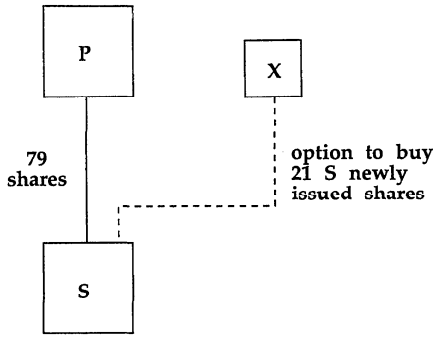
Hence, P cannot consolidate with S during the period that a third party (hereinafter "X") owns more than 20 percent of S's stock either by value or by vote.[1]

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

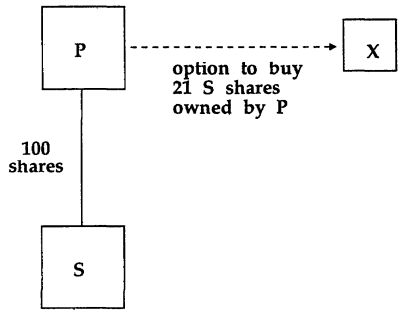
The Tax Reform Act of 1984 granted the IRS broad regulatory power to prescribe when an option, warrant, convertible debenture, or similar instrument or right (hereinafter an "option")[2] held by X to acquire S stock (either to acquire outstanding S stock from P or to acquire newly issued S stock from 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.[3]

Example (1): P owns all 79 shares of outstanding S stock. However, X holds an option 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's stock, P's 79-percent ownership of S will not satisfy the 80-80 test, and P thus will be unable to file a consolidated return with S.



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



In March 1992, eight years after the 1984 act granted the IRS regulatory power, the IRS issued a proposed regulation addressing the treatment of options and similar instruments under section 1504.[4] In December 1992, the IRS issued the final regulation, which significantly amended and improved on the proposed regulation.[5] The following discussion concerns the final regulation. Although complicated and less than perfect, it 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 section 1504 purposes.

---

[1]In applying the 80-80 test, nonvoting debt-like preferred stock (whether held by P or by X) will be ignored if it meets all of the following conditions:

(1) it is not entitled to vote,

(2) it is limited and preferred as to dividends and does not significantly participate in corporate growth,

(3) its redemption and liquidation rights do not exceed its issue price plus a reasonable redemption or liquidation premium, and

(4) it is not convertible into another class of stock.

Section 1504(a)(4).

[2]Throughout this discussion, the term "option" includes (a) a call option, (b) a put option, (c) a warrant, (d) convertible debt, (e) a redemption agreement (including a right to cause the redemption of stock), (f) any other instrument that provides for the right to issue, redeem, or transfer stock (including an option on an option), and (g) a cash settlement option, phantom stock, an SAR, or any other similar interest (except for stock), as described in IV below.

[3]Section 1504(a)(5).

[4]Prop. Reg. section 1.1504-4 (CO-152-84). For critical analysis of the proposed regulation, *see* Levin & Welke, "New Proposed Section 1504(a)(5) Regulation — Effect of Subsidiary's Options, Warrants, and Convertible Debentures on Subsidiary's Affiliated Group Membership," 55 *Tax Notes* 1523 (June 15, 1992); New York State Bar Association Tax Section, Committee on Consolidated Returns, "Report on Proposed Treasury Regulations Section 1.1504-4: Definition of 'Affiliated Group'," 57 *Tax Notes* 391 (October 19, 1992).

[5]Reg. section 1.1504-4 (T.D. 8462).

II. GENERAL OPTION RULE

Where X holds an option to acquire S stock, the option will be treated as exercised (in determining whether P fails section 1504's 80-percent-by-value test, but not for purposes of the 80-percent-by-vote test) on any "measurement date" (i.e., generally each date on which the option is either issued, transferred [generally except for a transfer between two persons neither of which is affiliated with S], or adjusted [in a manner that materially increases the likelihood of exercise, including an adjustment under the terms of the instrument] — as described at more length in V below) if on such date the option does not fit within at least one of the 13 safe harbors and exceptions described in III[6] below.

Where an option meets one of the 13 safe harbors and exceptions, it is not treated as exercised for purposes of the 80-80 test.

Where an option meets one of the 13 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.

III. SAFE HARBORS AND EXCEPTIONS

An option will not be treated as exercised on a measurement date if it meets at least 1 of the following 13 safe harbors or exceptions on such date:[7]

(1) A stock appreciation right ("SAR"), phantom stock, warrant, option, or any similar instrument issued to an employee, director, or independent contractor in connection with the performance of services for S or for a "related" corporation, provided the option (i) represents reasonable compensation, (ii) is nontransferable (except upon death) as defined in the regulation, (iii) does not have a "readily ascertainable fair market value" (as defined in Reg. section 1.83-7(b)) on the measurement date, and (iv) is not issued or transferred with "a principal purpose of avoiding" application of the regulation.

An instrument that is transferable in any circumstance other than death (e.g., divorce) would apparently not qualify for the safe harbor.

The regulation does not elaborate on what arrangements might violate the "principal purpose" test. Indeed, the principal purpose exception does not appear necessary in light of (i) the requirements that the option not constitute "excessive" compensation and not be transferable, and (ii) the rule (discussed in IV.A below) that general tax principles (including the treatment of sufficiently deep-in-the-money options as "stock" under the principles of Rev. Ruls. 82-150 and 83-98) continue to apply to an instrument treated as an "option" under the regulation. Moreover, a similar safe harbor under the S corporation one-class-of-stock regulation for options issued to service providers is not restricted by a "principal purpose" limitation.[8]

(2) An option issued in connection with a loan to S if the lender is "actively and regularly engaged in the business of lending" and the loan is "commercially reasonable." This safe harbor continues to apply if the option is transferred with the loan (or if a portion of the option is transferred with a corresponding portion of the loan), but ceases to apply if the option is transferred without a corresponding portion of the loan.

Even if the lender separates the option from the loan, the option will not be treated as exercised under the regulation unless there is a new measurement date for the option and, on such measurement date, the option does not satisfy any other safe harbor or exception. For example, as discussed in V below, if the lender transfers the option and neither the lender nor the transferee of the option is a member of P's affiliated group, the transfer date will not be a measurement date unless (i) the terms of the option have been modified in a manner that materially increases the likelihood of exercise or (ii) the transfer is deemed to be a part of a plan with a principal purpose to avoid the regulation and either the lender or the transferee is related to or acting in concert with S or a P group member.[9] Similarly, if the lender transfers the loan and retains the option, there will be no measurement date (assuming, again, that the terms of the option are not modified).

If the separation of the option from the loan is stepped together with their original issuance, the option might be either retested at issuance (on the ground that the issued-in-connection-with-a-loan safe harbor does not apply under a step transaction analysis) or tested at the later transfer date (on the ground that the transfer of the option is a measurement date if the transfer is deemed to be a part of a plan with a principal purpose to avoid the regulation and either the lender or the transferee is related to or acting in concert with S or a P group member).

[6]The general rule set forth in the 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(12) and III(13), and also fails to satisfy any of the 11 safe harbors and exceptions set forth in III(1) through III(11) above. However, we find the regulation easier to understand if the two threshold tests described in III(12) and III(13) are restated as safe harbors and exceptions, making a total of 13 safe harbors and exceptions.

[7]*See* Reg. section 1.1504-4(d)(2)(e)(g).

[8]Reg. section 1.1361-1(l)(4)(iii)(B)(2).

[9]*See* Reg. section 1.1504-4(c)(4)(i) and 1.1504-4(c)(4)(ii)(B)(2).

(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.[10] However, this safe harbor does not apply if 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)," disregarding for this purpose any such rights associated with stock actually owned by the option holder (hereinafter "stockholder rights"). For purposes of this safe harbor, stockholder rights that arise upon a default under the option or a related agreement are ignored.[11]

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.

The 24-month limitation seems to us unfortunate and unnecessary. The 90-percent FMV safe harbor for options that is contained in the S corporation one-class-of-stock regulation, we note, has no such 24-month time limitation.[12]

(4) An option with an exercise price of at least 100 percent of the underlying stock's FMV on the exercise date,[13] 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 safe harbor 5 described below are very limited. In order to qualify for one of these two safe harbors, the option exercise 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.

We believe that this safe harbor 4 should have been available for an option whose exercise price is at least 100 percent of the underlying stock's FMV on the measurement date (rather than on the exercise date, as the 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's business and hence the option is not "reasonably certain to be exercised."

It is ironic that a 10-percent-in-the-money option with only a short time until expiration, i.e., less than a 24-month remaining life, is highly likely to be exercised within a short time, but is nevertheless safe harbored under 3 above. 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's business, but such an option is not safe harbored under this 4.

(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) An option that is publicly traded (as defined in the regulation) on the measurement date, unless the option is issued, transferred or listed with "a principal purpose" of avoiding the application of the regulation. The regulation states that such a principal purpose "may" exist where (i) an option has an exercise price (or, for a convertible or exchangeable instrument, a conversion or exchange premium) that is materially less than, or a term that is materially longer than, "customary for publicly traded instruments of [its] type," or (ii) a "large percentage" of an option issuance is placed with one investor (or a "group" of investors) and a "very small percentage" of the issuance is traded. The language of the final regulation makes clear (as does the regulatory preamble) that the publicly traded exception ceases to apply if on a subsequent measurement date the option is no longer publicly traded.

(7) A stock purchase agreement or "similar arrangement" (e.g., a reverse subsidiary merger agreement) whose terms are "commercially reasonable" and in which the buyers and sellers are obligated to close the transaction "subject only to reasonable closing conditions."

(8) An escrow, pledge, or other security agreement that is "a typical commercial transaction" and "subject to customary commercial conditions."

(9) An option created pursuant to a plan of reorganization in a title 11 bankruptcy or similar case (an "11 plan") prior to the time the plan becomes effective. Such an option is disregarded until the 11 plan's effective date, but apparently from that date forward is fully subject to the regulation. Thus, where an 11 plan offers an S creditor new S stock, the option created by the pendency of the 11 plan is disregarded; once the 11 plan becomes effective, the S creditor is treated as holding the new S stock issued pursuant to the plan. Moreover, where an 11 plan offers an S creditor a new S stock option, the option created by the pendency of the 11 plan is disregarded; once the 11 plan becomes effective, the new S stock option issued pursuant to the plan apparently is subject to and hence is tested under the regulation, and this safe harbor 9 becomes inapplicable.

(10) Convertible preferred stock if "the conversion feature do[es] not permit or require the tender of any consideration other than the stock being converted." Such convertible preferred stock is treated solely as stock and not as an option for section 1504 purposes.

---

[10]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.

[11]Query whether stockholder rights continue to be ignored after a default has actually occurred.

[12]*See* Reg. section 1.1361-1(l)(4)(iii)(C).

[13]In the case of a put option, the option's exercise price must not exceed the stock's FMV on the exercise date.

Example (3): X purchases from S, for $1,000 cash, nonvoting preferred S stock with a $1,000 liquidation preference, a seven-year maturity, and a fixed dividend at a market rate. The preferred stock is convertible at the holder's option into 10 S common shares (FMV $900 at the time the preferred is issued) solely by delivery of the preferred stock to S, without payment of any other consideration. The preferred stock has a $1,000 FMV at issuance.

Under the regulation, the convertible preferred is treated solely as stock for purposes of the 80-80 test. Therefore, the preferred stock will continuously be taken into account for purposes of the 80-80 test at its fluctuating FMV (initially $1,000).

Any other convertible preferred stock (i.e., any convertible preferred stock that permits or requires the tender of consideration other than the stock being converted) will not satisfy this safe harbor, and hence will not be treated solely as stock. Specifically, the preamble to the regulation states that any convertible preferred stock failing this safe harbor "may be treated as stock and/or an option, depending on the circumstances." See VII.F below for a discussion of convertible preferred stock that fails this safe harbor.

(11) Any other instrument specified by the IRS in regulations, a revenue ruling, or a revenue procedure.

(12) 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"). According to the regulatory preamble, "the fact that an option cannot, or may not, be exercised for a period of time after its issuance" does not preclude deemed exercise as of a measurement date.

(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.[14]

This reasonable-certainty-of-exercise test is obviously subjective, unlike the objective 24-month, 90-percent-FMV test described in safe harbor 3 above. An example in the regulation concludes that a three-year option to buy a share of S's stock at a $30 exercise price per share, granted when S's stock had a $40 FMV per share (i.e., an option that was 25 percent in the money at grant), is reasonably certain to be exercised.[15] The regulation gives no guidance as to the point (obviously less than 25 percent in the money) at which the IRS would consider an option not reasonably certain to be exercised.

Regarding an option with an exercise price that varies over time, the regulatory preamble states that (i) if the possible exercise prices are specified in the option agreement, the lowest exercise price (or in the case of a put option, the highest exercise price) is used to determine whether the option is reasonably certain to be exercised and (ii) any date on which the exercise price of the option changes constitutes a measurement date (as further discussed in V(4) below).

The IRS explanatory release accompanying the proposed version of the regulation[16] stated that an option is considered reasonably certain to be exercised "only if a strong probability exists that the option will be exercised." It 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."

The final regulation includes an example in which P and X establish "a new business venture" (S) in corporate form with P owning 80 percent and X owning 20 percent of S's stock plus an option to acquire an additional 30 percent of S's stock. The example states that the option terms are "such that the option will only be exercised if the new business venture succeeds." The example concludes that "because of the true business risks involved in the start-up of [S] and whether the business venture will ultimately succeed . . . it is not reasonably certain [at the outset] that the option will be exercised. . . ."[17]

By contrast, another example sensibly concludes that where P and X have complementary put and call options on 50 percent of S's stock, which are exercisable for the same exercise price and on the same date, either the put or the call is reasonably certain to be exercised.[18]

Because the 24-month, 90-percent-FMV safe harbor 3 described above does not apply if the option's remaining term exceeds 24 months, and because safe harbor 4 described above requires an exercise price not less than 100 percent of the stock's FMV at exercise (not at the measurement date), generally 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 (i) the subjective reasonable-certainty-of-exercise exception discussed in this safe harbor 12 and (ii) the

[14]Reg. section 1.1504-4(h), Examples 6 and 7.

[15]Reg. section 1.1504-4(h), Example 1.

[16]CO-152-84 issued in March 1992.

[17]Reg. section 1.1504-4(h), Example 7.

[18]Reg. section 1.1504-4(h), Example 6.

no-substantial-tax-saving exception discussed in safe harbor 13 below.

In contrast to other types of options, the regulation states that a cash settlement option, phantom stock, SAR or similar instrument (i.e., an instrument that does not require the delivery of any cash or other property by the holder on exercise) is considered reasonably certain to be exercised "if it is reasonably certain that the option will have value at some time during the period in which the option may be exercised."[19] For this purpose, the regulation presumably uses "value" loosely to mean a positive spread between the FMV of the underlying stock on which the instrument is based and the deemed exercise price of the instrument. If, on the other hand, the regulation had used "value" to mean the FMV of the instrument itself, then virtually all such instruments would be treated as reasonably certain to be exercised at issuance (assuming no other safe harbor applied), because even an instrument that is issued substantially out of the money generally has some (albeit small) positive FMV at issuance (i.e., in a Black-Scholes option valuation sense).

(13) If P or S had actually transferred to X the stock underlying the option (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.

The regulatory preamble states that the intended standard is whether "the parties expect, or should reasonably have expected," that substantial tax liability would be eliminated by issuing the option rather than the underlying stock. The "mere possibility" of such savings will not cause an option to fail the safe harbor.

All options with the same measurement date (including all options issued pursuant to a "plan," and all "related or sequential" options — see V below) are aggregated in determining whether the transfer of the option to X in lieu of the underlying stock would eliminate a substantial amount of federal income tax liability.[20]

The regulatory preamble states that "any benefit related to the affiliation of [S] and its affiliated group" is taken into account in determining whether tax liability is eliminated. For example, if transferring the underlying stock rather than the option would deconsolidate S from its affiliated group, the resulting additional tax liability would reflect the entire amount of any excess loss account or deferred intercompany gain (not just the portion associated with the transferred stock) that would be triggered as a result of such stock transfer.

It appears that any federal income taxes that would result from the failure of a transaction to qualify under section 332 (in the case of a liquidation of S into P) or section 338(h)(10) (in the case of a sale by P of S's stock to a corporate buyer) if the underlying stock were transferred in lieu of the option also would be counted in determining whether there is substantial elimination of tax liability. This is because the benefits of sections 332 and 338(h)(10) are "related to the affiliation of [S] and its affiliated group." On the other hand, Reg. section 1.1504-4(e) ignores for this purpose any tax on "the gain with respect to the stock subject to the option that would be recognized if such stock [rather than the option] were sold on a measurement date."

Where P and S are both expected to be profitable corporations with no NOLs or other tax attribute carryforwards, this safe harbor 13 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 on S stock.

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 P-S consolidation 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.

The 'principal purpose' exception [to the compensatory option safe harbor] does not appear necessary.

In determining whether there is an elimination of tax liability, "the tax consequences to all involved parties are considered" (emphasis added).[21] Therefore, 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.[22]

Example (4): P owns all 100 shares of S's stock. P grants X an option to purchase 80 shares, i.e., 80 percent, of S's stock. (Or S grants X an option to purchase 400 newly issued S shares, i.e., 80

[19]Reg. section 1.1504-4(g)(2).

[20]Reg. section 1.1504-4(b)(2)(ii). In its most simple application, this rule means that all options issued on the same date are generally aggregated on that date (since issuance is generally a measurement date). This rule, which was not included in the proposed version of the regulation, is necessary because if multiple options, not one of which represents more than 20 percent of S's stock, were each tested separately, literally the transfer of the options rather than stock should eliminate no tax under the basic test (since issuance of stock in lieu of each separate option would not violate the 80-percent-by-value test and hence would not break consolidation).

[21]Reg. section 1.1504-4(e).

[22]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 useable because of S's anticipated current year losses. *See* CO-152-84, the preamble to the proposed version of the regulation.

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.

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's $90 loss each year against X's $90 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 13 should 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, even though for purposes of the regulatory deemed exercise rule (see VII below), X's non-safe-harbor option would cause X to be treated as owning S stock covered by the option only for purposes of the 80-percent-by-value (not the 80-percent-by-vote) test.[23]

IV. MEANING OF OPTION

For purposes of the regulation, an option includes (a) a call option, (b) a put option, (c) a warrant, (d) convertible debt, (e) a redemption agreement (including a right to cause the redemption of stock), (f) any other instrument that provides for the right to issue, redeem, or transfer stock (including an option on an option), and (g) a cash settlement option, phantom stock, an SAR, or any other similar interest (except for stock).[24] 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).

However, an option issued by an S shareholder with respect to S stock held by that S shareholder will generally have no effect under the regulation unless the S shareholder is a member of P's consolidated group. Where the S shareholder granting the option is not a member of P's consolidated group, then even if the option issuance is a measurement date (which often it will not be — see V below), the S stock held by that shareholder is already counted as not held by P for purposes of the 80-80 test.

A. Substance Over Form

The treatment of an instrument as an "option" under the regulation does not preclude treatment of the instrument as stock "under general principles of law."[25] Hence, an instrument that in form constitutes an "option" as broadly defined in the regulation (see IV) but that is treated as stock under substance-over-form principles apparently could be treated both (a) as an option for section 1504 purposes, so that if such an option failed all 13 of the safe harbors and was thus deemed exercised under the regulation, it would be treated as the stock into which it is exercisable for purposes of the 80-percent-by-value test, and (b) as stock for purposes of both the 80-percent-by-value and the 80-percent-by-vote tests, whether or not the option fits 1 of the 13 safe harbors. Presumably, whichever characterization (stock treatment or option treatment) produced the worst result for the taxpayer at any particular time would control.

Potential dual classification of an instrument as both stock and an option is peculiar in theory and confusing in application.

This potential dual classification of an instrument as both stock and an option is peculiar in theory and confusing in application. If under general principles of law, an instrument is properly treated as stock, this regulation, which by its terms applies only to "options," should be irrelevant in analyzing the section 1504 implications of the instrument. We find it unfortunate that the regulation did not adopt this rational and straightforward approach.[26]

Regarding the scope of "general principles of law," the preamble to the proposed version of the regulation specifically mentioned Rev. Rul. 82-150, 1982-2 C.B. 110 (X was 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 was 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 as stock.[27]

[23]Reg. section 1.1504-4(h), Example 3.

[24]Reg. section 1.1504-4(d)(1).

[25]Reg. section 1.1504-4(a)(1).

[26]*See* VII.F and VII.G below for the consequences of stock versus option treatment in connection with convertible preferred stock and certain other instruments.

[27]*See, e.g., Penn-Dixie Steel Corp. v. Commissioner*, 69 T.C. 837 (1978) (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 was 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, Morrison v. Commissioner*, 59 T.C. 248 (1972) (option was 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).

B. SARs, Phantom Stock, Cash Settlement Options

The regulatory inclusion of SARs, phantom stock, cash settlement options, and similar interests within the definition of "option" is a significant expansion of the conventional option concept, because the holder has no right under the instrument ever to receive actual S stock. Indeed, the statutory language of section 1504(a)(5), granting regulatory authority to the IRS with respect to options, warrants, obligations convertible into stock, "and other similar interests," suggests a contrary conclusion. 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 "nonstock instrument"), it does not appear to be a "similar interest" to an option, warrant, or convertible obligation within the meaning of section 1504(a)(5). We therefore consider the inclusion of nonstock instruments a questionable expansion of the statutory term "other similar interests." This is particularly true in light of the conclusion in the final regulation, as discussed below, that an instrument is not an option merely because it may share in corporate growth.

Nonetheless, given the economic resemblance between conventional option, on one hand, and SARs, phantom stock, and cash settlement options on the other, all of which entitle the holder to a proportionate share of future corporate growth based on fluctuations in stock value, including this category of nonstock instruments in the definition of "option" for section 1504 purposes, as Treasury has done, does not amaze us, especially in light of section 1234(c)(2) (treating a cash settlement option as an option for purposes of capital gain and related issues). Since nonstock instruments are generally issued either as compensation or in connection with a loan, the safe harbors for compensatory options and commercially reasonable-active-lender options will often apply (see III(1) and III(2) above).

The proposed version of the regulation had defined "option" much more broadly to include "any other instrument or right (other than stock itself) pursuant to which the holder may share in the growth of the issuing corporation." This sweeping language arguably encompassed purchase price earnouts, royalty streams, and other nonabusive interests that should be irrelevant to testing for affiliation. The preamble to the final regulation states that the "corporate growth" concept was eliminated to "limit the application of the regulations to instruments with greater abuse potential."

See III(12) above for the circumstances under which a nonstock instrument will be considered "reasonably certain to be exercised." See VII.E below regarding the consequences of deemed exercise of a nonstock instrument.

C. Subsidiary Tracking Stock

According to its preamble, the regulation "do[es] not address" the treatment of subsidiary tracking stock (e.g., P stock with dividend rights based on the earnings of its subsidiary S). This conclusion is consonant with the regulation itself, since tracking stock does not fall within the definition of an "option" (see text at note 24 above).

Indeed, there is no good reason for the 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 to P's ownership of S without regard to this regulation, which deals only with options).

D. Restricted or SRF Stock

The regulation does not expressly address the treatment of restricted stock (i.e., stock that is nontransferable and subject to a substantial risk of forfeiture (an "SRF") — see Reg. section 1.83-3(b)). However, restricted stock for which the holder has made a section 83(b) election is presumably treated as outstanding stock for purposes of the 80-80 test and hence is not a section 1504 option.[28]

The treatment of restricted stock for which a section 83(b) election has not been made ("non–section 83(b) restricted stock") is less clear. One supposes that it would not be treated as outstanding stock for purposes of the 80-80 test.[29] If not treated as outstanding stock, however, non–section 83(b) restricted stock literally might be a section 1504 option, since in effect it is a right to acquire stock contingent upon vesting (i.e., upon satisfaction of the SRF). Fortunately, in the ordinary case, non–section 83(b) restricted stock will qualify for the compensatory option safe harbor described in III(1) above.

E. Redemption Rights

The regulation defines "option" to include any "redemption agreement (including a right to cause the redemption of stock)" and "any other instrument that provides for the right to . . . redeem . . . stock. . . ."[30] If a redemption right fails all 13 safe harbors and exceptions described in III above, so that the "option" deemed granted to S by the owner of the S redeemable preferred is treated as exercised under the regulation, the stock covered by the redemption right would be treated as no longer outstanding.

---

[28] *See, e.g.*, Reg. section 1.83-2 (holder of restricted stock covered by an 83(b) election essentially reports gain and loss as owner of the stock); Rev. Rul. 83-22, 1983-1 C.B. 17 (holder of restricted stock covered by an 83(b) election reports dividends received as dividend income); Rev. Proc. 83-38, 1983-1 C.B. 773 (same). *Cf.* Reg. section 1.1361-1(b)(3) (for purposes of the subchapter S one-class-of-stock rules, restricted stock covered by an 83(b) election is treated as outstanding stock).

[29] *See, e.g.*, Reg. section 1.83-1(a) ((the transferor), not the transferee employee or independent contractor, of nonsection 83(b) restricted stock) shall be regarded as the owner of such property, and any income from such property received by the [transferee] employee or independent contractor . . . constitutes additional compensation. . . ."); Rev. Proc. 80-11, 1980-1 C.B. 616 (dividends paid on nonsection 83(b) restricted stock are reported by the transferee as compensation income). *Cf.* Reg. section 1.1361-1(b)(3) (for purposes of subchapter S one-class-of-stock rules, nonsection 83(b) restricted stock is not treated as outstanding stock).

[30] Reg. section 1.1504-4(d)(1)(i).

Example (5): On 1/1/94, P and X form S, contributing $1,000 in exchange for the following S stock:

Holder	Type of Stock		Purchase Price	Number of Votes
P	Preferred	$ 300		30
P	55 common shares	$ 550	(i.e., $10/share)	55
X	15 common shares	150	(i.e., $10/share)	15
		$1,000		100

The preferred stock has the following terms:

- Fixed market dividend rate.
- 30 votes.
- Optionally redeemable at any time within the first six years after issuance (i.e., until 12/31/99) at X's direction for $600. (See Example (6) for a similar preferred stock that is redeemable at S's rather than X's direction.)
- Entitled to receive on liquidation of Newco the greater of $300 or the FMV of 30 S common shares.

P and S are affiliated, because the stock held by P possesses (i) 85 percent of S's total stock value (i.e., [$300 FMV of preferred + $550 FMV of common held by P] ÷ $1,000 total FMV of S's stock) and (ii) 85 percent of S's voting power (i.e., [30 preferred stock votes + 55 common stock votes held by P] ÷ 100 total S votes).

By 1/1/97 (three years after issuance of the preferred), S's FMV has increased from $1,000 to $3,000. As noted above, upon liquidation of Newco, the preferred holder is entitled to receive the greater of $300 or the FMV of 30 shares of S common stock. Hence, if Newco were liquidated on 1/1/97, P would be entitled to receive $900 (i.e., the greater of (i) $300 or (ii) 30 percent of S's $3,000 total stock value). However, X can cause the preferred stock to be optionally redeemed for $600 at any time before 1/1/2000 (six years after issuance). Therefore, X's optional redemption right is substantially in the money.

P and S could be disaffiliated on 1/1/97 under one of two analyses. *First*, if there were a measurement date, the preferred stock, because it is substantially in the money, could be treated as redeemed (unless one of the 13 safe harbors or exceptions applies).[31] Deemed redemption of the preferred stock would disaffiliate P and S, because P would be considered to own only 73 percent of S's remaining stock (i.e., 55 of the 75 outstanding common shares).

Second, even if there were no measurement date with respect to the preferred, so that the preferred is deemed to remain outstanding, the preferred stock could well be valued on 1/1/97 for purposes of the 80-80 test at $600 (i.e., the exercise price of X's optional redemption right, which is the maximum amount P is likely to receive with respect to the preferred stock) rather than its liquidation value of $900. Under this approach, P and S also would be disaffiliated, because P would be considered to own only 79 percent of S's $3,000 total stock value (i.e., [$600 preferred stock FMV + 55/75 of $2,400 residual FMV of T] ÷ $3,000 total stock FMV).[32]

Example (6): Same as Example (5), except that the preferred stock is redeemable by S at S's option, not at X's direction. Same result as in Example (5), unless a court were to conclude that P, as S's controlling shareholder, could prevent S from optionally redeeming the preferred stock, even though there were strong economic reasons for S to do so. Whether a court would so conclude might turn on such issues as P's fiduciary duty (as majority shareholder) to S's minority shareholder (X), P's control (as S's 90-percent shareholder) over S's board of directors, and other factors.

The regulatory treatment of any redemption right as a section 1504 option has peculiar implications for preferred (or other) stock with a mandatory redemption date (e.g., on the eighth anniversary of issuance) that fails to qualify for the straight preferred safe harbor of section 1504(a)(4) (e.g., because the preferred is voting, has a fluctuating dividend rate, or is participating) ("fixed maturity nonstraight preferred stock").[33] The mandatory redemption feature of such preferred stock would literally appear to be an option under the regulation (granted to S by the owner of the mandatorily redeemable S preferred). Therefore, unless such preferred qualifies for one of the 13 safe harbors or exceptions, the redemption feature would apparently be deemed exercised under the regulation on any measurement date (including the preferred's issue date), so that the preferred would be treated as not outstanding. In particular, because the redemption feature is man-

[31]As discussed in V below, a measurement date for the preferred stock generally would be any date on which the preferred is issued, transferred (generally except for a transfer between two persons, neither of which is affiliated with S), or adjusted (in a manner that materially increases the likelihood of exercise, including an adjustment under the terms of the preferred). Hence, there may never be a post-issuance measurement date for the preferred. On the other hand, if the optional redemption price were $600 for the first four years after issuance, $550 during the fifth year, and $500 during the sixth year, for example, there would be a measurement date on each date the optional redemption price changed.

[32]Section 1504(a)(5)(D) grants the IRS authority to issue regulations "which disregard an inadvertent ceasing to meet the requirements of [the 80-percent-by-vote test] by reason of changes in relative values of different classes of stock." No such regulations have ever been issued. Nevertheless, since disaffiliation under the analysis in the text would indeed result from changes in the "relative values" of the preferred and common stock, regulations might disregard any resulting disaffiliation if the disaffiliation were "inadvertent." Query whether disaffiliation could be "inadvertent" in light of the fixed $600 optional redemption price for the preferred stock.

[33]*See* I above.

datory, there is no question that it is "reasonably certain to be exercised." Moreover, the regulatory preamble expressly states that "[t]he fact that an option cannot, or may not, be exercised for a period of time after its issuance is not determinative as to whether the option is treated as [reasonably certain to be] exercised as of a measurement date." Hence, the mere fact that the mandatory redemption may not (or cannot) occur until some future time should not be an obstacle to deemed exercise.

The affiliation consequences of treating fixed maturity nonstraight preferred stock as redeemed under the regulation would depend on who owns the preferred stock. If consolidation of P and S turns on P's ownership of such stock, treating the stock as redeemed (i.e., as not outstanding) for purposes of the 80-percent-by-value test under the regulation would prevent P-S consolidation. On the other hand, if X's ownership of nonvoting, fixed maturity nonstraight preferred stock prevents consolidation of P and S under the 80-percent-by-value test,[34] treating such stock as not outstanding would permit P-S consolidation.

It is not at all clear that Treasury intended this regulation to treat fixed maturity nonstraight preferred stock as redeemed for purposes of the 80-percent-by-value test.

In general, this interpretation of the regulation will produce (or break) consolidation only where it is not a benefit for the parties. Under the no-substantial-tax-savings safe harbor, discussed at III(13) above, the redemption option is treated as not exercised (i.e., the redeemable preferred stock is treated as remaining outstanding) unless a redemption (i.e., treating the redeemable preferred stock as if it were not outstanding) would produce substantial additional federal income taxes.

It is not at all clear that Treasury intended this regulation to treat fixed maturity, nonstraight preferred stock as redeemed for purposes of the 80-percent-by-value test. Among other things, this interpretation would render section 1504(a)(4) itself largely superfluous, because it would result in disregarding, for purposes of the 80-percent-by-value test, many types of fixed maturity preferred that do not satisfy the requirements of section 1504(a)(4) (subject to the special treatment of certain convertible preferred under the regulation, as discussed in III(10) above and VII.F below). In contrast, section 1504(a)(4) is intended to *count* as section 1504 stock any preferred that does not satisfy such requirements.

IRS guidance on the treatment of fixed maturity nonstraight preferred stock under the option regulation would be helpful.

IRS guidance on the treatment of fixed maturity nonstraight preferred stock under the option regulation would be helpful. For example, it might be clarified that a mandatory redemption feature, because its exercise is not in S's discretion, is not a "right" to redeem or an "option" under the 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). The option is treated as exercised for purposes of the 80-percent-by-value test unless on such date at least one of the 13 safe harbors and exceptions described in III above is satisfied.

If options are "issued pursuant to a plan," a measurement date for any of the options constitutes a measurement date for all options issued pursuant to the plan that are outstanding on the measurement date.[35] The regulation does not suggest a standard for what constitutes a "plan." Similarly, if options are "related or sequential" options (as described in VI.C below), a measurement date for any of the options constitutes a measurement date for all related or sequential options outstanding on the measurement date.[36]

A measurement date for an option is each date on which (a) the option is issued, transferred, or adjusted (including an adjustment pursuant to the terms of the option) or (b) the terms of the underlying stock are adjusted (including an adjustment pursuant to the terms of the stock).[37] However, a measurement date does not occur where any of the following five tests is satisfied:

(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 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 (determined with the

[34]Under the regulation, an option is treated as exercised only for purposes of the 80-percent-by-value test and not for the 80-percent-by-vote test. *See* VII.A and VII.B below. Thus, if voting redeemable preferred stock causes P to fail the 80-percent-by-vote test, the redemption feature could not cause such stock to be redeemed for purposes of the 80-percent-by-vote test and hence could not produce P-S consolidation under the regulation.

[35]Reg. section 1.1504-4(c)(4)(iv).

[36]Reg. section 1.1504-4(c)(4)(v).

[37]Reg. section 1.1504-4(c)(4). The regulatory preamble states that the lapse or forfeiture of an option does not cause a measurement date, but that "the option is not taken into account in determining affiliation after such [lapse or forfeiture] date," even without a measurement date.

section 1504(b) exceptions, but without application of this regulation).

(3) An issuance or transfer of the option between persons, neither of whom is a member of the affiliated group of corporations of which S is a member (determined without the section 1504(b) exceptions and without application of this regulation), unless both (i) any such person is "related to (or acting in concert with)" S or a member of S's affiliated group and (ii) the issuance or transfer is "pursuant to a plan a principal purpose" of which is to avoid the application of the regulation. For purposes of clause (i), "related" generally means a 10-percent stock ownership standard (determined without regard to the stock interest underlying the option itself).[38]

Example (7): P owns 100 percent of S'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's affiliated group.

The original issuance of the option to X is a measurement date, because the transfer of an option on S shares from a member of S's affiliated group (e.g., S or P) to a person (here X) not a member of S's affiliated group does not qualify for any of the five measurement date safe harbors.

Thereafter X transfers the option to Y. There is no other stock interrelationship between X, Y, S, or any member of S's affiliated group. In addition, neither S nor any member of S's affiliated group has knowledge of the transfer between X and Y. Because neither the transferor (X) nor the transferee (Y) belongs to S's affiliated group, and because neither X nor Y is 10-percent related to or acting in concert with S or an S affiliate, under this safe harbor the transfer of the option from X to Y does not cause a measurement date.

Example (8): Same as Example (7), except as follows: When S issues the option to X, it is not reasonably certain that the option will be exercised, but there is an understanding between P, S, X, and Y that X will "warehouse" the option for subsequent transfer by X to Y when the option is in the money. The principal purpose of X's role is to avoid triggering a measurement date (and hence potential deemed exercise of the option) when X subsequently transfers the option to Y, since S's direct transfer of the option to Y at such time would have caused a measurement date. Because X is acting in concert with S for a principal purpose of avoiding application of the regulation, X's transfer of the option to Y would give rise to a measurement date.

(4) An adjustment that does not "materially" increase the likelihood that the option will be exercised. Accordingly, any adjustment to an option that does materially increase the likelihood of exercise, including an adjustment pursuant to the option's terms, triggers a measurement date (unless exception 5 described below applies). The regulatory preamble clarifies, in connection with an option whose exercise price varies over time (e.g., under a formula specified in the option agreement or because the exercise price is linked to an index or to some other standard outside the agreement), that any date on which the option exercise price changes (in a manner that materially increases the likelihood of exercise) constitutes a measurement date. Hence, a variable price option could be subject to frequent measurement dates if the price fluctuations materially increase the likelihood of exercise.

Example (9): P owns 100 percent of S's stock. X acquires (either from S or from P) a 10-year option to purchase S stock for $10 per share. The option agreement states that if the option is not previously exercised, the option price will decline from $10 to $9 per share on the fifth anniversary of the option grant. A measurement date occurs when the option price declines on the fifth anniversary.

(5) An adjustment pursuant to a reasonable antidilution formula.

The five exceptions to the "measurement date" definition are important. Their effect is that an option issued to a person other than a member of S's affiliated group generally is tested only at issuance, unless (i) the terms of the option (or the underlying stock) are adjusted, (ii) the option is thereafter transferred back to S or an S affiliate, or (iii) the option is thereafter transferred "pursuant to a plan" with "a principal purpose" of avoiding application of the regulation where the transferor or transferee is 10-percent related to or acting in concert with S or an S affiliate.

VI. ANTIAVOIDANCE AND OTHER RULES

The regulation contains several antiavoidance and other special rules, discussed below.[39]

A. Changes in Capital Structure or Value of 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's stock be altered (by transferring assets to or from S or by other means):

[38] *See* Reg. section 1.1504-4(c)(3).

[39] In contrast to the generally reasonable approach of the final regulation, the proposed regulation contained antiavoidance and "device" restrictions so expansive that taxpayers were left with very little objective guidance on which to rely. Perhaps the IRS's overreaction in the proposed regulations arose from the *Woods Investment* decision, 85 T.C. 274 (1985), holding the IRS to the literal words of the consolidated return investment adjustment rules (prior to the adoption of section 1503(e), which overruled *Woods Investment*), and from the difficulty the IRS has encountered from time to time in litigating substance-over-form and step-transaction cases.

(1) the intended change or alteration will be taken into account in determining whether an option is reasonably certain to be exercised,[40]

(2) the safe harbors described in III(3), III(4), and III(5) above will not apply,[41] and

(3) if the change or alteration occurs, it triggers a measurement date.[42]

B. Related Agreements

The preamble to the proposed version of the regulation stated that in applying the 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 safe harbors and exceptions.[43]

C. Related or Sequential Options and Options Issued Pursuant to a Plan

Special rules apply to a related or sequential option, defined by the regulation as "one of a series of options issued to the same or related persons."[44] 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. The safe harbors described in III(3), III(4), and III(5) above 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.[45]

In addition, as discussed above, special aggregation rules apply to related and sequential options, as well as to options issued "pursuant to a plan," for purposes of determining (i) measurement dates (see V above) and (ii) whether the issuance or transfer of such options in lieu of the underlying stock would eliminate a substantial amount of federal income tax liability (see III(13) above).

D. Valuation of Shares

The regulation specifically states that in applying the 80-percent-by-value test, "all shares of stock within a single class are considered to have the same value," so that "control premiums and minority and blockage discounts . . . are not taken into account."[46] This provision applies to all valuations of stock under the 80-percent-by-value test of section 1504, not merely to valuation determinations relating to options (see I above). It is effective for stock outstanding on or after February 28, 1992.[47]

VII. EFFECT OF DEEMED EXERCISE

A. In General

If an instrument is treated as an "option" under the regulation (see IV above) and does not qualify for any safe harbor or exception (see III above), the option is "treated as exercised for purposes of determining the percentage of value of stock owned by the [option] holder and other parties" (so that, in the case of a call option, for example, the option holder, rather than the option issuer, is treated as owning the underlying S stock for purposes of the 80-percent-by-value test).[48] This deemed exercise applies both (i) in determining whether S is a member of P's affiliated group and (ii) for purposes of all provisions of the code and Treasury regulations that incorporate the 80-80 test or the concept of section 1504 affiliation (except as noted in VII.C below).[49]

However, the option "is not treated as exercised for purposes of determining the percentage of the voting power of stock owned by the holder and other parties" (so that, in the case of a call option, for example, the option issuer, rather than the option holder, is treated as owning the underlying S stock for purposes of the 80-percent-by-vote test).[50] The regulatory preamble adds that under the regulation, "an option is never treated as exercised for voting power purposes. Instead, the determination of the voting power owned is made under other applicable principles of law."[51]

B. Affiliation and Consolidation

P and S will be affiliated (and hence may file a consolidated return) only if P and S satisfy the 80-80 test. 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 under the regulation is effective for purposes of the 80-percent-by-value test but not the 80-percent-by-vote test, application of the regulation may break affiliation/consolidation between P and S, but it will not create affiliation/consolidation between X and S (subject to the operation of "other applicable principles," as discussed in the examples below).

Example (10): 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 13 safe harbors and exceptions and hence it is treated as exercised. The option does not permit

[40]Reg. section 1.1504-4(g)(1)(ix).

[41]Reg. section 1.1504-4(g)(3)(iv)(B).

[42]Reg. section 1.1504-4(c)(4)(iii).

[43]CO-152-84, the IRS explanatory release accompanying the proposed regulation.

[44]Reg. section 1.1504-4(c)(2).

[45]Reg. section 1.1504-4(g)(3)(iv)(C).

[46]Reg. section 1.1504-4(b)(2)(iv).

[47]Reg. section 1.1504-4(i).

[48]Reg. section 1.1504-4(b)(2)(iii)(A).

[49]Reg. section 1.1504-4(a)(1).

[50]Reg. section 1.1504-4(b)(2)(iii)(A). By contrast, the proposed regulation would have treated the option holder as owning the optioned stock for purposes of the 80-percent-by-vote test where both (i) the option failed to meet any of the safe harbors and exceptions and (ii) there was an arrangement allowing the optionee (or a related person) to direct the vote of the underlying stock prior to option exercise.

[51]Regarding the impact of "other applicable principles" on voting power, *see* the examples in VII.B below.

X (or any other person besides P) to vote the S shares prior to X's 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'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's voting power for purposes of the 80-percent-by-vote test.

Example (11): Same facts as Example (10), except that P gives X its irrevocable proxy to vote the S shares while the option is outstanding.

As in Example (10), the option is considered exercised for purposes of the 80-percent-by-value test, so that P cannot consolidate with S. Moreover, the option is not considered exercised for purposes of the 80-percent-by-vote test (even though X holds an irrevocable proxy to vote all of S's shares), so that X cannot consolidate with S.

If, however, "under applicable principles of law," X is treated as owning the S stock and the voting power conferred thereby, X could consolidate with S (e.g., the option price is very low and the price paid by X to P to purchase the option is very high).[52]

Example (12): Same as Example (11), except that the option meets at least one of the 13 safe harbors and exceptions, i.e., P owns all 100 outstanding S shares, P grants S an option to purchase all 100 S shares (which option meets at least one of the 13 safe harbors and exceptions), and P gives S an irrevocable proxy to vote the 100 S shares while the option is outstanding.

Because the option meets at least one safe harbor or exception, P's ownership of the 100 S shares is not affected by the regulation. However, there are two additional hurdles that must be considered before concluding that S remains affiliated with (and hence able to consolidate with) P: *First*, is X treated as owning the S stock "under applicable principles of law," as discussed in Example (11)? If so, S is no longer affiliated with P and is affiliated with X. *Second*, does P's contractual shifting to X of the voting power over the S stock prevent P from meeting the 80-percent-by-vote test?[53]

Example (13): P owns all 90 of S's outstanding Class A common shares. S grants X an option to purchase 10 shares of S's Class B common. If exercised, X's Class B shares will represent 10 percent of the value of S's outstanding stock and 21 percent of its voting power. The option does not satisfy any of the 13 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'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.

C. Applies to Most Code Provisions Incorporating the 80-80 Test

Except as noted below, deemed exercise of an option (for purposes of the 80-percent-by-value test) under the regulation applies for purposes of all provisions of the code and Treasury regulations that incorporate the 80-80 test or the concept of section 1504 affiliation.[54] In particular:

[52]*See* IV.A above for a discussion of substance-over-form principles that could treat X as owner of the S stock. In such 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 1.1504-75(e); Reg. section 1.1504-76(b)(1).

[53]Where P owns stock possessing 80 percent or more of S's voting power but, by contract (including a voting trust or voting agreement), P has agreed to exercise the voting power as directed by a third party ("X"), the law is unclear whether P will satisfy the 80-percent-by-vote test. Among the precedents on this confusing issue are Rev. Rul. 70-469, 1970-2 C.B. 179 (P is treated as owning S stock where P transfers title to X, as nominee, but retains the "entire beneficial interest" in the stock and can obtain title at any time on demand); Rev. Rul. 55-458, 1955-2 C.B. 579 (where P purchases all of S's stock, the holding of such stock in escrow by X as security for the purchase price will not prevent P's and S's affiliation); Rev. Rul. 84-79, 1984-1 C.B. 190 (where P transfers S stock to a *revocable* voting trust to comply with FAA ownership requirements, the voting trustee elects S's directors, P retains the right to replace the trustee with another qualified trustee, and P can terminate the trust at any time, P is treated as owning the S stock); Rev. Rul. 78-119, 1978-1 C.B. 277 (S is not deconsolidated merely because P temporarily loses its power to vote S stock through a court order issued during the pendency of litigation). *See also* Rev. Rul. 72-72, 1972-1 C.B. 104 (where P acquired S in a purported "B" reorganization in which P issued solely voting stock to S's shareholders, but P's sole shareholder retained a five-year *irrevocable* voting right with respect to the P stock, such P stock was not "voting stock," so that the "B" reorganization failed).

[54]Reg. section 1.1504-4(b)(2)(iii)(A).

(1) Under 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 an option held by X is deemed exercised under the regulation and thereby breaks affiliation between P and S, the liquidation of S into P would be taxable to both S and P. For an effective date issue particularly relevant to section 332, see IX below.

(2) P, a corporate purchaser of S's stock from the selling parent of S ("Bigco"), makes a qualified stock purchase (a "QSP") of S under 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 regulation could prevent P from making a QSP of S's stock and hence prevent the making of a section 338 or 338(h)(10) election.[55] For an effective date provision particularly relevant to making a QSP, see IX below.

(3) Where P makes a QSP of S, the parties (by joint action of P and Bigco) may elect under section 338(h)(10) to treat the purchase of S's stock as a purchase of S's assets only if S was (before the QSP) a member of Bigco's affiliated group and Bigco and S filed a consolidated return. Application of the regulation to break affiliation and hence consolidation between Bigco and S before P's purchase of S's stock would prevent P and Bigco from jointly making a section 338(h)(10) election.[56] However, the mere execution of a stock purchase agreement between P and Bigco 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. For an effective date issue particularly relevant to making a section 338(h)(10) election, see IX below.

(4) A number of other (generally less significant) code provisions also turn on affiliated group status, e.g., the 100-percent dividend-received deduction for affiliated group members not electing to file a consolidated return, and the regulation is thus relevant in applying these other code provisions that incorporate by reference section 1504's affiliated group definition.

[55]If P, in addition to purchasing sufficient S stock to meet the 80-80 test on its face, also purchases the option held by X within the 12-month acquisition period, it would appear that P has made a QSP of S.

[56]Under current regulations, if P and Bigco 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 Bigco's consolidated group, it appears that P 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 P 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 P and Bigco attempt to make a section 338(h)(10) election for S and S is ineligible, a section 338 election is not considered made for S. Prop. Reg. section 1.338(h)(10)-1(d)(1).

The regulation does not apply to any code provision that *modifies* the 80-percent-by-vote and 80-percent-by-value tests.[57] For example, it does not apply for purposes of section 382(l)(5) (special bankruptcy rule for NOL corporation adopting a 50-percent rather than an 80-percent "affiliation" test).

In addition, the regulation is expressly inapplicable to sections 163(j) (earnings-stripping provision), 864(e) (rules for allocating U.S.-source interest expense), and 904(i) (deconsolidation to avoid foreign tax credit limitation), and to any other provision specified by the IRS in future administrative pronouncements.[58]

The 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 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) dividends-received deduction under section 243(c).

Conversely, substance-over-form principles continue to apply to section 1504 options for all purposes of the code. See IV.A above.

D. Post-disaffiliation Events

An option that is not treated as exercised on one measurement date may be treated as exercised on a subsequent measurement date. Conversely, the regulatory preamble makes clear that an option previously treated as exercised, and resulting in disaffiliation of P and S, continues to be tested on each subsequent measurement date.[59] Thus, if such an option satisfies one of the 13 safe harbors on a later measurement date, the option will no longer be treated as exercised, so that P and S might reconsolidate, subject to the normal five-year waiting period for reconsolidation of a previously deconsolidated subsidiary.[60]

The regulatory preamble also states that where an option is treated as exercised, resulting in disaffiliation of P and S, and the option subsequently lapses unexercised or is forfeited, "the option is not taken into account in determining affiliation on or after such

[57]Reg. section 1.1504-4(a)(1).

[58]Reg. section 1.1504-4(a)(2).

[59]In this context, the rather generous measurement date exceptions described in V above may have an anti-taxpayer effect by preventing a subsequent measurement date for an option and thus preventing a retesting of such option to cause reaffiliation.

[60]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 section 1504 may not permit S immediately to reenter P's consolidated return. 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. Section 1504(a)(5)(D) (implemented by Rev. Proc. 90-53, 1990-2 C.B. 636) waives this waiting period in certain circumstances.

date," so that such lapse or forfeiture "may reaffiliate [S] with its affiliated group as of the date of lapse or forfeiture," again subject to the normal five-year waiting period.[61]

E. Nonstock Instruments

The "exercise" of a nonstock instrument (e.g., an SAR, phantom stock, or a cash settlement option) would not result in any actual transfer of stock to the holder. Therefore, in order to make the deemed exercise rule meaningful for a nonstock instrument, the regulation states that upon the "exercise" of a nonstock instrument, the option is treated as having been converted into S stock. Specifically, if the amount to be received on exercise of the option is determined by reference to "a multiple of the increase in the value of an [S share] on the exercise date over the value of an [S share] on the date the option is issued," the option is treated as converted into a corresponding number of S shares.[62] The regulatory preamble gives as an example of such a "multiple" an SAR on 40 shares of S stock, i.e., an agreement to pay 40 times the increase in value of an S share over current value.

Example (14): P owns all 79 shares of S's outstanding stock. Each S share has an FMV of $100. S grants a 10-year SAR on 21 shares to executive X, entitling X to receive on exercise of the SAR at any time within 10 years after issuance an amount of cash equal to 21 times the excess of (i) the FMV of an S share on the exercise date, over (ii) $100 (i.e., the FMV of an S share on the SAR grant date). Assume that no safe harbor or exception applies (e.g., the SAR's FMV exceeds an amount that would be reasonable compensation or the SAR is transferable).

If upon grant the SAR is deemed exercised under the regulation, X will be deemed to own 21 percent of S's stock (i.e., 21 out of 100 shares outstanding), thus breaking consolidation of P and S.

The regulation states that "appropriate adjustments" are made if the amount to be received on exercise of a nonstock instrument is *not* determined by reference to a multiple of the increase in value of a share of S stock on the exercise date over the value of a share of S stock on the grant date. The regulation does not indicate what those adjustments might be.

Example (15): Same as Example (14), except that the SAR entitles X to receive on exercise the full FMV of 21 S shares on the exercise date (without reduction for the FMV of such S shares on the SAR grant date).

The regulation suggests that, if on the grant date the SAR is deemed exercised, an "adjustment" might be appropriate (i.e., X might be deemed to own something other than 21 S shares), since X is entitled to receive more than a multiple of the mere increase in S's stock value above its value on the grant date. However, it appears that X should be treated as owning 21 shares, without any adjustment, since X is entitled to receive the value of 21 S shares on actual exercise of the SAR.

F. Convertible Preferred Stock

As discussed in III(10), under one of the regulatory safe harbors convertible preferred stock is treated solely as stock and not as an option for section 1504 purposes if the conversion feature "do[es] not permit or require the tender of any consideration other than the stock being converted." Any other convertible preferred stock "may be treated as stock and/or an option, depending on the circumstances."

Example (16): X purchases from S, for $1,000 cash, nonvoting preferred stock with a $1,000 liquidation preference, a seven-year maturity, and a fixed dividend at a market rate. The preferred stock is convertible at the holder's option at any time into 10 shares of S common stock (FMV $900 at the time the preferred is issued) solely by delivery of the preferred stock to S, without payment of any other consideration. The preferred stock has a $1,000 FMV at issuance.

Under the regulation, the convertible preferred is treated solely as stock for purposes of the 80-80 test. Therefore, the preferred stock will continuously be taken into account for purposes of the 80-80 test at its fluctuating FMV (initially $1,000).

Example (17): Same as Example (16), except that X may convert the preferred into common *either* (a) by delivering the preferred stock to S *or* (b) by paying $1,000 cash to S (in which case the preferred will remain outstanding without the conversion feature). Since the conversion feature permits the tender of consideration other than the stock being converted, the preferred stock will not satisfy the convertible preferred safe harbor and hence will be treated as stock and/or an option (presumably whichever produces the worse result for the taxpayer) for purposes of the 80-80 test.

Viewed as stock, the preferred stock would be taken into account continuously for section 1504 purposes at its fluctuating FMV (initially $1,000). Viewed as an option, the preferred stock would be taken into account for section 1504 purposes on each measurement date based on the FMV of the underlying common stock (initially $900) unless, on such measurement date, the option inherent in the preferred stock satisfies one of the 13 safe harbors described in III above (e.g., the 24-month, 90-percent-FMV safe harbor or the publicly traded safe harbor).

In this case, treatment as both stock and an option would not appear to pose a greater decon-

[61] In contrast to this harsh rule, section 382 (limiting use of S's net operating loss upon a change of control of S) permits S to treat a lapsed or forfeited option as never having existed, thus avoiding altogether the adverse effects of the prior deemed exercise of the option. Reg. section 1.382-2T(h)(4)(viii). The preamble to the section 1504 regulation states that the Treasury considered and rejected this approach.

[62] Reg. section 1.1504-4(b)(2)(iii)(B).

solidation risk for S than treating the preferred solely as stock. This is because, if the option is deemed exercised, the FMV of the underlying common stock deemed held by X should never exceed the FMV of the preferred stock itself (which will always reflect not only the value of the common, but also the value of the $1,000 liquidation preference and the preferred dividends).[63]

Example (18): X purchases from S, for $500 cash, nonvoting preferred stock with a $500 liquidation preference, a seven-year maturity, and a fixed dividend at a market rate. The preferred stock is convertible at the holder's option at any time into 10 shares of S common stock (FMV $900 at the time the preferred is issued) by delivering to S the preferred stock plus $500 cash. The preferred stock has a $500 FMV at issuance.

Since the conversion feature requires the tender of consideration other than the stock being converted, the preferred stock will not satisfy the convertible preferred safe harbor and hence will be treated as stock and/or an option for purposes of the 80-80 test (presumably whichever produces the worse result for the taxpayer).

Viewed as stock, apparently the preferred would be taken into account for purposes of the 80-80 test initially at its $500 original FMV, and continuously thereafter at its fluctuating FMV, which will reflect the value of both (i) the preferred stock's $500 liquidation preference and the preferred dividends and (ii) the right to obtain 10 common shares. Viewed as an option, on each measurement date, X would be considered to own 10 S shares (as if the preferred had been converted), initially at a $900 FMV and thereafter at their fluctuating FMV unless, on the applicable measurement date, the convertible preferred satisfies one of the safe harbors described in III above.[64]

G. Comparison of Options and Economically Equivalent Stock

By treating an option as "exercised" for purposes of the 80-percent-by-value test, the regulation looks to the stock underlying the option, rather than treating the option itself as stock.[65] As the following two examples illustrate, taking into account options based on the value of the underlying stock rather than based on the value of the option itself results in disparate treatment of options and economically equivalent stock.

Example (19): P owns all 79 shares of S's outstanding stock. S has an aggregate FMV of $7,900 and hence each of its 79 outstanding shares has an FMV of $100. X purchases from S a three-year option to acquire 21 S shares for an exercise price of $75 per share. Assume the option has an FMV of $30 per share, or $630 in the aggregate ($30 per share x 21 shares). X pays S $630 for the option.

If upon issuance the option is deemed exercised under the regulation (i.e., if none of the safe harbors described in III above applies), X will be treated as owning the 21 S shares on which X has an option, i.e., X will be deemed to own 21 percent of S's stock, thus disaffiliating and deconsolidating P and S. This results even though the actual FMV of the option on its grant date ($630) is substantially less than 21 percent of S's stock FMV. Specifically, the option's $630 FMV on the grant date represents only 7 percent of S's stock FMV immediately after the option is granted (i.e., $630 option FMV ÷ [$7,900 stock FMV + $630 option FMV]).

Example (20): P owns all 79 shares of S's outstanding stock, all of which are Class A shares.

[63]The analysis in the examples assume that, under the option scenario, X would *not* be treated for section 1504 purposes as owning simultaneously both (i) the common stock underlying the $1,000 cash option and (ii) a nonconvertible preferred stock (i.e., the preferred stock X would own after exercising the $1,000 cash option) that failed to satisfy the "straight preferred" safe harbor of section 1504(a)(4), described in I above. If such nonconvertible preferred stock did fail the section 1504(a)(4) safe harbor, then taking into account the value of both elements of X's investment in S might be appropriate, but only if the preferred stock were valued without its conversion feature. Otherwise, the conversion feature would be double counted (once in the FMV of the underlying common stock, and once in the FMV of the preferred).

[64]Regarding the complex issue of how to characterize a convertible instrument that, in addition to requiring the surrender of such instrument on conversion, permits or requires the payment of cash as part of the consideration for stock to be received on conversion, *see* Rev. Rul. 62-140, 1962-1 C.B. 181, and Rev. Rul. 70-108, 1970-1 C.B. 78. Rev. Rul. 62-140 concludes that, in the case of a $100 debenture convertible into common stock upon surrender of the debenture plus a *required* payment of $50 cash, the holder's investment in the underlying common stock (for holding period purposes) is divided into two parts: (i) the portion attributable to the debenture (valued as the excess of the FMV of the underlying common stock over the $50 cash portion of the exercise price) and (ii) the portion attributable to the cash portion of the exercise price (valued at $50). Rev. Rul. 70-108 concludes that, where a holder of S voting preferred stock, convertible into one share of S common stock, has the *option*, upon conversion of the preferred stock, to pay cash for an additional share of S common stock, the cash option is a separate property right, so that the preferred stock is not "solely" voting stock for "B" reorganization purposes.

[65]*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 one-class-of-stock rules. *See* the discussion at VIII below.

Each Class A share is entitled to a $75-per-share Class A preference on distributions, so that S's 79 Class A shares owed by P are (in the aggregate) entitled to the first $5,925 of S's distributions. Thereafter, any outstanding Class A and Class B shares participate (share for share) in distributions in excess of the Class A preference of $5,925. Before the issuance of any Class B shares, S has an aggregate FMV of $7,900, so that each Class A share has a $100 FMV.

X purchases from S 21 shares of nonvoting Class B stock (not an option, but the Class B stock itself), entitling X to 21 percent of S's aggregate distributions after S's Class A shareholders have first received payment of their $75-per-share preference, i.e., an aggregate of $5,925. X pays S $30 per Class B share, i.e., $630 in the aggregate for the 21 Class B shares, which is the FMV of those shares.

The Class B stock held by X, because it is actual stock, is not an "option" as defined in the regulation (see IV above). Therefore, it is not subject to the section 1504 option rules. Rather, it is actual stock for section 1504 purposes and hence is taken into account at its FMV. At issuance the FMV of the Class B stock is only 7 percent of S's aggregate stock FMV (i.e., $630 Class B FMV ÷ [$7,900 Class A FMV + $630 Class B FMV]). In addition, the Class B stock is nonvoting. Hence, the issuance of the Class B stock will not break P-S affiliation and consolidation, even though X's economic interest in S in this example is, if anything, greater than X's economic interest in S through the option described in the preceding example.

Naturally, as S's stock FMV increases, the Class B shares held by X will become proportionately greater in value relative to the Class A shares, so that the Class B shares held by X may ultimately have a value exceeding 20 percent of S's aggregate stock FMV (but never more than 21 percent). However, it may require years of growth before the FMV of X's Class B shares approaches 20 percent.

See also the discussion of the treatment of convertible preferred stock as stock and/or an option in VII.F above.

VIII. 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.[66] 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 section 1504 regulation.

First, the S regulation provides an exception for an option that is not "substantially certain to be exercised." The section 1504 regulation provides an exception for an option that is not "reasonably certain" to be exercised.[67] The S exception is more generous.

Second, the S regulation creates an additional exception so that even an option that "is substantially certain to be exercised" will not be treated as stock unless the option "has a strike price substantially below the [FMV] of the underlying stock" on the date the option is tested.[68] There is no similar exception under the section 1504 regulation.

Third, the S regulation offers a safe harbor for an option issued to a service provider that is similar to the safe harbor described in III(1) above, except that it is not conditioned on the absence of "a principal purpose" of tax avoidance.

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 section 1504 safe harbors described in III(3) and III(4) above: Unlike safe harbor 3, it is not limited to options with a term of 24 months or less, and unlike safe harbor 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 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 unless the instrument "constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of federal tax law."[69]

There is generally no reason why the section 1504 regulation should be more restrictive with respect to options than the S corporation one-class-of-stock regulation.

IX. EFFECTIVE DATE

The regulation applies to all options (even if issued long ago) for each measurement date occurring on or after 2/28/92 with respect to such option. 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 for such option.

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

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

---

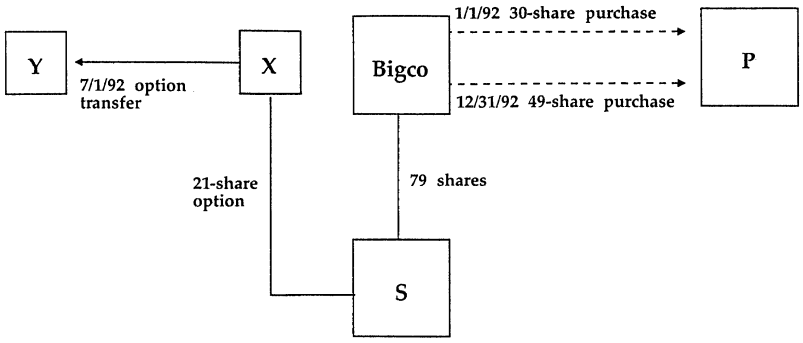
[66]Reg. section 1.1361-1(l)(4)(iii). For an extensive discussion of the S corporation one-class-of-stock regulation, *see* Ginsburg & Levin, "The New Subchapter S One Class of Stock Proposed Regulation: Much Better, But Still Not Awfully Good," 53 *Tax Notes* 81 (Oct. 7, 1991). The general rule set 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.

[67]Reg. section 1.1361-1(l)(4)(iii)(A).

[68]*Id.*

[69]Reg. section 1.1361-1(l)(4)(i), (ii)(A)(1). *See* IV.A and IV.B above.

Second, the release accompanying the proposed version of the regulation stated 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 IV.A. The preamble to the final regulation makes clear that substance-over-form principles can be applied to treat an old option as stock whether or not the option has a post-2/27/92 measurement date.



Third, the general stock valuation rule described in VI.D is effective for *stock outstanding* on or after 2/28/92.[70]

The regulation does not expressly incorporate the special effective date provisions described in Notice 87-63, 1987-2 C.B. 375. In that notice, the IRS stated that regulations under section 1504 would not be effective (i) under section 332 for plans of liquidation adopted on or before the date that a section 1504 regulation was proposed (i.e., 2/28/92) and (ii) under section 338(d)(3) (defining QSP) for purchases made during any 12-month acquisition period beginning on or before the date that a section 1504 regulation was proposed (i.e., 2/28/92). However, since the regulation is silent regarding Notice 87-63 and the notice has not been withdrawn, taxpayers may be able to rely on it. Even if a taxpayer is entitled to rely on Notice 87-63, it applies only "for purposes of section 338(d)(3)," defining a QSP. Hence, it would apparently not apply in determining whether S and its selling parent were consolidated before the P-S acquisition so that the acquisition could be covered by a section 338(h)(10) election.

Example (21): Bigco, the selling parent corporation of S, owns all 79 shares of outstanding S stock. X holds an option to purchase directly from S 21 S shares. On 1/1/92, P purchases 30 of the S shares owned by Bigco. On 7/1/92, X transfers to Y its option to purchase 21 S shares. Assume that, in the absence of Notice 87-63, X's 7/1/92 transfer of the option to Y would trigger a measurement date and a deemed exercise of the option under the regulation. On 12/31/92, P purchases the remaining 49 outstanding S shares owned by Bigco, so that P owns all 79 outstanding S shares. P and Bigco make a section 338(h)(10) election with respect to the S stock sale.

If the regulation supersedes Notice 87-63, the deemed exercise of Y's option on 7/1/92 would cause P's stock purchases on 1/1/92 and 12/31/92 to fail to qualify as a QSP, since P would be treated as having acquired only 79 percent, not 100 percent, of S's stock within a 12-month period. Accordingly, neither the regular section 338(g) election nor the section 338(h)(10) election would be valid (see VII.C(2) above).

On the other hand, if Notice 87-63 is still valid, Y's option would not be deemed exercised under the regulation in determining whether P made a QSP of S's stock. This is because the QSP occurred during the 12-month acquisition period commencing 1/1/92, a date prior to the 2/28/92 publication date of the proposed regulation. However, Notice 87-63 literally would not apply (and hence the option would be deemed exercised) in determining whether Bigco and S were consolidated for purposes of section 338(h)(10). Since such deemed option exercise would deconsolidate Bigco and S, apparently the section 338(h)(10) election would be invalid, but the regular section 338(g) election would be valid under the notice. The net result is that P would unexpectedly bear the economic burden of the section 338 tax on a deemed sale of S's assets.

Example (22): Same as Example (21), except that all of the sales of transfers took place after 2/28/92, i.e., after issuance of the proposed regulation. In this case the regulation would apply and the P-S acquisition clearly would not qualify for either a section 338 or a section 338(b)(10) election.

X. CONCLUSION

The final regulation addresses many of the ambiguities and other concerns that marred the proposed version of the regulation and yields a welcome and substantial improvement.

Some relatively minor problems persist in the final regulation. For example, the treatment of preferred stock with a fixed mandatory redemption date that does not qualify for the straight preferred safe harbor of section 1504(a)(4) is unclear. In addition, the treatment of instruments that are options in form but are viewed as stock under general tax principles continues to be somewhat confused.

Nevertheless, subject to these and a few other minor exceptions, the final regulation, through greater clarity and relatively generous safe harbors and exceptions (including a significant reduction of the circumstances in which an option transfer will trigger a "measurement date"), is broad enough to exempt in a clear manner most legitimate (i.e., non-tax-avoidance) option transactions, so that such options will not be treated as exercised for section 1504 purposes.

[70]Reg. section 1.1504-4(i).