REPORT #724

TAX SECTION
New York State Bar Association

REPORT ON PROPOSED TREASURY REGULATIONS SECTION 1.1504-4 (DEFINITION OF "AFFILIATED GROUP")

July 1, 1992

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TAX SECTION
New York State Bar Association

July 2, 1992

The Honorable Shirley D. Peterson
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Peterson:

I enclose a report on the proposed regulations under section 1504(a)(5) of the Internal Revenue Code concerning the effect of options on affiliation. The report was prepared by a subcommittee, headed by Patrick C. Gallagher, of the Committee on Consolidated Returns.

The report commends the Treasury for thoughtfully implementing the anti-abuse purpose contemplated by the statute and the legislative history and for generally striking a reasonable balance between objective rules and subjective principles.

However, the report identifies two features of the proposed regulations that significantly undermine the ability of taxpayers to apply the regulations with reasonable predictability. One is the "device" exception to the safe harbors, which the report recommends replacing with more precise and objective exceptions targeted to those safe harbors susceptible to abuse. The second is the inclusion of a broad category of post-issuance transfers as "measurement dates," which the c report recommends limiting. The report makes a number of other suggestions as well. In this regard, the report, while generally applauding regulatory simplification, concludes that in this critical area of the consolidated return regulations it is more important, for the sake of clear application, to address some of the issues that the report raises than not to do so in order to avoid regulatory complexity.

We would be pleased to meet with your staff at their convenience to discuss this report and related matters.

Very truly yours,

John A. Corry

Identical Letter Sent to
The Honorable Fred T. Goldberg

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Tax Report #724

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON CONSOLIDATED RETURNS

REPORT ON PROPOSED TREASURY REGULATIONS SECTION 1.1504-4 (DEFINITION OF "AFFILIATED GROUP")

July 1, 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")"[1]

I. INTRODUCTION.

This report comments on proposed regulations section 1.1504- 4 (the "Proposed Regulations"), released February 28, 1992.[2] The Proposed Regulations were issued under the authority of section 1504(a)(5)[3] and identify circumstances under which warrants, options, obligations convertible into stock, and other similar interests will (and will not) be treated as exercised for purposes of determining whether a corporation is a member of an affiliated group. After briefly describing the origin and content of the Proposed Regulations, this report contains the Committee's comments and recommendations.

A. Origin of Proposed Regulations.

The Tax Reform Act of 1984 (the "1984 Act") significantly amended the definition of "affiliated group" contained in section 1504(a). Under prior law, section 1504(a) defined an affiliated group as one or more chains of "includible

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[1] This report was prepared by a subcommittee of the Committee on Consolidated Returns, headed by Patrick C. Gallagher and including Gail M. Aidinoff, Richard M. Fabbro, David S. Miller, Lee S. Parker, Yaron Z. Reich and Irving Salem. Helpful comments were received from Brian E. Bloom, Peter C. Canellos, John A. Corry, Richard L. Reinhold, James M. Peaslee, Michael L. Schler and William R. Welke.

[2] CO-152-84, 57 Fed. Reg. 7340 (March 3, 1992).

[3] Except as otherwise indicated, section references herein are to the Internal Revenue Code of 1986, as amended (the "Code") or the proposed, temporary and final Treasury regulations thereunder.

corporations” connected through stock ownership with a common parent if (i) stock possessing at least 80% of the voting power of all classes of stock, and at least 80% of each class of nonvoting stock, of each includible corporation except the common parent was owned directly by one or more of the other includible corporations, and (ii) the common parent owned directly stock of at least one includible corporation meeting these 80% requirements. This definition enabled a parent corporation (P) to file a consolidated return with a second corporation (S) despite P's ownership of only a relatively small economic interest in S's future growth. For example, P and S could consolidate if S had outstanding only voting stock and P owned a class of such stock possessing 80% of the voting power but only 10% of the equity value of all outstanding S stock, while another shareholder held a second class of S voting stock possessing 20% of S's voting power and 90% of S's equity value.

In part to prevent the transfer of tax losses through consolidation of P and S where P owned a relatively small share of the equity capital at risk in S's business, the 1984 Act amended section 1504(a) to require that, in order for S to be a member of P's affiliated group, stock of S representing both 80% of the voting power and 80% of the total value of S's stock must be owned by P or P's other affiliates.

In addition, the 1984 Act added section 1504(a)(5), which grants the Treasury authority to prescribe regulations “necessary or appropriate to carry out the purposes” of section 1504(a), including regulations

"(A) which treat warrants, obligations convertible stock, and other similar interests as stock, and stock as not stock, [and]

"(B) which treat options to acquire or sell stock as having been exercised."

The legislative history indicates that the regulations to be adopted under the above provisions were intended to be anti-abuse measures.[4]

B. Summary of Proposed Regulations.

The Proposed Regulations were issued under the regulatory authority of sections 1504(a)(5)(A) and (B). They state as a general rule that for purposes of section 1504 an "option" is not considered either as stock or as exercised, but rather is disregarded in determining whether a corporation is a member of an affiliated group. However, consistent with the anti-abuse purpose of the statute, the Proposed Regulations, solely

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[4] See Conference Committee report, H.R. Rep. No. 98-861, 98th Cong., 2d Sess. (1984) (the "1984 Conference Report") at 834:

"The conference agreement contains rules similar to those in the House bill and the Senate amendment authorizing the Treasury to prescribe anti-abuse regulations to carry out the purposes of the provision. For example, the Treasury is authorized to prescribe regulations pursuant to which warrants to acquire stock are to be treated as stock and options to acquire stock are to be treated as having been exercised. Thus, assume that corporation A's common stock is worth $40 a share. Assume further that corporation B, the owner of all of A's common stock, grants corporation C an option to acquire that stock for $20 a share at a date beginning 3 years from the date of the grant. The facts indicate that A and C are likely to be loss corporations but that B is profitable. If it can reasonably be expected that C will exercise the option, the regulations may treat the option as having been exercised, for purposes of the new provisions.

"The Treasury is also authorized to prescribe regulations under which obligations convertible into stock (and similar interests) are treated as stock and stock (like "puttable" stock) is not treated as stock."

for purposes of determining section 1504 affiliation, treat an option as exercised if, on any "measurement date," (i) it "could reasonably be anticipated" that, but for these regulations, the issuance or transfer of the option in lieu of the underlying stock "will result in the elimination of a substantial amount of federal income tax liability," and (ii) it is "reasonably certain" that the option will be exercised.[5] A "measurement date" includes, with exceptions, any date on which an option is issued, transferred or modified. There are safe harbors pursuant to which certain options will not be considered reasonably certain to be exercised. Several examples illustrate the application of the above tests.

The Proposed Regulations apply to any "option," which is defined expansively to include call and put options, warrants convertible obligations, any other instrument that provides for the right to issue or transfer stock, and any other instrument or right (except for stock itself) permitting the holder to share in the growth of the issuing corporation (e.g., a cash settlement option or an option on an option).[6] However, safe harbors exclude from this definition certain options that ordinarily do not have an abuse potential, including publicly traded options, stock purchase agreements, customary escrow, pledge or other security agreements, certain employee stock options and other compensation arrangements, and options issued pursuant to a bona fide loan agreement.

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[5] The Preamble ("Background") states: "These proposed regulations do not specifically require that a tax abuse motive exist for an option to be treated as exercised. The tests and safe harbors of the proposed regulations, however, seek to ensure that the regulations apply only to abusive situations."

[6] The term "issuing corporation" as used in this report has the meaning ascribed to it section 1.1504-4(c) (1), i.e., the corporation whose stock is subject to the option.

If an option is deemed exercised under the Proposed Regulations, generally it is treated as exercised only for purposes of determining the value of the stock owned by the holder and the other relevant parties and not the amount of voting power owned (unless, prior to exercise, the person who would receive the stock on exercise of the option or a related person could direct the vote of the corporation's stock pursuant to some arrangement). Thus, generally these rules will only break affiliation and cannot be used as a tax planning device to establish affiliation between the issuer and the person who would receive the stock on exercise.

The Proposed Regulations generally apply only for purposes of those sections of the Code and regulations to which section 1504 affiliation is relevant. The Proposed Regulations generally apply to options with a measurement date on or after February 28, 1992.

II. SUMMARY OF CONCLUSIONS AMD RECOMMENDATIONS.

A. Overview.

On the whole, we believe that the Proposed Regulations thoughtfully implement the anti-abuse principles contemplated by the statute and the legislative history. Moreover, by generally striking a reasonable balance between objective rules and subjective principles, the Proposed Regulations are relatively simple and easy to understand.

Given the sweeping ramifications of membership in an affiliated group, we believe it is critical that any guidance on this subject be sufficiently clear and objective that taxpayers can apply it with relative certainty to their particular circumstances. The safe harbors contained in the Proposed Regulations, by excluding many categories of conventional options that arise in customary commercial transactions, are particularly useful (subject to modifications suggested below).

However, we believe that two features of the Proposed Regulations significantly undermine the ability of taxpayers to apply the safe harbors and other objective tests with reasonable predictability. One is the “device” exception to the various safe harbors. The Proposed Regulations provide no guidance on those instruments or circumstances that would be considered a “device.” As further discussed below, we generally recommend replacing the device concept with more precise and objective exceptions specifically tailored to those safe harbors that are susceptible to abuse. The second feature undermining predictability is inclusion of a broad category of post-issuance transfers as “measurement dates.” We recommend that the testing of options upon transfer be limited as further described below.

In the Preamble to the Proposed Regulations, the Service solicits suggestions to reduce the complexity of the Proposed Regulations. As a general matter we support regulatory simplification and believe the Proposed Regulations have been drafted in a manner that is consistent with this objective. As the scope of this report suggests, however, we believe that in this critical area of the consolidated return regulations it is more important, for the sake of clear application, to address some of the issues that the report considers than not to do so in order to avoid regulatory complexity.

Our principal recommendations and other comments are summarized immediately below. They are discussed in greater detail in Part III below, together with a number of minor and technical comments.

B. Principal Recommendations.

1. General scope of "option" definition (see III.A.l.c). We recommend that the final regulations eliminate the sweeping and ambiguous corporate "growth" concept of section 1.1504-4(d)(1)(ii) and define "option" more narrowly as follows:

"(i) A call option, warrant, convertible obligation, put option, redemption agreement, or any other instrument that provides for the right to issue or transfer stock (including an option on an option); and

"(ii) A cash settlement option, phantom stock, stock appreciation right, or any other similar interest (except for stock itself)."

In addition, assuming the final regulations preserve the treatment of at least some cash settlement options or similar interests as "options," they should clarify (i) how the deemed exercise rule applies to an option that does not entitle the holder to acquire stock, (ii) whether such an option is to be valued by reference to the stock to which it relates or independently and (iii) how the reasonable certainty of exercise test applies to an option whose exercise does not require any outlay of cash or property by the holder.

2. “Device” exception to safe harbors (see III.A.2.a(1), III.B.l.a(2)). We recommend that the final regulations (i) eliminate the blanket “device” exception relating to the safe harbors to the definitions of “option” and “measurement date” and (ii) revise (in the manner suggested by this report) those existing safe harbors that are susceptible to abuse so as to limit their abuse potential in a reasonably objective manner.

3. Scope of “measurement date” definition (see III.B.1.a(1)). We strongly urge Treasury to reduce the scope of potential post-issuance measurement dates with respect to options that are not deemed exercised at the time of issuance. In particular, we recommend that “measurement date” be defined to include only dates on which an opt ion is issued or transferred (i) between the issuing corporation (or any member of its affiliated group) and a non-member of such group and (ii) by or to any person that is “related” to (or acting in concert with) any member of the issuing corporation's affiliated group (other than an issuance or transfer between two corporate affiliates) if the issuance or transfer is pursuant to a plan a principal purpose of which is to avoid the application of section 1504.

4. Relationship to general tax principles (see III.A.3). We recommend that the final regulations specifically provide that (i) substance over form principles will continue to apply to instruments that in form are “options” within the meaning of the regulations but under general tax principles would be treated as stock and (ii) for this purpose general tax principles will be considered to include the principles of Revenue Rulings 82-150 and 83-98 (regarding deep-in-the-money options).

5. Subsidiary tracking stock (see III.A.1.d). The final regulations should either clarify that subsidiary tracking stock is not an "option" or state that the application of the final regulations to subsidiary tracking stock is currently being studied and that any regulations addressing this issue will not be effective until published.

6. Publicly traded options (see III.A.2.a(3)). We recommend limiting the publicly traded option safe-harbor to publicly-traded instruments with a strike price (or, in the case of a convertible or exchangeable instrument, a conversion or exchange premium) that is not materially less than, and a term that is not materially greater than, those that are customary for publicly traded instruments of their type. In addition, consideration should be given to whether the safe harbor should be made available where most of the class of security issued is held by one (or a handful) of persons and only a small portion is traded.

C. Other Comments.

We have various technical and other comparatively minor comments to the Proposed Regulations, some of which are summarized below:

1. Escrow, pledge and other security agreements (III.A.2.a(5)). Treasury should consider providing in the final regulations that, where the parent ("P") of an issuing corporation ("S") actually transfers S stock pursuant to an escrow, pledge or other security agreement, but has the right to recover the stock (e.g., by curing a default) and in fact does recover the stock (perhaps within a specified period of time), P will be treated as continuously owning the S stock for affiliation purposes.

2. Definition of “related person” (III.B.1.a(3)). The definition of “related person” (section 1.1504-4(c) (3)) should be amended to exclude the option attribution rule of. section 1563(e)(1). In addition, we recommend that relatedness be determined without regard to the partner attribution rule of section 267(c) (3).

3. Modification (III.B.1.b). Regarding the rule that treats only modifications increasing the likelihood of option exercise as giving rise to a measurement date (section 1.1504-4(c)(4)(ii)(C)), we recommend that the final regulations take account only of modifications that “materially” increase the likelihood of exercise. Regarding modifications generally, the final regulations should clarify that, even if an option is modified to such an extent that there is a deemed reissuance under section 1001 or other general tax principles, the option will not be treated as newly issued for section 1504 purposes.

4. Lapse or forfeiture of option (III.C.4.a). Treasury should consider incorporating in the final regulations a rule similar to section 1.382-2T(h)(4)(viii) (providing that, if an option is treated as exercised for section 382 purposes and then lapses unexercised or is forfeited, the option is treated as never having been issued, and the taxpayer may amend its prior tax returns accordingly, subject to any applicable statute of limitations). The scope of such a rule might be limited to a lapse or forfeiture that occurs within a specified period after the deemed exercise date.

5. Retesting an option (III.C.4.b). The final regulations might provide that an option which is deemed to have

been exercised will continue to be tested on subsequent measurement dates, so that, if upon a subsequent measurement date the option is not deemed exercised, then the previously deconsolidated subsidiary could reconsolidate (subject to section 1504(a)(3) and satisfying the automatic waiver provisions of Rev. Proc. 90-53). Alternatively, the final regulations should clarify that deemed exercise is permanent (subject to lapse or redemption of the option), regardless of option status on subsequent measurement dates.

6. Effective dates (III.E). We question the reasonableness of Treasury's issuance of the Proposed Regulations in proposed form with an immediate effective date.

III. DISCUSSION

A. Scope of "Potion" Definition.

1. Basic Definition. Section 1.1504-4(d)(1) defines an "option" (subject to the safe harbors discussed in III.A.2 below) as:

> "(i) A call option, warrant, convertible obligation, put option, or any other instrument that provides for the right to issue or transfer stock; and
>
> "(ii) Any other instrument or right (except for stock itself) pursuant to which the holder may share in the growth of the issuing corporation (e.g., a cash settlement option or an option on an option)."

a. Warrants and convertible obligations.

Section 1504(a)(5) authorizes regulations that treat "warrants, obligations convertible into stock and other similar interests as stock." and "options to acquire or sell stock as having been exercised" (emphasis added). The Proposed Regulations, however, treat warrants and convertible obligations like all other "options" (i.e, as "exercised" rather than "as stock"), the effect of which is to value them by reference to the stock that would be received upon exercise.[7] In contrast, the statute could be read to require valuing warrants and convertible debt independently of the underlying stock, which often will be more difficult. Moreover, if warrants themselves were treated as stock and valued for purposes of the 80% test of section 1504(a)(2)(B) independently of the stock receivable on exercise, warrants could create tax-advantaged treatment when compared to economically equivalent options.[8] We commend Treasury's

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[7] Cf. Revenue Ruling 68-601, 1988-2 C.B. 24 (warrants and convertible debentures are options within the meaning of 318(a) (4)).

[8] example, assume corporation S has 100 shares of stock outstanding, all of which are held by A and each of which is valued at $20. S proposes to issue either warrants or options, in each case for 30 shares of S stock with an exercise price of $10. Assuming the warrants are worth $12 each, a literal reading of the statute would value the warrants at $360, so that their issuance would not jeopardize consolidation ($360/$2,360 = 15%). In contrast, the economically equivalent options would be treated as exercised and valued by reference to the underlying stock (i.e., $600), so that their issuance would result in deconsolidation ($600/$2,600 = 23%). See NYSBA Tax Section, Report on Tax Reform Act of 1984 Amendments to Section 1504(a): The Definition of 'Affiliated Group' at 906-907 (Aug. 19, 1985) ("1985 NYSBA Report").

The 1984 Act House Ways and Means Committee Report makes no distinction between warrants and options, but rather states that options, warrants and convertible securities are all to be treated as having been exercised or converted. H.R. Rep. No. 432, Part II, 98th Cong., 2d Sess. 1206, 1207 (1984). In contrast, the 1984 Conference Report (at 834) simply tracks the statutory language.

decision to treat consistently convertible obligations, warrants and options, which is a liberal but sensible reading of the statute justified by the economic similarities among those interests.

b. Convertible or exchangeable preferred stock. The final regulations should clarify that, for purposes of section 1504, convertible preferred stock will be treated solely as "stock" and not as an "option."

The Proposed Regulations are not clear as to whether convertible preferred stock should be treated as an option.[9] In contrast, under section 1504(a)(4), any preferred stock not satisfying the statutory safe harbor (including by reason of a conversion feature) is treated as "stock" for section 1504 purposes, although section 1504(a)(5)(A) grants the Treasury the authority to prescribe regulations which treat "stock as not stock.".

Since the value of the option should be included in any valuation of the preferred stock, it appears unlikely that the Service would obtain any benefit from treating convertible preferred stock both as a stock and as an option for purposes of section 1504. Moreover, treating convertible preferred stock solely as stock rather than solely as an option is more likely to

[9] The Proposed Regulations do not specifically exclude such stock from the definition of "stock." Moreover, convertible preferred stock literally would appear to be an "instrument that provides for the right to issue or transfer stock" under section 1.1504-4(d)(1)(i). On the other hand, the phrase "convertible obligation" in section 1.1504-4(d)(1)(i), although undefined, seems to contemplate only debt instruments, and the "other instrument or right" concept of 1.1504-4(d)(1)(ii) excludes actual stock.

result in deconsolidation, because (i) the general rule of the Proposed Regulations that options are to be ignored unless certain conditions exist would not apply and (ii) the value of the preferred stock component held by the non-member holder would have to be taken into account.

A similar issue arose in connection with the section 382 option regulations. Section 382(k)(6)(A), like section 1504, defines "stock" to include any stock other than section 1504(a)(4) stock, except as provided in regulations. At the same time, section 1.382-2T(h)(4)(v) defines "option" to include "a convertible debt instrument [and] an instrument other than debt that is convertible into stock." Hence, as the statute and regulations are presently drafted, convertible preferred stock literally constitutes both stock and an option for section 382 purposes. In order to clarify the treatment of convertible preferred stock, the Service issued Notice 88-67.[10] Notice 8867 provides, among other things, that for section 3 82 purposes convertible stock which, except for its conversion feature, would qualify as section 1504(a)(4) stock will be treated in the same manner as convertible debt (i.e., as an "option") rather than as stock.[11]

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[10] 1988-1 C.B. 555.

[11] Notice 88-67 also states that (i) any other convertible stock (e.g., convertible voting preferred) will be treated solely as stock (and not as an option) "as long as the terms of the conversion feature do not permit or require the tender of any consideration other than the stock being converted" and (ii) the Service is "studying the appropriate treatment" of convertible stock not covered by the preceding rules. Notice 88-67 generally applies with respect to stock issued after the date of the Notice and treat stock issued before such date as "stock" and not as an "option."

We believe the approach taken by the Service in Notice 88-67 should not apply for purposes of section 1504, because there seems to be no compelling reason in the section 1504 context to alter the statutory result.

Regulations under section 1504(a)(4) also should clarify the treatment, with respect to the issuer of the preferred stock, of preferred stock that is exchangeable into stock of a corporation other than such issuer. Regardless of the treatment of such stock for purposes of applying section 1504 to the issuer of the preferred stock, it appears that section 1.1504-4(d)(1)(i) (covering "any ... instrument that provides for the right to issue or transfer stock") appropriately treats the exchange right itself as an option with respect to the corporation to whose stock the option relates.

c. "Any other instrument or right..." The Proposed Regulations define "option" to include not only an interest that entitles the holder to become a shareholder, but also any other instrument or right permitting the holder to "share in the growth of the issuing corporation (e.g., a cash settlement option...)."[12] The safe harbor of section 1.1504-4(d)(2)(v) indicates that stock appreciation rights and phantom stock (to the extent not expressly excluded by the safe harbor) also are "options" for this purpose.

[12] This language appears derived from section 1504(a)(4)(B) (stock participat[ing] in corporate growth to any significant extent") and presumably is designed to cover interests not enumerated in section 1.1504-4(d)(1)(i) that are perceived to put the holder in an economic position comparable to that of a shareholder. cf. 1984 Conference Report at 833 ("preferred stock carrying a dividend rate materially in excess of a market rate when issued would hot be ignored" under section 1504(a)(4)).

The Proposed Regulations seem to be the first instance where, without express statutory authority, the Treasury has treated as equivalent to stock an interest that under no circumstances permits the holder to become a shareholder. Section 1504(a)(5)(A) refers only to interests "similar" to warrants and convertible obligations (both of which entitle the holder to receive actual stock), and section 1504(a)(5)(B) refers only to "stock" options.[13] Thus neither section seems to contemplate interests that do not represent some entitlement to stock. By comparison, the recently issued regulations regarding the one-class-of-stock test under section 1361 disregard any such interest unless it would constitute "equity" or otherwise result in the holder being treated as the "owner of stock" under general tax principles.[14] Moreover, past ruling practice consistently has disregarded phantom stock and stock appreciation rights for section 1361 purposes.[15]

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[13] In contrast, section 1234(c) expressly defines "option" to include a cash settlement option. Similarly, section 897(c)(1)(A)(ii) (which section 1.897-l(d)(3)(i)(D) interprets to include not only stock, but also a right to share in the appreciation in the value of corporate stock or assets, or in gross or net proceeds or profits of a corporation) refers broadly to "any interest ... in any domestic corporation," rather than more narrowly to "interests" that are "similar" to warrants and obligations convertible into stock.

[14] Section 1.1361-1(1)(4)(i), (ii)(A)(1).

[15] See, e.g., Private Letter Ruling 9040035 (July 6, 1990) (phantom shares issued under phantom stock plan are not treated as stock for section 1361 purposes); General Counsel Memorandum 39750 (August 22, 1988) (same); Private Letter Ruling 8828029 (April 14, 1988) (stock appreciation rights are not treated as second class of stock for section 1361 purposes). See generally Berkwitz v. Humphrey. 163 F. Supp. 78, 89 (N.D. Ohio 1958) (describing corporate law differences between actual and phantom stock).

Although the issue is a difficult one, the Committee nonetheless believes that the decision to include cash settlement options and stock appreciation rights within the scope of the Proposed Regulations is, given the economic resemblance between such interests and conventional options, a reasonable and appropriate exercise of regulatory authority and consistent with the purposes of the statute.[16]

As drafted, however, the Proposed Regulations potentially apply to numerous rights and instruments that are not options in any conventional sense and presumably should not be covered. Many customary, nonabusive, commercial transactions involve circumstances where a third party has a right or interest entitling it to share in corporate "growth" to some extent. Consider the following examples:

-- A royalty or similar interest in trademarks, patents or other corporate assets would seem literally to be a section 1504(a)(5) option if it permits the holder to "share in the growth" of the corporation (which it generally would).

-- A purchase price "earn-out" (i.e., an amount payable by the buyer of a business to the seller based on future profits of the business over a specified period) would seem to be covered.

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[16] While the holder of a cash settlement option or similar interest has no right to receive actual stock of the issuer, economically the holder benefits from the appreciation of the stock of the issuing corporation to the same extent as the holder of a conventional stock option. See Revenue Ruling 88-31, 1988-1 C.B. 303 (cash settlement put option is economically identical to holder of put with respect to underlying stock). See also section 1.1275-4(g) (characterizing certain contingent debt payments determined by reference to publicly traded stock or other property as a cash settlement or other option). Cf. section 1234(c) (cash settlement options treated as options).

-- The creditors of an insolvent corporation often have a more significant interest in corporate growth than the actual shareholders, although, in the absence of the Proposed Regulations, one would have supposed that such an interest should not be regarded as stock except under general tax principles.[17]

The safe harbors of section 1.1504-4(d)(2) do not expressly exclude any of the above arrangements from the definition "option." Thus, the Proposed Regulations could be read to apply in each case, although presumably Treasury did not intend that such interests be covered.[18]

In view of the foregoing, we recommend that section 1.1504- 4(d)(1)(ii) be deleted, thereby eliminating the confusion created by the sweeping and ambiguous corporate "growth" concept, and be replaced by a provision that more clearly delineates interests that are measured by reference to the stock of the issuing corporation. Specifically, we recommend that section 1.1504-4(d)(1) be restated to provide that the following are treated as options:

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[17] See, e.g., Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942) (creditor command over property equivalent to proprietary interest).

[18] While certain of the interests described above would not involve, strictly speaking, the "issuance" of an option, see section 1.1504-4(d)(ii), the definition of issuing corporation does not require that it "issue" an option, only that its stock be subject to one. See section 1.15044 (c) (i).

"(i) A call option, warrant, convertible obligation, put option, redemption agreement,[19] or any other instrument that provides for the right to issue or transfer stock (including an option on an option); and

"(ii) A cash settlement option, phantom stock, stock appreciation right, or any other similar interest (except for stock itself)."[20]

Assuming the final regulations preserve the treatment of at least some cash settlement options or similar interests as "options," they should clarify the application of certain operative provisions of the regulations to such interests. Three issues come to mind.

First, the final regulations should clarify the consequences of the deemed exercise (under section 1.1504-4(b)(2)) of an option that does not represent a right to issue or transfer actual stock (e.g., a cash settlement option, phantom stock, or a stock appreciation right). We assume the intended consequence is that stock is constructively issued to the holder of the right in an amount corresponding to the right's share of profits. Reading the Proposed Regulations literally, however, no stock will be deemed issued (because the holder of a right to receive solely cash is never entitled to any stock), and so there is no adverse effect.

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[19] Redemption agreements are discussed in III.A.1.e below.

[20] Consideration might also be given to including an explicit safe harbor exception for a purchase price "earn-out" payable to the seller of a business from the buyer, perhaps limited to earn-outs payable within a specified period of time.

Second, the final regulations should clarify how a cash settlement option or similar interest should be valued for purposes of determining whether, as a result of its deemed exercise, the members of the affiliated group continue to own at least 80% of the value of the issuing corporation's stock. In particular, because the holder of such an interest will never receive stock itself, it might be questioned whether it is appropriate to value such an interest by reference to the stock to which it relates (as the Proposed Regulations provide in the case of an actual option or warrant, as discussed in III.A.1.a above) or whether, instead, such an interest should be valued independently.

Third, the final regulations should clarify how the "reasonable certainty of exercise" test of section 1.1504-4(b)(2)(i)(B) is to be applied to an option whose exercise does not require any outlay of cash or property by the holder (e.g., a cash settlement option, phantom stock, or a stock appreciation right). Presumably the "exercise" of such a right occurs when the holder actually receives cash pursuant to the right's terms. The test under the Proposed Regulations then would be whether there is a reasonable certainty that the right will not expire worthless (i.e., "unexercised"). Such treatment would make cash settlement rights directly analogous to a conventional option, which will not be deemed exercised unless there it is reasonably certain that the option will not expire out-of-the-money.

d. Subsidiary tracking stock. Subsidiary tracking stock represents an economic stake in the growth of the issuer's subsidiary. It is not entirely clear whether subsidiary tracking stock is an "option" under the Proposed Regulations. Subsidiary

tracking stock is not covered by section 1.1504- 4(d)(1)(i) (quoted at the beginning of III.A.l above), because such stock does not include a "right to issue or transfer [actual] stock." Similarly, the first parenthetical in section 1.1504-4(d)(1)(ii) (also quoted at the beginning of III.A.l above) appears to foreclose treatment of subsidiary tracking stock as an option, because it is actual stock. Under a strained reading of that provision, however, the phrase "stock itself" could be construed to mean stock of the "issuing corporation," i.e., the subsidiary (see section 1.1504-4(c)(1)). Under this reading, subsidiary tracking stock would be an option described in section 1.1504-4(d)(1)(ii), since tracking stock is literally stock of the parent, not the subsidiary.

Subsidiary tracking stock neither has an "exercise" price nor entitles the holder actually to receive subsidiary stock. Therefore, treating it as an option would raise issues under the deemed exercise test and the reasonable certainty of exercise test similar to those discussed in connection with cash settlement rights (see end of (c) above). Such treatment also would raise more complicated valuation questions. For example, usually subsidiary tracking stock represents rights against the parent as well as the subsidiary. It is not clear whether the value of subsidiary tracking stock for section 1504 purposes should include the value of the rights against the parent or only the value of the interest in the subsidiary.[21]

[21] See III.A.1.b above for a similar valuation issue relating to convertible preferred stock.

There is an economic resemblance between subsidiary tracking stock and a cash settlement option with respect to the subsidiary's stock, insofar as both represent an interest in corporate growth of the subsidiary but do not entitle the holder actually to receive subsidiary stock. Nevertheless, the tax issues surrounding tracking stock are particularly complex,[22] and the Service has included tracking stock classification on its list of areas currently under "extensive study."[23] Accordingly, we believe that, until thoughtful and specific guidance is issued, the section 1504 implications of tracking stock should continue to be resolved under general tax principles (which would classify tracking stock, in contrast to a cash settlement option, as stock of either the parent or the subsidiary) rather than by the expedient of treating tracking stock as a section 1504 option.

Therefore, particularly if the final regulations do not adopt our recommendation that section 1.1504-4(d)(1)(ii) be modified (see (c) above), we recommend that they clarify that tracking stock is not an "option." Alternatively, they should state that the application of the final regulations to subsidiary tracking stock is currently being studied and that any regulations addressing this issue will not be effective until published.

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[22] See generally New York State Bar Association Tax Section Corporations Committee and Reorganizations Committee Report Regarding "Tracking Stock" Arrangements, 43 Tax L. Rev. 51 (1987).

[23] See Rev. Proc. 92-3, §5.23, 1992-1 I.R.B. 55. Tracking stock was added to this list in 1987 by Rev. Proc. 87-59, 1987-2 C.B. 764.

e. Redemption agreements. we recommend that the option definition of section 1.1504-4(d)(1) specifically include redemption agreements. A redemption agreement under which, for example, a subsidiary may redeem shares held by one of its shareholders at the behest of another of its shareholders could increase the second shareholder's stock ownership but is not, strictly speaking, a call option, nor is it entirely clear that it is covered by section 1.1504-4(d)(1)(ii).

Regarding application of the deemed exercise test to options involving redemption of shares, see III.C.3 below.

2. Safe Harbors. We commend the inclusion of significant and useful safe harbors to the “option” definition (section 1.1504-4(d)(2)). The six existing safe harbors exempt from option treatment many nonabusive interests that are customary in routine business transactions. Even where their exclusion from the scope of the statute may otherwise seem clear, safe harbors provide quick answers and offer needed comfort in an area of the law where predictability should be a key objective. We have comments on the existing safe harbors as well as suggestions for additional safe harbors.

a. Comments on current safe harbors.

(1) Device exception to safe harbors. We believe the provision excluding from safe harbor protection an instrument “used as a device to avoid the application of section 1504 and this section” is so vague as to remove in large part the comfort the safe harbors would ordinarily be expected to provide.

A blanket “device” exception implies that even as to transactions that by definition are customary and commercially reasonable,[24] the Service reserves the right to challenge the arrangement on the ground that the taxpayer intended to create a “disproportionate capital structure” in which “a substantial portion of the equity” of the consolidated subsidiary was held by a nonaffiliate.[25] The Proposed Regulations give no guidance on what constitutes a device, leaving open, for example, whether (i) any motive to reduce a parent's equity interest below 80% may be a device, (ii) such motive must be a principal purpose for the transaction,[26] (iii) such motive must be the principal purpose for the transaction or (iv) a device may exist whenever the effect of an instrument is to reduce a parent's interest below 80% (regardless of motive). The vagueness of the device concept substantially reduces the tax planning effectiveness of the safe harbors, which should be designed to enable taxpayers to apply them objectively and with reasonable certainty.

We acknowledge (without endorsement) that recently adopted section 1.1502-20 contains an anti-abuse provision even broader than the “device” limitations in the Proposed Regulations,[27] and we appreciate Treasury's concern that concise

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[24] See section 1.1504-4(d)(2)(iii) through (vi).

[25] See Preamble (“Background,” describing purpose of Proposed Regulations).

[26] Cf. section 1.1504-4(c)(4)(iii).

[27] Section 1.1502-20(e)(1) states: “The[se] rules ... must be applied in a manner that is consistent with and reasonably carries out their purposes. If a taxpayer acts with a view to avoid the effect of the rules of this section, adjustments will be made as necessary to carry out their purposes.”

regulations require adequate safeguards against taxpayer abuse. As further discussed, below, however, we believe that most of the provisions to which the Proposed Regulations apply a device test either are not susceptible to abuse or can be modified in a reasonably objective manner that adequately addresses abuse potential.

A "device"-type exception to safe harbor treatment is unusual in regulations, and experience has demonstrated that in the limited situations in which a "device" test has been adopted, it has not been easily applied. For example, section 1.103-13 (j) generally provides that the employment of an "artifice or device" in connection with the issuance of a government obligation will result in the obligation being treated as an arbitrage bond. First it should be noted that those regulations, unlike the Proposed Regulations, contain several examples illustrating the "artifice or device" concept. Moreover, the Service originally ruled that "deliberate and intentional" action satisfied the device test,[28] but subsequently ruled that any customary or traditional issuance would not be deemed an "artifice or device," regardless of motivation.[29] Thus the Service, apparently recognizing the difficulty of applying an amorphous "intent" standard, replaced it with a more objective standard, based on commercial custom, upon which taxpayers could better rely.[30]

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[28] See Revenue Ruling 80-188, 1980-2 C.B. 47; Revenue Ruling 80-92, 1980-1 C.B. 31; Revenue Ruling 80-91, 1980-1 C.B. 30.

[29] See General Counsel Memorandum 39409 (Sept. 13, 1985); Revenue Ruling 85-146, 1985-2 C.B. 38.

[30] See also section 1.355-2(d)(2) and (3) (providing specific factors to delineate the scope of a device test).

Similarly, we believe that the final regulations should exempt unconditionally from the "option" definition specified options that are commercially customary. Specifically, we recommend that the final regulations (i) eliminate the blanket device exception contained in section 1.1504-4(d)(2) and (ii) revise those existing safe harbors that are susceptible to abuse (e.g., the publicly traded option safe harbor, as discussed below) so as to limit their abuse potential in a reasonably objective manner. In keeping with these recommendations, the following specific comments on the safe harbors are intended in part to address the abuse potential implicit in certain of the safe harbors.

(2) Options on section 1504(a)(4) stock. Section 1.1504-4(d)(2)(i) generally exempts options on section 1504(a)(4) preferred stock. This exemption seems unnecessary, because treating such an option as exercised under section 1.1504- 4(a)(2) would not affect the consolidation of the issuing corporation.[31] Nevertheless, the clarification avoids any question about the result and eliminates needless analysis. This exemption presents no abuse potential and therefore should not be subject to a device or similar exception.

(3) Publicly traded options. Section 1.1504-4(d) (2) (ii) exempts options traded on a qualified board or exchange as defined in section 1256(g)(7) (which includes, among other things p, any national securities exchange registered with the SEC) or any other exchange or board of trade specified in the Internal Revenue Bulletin.

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[31] See section 1504(a)(4) ("stock" does not include section 1504(a) (4) preferred stock).

On the whole, this safe harbor is reasonable, because the types of publicly traded options with which we are familiar present little opportunity for abuse. Options traded on the options exchanges, for example, cannot be issued by the issuer of the underlying stock or any of its affiliates, so they cannot serve as a device to shift an interest in corporate growth from an affiliated group member to an unrelated party. The terms of the typical publicly traded convertible debt instrument make it similarly unsuitable for abuse. Typically, such an instrument is issued with a significant conversion or exchange premium that makes it far from certain that it will ever be converted into or exchanged for equity. It would therefore be inappropriate to discourage Legitimate uses of such financial instruments by subjecting them to the operation of the “deemed exercise” rule of section 1.1504-4 (b) (2).

Nonetheless, a safe harbor covering all publicly traded options without exception is too broad. Deep-in-the-money warrants and convertibles issued without any conversion premium should not tie made eligible for a safe harbor merely because they are listed on a qualified board or exchange. Arguably the “device” test contained in the Proposed Regulations would narrow the scope of the publicly-traded safe harbor in a way that would discourage such abuse. In view of the uncertainty created by the “device” test, however, a better approach in our view would be to limit the safe harbor to instruments that do not differ substantially from typical, non-abusive publicly traded instruments in the terms that bear on the likelihood of exercise. Specifically, we recommend limiting the safe-harbor to publicly-traded:

"warrants, convertible and exchangeable debt instruments, and other similar instruments, with a strike price (or, in the case of a convertible or exchangeable instrument, a conversion or exchange premium) that is not materially less than, and a term that is not materially greater than, those that are customary for publicly traded instruments of their type."[32]

In most cases, customary terms should be ascertainable from financial data bases readily available to investment banks and the financial media, so the limitation on the safe harbor that we propose should not be as difficult to apply as the proposed "device" test.[33]

Another possible concern with the publicly traded safe harbor arises where most of the class of security, issued is held by one (or a handful) of persons and only a small portion is traded.

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[32] Note that the customary conversion or exchange premium for a debt instrument may depend on whether it provides for current payments of interest. It appears that the majority of current pay instruments have an initial premium in the range of 18%-23%, while the majority of zero-coupon instruments appear to have an initial premium in the range of 13-15%.

[33] A similar approach to allaying uncertainty is provided in the regulations governing installment sales, which contain a safe harbor permitting installment sale treatment for a security that is convertible into tradeable common if it is issued with a conversion premium of at least 25%. Section 15A.453-1(e)(5)(ii).

Example (1): Corporation S issues debt convertible into 50% of S's stock. 99% of the debt is placed with one investor and 1% is listed on a qualified board or exchange. Query whether the safe harbor should exclude this case, or whether the limitations on conversion premium and term recommended above would adequately prevent abuse.

Assuming that the concern described in the preceding paragraph is either addressed directly in the final regulations or considered not to be abusive, we believe that the modifications described above eliminate the need for a device exception to this safe harbor.

(4) Stock purchase agreements. Section 1.1504-4(d)(2)(iii) exempts stock purchase agreements in which the parties' obligations to complete the transaction are subject only to reasonable closing conditions. This safe harbor is reasonable and supported by case law.[34] We recommend that the safe harbor also cover agreements similar to stock purchase agreements (e.g., reverse subsidiary merger agreements). In lieu of applying a "device" or similar anti-abuse restriction on this safe harbor, we recommend adding a requirement that the provisions of the stock purchase agreement relating to the terms and conditions of the "option" be commercially customary or reasonable.

(5) Escrow, pledge and other security agreements. Section 1.1504-4(d)(2)(iv) exempts escrow, pledge and other security agreements that are part of a typical commercial transaction and subject to customary commercial conditions. This

[34] Stock purchase agreements for unconsummated transactions have been held not to cause deconsolidation. See American Utilization Co. v. Commissioner 38 B.T.A. 322 (1938) (stock purchase agreement pursuant to which stock was recorded as sold but for which sale was not consummated is not a sale for purposes of invalidating consolidated return filing).

safe harbor also is reasonable and supported by published rulings and case law.[35] Given the requirement of a "typical commercial transaction" with "customary commercial conditions," this exemption presents no abuse potential and therefore should not be subject to a device or similar exception.

We recommend that Treasury consider including in the final regulations a provision covering the case where the parent ("P") of the issuing corporation ("S") actually transfers S stock pursuant to such an agreement, but has the right to recover the stock (e.g., by curing a default) and in fact does recover the stock. Under the statute and Proposed Regulations, the temporary stock transfer would break P-S affiliation. In contrast to this result, we believe that, under these nonabusive and typically involuntary circumstances, P should be treated as continuously owning the S stock for affiliation purposes. This could be accomplished in the final regulations by treating P's option to recover the S stock as automatically deemed exercised for affiliation purposes. The operation of this provision might be limited to cases where the stock recovery occurs within a specified period of time. In order to preserve P-S affiliation, such deemed exercise, in this limited instance, would need to apply for both vote and value purposes, in contrast to the general rule of section 1.1504-4(b)(2)(ii)(B).

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[35] Escrow, pledge and other security agreements have been determined not to jeopardize consolidation. See Miami Nat. Bank v. Commissioner, 67 T.C. 793, 799 (1977) (citing cases where beneficial owner is treated as a direct owner for consolidation purposes in connection with nominee situations, pledges and other security arrangements); Doernbecker v. Commissioner, 80 F.2d 573 (9th Cir. 1935); Revenue Ruling 55-458, 1955-2 CB 579.

(6) Compensatory arrangements. Section 1.1504-4(d)(2)(v) provides that stock appreciation rights, warrants, stock options, phantom stock and other similar arrangements (collectively, "compensatory options") provided to employees, directors or independent contractors as reasonable compensation are not options if the compensatory option is nontransferable within the meaning of section 1.83-3(d) and does not have a readily ascertainable fair market value as defined in section 1.83-7(b) on the measurement date. We recommend eliminating the last requirement (section 1.1504-4(d)(2)(v)(B)) as surplusage. Because section 1.1504-4(d)(2)(v)(A) already requires nontransferability, it ensures that the interest will have no readily ascertainable value on the measurement date.[36] This change would remain consistent with the current practice of publicly-traded companies to issue only non-transferable compensatory options within the exclusion provided by Section 16 of the Securities Exchange Act.[37]

In addition, we recommend that the safe harbor clarify that compensatory options include options on the stock of corporate affiliates of the employer corporation. Such a change is consistent with both section 422A (incentive stock option includes an option granted by the employer corporation, its parent corporation or its subsidiary corporation) and section 83 (any property transferred in connection with the performance of services) and with the current market practice of granting incentive or nonqualified options on P stock to S's employees.[38]

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[36] See section 1.83-7(b)(2)(i).

[37] 15 U.S.C. § 78p.

[38] See also recently adopted section 1.1361-1(1) (4) (iii) (B) (2), which includes in an analogous compensatory option safe harbor an option issued to an employee of a corporation 50% of whose total stock voting power and total stock value is owned (apparently without attribution) by the issuing corporation.

We believe that a device exception is unnecessary for this safe harbor in light of (i) the requirements that the option represent reasonable compensation and be nontransferable and (ii) our recommendation (discussed in III.A.3 below) that general tax principles (including the treatment of sufficiently deep-in-the-money options as "stock" under the principles of Revenue Rulings 82-150 and 83-98) continue to apply to instruments covered by the Proposed Regulations.

(7) Options granted in connection with a loan. Section 1.1504-4(d)(2)(vi) exempts any option granted in connection with a loan if the lender is actively and regularly engaged in the business of lending and the loan is commercially reasonable.

We recommend that the final regulations provide that this safe harbor is unavailable if the option is held by a person "related" to the issuing corporation or its affiliates. For example, it is difficult to see why an in-the-money option issued to a lender that also owns at least 10% of the issuing corporation's stock should not be taken into account under the deemed exercise rules. In addition, the final regulations should clarify that a post-issuance transfer of the loan and/or the option issued in connection therewith will not cause the option to cease to qualify under the safe harbor.[39]

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[39] While we believe this to be the result under the Proposed Regulations, the continued application of the safe harbor arguably is unclear in the case of a transfer to a person not in the lending business, since the term "lender" could refer either to the original lender alone or to the current holder of the note.

The other safe harbors of section 1.1504-4(d)(2) generally have the effect of permanently exempting an interest from the deemed exercise rule, including on subsequent measurement dates. This is because status as a "non-option" is based solely on conditions existing at the time of original issuance (except that the compensatory option safe harbor of 1.1504-4(d)(2)(v) continues to apply only for so long as the option is not transferable).

In order to implement the above recommendations, we would suggest revising the safe harbor to read as follows:

> "An option issued in connection with a loan if the original lender is actively and regularly engaged in the business of lending and the loan terms are commercially reasonable at the time of original issuance, but only for so long as the option is not held by a person related to the issuing corporation or to any member of the affiliated group (determined without the exceptions in section 1504(b) and without the application of this section), if any, of which it is a member."[40]

The above suggested amendments to this safe harbor are intended to apply in lieu of the "device" limitation.[41]

b. Additional safe harbors. We recommend several additional safe harbors to "option" classification.

(1) Drag-along rights and tag-along rights. The final regulations should exempt drag-along rights and tag-along rights from option classification.

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[40] The suggested language also cures a drafting error in the Proposed Regulations as published. This could be remedying without otherwise altering the safe harbor by replacing the words "are issued in connection with a loan that" (which seem redundant, unless a distinction is intended to be drawn between "granted" and "issued") by the words "the loan".

[41] For an analysis of the comparable safe harbor appearing in section 1.1361-1(1)(4)(iii)(B)(1), see Ginsburg & Levin, The New Subchapter S One Class of Stock Proposed Regulation: Much Better, But Still Not Awfully Good, Tax Notes 81, 92-93 (Oct. 7, 1991).

A drag-along right allows a shareholder selling stock to compel another shareholder to sell its shares at an identical price per share. Technically, a drag-along right could be viewed as an option, because it is a "right to ... transfer stock" (section 1.1504-4(d)(1)). However, a drag-along right should not be treated as an option for the following reasons. First, a drag-along right, which usually is granted solely to increase the marketability of the holder's shares, only benefits the holder to the extent of possible control premium (which section 1.1504-4(b)(2)(iii) expressly provides is to be disregarded for purposes of determining percentage of stock value owned). Since the holder has no opportunity to participate in "corporate growth" with respect to the drag-along shares, the right presents no potential abuse of section 1504. Second, once the holder of the right receives an offer to purchase its shares plus any shares subject to the drag-along right, the drag-along right presumably would be reasonably certain to be exercised, resulting in possible deemed exercise of the right.[42] This would be inconsistent, however, with the stock purchase agreement safe harbor of section 1.1504-4(d)(2)(iii). That is, if an agreement to purchase stock is not an option, an instrument that merely facilitates the transfer of the very shares that are the subject of the stock purchase agreement should not be treated as an option. Third the exercise of a drag-along right is subject to a substantial condition subsequent (purchase of the holder's shares by a third party)

[42] Because a drag-along right, in contrast to a tag-along right (see text below), is neither an option to buy nor an option to sell stock, it apparently does not qualify for the safe harbors of section 1.1504-4(g)(2) (relating to reasonable certainty of exercise).

which should exempt the option from option status.[43] Again, any other result would be inconsistent with the safe harbor for stock purchase agreements.[44]

A tag-along right entitles the holder to sell its own shares in connection with the sale of another person's shares at an identical price per share. In contrast to a drag-along right, a tag-along right clearly is an “option to sell stock.” Therefore, ordinarily it should be protected by one or both of the safe harbors to the reasonable certainty of exercise test (section 1.1504-4(g)(2)(ii)(B)). Nevertheless, for the second and third reasons described above, tag-along rights, like drag- along rights, should be excluded from the option definition.

(2) Poison pill rights. We recommend a safe harbor for rights held by shareholders of a publicly-held parent to purchase stock of its subsidiary if such rights were issued pursuant to a poison pill mechanism established to defend against unsolicited offers to acquire the parent's stock.[45] Such rights, as narrowly defined, do not present abuse potential. A safe harbor of this type is already implicit in the publicly traded option safe harbor of section 1.1504-4(d)(2)(ii), but it should be clarified there or elsewhere.

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[43] Cf. Revenue Ruling 90-11, 1990-1 C.B. 10 (described in text at (2) below).

[44] A third party could acquire from the holder of a drag-along right a call option to acquire both the holder's shares and the shares subject to the drag-along right. Subject to other available safe harbors, such a call option properly would be treated as an option (including with respect to the drag-along shares) under the Proposed Regulations. A safe harbor treating the drag-along right (viewed in isolation) as a non-option would not alter this result, since the call option would represent an independent right to acquire the drag-along shares.

[45] Cf. Revenue Ruling 90-11, 1990-1 C.B. 10 (described in text below).

Alternatively, a safe harbor could be added to the "reasonable certainty of exercise" test, the scope of which is based on the standard described in Revenue Ruling 90-11 (concluding that rights acquired by public shareholders under a poison pill plan, the exercise of which is "remote and speculative," are not considered to be exercised under the option rule of section 382 "until the rights can no longer be redeemed for a nominal amount by the issuing corporation without shareholder approval").[46]

(3) "Options" created under bankruptcy plan prior to effective date. A bankruptcy reorganization plan for a consolidated group of corporations may provide for the transfer of subsidiary stock to creditors in satisfaction of their claims. We recommend that the final regulations include a rule similar to section 1.382-3(o), i.e., that options created in connection with a bankruptcy reorganization plan either will not be treated as options for affiliation purposes or will not be considered exercised before the effective date of the plan. This will ensure that deconsolidation of the subsidiary will not occur before the effective date of the plan, which in turn will coordinate the operation of sections 382 and 1504 by making the plan effective date the relevant date for purposes of both sections.[47]

3. Relationship to General Tax Principles. It is unclear whether the Proposed Regulations are intended to control the treatment of an interest or right that is in the form of an "option" but that would be treated as stock or as exercised under

[46] 1990-1 C.B. 10.

[47] See sections 1.382-2T(h)(4)(x)(J), 1.382-3(o).

general substance over form principles. The Preamble, in discussing effective dates, states that, with respect to "options with no measurement date after February 28, 1992 [the general effective date] ... the Service may apply substance over form principles in determining whether options will be treated as stock or as exercised in appropriate circumstances," citing Revenue Rulings 82-150 and 83-98.[48] This language is ambiguous. It could be read as a negative inference that the treatment (for section 1504 purposes) of any "option" that does have a post-February 27, 1992 measurement date will be determined solely under the Proposed Regulations, not under general tax principles. In contrast, read more broadly, the quoted language may mean that, whether or not an option has a post-February 27, 1992 measurement date, general substance over form principles will continue to apply.[49]

> Example (2): Corporation P owns 100% of corporation S's outstanding stock, which has a fair market value of $1,000,000. S issues to unrelated individual X, in reasonable compensation for X's services, a nontransferable

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[48] Revenue Ruling 82-150, 1982-2 C.B. 110 (corporation that acquires, for a purchase price of $70, an option with an exercise price of $30 to acquire stock worth $100 "has assumed the benefits and burdens of ownership" of the underlying stock and therefore is treated as the actual owner of the stock); Revenue Ruling 83-98, 1983-2 C.B. 40 (adjustable rate convertible notes that are purchased for $1,000, worth $600 at maturity, and convertible at any time into stock currently worth $1,000 are treated as stock because of "the very high probability" of conversion into stock).

[49] The Preamble (under "Background") also states: "Although the proposed regulations do not treat options as exercised for any other purpose, no inference is intended that options will not be treated as stock or as exercised under other provisions of the Code or regulations, or other principles of law." We interpret this language simply as a clarification that the Proposed Regulations have no bearing on the treatment of options for purposes other than section 1504 affiliation.

option to acquire 50% of S's stock (on a fully diluted basis) for an exercise price of $1. There are two possible results under the Proposed Regulations. One is that the Proposed Regulations are wholly inapplicable, because under substance over form principles X would be treated as owning actual stock, so that the instrument would not be a "call option" for purposes of section 1.1504-4(d)(1)(i) (nor would the instrument be an interest in corporate growth covered by section 1.1504-4(d)(1)(ii), since it is "stock itself"). Under that analysis, P and S would be disaffiliated, since P would be considered to own only 50% of S's stock. X's "option" would be treated as stock for other tax purposes as well. Alternatively, if the Proposed Regulations override general substance over form principles, the instrument would be viewed literally as a "call option." If so (and assuming the option were not considered a "device" under the regulations in their present form), the option would be treated as an exempt compensatory option described in section 1.1504-4 (d) (2) (v).[50] In that case, the instrument would be respected as an option for affiliation purposes (thus preserving P-S affiliation) but would be treated as stock for other tax purposes.[51]

On one hand, to apply general substance over form principles to options already covered by the Proposed Regulations would complicate analysis and create uncertainty, particularly in

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[50] Even a deep-in-the-money option that does not satisfy a safe harbor would not be deemed exercised under the Proposed Regulations if the tax positions of the parties are such that there is no reasonable anticipation at issuance that the issuance of the option in lieu of the underlying stock could eliminate a substantial amount of federal income tax liability.

[51] Cf. Ginsburg & Levin, supra note 41, at 92 n. 31, 93 n. 33.

the case of instruments whose classification is less obvious than the deep-in-the-money arrangements described in Revenue Rulings 82-150 and 83-98. The absence of clear guidance would undermine in some instances the ability of taxpayers to rely on the safe harbors and the other objective tests contained in the Proposed Regulations.

On the other hand, treating an option as such for affiliation purposes but as stock for other purposes of the Code may lead to anomalous results. Moreover, given the economic equivalence between stock and deep-in-the-money options, ignoring substance over form principles for affiliation purposes would permit, for affiliation purposes, arbitrary formal distinctions between economically identical arrangements.

On balance, we believe that the importance of ignoring arbitrary formal distinctions of this type outweighs any resulting uncertainty under these regulations. Therefore, we recommend that the final regulations specifically provide (in lieu of a “device” exception whose scope is unclear) that substance over form principles will continue to apply to instruments that in form are “options” within the meaning of the regulations but under general tax principles would be treated as stock. Moreover, because case law concerning deep-in-the-money options is inconsistent and could lead to results considerably more lenient for taxpayers than the above rulings would,[52] we

[52] See, e.g., Victorson v. Commissioner, 326 F.2d 264 (2d Cir. 1964) (respecting the form of a stock option with an exercise price equal to 0.2% of the underlying stock's fair market value on the grant date); Simmons v. Commissioner, 23 TCM 1423 (1964) (same where the exercise price was 0.1% stock value on the grant date).

recommend that the final regulations expressly provide that, for purposes of section 1504, general tax principles will be considered to include the principles of Revenue Rulings 82-150 and 83-98 (regarding deep-in-the-money options).

B. Exercise Test.

Section 1.1504-4(b)(2) provides that an option will be treated as exercised if, (i) on any "measurement date," (ii) it could reasonably be anticipated that, if not for the operation of these regulations, the issuance or transfer of the option in lieu of the issuance or transfer of the underlying stock will result in the elimination of a substantial amount of federal income tax liability, and (iii) it is reasonably certain that the option will be exercised.

1. Measurement Date. Section 1.1504-4(c)(4) defines "measurement date" with respect to an option to include any date on which any one of the following occurs: (1) an issuance or transfer of the option (subject to safe harbors), (2) a modification of the option or the underlying stock (subject to safe harbors) or (3) a transaction that alters the capital structure or stock value of the issuing corporation for a principal purpose of increasing the likelihood of exercise. Section 1.1504-4(c) (4) (iv) provides that in the case of "related or sequential options" (as defined in section 1.1504-4(c) (2)), a measurement date for any of the options constitutes a measurement date for all such options outstanding on the measurement date. These triggering events are discussed separately below.

a. issuance and transfer. An option is tested on any date on which it is issued or transferred, subject to three safe harbors. Section 1.1504-4(c)(4)(ii) provides that, "except where used as a device to avoid the application of section 1504 and [the Proposed Regulations]," a measurement date does not include a date on which an option is issued or transferred:

(i) by gift, at death, or between spouses,

(ii) between members of an affiliated group (determined without regard to the Proposed Regulations), whether or not the affiliated group of the issuing corporation, or

(iii) between persons none of which is "related" to any member of the issuing corporation's affiliated group (determined without regard to the exceptions of section 1504(b) and without regard to the Proposed Regulations).

For purposes of the third safe harbor (and the Proposed Regulations generally), persons are "related" if they are related within the meaning of section 267(b) or 707(b)(1), substituting "10 percent" for "50 percent" wherever it appears.

(1) Scope generally. The Committee believes that the definition of "measurement date" is broader than is necessary to curb the abuses that the Proposed Regulations are intended to address.

The Proposed Regulations are intended to prevent taxpayers from circumventing, through an issuance or transfer of options rather than stock, the requirement that a corporate

subsidiary may be included in an affiliated group only if other members of the affiliated group own at least 80% of the subsidiary's stock by vote and by value. Accordingly, the option, if it is a call option, must be issued by (or otherwise relate to stock held by) a member of the issuing corporation's affiliated group, and if it is a put option, must be held by (or otherwise be exercisable with respect to stock held by) a member of the issuing corporation's affiliated group. For this reason, the Proposed Regulations sensibly treat an issuance or transfer of an option between a member of the issuing corporation's affiliated group and a non-member as giving rise to a measurement date.

The Proposed Regulations go much beyond this, however, by treating any issuance or transfer by or to a person “related” to any member of the issuing corporation's affiliated group as giving rise to a measurement date unless the transferor and transferee belong to the same affiliated group.

> Example (3): The stock of corporation S is owned 80% by corporation P and 10% by each of two individuals, A and B, who are not otherwise related to P, S or each other. S issues to unrelated individual C an option to acquire 1% of S's stock. Assume the option does not satisfy any safe harbor to the option definition, but that the option, because it is not in-the-money and for other reasons, is not treated as exercised at issuance. C, without S's knowledge, later transfers the option to A. A, as a 10% shareholder of S, is “related” to S. Therefore, the transfer causes a measurement date under the Proposed Regulations, jeopardizing continued consolidation of S.

Example (4): Same as the preceding example, except that C transfers the option to D, an individual who owns 15% of the stock of P and otherwise is not related to any of P, S, A, B or C. Since D indirectly owns 12% of S's stock (i.e., 15% of 80%), the transfer date is a measurement date, as in the preceding example.

Expanding the scope of issuances and transfers of options that give rise to a measurement date to include not only an issuance or transfer between a member and a non-member of the issuing corporation's affiliated group, but also an issuance or transfer involving a person “related” to any member of the group (as well as any other transfer that may be a “device”) appears to be justified in the limited circumstance in which the related person (or other person) is used as a conduit for the transfer of the option by or to a member of the issuing corporation's affiliated group. Thus, for example, in the absence of a related person rule, S in Example (3) above could issue an option to A on terms that make it not reasonably certain to be exercised, for the purpose of “warehousing” the option for subsequent transfer by A to an unrelated person at a time when the option is in the money.

Similarly, in the absence of a “device” or similar test, S might issue the option to an unrelated person for warehousing with the understanding that the option would be transferred to S's designee at a future date. At the same time, it is difficult to imagine how a transfer of an option between unrelated persons could be abusive unless one of those persons were acting in concert with a member of the issuing corporation's affiliated group.

As Examples (3) and (4) illustrate, however, in the Proposed Regulations as drafted, the related person rule can result in the somewhat harsh consequence of deconsolidating the issuing corporation from its affiliated group as a result of actions taken by persons with as little as a 10% direct or indirect equity stake in the issuing corporation, which actions the issuer's affiliated group cannot control and may not even have reason to know about (unless the issuer imposes strict transfer restrictions on any option that does not qualify for a permanent safe harbor). Moreover, treating such a broad range of transfers involving related persons as measurement dates creates a substantial risk that an option which is issued in a nonabusive context may at a later date, as a result (for example) of changes in the financial or tax position of the issuing corporation, have characteristics that will cause it to be deemed exercised. Given the anti-abuse purpose of the regulations, this seems inconsistent with the initial conclusion that the option was not reasonably certain to be exercised when issued, which arguably should be sufficient to demonstrate no abuse in most circumstances. Finally, the potential frequency of measurement dates creates complexity and tax planning uncertainty.

For these reasons, the Committee strongly urges that Treasury reduce the scope of potential post-issuance measurement dates with respect to options that are not deemed exercised at the time of issuance. In particular, we recommend that “measurement date” be defined to include only dates on which an option is issued or transferred (i) between the issuing corporation (or any member of its affiliated group) and a nonmember of such group and (ii) by or to any person that is

"related" to (or acting in concert with) any member of the issuing corporation's affiliated group (other than an issuance or transfer between two corporate affiliates) if the issuance or transfer is pursuant to a plan a principal purpose of which is to avoid the application of section 1504.[53] But for the conduit concept and the anti-abuse limitation in clause (ii) above, this provision is identical to the measurement date concept in the Proposed Regulations.

(2) Device test. Section 1.1504-4(c)(4)(ii) provides that the safe harbors to the general treatment of an issuance or transfer as a measurement date will not apply where the issuance or transfer is considered to be a "device" to avoid the application of section 1504. The Proposed Regulations offer no guidance as to what would constitute a device in this context or what abuses the rule is designed to prevent.

As discussed above in III.A.2.a(l), we believe that a general "device" exception to safe harbors is so vague that it substantially removes any comfort which taxpayers might otherwise derive from the safe harbors. As discussed immediately above, we believe that revising section 1.1504-4 (c) (4) (ii) (B) to include a more precise and objective anti-abuse restriction will adequately prevent the use of that safe harbor to circumvent

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[53] The approach summarized in the text could be implemented by revising section 1.1504-4(c)(4)(ii)(B)(2) to read as follows:

> "(2) Between persons none of which is a member of the affiliated group of which the issuing corporation is a member (determined without regard to the exceptions provided in section 1504(b) and without the application of this section), unless (A) any such person is related to (or acting in concert with) any member of such affiliated group and (B) the issuance or transfer is pursuant to a plan a principal purpose of which is to avoid the application of section 1504 and this section."

section 1504 without interfering with legitimate transactions. Moreover, the other safe harbors of section 1.1504-4(c) (4) (ii), as further discussed in III.B.1.b below, are so narrow that they pose no apparent abuse potential. Accordingly, we recommend eliminating the device exception of section 1.1504-4(c) (4) (ii).

However, if an anti-abuse exception is retained with respect to any of the safe harbors in section 1.1504-4(c)(4)(ii), we recommend that the final regulations provide a clearer standard than the current "device" exception and give examples of its application.

(3) Definition of "related person." Under section 1.1504-4(c)(4)(ii)(B)(2), the transfer of an option between two parties, if neither is "related" to the issuing corporation or to any member of its affiliated group, will not give rise to a measurement date (subject to a device exception). Section 1.1504-4(c)(3) defines "related persons" as persons related within the meaning of section 267(b) or 707(b)(1), substituting 10% for 50% wherever it appears. Two aspects of the "related person" definition seem unnecessarily broad, thereby causing an unreasonable proliferation of measurement dates.

First, the definition incorporates the rules of section 267(b), which in turn (through section 267(f)) incorporate the rules of section 1563 to determine whether two corporations are related. The attribution rules of section 1563(e) provide that a corporation is deemed to own any stock that it has an option to acquire. Thus, the safe harbor described above literally is inapplicable to any transfer by (or to) a corporation of an option to buy at least 10% of another corporation's stock, since

the first corporation will be related to the second corporation before (or after) the transfer. The current result under the Proposed Regulations is that, unless the transferor and transferee are affiliates, virtually every issuance or transfer of a 10%-or-more call option by or to any corporation (other than the issuing corporation) will give rise to a measurement date.

Presumably this result is unintended. Testing an option merely because it is an option with respect to a significant amount of stock defeats the purpose of the related person concept and is overbroad. Moreover, because this option attribution rule applies only for determining relatedness between. corporations, it creates an irrational distinction between the treatment of corporations and the treatment of other persons. That is, there is no reason for the issuance or transfer of a 10% option to give rise to a measurement date merely because one of the parties is a corporation rather than an individual or a partnership, for example. Consequently, we recommend that the definition of related person be amended to exclude the option attribution rule of section 1563(e) (l).

Second, section 267(c)(3), which is incorporated by reference in the “related person” definition, treats an individual who owns some stock of the issuing corporation or its affiliates as owning in addition any stock that is owned by any partner such individual may have in related or unrelated partnerships. We believe that any attempts to circumvent section 1504 through the use of partnership arrangements are adequately addressed by defining “related persons” to include persons related under section 267(b)(10) and 707(b)(1). The partner attribution rule of section 267(c) has always been a trap for the

unwary, and it is difficult to see how it furthers the anti-abuse purpose of the Proposed Regulations. Accordingly, we recommend that whether persons are related under section 1.1504-4(c)(3) be determined without regard to the partner attribution rule of section 267(c) (3).[54]

b. Modification. In addition to issuances and transfers, any modification of the terms of an option or the stock underlying such option will trigger a measurement date, subject to two safe harbors.

First, section 1.1504-4(c)(4)(ii)(D) provides that a change in the exercise price of an option or in the number of shares which may be issued or transferred pursuant to the option will not cause a measurement date if such change is determined pursuant to "a bona fide, reasonable adjustment formula" which prevents dilution of the interests of the option holders. This safe harbor does not apply, however, if the modification "is used as a device to avoid the application of section 1504 and this section" (section 1.1504-4(c) (4) (ii)). Given the requirement that the adjustment formula be "bona fide" and "reasonable," it is not apparent how this safe harbor might be used abusively. Accordingly, we recommend that the final regulations either eliminate the "device" exception with respect to this safe harbor or provide guidance regarding the sort of device that is contemplated.

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[54] We also believe the 10% relatedness threshold is extremely low for purposes of the "measurement date" definition in its current form. However, the harsh effects of the low threshold would be ameliorated significantly by amending the basic measurement date definition as described in the text at III.B.1.a.(1) above.

Second, subject to the same "device" exception, section 1.1504-4(c)(4)(ii)(C) provides that a modification to an option or the underlying stock that is "insignificant (i.e., a change that does not increase the likelihood that the option will be exercised)" will not trigger a measurement date. We have several comments to this safe harbor. Again, since modifications that do not increase the likelihood of exercise would appear by definition to be nonabusive, we recommend either eliminating the device exception with respect to this safe harbor or clarifying what might constitute a device in this context. In addition, unless "insignificant" is intended to have a meaning different from that expressed in the parenthetical immediately following it (which appears not to be the case), this provision would be somewhat clearer if the term "insignificant" were deleted and the applicable standard were merely the words used in the parenthetical.

Finally, in order to avoid unnecessarily frequent measurement dates and to adequately reflect the original intent not to test "unimportant" modifications, we recommend that the final regulations take account only of modifications that "materially" increase the likelihood of exercise. Often it may be difficult to know the precise effect of a modification on likelihood of exercise. An innocent modification that increases such likelihood by a de minimis amount should not trigger a measurement date. Otherwise, for example, if the option happened to be sufficiently in the money on the measurement date for reasons unrelated to the modification (e.g., normal market fluctuations in stock value), a deemed exercise could occur, a result which seems inconsistent with the anti-abuse purpose of the regulations. Such a materiality standard also would be

consistent with the analogous regime of section 1.1361-1(1)(4)(iii) (which provides that, in determining whether an option constitutes a second class of stock for section 1361 purposes, only "material" modifications of the option terms trigger a measurement date).

Regarding modifications generally, we recommend that the final regulations clarify that, even if an option is modified to such an extent that there is a deemed reissuance under section 1001 or other general tax principles, the option will not be treated as newly issued for section 1504 purposes. The modification rules of the Proposed Regulations already identify the universe of modifications that could be abusive. To permit other (invariably nonabusive) modifications to trigger measurement dates under general tax principles could nullify the safe harbor protection of 1.1504-4(c)(4)(ii)(C) (exempting modifications not increasing the likelihood of exercise). Moreover, the 1991 Cottage Savings case (under which a deemed reissuance could occur under section 1001 if the original option and the option as modified confer on the holder "legal entitlements that are different in kind or extent") adds further uncertainty to the determination of when modification of an option will cause a deemed reissuance under general tax principles.[55]

This deemed reissuance problem could arise, for example, with respect to outstanding convertible debt. If the terms of such debt were modified in a way that made conversion less likely

[55] Cottage Savings Association v. Commissioner, 91-1 USTC 50,187 (S.Ct. 1991).

to occur, such debt could be deemed newly issued under general tax principles, even though there should be no measurement date by virtue of the modification safe harbor of section 1.1504-4(c)(4)(ii)(C).[56]

c. "Transactions increasing the likelihood of exercise": "related or sequential options." We have no comments to these provisions (sections 1.1504-4(c)(2) and -4(c)(4)(iii) - (v)).

2. Elimination of a Substantial Amount of Federal Income Tax Liability. Under section 1.1504-4(b)(2), an option is not treated as exercised unless, on a measurement date, "[i]t could reasonably be anticipated that, if not for this section, the issuance or transfer of the option in lieu of the issuance or transfer of the underlying stock will result in the elimination of a substantial amount of federal income tax liability."

a. In general. We believe that in most cases this provision, because it requires assessing all relevant facts and circumstances, including the likelihood of unknown future events, will prove too subjective and elusive for taxpayers to rely on it for planning purposes. Nevertheless, its inclusion thoughtfully implements the anti-abuse purpose of the Proposed Regulations, protecting certain "innocent" taxpayers with respect to options that fail to satisfy any safe harbor and are considered reasonably certain to be exercised as of a measurement

[56] See, e.g., Revenue Ruling 89-122, 1989-2 C.B. 200 (change in the stated principal amount or the interest rate of a debt instrument is a material modification resulting in a deemed exchange of old bonds for new bonds under section 1001); Revenue Ruling 87-19, 1987-1 C.B. 249 (waiver by noteholder of right to receive a higher interest rate under an interest adjustment clause is a material change resulting in a deemed exchange under section 1001).

date. It should be noted that this test almost always will be satisfied where the issuing corporation ("S") and its historic parent expect to net income against losses (either losses carried forward or losses to be generated) in the future, unless the option covers 80% of S's stock and an actual sale of the underlying stock in lieu of issuing the option would give rise to a new affiliated group that would receive a comparable tax benefit.

b. "Substantial amount." Section 1.1504-4 (f) provides that all facts and circumstances are to be considered in determining if the amount of federal income tax liability that is eliminated by the issuance of options rather than stock is "substantial." The facts and circumstances to be considered include the absolute amount of the elimination, the amount of the elimination relative to the overall tax liability, and the timing of items of income and deductions (taking into account present value concepts). The Preamble adds that "an elimination of $10,000 in current tax liability may be substantial for one affiliated group, but not for a group with a much greater tax liability." Requiring "substantial" anticipated tax savings as a condition to treating an option as exercised is consistent with the anti-abuse purpose of the Proposed Regulations. While limiting the test in this way is helpful, however, the "substantial" prong of the deemed exercise test, because of its subjective and relative nature, is likely to comfort taxpayers only in relatively rare instances.

c. "Elimination of federal income tax liability." Section 1.1504-4(e) describes what constitutes "elimination of federal income tax liability" for purposes of the deemed exercise test. In determining whether tax liability is eliminated, "the tax consequences to all involved parties are considered."

Section 1.1504-4(e) defines “elimination” to include both elimination and deferral of federal income tax liability, giving as an example of elimination “the deferral of gain or income to a year later than the year in which the gain or income would otherwise be reported.” However, expressly excluded from the elimination concept is “the deferral of gain with respect to the stock” underlying the option that would be recognized if such stock were sold in lieu of the option. This makes sense, because the deferral of gain with respect to the underlying stock is not a benefit arising from continued consolidation per se, but rather is merely a consequence of not making a current sale. Therefore the deferral of such gain should not be regarded as an abuse of section 1504. Moreover, as a practical matter, the elimination test would be satisfied automatically in many or most cases (and hence become meaningless) if such deferred gain were taken into account.

The final regulations should address, by example or otherwise, the related issue of whether deferral of gain that would be triggered with respect to an excess loss account (“ELA”) in the underlying stock as a result of deconsolidation should be considered in testing for elimination of federal income tax liability. On the one hand, the Proposed Regulations specifically exclude “the deferral of gain with respect to the stock,” and an ELA is analogous to a negative basis in the optioned stock. Therefore, it would appear arbitrary to ignore gain attributable to the excess of stock value over positive stock basis while taking account of income includible upon deconsolidation with respect to an ELA. On the other hand, in contrast to deferring gain attributable to stock value in excess of positive stock basis, deferring gain with respect to an ELA is a benefit

deriving from consolidation per se. We recommend that the final regulations also clarify, by example or otherwise, the treatment of deferred intercompany gain.

It seems reasonably clear under the Proposed Regulations that the "elimination" determination takes into account statutory or other limitations on the ability of the relevant affiliated group to benefit from consolidation. For example, a realistic assessment of whether either the "selling" group or (if either the person who would acquire the stock on exercise is a corporation, or the issuing corporation itself has subsidiaries) the "buying" group would benefit from consolidation would need to consider any applicable restrictions (both existing restrictions and those that would arise if the option were deemed exercised) on the use of net operating loss carryovers imposed under section 382 and the separate return limitation year regulations, and on the use of built-in gains under section 384. The final regulations might include an example considering the effects of such restrictions in evaluating whether tax liability has been eliminated (or they might include at least a reference that such limitations will be considered).

The requirement that "the tax consequences to all involved parties are considered" in determining whether tax liability would be eliminated creates certain administrative difficulties. Under this requirement, any person wishing to satisfy itself (or to build a record for its files) that substantial tax liabilities are not likely to be eliminated will need to know the tax positions of several parties. Such knowledge may be difficult to acquire in typical commercial transactions.

This is a further indication that taxpayers may not derive much comfort from the tax elimination prong of the deemed exercised test.

d. "Reasonable anticipation." An option will not be considered exercised unless, on a measurement date, the elimination of a substantial amount of federal income tax liability "could reasonably be anticipated." As the examples in the Preamble and in section 1.1504-4(h) illustrate, making this determination requires taxpayers to make projections regarding future income and expenses, the extent to which tax benefits would expire unused if consolidation were broken, etc. This requirement raises two difficulties.

First, needless to say, events might unfold quite differently than the parties "reasonably anticipated" on the measurement date. The Service, applying hindsight, might use such a disparity as evidence that the original projections were not, in fact, reasonable.

Second, the "could reasonably be anticipated" standard seems to be a less-than-50% standard, since the same set of facts might support multiple predictions as to future tax consequences. Therefore, it appears insufficient for the parties merely to reasonably "anticipate" or "expect," based on the available data, that continued consolidation will not eliminate substantial tax liability (although this is what some of the examples suggest[57]),

[57] See section 1.1504-4(h), Example 2; Preamble, second example under "Elimination ...."

because this would not necessarily preclude a finding, based on the same data, that substantial tax savings "could" be reasonably anticipated.[58]

In light of these concerns, and in order to better enable taxpayers to apply this prong of the tax elimination test, it would be helpful if the final regulations provided additional guidance as to the burden of proof required for demonstrating the projected tax effect of the option arrangement. The above difficulties of course would be alleviated to the extent the number of measurement dates is minimized (as discussed in III.B.1.a above).

3. Reasonable Certainty of Exercise. An option will not be treated as exercised under the Proposed Regulations on any measurement date unless, as of that measurement date, it is "reasonably certain to be exercised" based on all the facts and circumstances.[59] The Proposed Regulations provide safe harbors for this test.[60]

a. "Reasonable certainty" standard. we commend Treasury's decision to adopt a standard more generous for taxpayers than what was required by the enabling legislation or

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[58] To address the second concern, we considered recommending that the reasonable anticipation test be inverted to provide that an option would not be deemed exercised if it could be reasonably anticipated that the issuance or transfer of the option rather than the underlying stock would not result in the elimination of a substantial elimination of federal income tax liability. However, we rejected that suggestion because we believe that such a standard would limit excessively the Service's ability to attack abusive options.

[59] Sections 1.1504-4(b)(2)(i), -4(g)(1).

[60] Section 1.1504-4(g) (2).

suggested by the legislative history.[61] A high exercise threshold, such as the "reasonable certainty" standard, is appropriate, particularly given the treatment of many post-issuance transfers as measurement dates (rather than testing options at issuance only), as well as the difficulty of taxpayer reliance on the elusive tax "elimination" prong of the deemed exercise test. In addition, we believe that this standard adequately serves the anti-abuse purpose of the Proposed Regulations.

By way of comparison, recently published section 1.1361-1(1)(4)(iii) treats an option as a second class of stock for Subchapter S purposes only if it is "substantially certain to be exercised." Although consideration might be given to conforming the section 1504 standard to the section 1361 standard as a small step towards simplicity and uniformity, on balance we believe that a substantial certainty standard would be unreasonable high and therefore do not recommend such a change.

However, the final regulations might provide additional guidance on the application of the reasonable certainty standard. In this regard, the Preamble states that an option will be considered reasonably certain to be exercised "only if a strong probability exists that the option will be exercised."

Regarding the application of the reasonable certainty of exercise test to an "option" whose exercise does not require any outlay of cash or property by the holder (e.g., cash settlement option, phantom stock, etc.), see III.A.l.c above.

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[61] The 1984 Conference Report (at 834) states that "[i]f it can reasonably be expected that [the option holder] will exercise the option, the regulations may treat the option as having been exercised" (emphasis added).

b. Relevant factors. Section 1.1504-4(g)(l) provides a useful nonexclusive list of factors to be taken into account in determining reasonable certainty of exercise:

(i) the purchase price of the option,

(ii) whether and to what extent the option is in or out of the money on the measurement date,

(iii) the exercise price of the option (and whether the exercise price is fixed or fluctuates based on the issuing corporation's “economic performance”),

(iv) when the option is exercisable,

(v) whether the option is part of a series of related or sequential options,

(vi) whether the person who would acquire the stock on exercise (or any related person) has stockholder-like managerial or economic rights with respect to the issuing corporation (as further discussed below),

(vii) the existence of restrictive covenants or similar arrangements limiting directly or indirectly the ability of the issuing corporation to pay dividends, borrow funds, or take certain other actions while the option is outstanding,

(ix) whether there is any intention to take certain actions that would alter the fair market value of the issuing corporation's stock for “a principal purpose” of increasing the likelihood of exercise, and

(x) whether any contingencies (other than the passage of time) must be satisfied before the option may be exercised.[62]

Most of the above factors go directly to the question whether the option is likely to be exercised. Some, however, focus on whether stockholder-like benefits are associated with the option. Since a principal purpose of these regulations is to treat as exercised options that resemble stock, the presence of stockholder-like benefits should be deemed to increase the likelihood of exercise. As a practical matter, however, their presence may decrease the likelihood of exercise by essentially putting the option holder in the position of a stockholder prior to exercise. For example, if the person who would acquire the stock on exercise of an option has extensive stockholder-like "managerial or economic rights" in connection with the option (section 1.1504-4(g)(1)(vii)), the option should be considered more likely to be exercised for section 1504 purposes. In practice, however, the possession of such rights prior to exercise may produce a disincentive to exercise, because actual exercise would not yield additional benefits. Similarly, to the extent restrictive covenants imposed on the issuing corporation while an option is outstanding (section 1.1504-4(g)(l)(viii)) provide anti-dilution or other protection for the option holder, the holder may be less inclined to exercise than in the absence of such protection. Because of possible conflicting interpretations, the final regulations might clarify that factors

[62] For a discussion of the application of certain of the listed factors in the examples appearing in section 1.1504-4(h), see III.B.3.d below.

of this type will be considered to increase, not decrease, the likelihood of option exercise for section 1504 purposes.[63]

Regarding the stockholder rights provision of section 1.1504-4(g) (1) (vii), if an option holder also owns stock of the issuing corporation, the possession of stockholder rights attributable to such stock literally could be viewed under the current regulatory language as "[t]he existence of an arrangement (... in a related agreement) that ... affords managerial or economic rights in the issuing corporation that ordinarily would be afforded to owners of the issuing corporation's stock." In some circumstances it may be difficult to distinguish rights appropriately accorded to a taxpayer in its capacity as an actual stockholder from rights that are economically connected with an option held by such taxpayer. Such difficulties could arise, for example, in connection with a charter or shareholder agreement that requires a supermajority director or shareholder vote as a condition to taking certain corporate actions. Nevertheless, an option holder's ownership of stock is not in itself abusive, nor are supermajority provisions which protect minority shareholders. Accordingly, we recommend that the regulations clarify that rights arising from bona fide stock ownership by an option holder or related person will not be attributed to the option for purposes of this provision.

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[63] Treating essentially as exercised certain options that significantly resemble stock is consistent with the Service's approach prior to the issuance of the Proposed Regulations. See, e.g., Revenue Rulings 83-98 and 82-150 (discussed in III.A.3 above).

c. Safe harbors. Section 1.1504-4(g)(2) contains two safe harbors. If an option meets the requirements of either safe harbor on a measurement date, the option will not be considered reasonably certain to be exercised on that measurement date.

(1) 24-month option safe harbor. Subject to the exceptions described in (3) below, an option to acquire stock will satisfy the first safe harbor if (i) it must be exercised within 24 months of the measurement date (i.e., not necessarily the option issue date), (ii) in the case of an option to acquire stock, its exercise price is not less than 90% of the fair market value of the underlying stock on the measurement date and (iii) in the case of an option to sell stock, its exercise price is not greater than 110% of the fair market value of the stock on the measurement date. Because this safe harbor takes into account stock value on the measurement date, changes in market conditions or other factors may cause an option that initially satisfies the safe harbor to fail it (and hence possibly be deemed exercised) on a subsequent measurement date.

> Example (5): On 1/1/93, corporation S issues an option exercisable at any time within three years, i.e., until 12/31/95. The option has a fixed exercise price equal to the fair market value of the underlying stock at the time of grant. The option is transferred on 1/1/94, when its exercise price is equal to 90% of stock fair value, and again on 7/1/94, when its exercise price is equal 75% of stock fair value. Assume that the issue date and both transfer dates are measurement dates (and that none of the exceptions to safe harbor protection described in (3) below apply).

On issuance, the option does not qualify for the above safe harbor, because the option may be exercised more than 24 months after the measurement date. Because the option fails the safe harbor, whether it is reasonably certain to be exercised will depend on all relevant facts. Assume that, because the option is not in the money at issuance and for other reasons, it is not considered reasonably certain to be exercised at issuance. On 1/1/94, the first transfer date, the option will satisfy the safe harbor, because it must be exercised within 24 months of that date and it satisfies the 90% test. Therefore, even though the option is in the money at that time, it will not be considered reasonably certain to be exercised. However, on 7/1/94, the second transfer date, the option will fail the safe harbor, because it fails the 90% test. Therefore, whether is considered reasonably certain to be exercised will depend on all relevant facts.

The Proposed Regulations do not indicate how to determine the fair market value of the underlying stock on the measurement date for purposes of this safe harbor. In the similar context of the section 1361 second class of stock rules, section 1.1361-1(1) (4) (iii) (C) (containing an analogous 90% safe harbor for call options) provides that “a good faith determination of fair market value ... will be respected unless it can be shown that the value was substantially in error or the determination of the value was not performed with reasonable diligence to obtain a fair value.” Similarly, the valuation rule of section 1.1504-4(g)(2)(iii), which applies for purposes of the fair-market-value-at-exercise safe harbor discussed below, respects “a bona fide attempt to arrive at fair market value.” We recommend that the final regulations adopt a similar standard or otherwise provide guidance on this issue.

In addition, this safe harbor seems to apply to any option that meets the requirements on the measurement date, even if the terms of the option provide that the exercise price will decline (in the case of a call option) or increase (in the case of a put option) over time.[64] This inappropriate result might be addressed in the call option case, for example, by revising the applicable safe harbor to read as follows:

> "(A) The option must be exercised no more than 24 months after the measurement date and the minimum exercise price from the measurement date forward (determined without regard to adjustments described in section 1.1504-4(c)(4)(ii)(C) and (D)) is not less than 90 percent of the fair market value of the underlying stock on the measurement date."

(2) Fair market value at exercise safe harbor. Under the second safe harbor, subject to the exceptions described in (3) below, an option will not be considered reasonably certain to be exercised as of a measurement date if, by its terms, the exercise price of the option is (i) in the case of an option to acquire stock, not less than the fair market value of the underlying stock on the exercise date and (ii) in the case of an option to sell stock, not greater than the fair market value of the underlying stock on the exercise date. This exception is sensible, because the holder of an option whose exercise price fluctuates directly with the value of the underlying stock has no market incentive to exercise and bears none of the economic benefits or burdens of stock ownership. In contrast to the first

[64] This observation also applies to the comparable safe harbor for call options in section 1.1361-1(1) (4) (iii) (C).

safe harbor, this safe harbor is based on the terms of the option itself. Therefore, if it is satisfied at issuance, it should continue to be satisfied on each subsequent measurement date (assuming the option is not modified).

For purposes of this safe harbor, section 1.1504-4(g)(2)(iii) provides that an option whose exercise price is determined by a formula will be considered to have a fair market value exercise price "if the formula is agreed upon by the parties when the option is issued in a bona fide attempt to arrive at fair market value on the exercise date and is to be applied based upon the facts and circumstances in existence on the exercise date." This definition makes this safe harbor particularly useful in connection with conventional buy-sell agreements among shareholders, which typically determine exercise price by a formula based on either book value at the time of exercise or a multiple of recent earnings.[65] In addition, presumably this safe harbor would apply to a right of first refusal.

(3) Exceptions to safe harbors. Section 1.1504-4(g)(2)(iv) provides that the above safe harbors will not apply in any of the three circumstances described below. First, they will not apply if an arrangement exists that provides the option holder with stockholder rights described in section 1.1504- 4(g)(1)(vii) (i.e., "managerial or economic rights" that ordinarily would be afforded to stockholders of the issuing

[65] Cf. section 2703; section 20.2031-2(h). In determining whether a buy-sell agreement will determine the value of stock for estate tax purposes under section 2703, the 1990 Act Conference Report, H.R. Rep. No. 5835, 101st Cong., 2d Sess. 157 (1990), explicitly recognized that "general business practice may recognize more than one valuation methodology, even within the same industry."

corporation), other than rights arising upon a default under the option or a related agreement. We have several comments to this exception. As discussed in III.B.3.b above, the final regulations should clarify that such rights arising from bona fide stock ownership by the person who would acquire the stock on exercise or a related person will not be attributed to the option for purposes of this provision. This conclusion is implicit in Example 3 of section 1.1504-4(h), which treats a call option issued to a 10% shareholder as satisfying the 24-month safe harbor. However, the regulatory language itself should be clear on the point. In addition, this stockholder rights exception does not track the language of section 1.1504-4(g) (1) (vii) exactly in that it literally does not cover stockholder rights held by a person "related" to the holder. Thus it would permit such rights to be held by someone substantially related to the holder, which presumably is not intended. If stockholder rights held by a related person are intended to be covered by the exception, the final regulations should clarify this, subject to the above comment regarding exclusion of rights held in a person's capacity as a stockholder, as well as our comments regarding the scope of the "related person" definition (see III.B.1.a(3) above). Finally, the exception's use of the term "holder" does not cover put options; we suggest replacing it with the phrase appearing in section 1.1504-4(g)(1)(vii): "the person who would acquire the stock upon exercise of the option."

Second, the safe harbors will not apply on a measurement date if "[i]t is intended that through a change in the capital structure of the issuing corporation or a transfer of assets to or from the issuing corporation (other than regular, ordinary

dividends) or by any other means, the fair market value of the stock of the issuing corporation would be altered for a principal purpose of increasing the likelihood that the option would be exercised." This exception is similar to the language of section 1.1504-4(c)(4)(iii), which provides that the date of such a change will be a measurement date. Excluding from safe harbor protection an option that is issued with such intent reasonably prevents, for example, a corporation from issuing such an option in order to defer the deconsolidation event until the subsequent measurement date (i.e., the date of the actual capital structure change or asset transfer).

Third, the safe harbors will not apply to an option that is one in a series of "related or sequential options" unless all such options satisfy one of the safe harbors. We have no comments to this exception.

(4) Other possible safe harbors. We have considered other possible safe harbors to the reasonable certainty of exercise test. However, we believe that the Proposed Regulations generally afford adequate protection in the form of (i) the safe harbors to the "option" definition itself (subject to the modifications recommended in III.A above), which for the most part constitute permanent exemptions based on the option terms at issuance, and (ii) the facts and circumstances test that applies if an option fails to satisfy any safe harbor to the reasonable certainty of exercise test.[66]

[66] In this connection, section 1.1504-4(g)(2)(v) helpfully clarifies that an option's failure to satisfy any safe harbor will not effect the determination whether the option will be considered reasonably certain to be exercised.

For possible additional safe harbors covering poison pill rights and options created under a bankruptcy reorganization plan, see III.A.2.b above.

In the Preamble the Service "invites comments" regarding a safe harbor for convertible debt. For comments to the "option" definition safe harbor for publicly traded convertible debt, see III.A.2.a(3) above.

d. Examples. The Proposed Regulations provide limited guidance, in the form of three examples (found in section 1.1504- 4(h)), on the application of the facts and circumstances test in determining whether an option is reasonably certain to be exercised.

Example 5 sensibly concludes that where complementary put and call options are exercisable for the same exercise price and on the same date, either the put or the call is reasonably certain to be exercised. Example 6 merely stipulates that "the option will only be exercised if the new business venture succeeds" and therefore is not reasonably certain to be exercised.[67]

Example 1 concludes that an option, exercisable at any time, to acquire for $30 stock that is worth $40. when the option is issued, is reasonably certain to be exercised, even though the issuing corporation ("S") has had "substantial losses" for 5 consecutive years and is expected to continue its earnings history for several years more. This conclusion makes sense only

[67] Example 6 is consistent with the statement in the Preamble that "an option issued at the start-up of a venture, the exercise of which depends on the outcome of true business risks, such as the ultimate success of the venture, generally will be treated as not reasonably certain to be exercised."

if the $40 value ascribed to the S stock at issuance takes into account S's anticipated future losses, which would be the case assuming an efficient market. Otherwise, since S's expected losses, depending on their size, might quickly eliminate any bargain element in the option, the conclusion that the option is reasonably certain to be exercised would be questionable. This issue could be avoided altogether by revising the example to make S the profitable corporation and P, T and U all loss corporations. Such an arrangement would better support the conclusion, without any need for further explanation, that the option is reasonably certain to be exercised. Moreover, apart from minor conforming changes, it should not affect the rest of the analysis in Examples 1 and 2. Alternatively, Example 1 should be revised to clarify that the $40 stock value reflects S's anticipated expected future losses.

It would be helpful if the final regulations provided additional examples illustrating application of the facts and circumstances test. The examples in the Proposed Regulations described above all turn on exercise price and the risks inherent in a start-up venture. It would be particularly useful to have some guidance with respect to options subject to material contingencies other than the passage of time (e.g., options exercisable on obtaining regulatory approval, upon commencement of a public offering, etc.).

C. Effect of Treating an Option As Exercised.

1. In General. The deemed exercise of an option under the Proposed Regulations is relevant only for purposes of

determining whether a corporation is a member of an affiliated group.[68]

Regarding application of the deemed exercise test to an "option" that does not entitle the holder to acquire actual stock (e.g., cash settlement option, phantom stock, etc.), see III.A.1.c above. For the valuation and other implications of treating certain instruments as options subject to exercise rather than as actual stock, see III.A.1.a, .b and .d above. For the scope of the Proposed Regulations generally, see III.D below.

2. Value Implications. If an option is treated as exercised, it is so treated for purposes of determining the relative percentages of the value of stock owned by the holder and the other parties.[69]

Section 1.1504-4(b)(2)(iii) provides that, for purposes of section 1504(a)(2)(B) (the basic 80% value test for affiliation) and the Proposed Regulations, "in determining the percentage of the value of stock owned, all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not to be taken into account." This rule on its face seems to apply for all purposes of section 1504(a) (2) (B), whether or not options are involved. If so, its scope is much broader that the other provisions of the Proposed Regulations. We suggest that the final regulations clarify the

[68] Section 1.1504-4(b)(2)(i).

[69] Section 1.1504-4 (b) (2) (ii) (A).

intended scope of the rule. It would seem arbitrary and, as a practical matter, difficult to limit such a rule to cases where options are deemed to be exercised under the Proposed Regulations. For example, if control premium and minority and blockage discount may be taken into account in the absence of options, the same corporation could be subject to different valuation principles for affiliation purposes depending on whether it had options outstanding at any particular time. In addition, if the rule is intended to apply for all purposes of section 1504(a)(2) (B), the effective date provisions should be appropriately revised, as discussed in III.E below.

3. Voting Power Implications. If an option is treated as exercised under the Proposed Regulations, it is so treated for purposes of determining the relative percentages of the voting power of stock owned by the parties "only if, under all the facts and circumstances, the person who would acquire the stock on exercise, or a related person, can, prior to exercise of the option, because of the existence of an arrangement (either within the option agreement or in a related agreement), direct the vote of the stock of the corporation."[70] By severely limiting in this manner the circumstances under which the person who would acquire the stock on exercise is considered to possess the voting power associated with such stock, the general effect of the deemed exercise rule is to break affiliation, not to create affiliation between the issuer and the person who would receive the stock on exercise. This regime is consistent with the typical economics of owning an option rather than stock and reasonably prevents taxpayers from using the deemed exercise rule as a tax planning device.

[70] Section 1.1504-4(b)(2)(ii)(B).

The language quoted above could be read literally to treat an option as fully exercised for voting power purposes if the person who would acquire the stock on exercise possesses any voting power prior to exercise, even if such voting power (i) is associated with stock acquired through an agreement "related" to the option agreement or (ii) represents less than all of the voting power associated with the stock underlying the option.

> Example (6): Corporation X acquires in a single transaction 20% of corporation S's outstanding stock and a call option on the remaining 80% of S's stock. X's voting rights with respect to S are limited to the 20% of S voting power represented by the stock actually owned by X. Presumably the deemed exercise of the option should not result in affiliation of X and S. However, since X literally can "direct the vote of stock of the corporation" pursuant to an "arrangement" in an agreement "related" to the option agreement, the deemed exercise rule arguably would treat the option as exercised for voting as well as for value purposes.

> Example (7): Corporation X owns an option to acquire 100% of corporation S's stock and, pursuant to the option agreement, can direct the vote as to 50% of such stock prior to exercise. Again, the Proposed Regulations arguably would cause X and S to become affiliated on deemed exercise of the option, although this should not be the result.

We suggest that the final regulations clarify that an option will be deemed exercised for voting power purposes only if the person who would acquire the stock on exercise "can, prior to exercise of the option, ..., direct the vote of stock possessing at least

80% of the total voting power of the stock of the issuing corporation." Alternatively, an option could be deemed exercised for voting power purposes "only to the extent that the person who would acquire the stock upon exercise ... can, prior to exercise of the option, ... direct the vote of the stock underlying the option."[71]

The Proposed Regulations deem voting power to be possessed by the person who would acquire the stock on exercise if such person or a "related person" can direct the stock vote. The ability of a corporation that holds an option to consolidate with the issuer in a situation where someone perhaps only tenuously related to the option holder possesses the requisite 80% voting power seems inconsistent with the basic affiliation rule of section 1504:

> Example (8): Corporation P owns 100% of corporation S's outstanding stock. P grants corporation X an option to acquire 80% of S's stock. In addition, P enters into an arrangement with individual A, a 10% shareholder of X, permitting A, for so long as the option is outstanding, to direct the vote with respect to stock underlying the option. If the option were deemed to be exercised, the voting rule of section 1.1504-4(b)(2)(ii)(B) apparently would cause S and X to be affiliated. This is because A, who is "related" to X, can direct the vote as to 80% of S's stock prior to exercise. Therefore, upon deemed exercise of the option, X should be considered to own 80% of S's stock by vote and by

[71] Cf. the similar issue in connection with the stockholder rights concept used in the reasonable certainty of exercise test, discussed in III.B.3.b and III.B.3.c(3) above.

value. In contrast, if, in lieu of the option, X had purchased nonvoting S stock representing 80% of S's stock value, and S had granted A an irrevocable right to vote 80% of S's stock for some period of time, it is questionable whether S and X would qualify for section 1504 affiliation.[72]

In order to address this issue, we recommend that the final regulations, for purposes of determining whether an option is exercised for voting purposes, take into account only voting rights held by the person who would acquire the stock on exercise and any member of that person's affiliated group (rather than every "related person").

Apparently an option involving the redemption of shares (see III.A.1.e above) would never be deemed exercised for voting purposes under the Proposed Regulations as drafted (unless the "related person" rule applies), because "the person who would acquire the stock upon exercise" is the issuing corporation, not the person whose stock ownership would increase upon the deemed exercise of the option.

Example (9): Corporation P owns 8% of the stock of corporation S, and the remaining 92% of S's stock is owned by 23 4%-shareholders. P, under a redemption agreement with S and the other shareholders, has the right to compel S to redeem all of S's outstanding shares held by the shareholders other than P. P is not otherwise related to S or any other shareholder. Assume that the redemption

[72] See, e.g., Rev. Rul. 72-72, 1972-1 C.B. 104 (stock is not "voting stock" for "B" reorganization purposes where the sole shareholder of the corporation issuing the stock retained a 5-year irrevocable voting right with respect to the stock).

agreement is treated as an option that is deemed exercised under the Proposed Regulations, so that P is treated as owning all of S's stock for stock value purposes. Assume also that the redemption agreement permits P to vote all of S's outstanding shares prior to P's exercise of its rights under the redemption agreement. Logically P should be treated as owning all of S's stock for voting as well as value purposes. Under the Proposed Regulations, however, the option would not be deemed exercised for voting purposes, because, although P holds the voting rights, S, not P, is "the person who would acquire the stock on exercise."

This problem might be addressed by changing the phrase "the person who would acquire the stock upon exercise" to read "the person whose percentage interest in stock value would increase upon exercise."

4. Post-Disaffiliation Events.

a. Lapse or forfeiture of option. The Proposed Regulations do not address the treatment of an option that lapses or is forfeited after having been deemed exercised. If the deemed exercise of the option caused deconsolidation of the issuing corporation, section 1504(a)(3) generally will prevent such corporation from rejoining the affiliated group before the 61st month beginning after its first taxable in which it ceased to be a member of the group. However, section 1504(a)(3)(B) authorizes the Secretary to waive application of the 61-month rule for any period subject to such conditions as the Secretary may prescribe,

and Rev. Proc. 90-53[73] grants an automatic waiver of the 61-month rule to taxpayers that comply with its requirements. Accordingly, assuming compliance with Rev. Proc. 90-53, the Proposed Regulations implicitly permit immediate reconsolidation upon lapse of the option that caused the deconsolidation.

Generally, however, the lapse or forfeiture of an option without payment strongly suggests that the option holder genuinely intended to acquire an option rather than stock of the issuing corporation and that the option was not issued merely to defer potential deconsolidation. In such a case, the application of the Proposed Regulations in the first instance seems unduly harsh. In a similar context, section 1.382-2T(h)(4)(viii) provides that, if an option is treated as exercised for section 382 purposes and then lapses unexercised or is forfeited, the option is treated as never having been issued, and the taxpayer may amend its prior tax returns accordingly (subject to any applicable statute of limitations). In the section 1504 context, because lapse or forfeiture of an option tends to controvert the original conclusion that the option was reasonably certain to be exercised and that there was an abuse motive, we recommend that Treasury consider incorporating in the final section 1504(a)(5) regulations a similar rule for options deemed exercised thereunder. The scope of such a rule might be limited to a lapse or forfeiture that occurs within a specified period after the deemed exercise date, such as two or three years.

b. Retesting an option. Although the Proposed Regulations do not address the point directly, they seem to provide that once an option is deemed to be exercised on any

[73] 1990-2 C.B. 636.

measurement date, it will be treated as exercised for as long as the option remains outstanding.[74] This is so even if, on a subsequent measurement date, had the option been tested independently, it would not have been deemed exercised.

This result seems arbitrary, because the parties, on such a later measurement date, arguably could eliminate the effect of the prior deemed exercise (without necessarily altering the basic economics of the option arrangement) by cancelling the original option and issuing a new and similar but materially different option which, standing alone, would not be deemed exercised.[75]

In order to reconcile the apparently inconsistent treatment of the above two economically similar arrangements, we recommend that Treasury consider providing in the final regulations that an option that is deemed to have been exercised

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[74] See section 1.1504-4(b)(2)(i) ("an option is treated as exercised if, on a measurement date with respect to such option ....").

[75] Even if the original option and the new option are treated as "related or sequential options" under section 1.1504-4(c)(2), apparently they would be analyzed separately under the deemed exercised rule of section 1.1504-4(b)(2), so that the deemed exercise of the original option should not cause the successor option to be treated as exercised. Moreover, although section 1.1504-4(g)(1)(vi) identifies as a relevant factor in applying the reasonable certainty test "whether the option is one in a series of related or sequential options," it seems implausible that an option which, standing alone, is not reasonably certain to be exercised, would be treated as reasonably certain to be exercised merely because it succeeds an option which, at some earlier time, was deemed exercised.

The above analysis (including the conclusion in the text) assumes that the modification is significant enough that the new option will be treated as a new issuance and not merely as a continuation of the old option. See III.B.1.b above. If the new option were treated as a continuation of the old option, the modification either would simply give rise to a new measurement date with respect to the old option (if the modification increased the likelihood of exercise) or would have no impact at all under the Proposed Regulations. See section 1.1504-4(c)(4).

will continue to be tested on subsequent measurement dates. Under this approach, if upon a subsequent measurement date the option is not deemed exercised, then the issuing corporation (assuming it was deconsolidated as a result of the original deemed exercised) could reconsolidate, subject to section 1504(a)(3) and the automatic waiver provision of Rev. Proc. 9053. Alternatively, the final regulations should clarify that deemed exercise is permanent (subject to lapse or redemption of the option), regardless of option status on subsequent measurement dates.

c. Stock escrow or Pledge. For a discussion of the recovery of stock that actually has been transferred pursuant to an escrow, pledge or other security agreement, see III.A.2.a(5) above.

D. Scope of Proposed Regulations Generally.

1. In General. Except as otherwise provided by regulations or other guidance, the Proposed Regulations apply to all provisions under the Code and regulations to which affiliation within the meaning of section 1504 is relevant.[76]

2. Not Applicable to Sections 382(1)(5) or 864. Section 1.1504-4(a)(2) excludes from the application of the Proposed Regulations sections 382(1)(5) and 864 and the regulations thereunder. Recently issued final regulations under section 382(1)(5) already apply carefully tailored option attribution rules to determine whether qualifying creditors and

[76] Section 1.1504-4(a)(1).

shareholders own at least 50% of the loss corporation's stock (determined by reference to the rules of section 1504(a)(2)) immediately after a section 3 82 ownership change and hence entitle the loss corporation to relief from the section 382 loss limitation rules.[77] Similarly, the interest expense allocation regulations promulgated under section 864, which generally require allocating expenses incurred by a corporation among all members of its affiliated group by reference to their respective assets, expressly apply the option attribution rules of section 318 in determining whether two corporations are affiliated for this purpose.[78] Given the presence of independent option attribution rules in both cases, it is sensible to exclude these provisions from the scope of the Proposed Regulations.

It is less clear why the Proposed Regulations should not apply to determine affiliation for purposes of sourcing noninterest expense among affiliated group members under section 864, since the relevant regulations contain no independent attribution rules.[79]

Clarification should be provided as to the interrelationship between the Proposed Regulations and section l.163(j)-5(a)(3), which applies the option rules of section 318 for purposes of applying the interest-stripping rules of section 163 (j) to certain unaffiliated corporations. Presumably the

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[77] See section 1.382-3(e).

[78] See section 1.861-11T(d)(6); proposed regulations section 1.861-11(d).

[79] See section 1.861-14T(d); proposed regulations section 1.861-14(d).

Proposed Regulations should not apply in that situation notwithstanding the reference in the earnings stripping regulation to section 1504(b).

E. Effective Dates.

Under section 1.1504-4(i), the Proposed Regulations are proposed to apply generally to options with a measurement date on or after February 28, 1992. They would not apply, however, to options issued before February 28, 1992 that have a measurement date on or after February 28, 1992, if such measurement date occurs solely because the option is modified pursuant to the terms of the option as it existed on February 28, 1992.

We question the reasonableness of Treasury's issuance of the Proposed Regulations in proposed form with an immediate effective date. The issuance of the Proposed Regulations in proposed form rather than as temporary regulations deprives taxpayers of the ability to rely on the Proposed Regulations (except in avoiding penalties) to the extent the rules are favorable. At the same time, the adoption of an immediate effective date requires taxpayers to take the Proposed Regulations seriously to the extent the rules are adverse. We believe it is unfair to place taxpayers in such a position in the absence of a compelling need.

If the valuation rule of section 1.1504-4(b) (2) (iii) (discussed in III.D.2 above) is to apply for all purposes of section 1504(a)(2)(B), whether or not related to options, the effective date provision, which by its terms applies the Proposed Regulations only to “options,” should be appropriately expanded.