REPORT #751

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED SECTION 382 OPTION ATTRIBUTION RULES

Prepared by the Committee on Net Operating Losses

February 18, 1993

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TAX SECTION
New York State Bar Association

February 26, 1993

Michael P. Dolan
Acting Commissioner
Internal Revenue Service
1111 Constitution Ave. NW
Washington, D.C. 20224

Dear Commissioner Dolan:

I am pleased to enclose a report of the Committee on Net Operating Losses dealing with recently proposed Treasury regulations regarding option attribution under Section 382 of the Internal Revenue Code. The report's principal draftsman was Andrew Feiner.

Section 382 of the Code, as amended by the Tax Reform Act of 1986, has proved extremely difficult to deal with in practice. Among the areas of greatest complexity and uncertainty are the option attribution rules currently contained in Temporary Treasury Regulation §1.382-2T(h)(4). These rules treat options in a particularly complex and often perverse way, resulting in deemed owner shifts that do not reflect actual or likely beneficial ownership in the loss corporation's stock. In addition, particularly because of their "evergreen" features, these rules are almost impossible to apply in a public company context.

The recent Proposed Regulations are a marked improvement on the current rules. By limiting attribution to options issued or transferred for an "abusive principal purpose" the proposed regulations properly restrict the ambit of the option attribution rule to transactions designed to escape

Section 382 limitations. The Proposed Regulations add a degree of objectivity to the abusive principal purpose standard by enumerating factors relevant to the existence of such a purpose.

The enclosed report strongly supports the approach reflected in the Proposed Regulations. Under the Proposed Regulations, loss corporations will generally be able to ignore the impact of options in applying Section 382 except where the presence of an objective factor suggests tax avoidance modification. Accordingly, we believe that the Proposed Regulations represent a major simplification.

While fully agreeing with the philosophy in the Proposed Regulations, the report offers certain suggestions for clarifying the application of the abusive principal purpose text. Thus, the report suggests that one factor cited in the Proposed Regulations -- whether the loss corporation receives a capital contribution in connection with the issuance or transfer of the option -- should generally be ignored. The report also suggests that an option not be considered to have an exercise price substantially below fair market value if its exercise price is not less than 90% of fair market value on the date of issue or transfer.

The report also makes suggestions regarding the mechanics of the proposed option rule, including the treatment of options which are determined to have been issued for an abusive principal purpose, the treatment of options which have been deemed exercised on an earlier testing date, and the interrelationship between the new option rule and proposed new “segregation” rules contained in Proposed Regulation §1.382-3(j).

Finally, the report recommends that taxpayers be permitted to elect the application of the proposed option rules for testing dates before November 5, 1992, provided that disclosure is made sufficient to apprise the Service of the invocation of these of new rules.

We hope the enclosed report will be of assistance. We would be happy to meet with you and your representatives to discuss our comments.

Very truly yours,

Peter C. Canellos
Chair

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Tax Report #751

REPORT ON PROPOSED SECTION 382 OPTION ATTRIBUTION RULES

Prepared by the Committee on Net Operating Losses
New York State Bar Association
Tax Section

February 18, 1993

Report on Proposed Section 382 Option Attribution Rules

This report[1] discusses proposed Treasury Regulation § 1.382-4, dealing with option attribution under S 382 of the Internal Revenue Code of 1986, as amended (the "Code"). This report also discusses those portions of proposed § 1.382-3(j) that deal with options. Both sets of proposed regulations apply in determining whether an ownership change occurs under § 382.

I. BACKGROUND

Section 382 of the Code[2] limits the use of net operating losses following an "ownership change" of a loss corporation. Certain stock attribution rules apply in determining whether an ownership change has occurred. In particular, S 382(1)(3)(A)(iv) of the Code provides that "except to the extent provided in regulations, an option to acquire stock shall be treated as exercised if such exercise results in an ownership change."

In 1987, the Service promulgated temporary regulations implementing § 382(1)(3)(A)(iv). These regulations generally followed the statutory approach of deeming an option exercised

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[1] This report was prepared by a subcommittee of the Committee on Net Operating Losses, chaired by Andrew Feiner and including Matthew Brady, Jeffrey Cole, Brian Gallagher, Stuart Goldring, Abraham Gutwein, Kenneth Heitner and Richard Stern. Helpful comments were received from Herbert Camp, Peter Canellos, John Corry, James Peaslee, Yaron Reich, Richard Reinhold, David Sachs, Michael Schler, Kenneth Silbergleit, Eugene Vogel, David Watts and Ralph Winger.

[2] References are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

whenever the consequence would be to cause an ownership change,[3] This general rule was relatively easy to describe. However, because of its extraordinary breadth, it produced harsh results at times and was unwieldy to apply.

Many problems with the option rules of the temporary regulations resulted from the breadth of the definition of an option and from the fact that options are deemed exercised without regard to whether they are contingent, presently exercisable or have been outstanding for longer than the three year S 382 testing period. Another problem was the administrative difficulty of selectively deeming options exercised in the combination that produced the worst possible results.[4]

After studying the experience of the Service and taxpayers under the temporary regulations, the Service recently proposed regulations that take a significantly different approach to option attribution. We believe that the proposed regulations are a vast improvement over the temporary regulations and applaud the Service's efforts to simplify option attribution. In this report, we will briefly summarize the proposed regulations and provide general and specific comments.

II. SUMMARY OF THE PROPOSED REGULATIONS

The proposed regulations do not alter the definition of an option. Options therefore continue to include contingent

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[3] See Temp. Treas. Reg. § 1.382-2T(h)(4)(i) ("Solely for the purpose of determining whether there is an ownership change on any testing date, stock of the loss corporation that is subject to an option shall be treated as acquired on any such date, pursuant to an exercise of the option by its owner on that date, if such deemed exercise would result in an ownership change").

[4] See, e.g., Goldring & Feiner, Section 382 Ownership Change: Option Attribution, 66 Taxes 803 (1988).

purchase rights, warrants, convertible debt, puts, stock subject to a risk of forfeiture, contracts to acquire stock, and "similar interests".[5] Under the proposed regulations, however, convertible stock generally is not an option unless the terms of the conversion feature permit or require the tender of consideration other than the stock being converted.[6]

In contrast to the temporary regulations, the proposed regulations do not automatically treat an option as exercised in determining whether an ownership change occurs.[7] Rather, an option is treated as exercised only if it is issued or transferred "for an abusive principal purpose."[8] An option may be deemed exercised on the testing date on which it is issued or transferred or on any subsequent testing date (unless it was previously deemed exercised and was not thereafter transferred for an abusive principal purpose).

The regulations define an "abusive principal purpose" as a principal purpose of manipulating the timing of an owner shift to avoid or ameliorate the impact of an ownership change either by providing the holder of the option prior to exercise with a substantial portion of the attributes of ownership of the underlying stock or by facilitating the creation of income to absorb losses prior to the exercise of the option.[9] This definition appears to require subjective intent to alter the timing or minimize the impact of an ownership change through the

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[5] Prop. Treas. Reg. § 1.382-4(d)(3)(i).

[6] Prop. Treas. Reg. § 1.382-(d)(3)(ii). Convertible stock instead would be "stock" for § 382 purposes. See Prop. Treas. Reg. § 1.382-2(a)(3)(ii).

[7] See Prop. Treas. Reg. § 1.382-4(d)(1).

[8] Prop. Treas. Reg. § 1.382-4(d)(2)(i).

[9] Prop. Treas. Reg. § 1.382-4(d)(2)(ii).

use of an option. However, the determination of whether subjective intent exists is based on "all relevant facts and circumstances,"[10] including the following list of objective factors (individually and collectively referred to hereafter as the "Factors"):

1. The option has an exercise price that is substantially below the fair market value of the underlying stock on the date the option is issued or transferred.

2. The option, or an agreement entered into in connection with its issuance or transfer, entitles the holder to participate in management (other than through a bona fide employment arrangement).

3. The option gives the holder rights ordinarily afforded to shareholders (e.g., dividend rights).

4. In connection with acquiring a call option with respect to stock of the loss corporation, the acquiror (or a related person) issues a put option to the issuer of the call (or a related person).

5. In connection with issuance or transfer of the option, the loss corporation receives a capital contribution -- in exchange for stock or otherwise.

6. In connection with the issuance or transfer of the option, the loss corporation engages in transactions to accelerate income into the period prior to exercise of the

[10] Prop. Treas. Reg. S 1.382-4(d)(iii)(A).

option or to defer deduction, loss or credit until afterward.[11]

If any of the Factors applies to an option, but the loss corporation does not treat the option as exercised, it must disclose its treatment of the option on a statement attached to its tax return. The presence of a Factor does not give rise to a presumption that an abusive purpose exists, however.[12]

The deemed exercise rule of the proposed regulations does not apply to certain transfers of options. Specifically, it does not apply to transfers between persons who are not 5% shareholders, between members of separate public groups resulting from application of the segregation rules, or in the circumstances listed in § 382(1)(3)(B) (transfers by gift, in trust, upon death, between spouses or incident to divorce). Therefore, options transferred between these people or in these circumstances are not deemed exercised even if the transfer was made for an abusive purpose. This provides similar treatment to that accorded by paragraphs (e)(1)(ii) and (h)(4)(xi) of Temp. Treas. Reg. § 1.382-2T to transfers of stock and options under the temporary regulations.

If an abusive option is treated as exercised on a testing date on which an ownership change occurs, the option will not be deemed exercised again on a subsequent testing date, so long as it is not subsequently transferred for an abusive principal purpose. In addition, the actual exercise of the option by the person who held it immediately after the ownership change

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[11] Prop. Treas. Reg. § 1.382-4(d)(2)(iii)(B).

[12] Cf. Treas. Reg. § 1.707-3(c) (contribution of property to a partnership, followed within two years by a distribution of such property to another partner is presumptively treated as a deemed sale of the property).

will not cause a second ownership change.[13] This rule is referred to herein as the “before and after” rule.

If an option is actually exercised within three years after being treated as exercised in connection with an ownership change, then, in determining whether another ownership change occurs on a later testing date, the loss corporation can treat the option as if it had been actually exercised on the date of the prior ownership change. This rule is referred to herein as the “alternate look-back” rule. The practical effect of this rule is to treat stock subject to the option as outstanding from the date of the first ownership change in determining whether a second ownership change occurs. A consequence of this rule is that a transfer of the option after the change date is treated as a transfer of the underlying stock, even if the transfer is made for a nonabusive purpose.[14]

The Service and the Treasury have requested comment on whether an option that is issued or transferred for an abusive principal purpose should be deemed exercised on the date of issuance or transfer for the purpose of determining whether an ownership change occurs on a subsequent date, with corresponding rules that would treat the transfer, lapse or forfeiture of the option as a transfer of the underlying stock. (It is not clear whether this possible approach would be limited to issuances or transfers that caused an ownership change.)

At the time the proposed option rules were issued, amendments also were proposed to the segregation rules of the

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[13] Prop. Treas. Reg. § 1.382-4(d)(4)(i).

[14] Prop. Treas. Reg. S 1.382-4(d)(4)(ii).

temporary regulations.[15] These proposed amendments would provide exceptions under which segregation would not apply to "small issuances" and "cash issuances."

The small issuance exception generally would apply to issuances during a taxable year that add up to less than the "small issuance limitation." Issuances of stock to 5% shareholders would count in determining whether the small issuance limitation was exceeded.[16] The loss corporation could elect for the small issuance limitation to be either (i) 10% by value of the loss corporation stock outstanding at the beginning of the year (other than § 1504(a)(4) stock) or (ii) 10% by number of shares of the class of stock of which the issued shares were a part that were outstanding at the beginning of the year.

Under the cash issuance exception, if a loss corporation issues stock for cash, the segregation rules do not apply to a percentage of the issued stock equal to one- half of the percentage of the total loss corporation stock that was owned by less-than-5% shareholders immediately before the issuance.[17] The cash issuance exception applies only after the small issuance exception has been applied. Stock issued to less-than-5% shareholders that is exempt from segregation under either the cash or small issuance exception is treated as acquired proportionately by the direct public groups that existed before the stock was issued.[18]

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15 Prop. Treas. Reg. § 1.382-3(j).

16 Prop. Treas. Reg. § 1.382-3(j)(2).

17 Prop. Treas. Reg. § 1.382-3(j)(3).

18 Prop. Treas. Reg. § 1.382-3(j)(5).

Under the temporary regulations, the issuance of options to less-than-5% shareholders is a segregation event.[19] The proposed segregation rules would apply the principles of the cash and small issuance exceptions if a segregation event resulted from the issuance of options to less-than-5% shareholders.[20]

The proposed segregation rules also amend the actual knowledge rules of the temporary regulations in a way that relates to option attribution. Under the temporary regulations, a loss corporation can reduce the owner shift that results from an issuance of stock to less-than-5% shareholders by showing cross-ownership between the segregated group that acquires stock in the offering and the loss corporation's pre-existing public group.[21] The proposed regulations amend this actual knowledge rule as it applies to an issuance of stock upon exercise of an option. As amended, actual knowledge would be taken into account only if the loss corporation knew that the person exercising the option was a pre-existing shareholder of the loss corporation. According to the preamble to the proposed regulations, the purpose of this amendment is to insure “equal treatment for stock offerings and pro rata distributions of transferable stock rights.”

The temporary regulations accorded dual status to convertible stock -- as both stock and an option. This uncertain state of affairs was remedied by Notice 88-67.[22] The notice announced that, effective for stock issued after July 20, 1988, convertible pure preferred stock (i.e., stock described in § 1504(a)(4)) would be treated as an option and not as stock and

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[19] Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(D).

[20] Prop. Treas. Reg. § 1.382-3(j)(9).

[21] Temp. Treas. Reg. § 1.382-2T(k)(2).

[22] 1988-1 C.B. 555.

any other convertible stock would be treated only as stock and not as an option (except, for convertible stock that permits or requires the tender of consideration other than the stock itself for conversion).[23] The proposed regulations confirm this treatment for periods prior to November 5, 1992. Thereafter, except to the extent different treatment is accorded under proposed transition rules for convertible stock, the proposed regulations would treat convertible stock as stock and not as an option, unless the tender of consideration other than the stock being converted is permitted or required to exercise the conversion feature, in which case the convertible stock is treated as both stock and an option.[24]

The proposed option attribution rules would apply to testing dates on or after November 5, 1992, generally without regard to when the options were issued or transferred.

III. SUMMARY OF RECOMMENDATIONS

A. The Service should publish a notice stating that a loss corporation is permitted to rely on the proposed regulations during the period from November 5, 1992 until the proposed regulations are either finalized or formally abandoned.

B. An election should be available to apply the proposed regulations on testing dates before November 5, 1992. If no election is provided, the Service should issue rulings to

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[23] Convertible stock issued before July 20, 1988 is treated as stock and not as an option unless the loss corporation expressly elects to retroactively apply Notice 88-67. The election must be filed by the later of (i) October 18, 1988 or (ii) the due date (including extensions) of the first § 382 information statement that must be filed with a loss corporation's annual tax return after June 20, 1988.

[24] Prop. Treas. Reg. § 1.382-2(a)(3)(ii); Prop. Treas. Reg. § 1.382-4(d)(3)(ii).

clarify the more important areas of uncertainty under the temporary regulations.

C. Final regulations should clarify that an option that is issued or transferred for an abusive principal purpose is not deemed exercised until an ownership change would occur simultaneously with the deemed exercise.

D. Regulations should expressly provide (as does Temp. Treas. Reg. § 382-2T(h)(4)(vii)) that, when an option to acquire newly issued stock is deemed exercised, the stock subject to the option is treated as outstanding for the purpose of measuring the owner shifts during the testing period (with similar rules for options to redeem stock).

E. Once an option has been deemed exercised, it should be treated as equivalent to the underlying stock unless the option lapses or is forfeited within five years after it was issued, in which case the option should be treated as if it was never issued. If this suggestion is adopted, the before and after rule of Prop. Treas. Reg. § 1.382-4(d)(i) and the alternative look-back rule of Prop. Treas. Reg. § 1.382-4(d)(4)(ii) can be eliminated.

F. Final regulations should clarify that an option that is issued or transferred for an abusive purpose retains its abusive taint until it is deemed exercised in connection with an ownership change.

G. If final regulations do not adopt the Committee's recommendation E, above (that an option that is deemed exercised be treated as stock), and Prop. Treas. Reg. § 1.382-4(d)(4)(i)(B) is therefore retained, it should be clarified that, after an

option has been deemed exercised, the actual exercise of the option will neither cause nor contribute to a second ownership change. If the option that was deemed exercised is to acquire newly issued stock (and the alternative look-back rule is not applied), the stock subject to the option should be treated as outstanding from the date the option is actually exercised, for the purpose of determining whether a second ownership change occurs.

H. Final regulations should clarify whose subjective intent is relevant in determining whether an abusive principal purpose exists. When an option is issued by the loss corporation or a direct or indirect loss corporation shareholder, the abusive intent of either the issuer or the loss corporation should taint the option. For an option on a significant percentage of the loss corporation's stock, the holder's intention also might be considered relevant. In the case of a transfer of an option, the intent of either the transferor or the transferee should taint the option.

I. Final regulations should clarify that an option will not be treated as conveying substantial attributes of ownership of the underlying stock merely because it has a fixed exercise price. Furthermore, an option should be treated as per se nonabusive if the exercise price fluctuates so as to be equal to the fair market value of the underlying stock on the date of exercise.

J. Final regulations should clarify that managerial and economic rights held by an optionholder in its capacity as a shareholder will not be taken into account in determining whether an option is issued or transferred for an abusive purpose.

K. As a safe harbor, an option should not be viewed as having an exercise price substantially below the fair market value of the underlying stock if the exercise price is at least 90% of the fair market value of the underlying stock on the date the option is issued or transferred. A good faith determination of value should be respected for this purpose.

L. The Committee recommends that Factor (5) be eliminated or that it apply only to transfers and not issuances of options. At a minimum, Factor (5) should apply only if at least one other Factor is present. If, however, Factor (5) is retained, an exception should be made for options having customary terms that are sold to less-than-5% shareholders, unless at least one other Factor is present. Additionally, an example should be provided which clarifies that a capital contribution does not include a loan.

M. Prop. Treas. Reg. § 1.382-4(d)(5) and Temp. Treas. Reg. §§ 1.382-2T(e)(1)(ii) and (h)(4)(xi) should be revised to apply only to transfers between less-than-5% shareholders that are direct shareholders of the same entity or that would be direct shareholders of the same entity if their options were treated as exercised. Transfers between persons that are less-than-5% shareholders of the loss corporation by attribution from different entities should not be exempt (e.g. a transfer of loss corporation stock from a first tier entity owned exclusively by less-than-5% shareholders to a direct less-than-5% shareholder of the loss corporation).

N. Prop. Treas. Reg. § 1.382-4(d)(6) requires that a loss corporation disclose the existence of an option that satisfies one or more of the Factors, but that the loss corporation does not treat as exercised. While the Committee does

not necessarily think a penalty for failure to comply is appropriate, taxpayers are entitled to know if one is intended. In considering whether a penalty is appropriate, attention should be paid to the fact that failure to disclose an option that was not believed to be abusive will be inadvertent in many cases. Moreover, final regulations under § 382 should state that no negative inference will be drawn from an inadvertent failure to comply with one or more of the § 382 disclosure requirements.

O. The Committee recommends that principles similar to those in the proposed regulations apply in determining whether the continuity of ownership requirement of § 382(1)(5) is satisfied. Thus, options that are issued or transferred for an abusive principal purpose would be deemed exercised if they are issued or transferred to persons that do not receive the options in their capacity as pre-change shareholders and qualified creditors. For this purpose, in addition to the Factors, abuse would be indicated by the issuance or transfer of an option to a person that is not a pre-change shareholder or qualified creditor, if the sum of the amount paid for the option and the exercise price is not at least 10% greater than the fair market value of the underlying stock on the effective date of the bankruptcy plan.

P. When the proposed segregation rules are finalized, they should provide that the cash and small issuance exceptions will not apply to the issuance of options on any testing date to which the proposed option regulations apply.

Q. Prop. Treas. Reg. § 1.382-3(j)(5)(ii)(B) amends the actual knowledge rule of the temporary regulations to conform the treatment of pro rata rights offerings and stock offerings. The proposed amendment does not achieve its intended purpose,

however, due to technical problems described below. To fix the problem at which the proposed regulations were directed, regulations should bar the use of the pro rata exercise presumption (Temp. Treas. Reg. § 1.382- 2T(j)(2)(iii)(F)) to supply actual knowledge of cross-ownership between public groups upon exercise of an option. Instead, the pro rata exercise presumption should serve only as a tracing rule to determine from which public group the person exercising the option came (it would presume that shares previously owned by a less-than-5% shareholder that acquires additional stock by exercising an option were owned proportionately by the public groups that existed immediately before the option exercise).

R. Final regulations should provide that the owner shift that results from deeming an option exercised should be measured on the assumption that all of the loss corporation's stock (including stock deemed to be issued on the deemed exercise of the option) has the value it would have if it were outstanding on the date the option is deemed exercised -- without adjustment for payment of the option exercise price and, in the case of publicly traded stock only, without adjustment for dilution.

S. Final regulations should clarify that the transition rules for characterizing convertible stock issued before November 5, 1992 apply on testing dates after November 5, 1992.

IV. DISCUSSION

A. Effective Date Provisions

The proposed regulations generally would apply to testing dates after November 4, 1992. Because the rules are not

final, however, reliance on them is risky. On the other hand, a loss corporation cannot safely ignore the proposed rules because they will be effective from November 5, 1992 if they are ultimately finalized. It is therefore necessary to comply with both the temporary and the proposed rules from November 5, 1992 until the proposed rules are either finalized or abandoned. Compliance with the temporary regulations was burdensome enough when they were the only rules that applied. The proposed rules add to that already formidable burden. The problem is not a substantive one, as it is hard to complain about rules that do no more than prevent abusive transactions. Rather, the problem is the administrative burden of having to track owner shifts under two sets of rules.

The Committee believes that taxpayers should be allowed to rely on the proposed regulations after November 4, 1992. Accordingly, the Committee suggests that the Service publish a notice stating that a loss corporation can rely on the proposed regulations during the period from November 5, 1992 until the proposed regulations are either finalized or formally abandoned. Alternatively, the Service should allow taxpayers an election to rely on the temporary regulations until the proposed regulations are finalized.

Because the proposed regulations do not address the treatment of taxpayers in periods before November 5, 1992, it is important that significant areas of uncertainty in the temporary regulations be clarified. For example, certain very common business transactions, most notably pledges and buy-sell agreements (to the extent not exempt under narrowly drawn

regulatory exceptions[25]), may be options that could be deemed exercised under the temporary regulations. These common business arrangements may have inadvertently caused ownership changes for numerous taxpayers.

For that reason, the Committee believes that the proposed regulations should address the treatment of taxpayers for periods prior to November 5, 1992. The simplest way to do that would be to allow taxpayers an election to apply the proposed regulations retroactively. That approach was taken with the segregation rules (discussed above) that were proposed simultaneously with the option rules.[26]

Retroactive application of the proposed option rules would, as a practical matter, resolve the ambiguities of prior law by allowing those who acted without a tax avoidance motive to escape the effects of the deemed exercise rule. Because some taxpayers may have relied on the temporary regulations, however, it would be unfair to require that the proposed option rules be applied retroactively. Accordingly, retroactivity should be elective.

Retroactive application of the proposed regulations would require certain conforming changes. For example, the alternative look-back rule would be unavailable, as a practical

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[25] See Temp. Treas. Reg. § 1.382-2T(h)(4)(x)(D), (H). The safe harbor in the regulations excluded buy-sell rights triggered by irreconcilable differences among shareholders. Buy-sell rights triggered by the retirement of an owner were exempt from the deemed exercise rule, but only if the agreement was between noncorporate owners active in the conduct of the corporation's business and was entered into before the corporation became a loss corporation.

[26] Cf. Prop. Treas. Reg. § 1.382-3(j)(13)(ii) (providing an election to retroactively apply the proposed segregation rules).

matter, if a three-year statute of limitations prevented a loss corporation from amending tax returns to apply the rule. Accordingly, it would be necessary to waive the normal limitations period to permit application of the look-back rule (if that rule is retained).

In addition, special rules would be necessary with regard to disclosure obligations. Ordinarily, if a Factor is present and the taxpayer does not treat an option as exercised, it must disclose its treatment of the option on a statement accompanying its tax return. If a taxpayer elects retroactive application of the regulations, it should be required either to file this statement promptly upon making the election or, if an amended return is necessary in connection with election, to file the statement with the amended return.

At hearings on the proposed regulations, the Service expressed concern that it would be administratively difficult to determine, years after an option was issued or transferred, what the taxpayer's intention was at the time of issuance or transfer. The Committee notes that an audit ordinarily occurs many years after the circumstances that are the subject of the audit, especially when a company with net operating losses is involved. Making the proposed regulations retroactive would no doubt add a few years to that time gap. However, that difference does not justify denying the benefits of the proposed regulations to taxpayers who were unfortunate enough to have had ownership changes triggered by options before the November 5, 1992 cut-off date.

If the Service declines to make the proposed regulations retroactive, the Committee believes that published rulings or, where necessary, amendments to the temporary regulations should

be issued to clarify significant areas of ambiguity in the temporary regulations. The Committee would be pleased to assist the Service in developing a list of areas that should be addressed by such rulings.

B. The Deemed Exercise and Before and After Rules

Under the proposed regulations, an abusive option is treated as exercised for the purpose of determining whether an ownership change occurs at the time the option is issued or transferred or on a subsequent testing date.[27] Consistent with the statutory language of § 382,[28] the proposed regulations strongly imply -- but do not clearly state -- that the abusive option is treated as exercised only if an ownership change would occur on the deemed exercise date.[29] The intent to treat the option as exercised only if an ownership change occurs is indicated by the fact that the "before and after" rule of Prop. Treas. Reg. § 1.382-4(d)(4)(i) would be unnecessary to prevent an option from being deemed exercised a second time if the holder was treated as owning the underlying stock after the option was first deemed exercised. Also, the limitations on the alternative

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[27] The operative provision, Prop. Treas. Reg. § 1.382- 4(d)(2), reads as follows:

> An option that is issued or transferred for an abusive principal purpose is treated as exercised for purposes of determining whether an ownership change occurs on the date of its issuance or transfer, respectively, and, except as provided in paragraph (d)(4) of this section, on any subsequent testing date (as defined in section 1.382-2(a)(4)).

[28] See § 382(1)(3)(A)(iv).

[29] A positive effect of treating abusive options as exercised when first issued or transferred is that it would eliminate the "evergreen" effect of options under the temporary regulations. While we approve of limiting the evergreen effect of options, it is not at all clear that the proposed regulations intended to do so.

look-back rule (e.g., that the option must be actually exercised within three years) would be nullified if the deemed exercise of an option upon issuance or transfer carried forward to subsequent testing dates whether or not those limitations were satisfied.[30]

Thus, although the proposed regulations strongly suggest that an abusive option is treated as exercised only if an ownership change occurs, it would be helpful if final regulations made that point expressly. Final regulations could do so by stating that an abusive option is treated as exercised on the first testing date that it is outstanding on which an ownership change occurs (regardless of whether the deemed exercise of the option was necessary to cause the ownership change).

Final regulations also should expressly provide that, in testing whether the deemed exercise of an abusive option causes an ownership change, unissued stock subject to the option will be treated as outstanding (with similar rules for options to redeem stock).[31]

1. An Abusive Option That is Deemed Exercised Should Thereafter Be Treated as Stock

The Service and the Treasury requested comment on whether, if an option is treated as exercised upon issuance or transfer, regulations should treat the transfer, lapse, or

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[30] Final regulations should expressly provide that a formal election is not required to apply the alternative look-back rule (if that rule is retained despite the Committee's suggestion to treat an abusive option as stock after it is deemed exercised). Rather, if the requirements of the alternative look-back rule are satisfied, the loss corporation should be free to apply the rule or not (and to change its mind about whether to apply the rule from one testing date to another).

[31] See Temp. Reg. § 1.382-2T(h)(4)(vii).

forfeiture of the option as a transfer of the underlying stock. Such a rule presumably would treat the underlying stock as issued and subsequently redeemed if the option is repurchased, forfeited or lapses unexercised.

Because different issues are raised by a rule that would treat the transfer of an option as equivalent to a transfer of the underlying stock and one that would treat the lapse or forfeiture of the option as an issuance and redemption of the underlying stock, the two issues are discussed separately.

a. Transfers

In deciding whether an option should be treated as equivalent to the underlying stock after it is deemed exercised, it is helpful to begin by looking at what difference such a rule would make. Under the proposed rules as currently written, if the alternative look-back rule applies, an option is treated as equivalent to underlying stock after it is deemed exercised.[32] Even without the alternative look-back rule, there are many situations in which it would make no difference to treat the option as stock. For example, the before and after rule would not apply if an option was transferred for an abusive purpose (after being deemed exercised in connection with an ownership change).[33] Thus, the option could be deemed exercised a second time. That is the same result that would occur if the option were treated as stock and the "deemed stock" were transferred.

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[32] See Prop. Treas. Reg. § 1.382-4(d)(4)(ii) and text accompanying note 14, supra.

[33] See Prop. Treas. Reg. § 1.382-4(d)(4)(i) and text accompanying note 13, supra.

There appear to be only two circumstances in which a different result would be reached by treating an abusive option as stock. The first is a transfer of the option for a nonabusive purpose after it is deemed exercised in connection with an ownership change. In this circumstance, it usually would be detrimental for the loss corporation to treat the option as stock because a transfer of the “deemed stock” would be a shift, regardless of its purpose, while a transfer of the option would be a shift only if it had an abusive purpose.

The second circumstance in which it would make a difference to treat an option as stock after it is deemed exercised is in measuring owner shifts after an ownership change when the alternative look-back rule does not apply (either at the loss corporation's choice or because the requirements of the look-back rule are not satisfied). Here, the loss corporation generally would be helped by treating the option as stock because that would increase the number of outstanding shares against which shifts were measured. By contrast, under the proposed regulations, the option would increase the outstanding shares only if the requirements for the alternative look-back rule were satisfied.

The proposed rules could be simplified if a deemed exercised option were treated as stock because there would be no need for either the before and after rule or the alternative look-back rule. The result provided by those rules would be achieved by simply treating the option as stock. The main effect of this change is that a nonabusive transfer of the option would be an owner shift. The Committee believes that the benefits of simplification outweigh any injustice in treating the nonabusive transfer as a shift. The Committee notes that the option was deemed exercised only because it was issued or transferred for an

abusive purpose in the first place. The Committee therefore recommends that an abusive option be treated as equivalent to the underlying stock after it is deemed exercised and, if that recommendation is adopted, that the before and after rule and the alternative look-back rule be eliminated.

b. Lapse or Forfeiture

Options identified as abusive by the proposed regulations are those that, because of their terms or the circumstances under which they were issued or transferred, are akin to ownership of the underlying stock. When such an option lapses or is forfeited without significant consideration, it indicates that either the option was improperly characterized as abusive or the abuse no longer exists. The shorter the period between issuance and forfeiture, the more likely it is that there was no abuse when the option was issued. If a short-lived option were treated as equivalent to the underlying stock after being deemed exercised, then not only would the initial issuance be a shift, but also the lapse or forfeiture -- the very event which suggests that the option may not have been abusive in the first place.

On the other hand, after an option has been outstanding for a longer period, the lapse or forfeiture is more likely to indicate that an initial abusive purpose no longer exists. The Committee therefore believes that the treatment of lapse or forfeiture should depend on how long the option has been outstanding. As an arbitrary bright- line test, the Committee suggests that the lapse or forfeiture of an option that was previously deemed exercised be treated as a redemption of the underlying stock after the option has been outstanding for five years or longer.

Until the option has been outstanding for five years, the Committee would retain the lapse or forfeiture rule of the temporary regulations. That rule would permit a loss corporation to treat the lapsed or forfeited option as if it had never been issued.[34] The Committee notes that the conference report under § 382 in fact prescribes that treatment of a lapse or forfeiture.[35] In that regard, however, the Committee acknowledges that the deemed exercise rule in the proposed regulations is quite different than the one contemplated when § 382 was enacted. Nevertheless, the rationale for the lapse or forfeiture rule applies with even greater force when the short time between issuance and lapse or forfeiture suggests that there was never an abuse to justify treating the option as exercised in the first place.[36]

2. The "Taint" of an Abusive Issuance or Transfer Should Remain Even After the Abusive Purpose Disappears

The proposed regulations are unclear about how long an option that is issued or transferred for an abusive purpose retains the abusive purpose "taint." (This issue is distinct from the treatment, described above, of an abusive option that lapses). What happens, for example, if the originally abusive

[34] See Temp. Treas. Reg. § 1.382-2T(h)(4)(viii). We further recommend that final regulations clarify that an option will be treated as forfeited despite the payment of nominal and insignificant consideration for the forfeiture.

[35] H. Rep. No. 841, 99th Cong. 2d Sess., at II-183 (1986).

[36] In making this recommendation, the Committee recognizes that a similar lapse or forfeiture rule was rejected in the recently promulgated regulations under § 1504(a). Under those regulations, disaffiliation may result from the deemed exercise of an option that later lapses or is forfeited.

option is transferred for a nonabusive purpose before it is deemed exercised. One possibility is that the taint remains until an ownership change occurs. Another is that the taint remains until the abusive purpose no longer exists. Yet another is for the taint to disappear when the option is transferred for a nonabusive purpose.[37]

The Committee believes that the abusive purpose taint should remain until an ownership change occurs[38] even if the abusive purpose itself has disappeared (for example, if a deep-in-the-money option loses that status because of the falling price of the underlying stock).

3. Actual Exercise of an Option

If the before and after rule of Prop. Treas. Reg. § 1.382-4(d)(4)(i)(B) is retained (i.e., if an abusive option is not treated as stock after it is deemed exercised), final regulations should clarify that the actual exercise of an option that was previously deemed exercised will neither cause nor contribute to a second ownership change.[39]

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[37] Another possibility would be for the abusive purpose taint to lapse three years after the abusive issuance or transfer. Such a rule would limit the evergreen effect of an option so that its transfer would be treated no worse than a transfer of the underlying stock.

[38] The Committee notes that in the recent § 1504(a) regulations, an option that was treated as exercised is not treated as exercised on a subsequent measurement date if it no longer satisfies both the reasonable certainty of exercise and substantial elimination of tax liability tests.

[39] Likewise, Prop. Treas. Reg. § 1.382-4(h)(2)(iv)(B) should clarify that the actual exercise of an option that was outstanding at the time of a pre-November 5, 1992 ownership change will neither cause nor contribute to another ownership change. Also, in accordance with private rulings issued by the Service, the same subparagraph should be rewritten to clarify that it applies to options issued at the time of an ownership change, even if they were not outstanding immediately before the ownership change. See, e.g., PLR 9130044; PLR 8943043; PLR 8912043.

Another clarification that should be made -- if final regulations do not adopt the Committee's suggestion that an abusive option be treated as stock after it is deemed exercised-- is that, after the deemed exercise of an option to acquire newly issued stock, if the alternative look-back rule does not apply, the stock subject to the option should be treated as outstanding from the date the option is actually exercised, for the purpose of determining whether another ownership change occurs.[40]

C. Abusive Principal Purpose

Under the proposed regulations, an abusive principal purpose appears to require subjective intent to alter the timing of an ownership change through the use of an option.[41] The regulations should clarify whose subjective intent is relevant in determining whether an abusive principal purpose exists. When an option is issued by the loss corporation or a direct or indirect loss corporation shareholder, the intent of both the issuer of the option and the loss corporation should count. Conceivably, the intent of the holder of an option on more than a specified percentage of the loss corporation's stock also might be considered relevant. When an option is transferred, the intent of both the transferor and the transferee should count.

The existence of subjective intent is evidenced by one or more of the objective Factors listed above.[42] We endorse this

[40] See PLR 9130044 (under the before and after exception of Temp. Treas. Reg. § 1.382-2T(h)(4)(vi)(A), if an option that was outstanding at the time of an ownership change is actually exercised, the exercise is treated as if it occurred before the start of the testing period that begins on the day after the ownership change).

[41] See Prop. Treas. Reg. § 1.382-4(d)(2)(ii).

[42] See Prop. Treas. Reg. § 1.382-4(d)(2)(iii)(B) and text accompanying note 10, supra.

approach, but think that certain modifications should be made to the definition of "abusive principal purpose" and to the Factors that evidence an abusive purpose.

1. Definition of an Abusive Principal Purpose

One of the two abusive purposes spelled out in the proposed regulations is to manipulate the timing of an ownership change by providing an optionholder with substantial attributes of stock ownership before the option is exercised.[43] Despite the narrowing of this rule that results from requiring intent to manipulate the timing of an ownership change, this rule is still broad enough to give cause for concern. Any option that carries a fixed exercise price could be said to provide the holder with a beneficial interest in the corporation and thereby to convey substantial attributes of ownership of the underlying stock.

However, the general approach of the proposed regulations suggests that they were not intended to apply merely because an option has a fixed exercise price. Accordingly, it is necessary to distinguish abusive from nonabusive fixed price options. The abuse Factors discussed above adequately do this. However, because the Factors are only evidence of an abusive purpose, we think that the general rule should state that an

[43] Prop. Treas. Reg. § 1.382-4(d)(2)(ii) defines an "abusive principal purpose" as:

> a principal purpose of manipulating the timing of an owner shift to avoid, or ameliorate the impact of, an ownership change of the loss corporation by --
>
> (A) Providing the holder of the option, prior to its exercise, with a substantial portion of the attributes of ownership of all or part of the amount of stock covered by the option (through the option alone or in combination with one or more related arrangements); or
>
> (B) Facilitating the creation of income to absorb the loss corporation's losses prior to the exercise of the option.

option will not be treated as conveying substantial attributes of ownership merely because it has a fixed exercise price.

In addition, the Committee believes that an option should be treated as per se nonabusive if the exercise price fluctuates so that it is always equal to the fair market value of the underlying stock on the date of exercise.[44] An option whose exercise price fluctuates with the value of the underlying stock does not convey the economic benefits and burdens of ownership. Such an option should not have to run even the limited gamut of the proposed regulations. At a minimum, final regulations should provide an example demonstrating this point (e.g., no abusive purpose exists if a purchaser makes a capital contribution in exchange for both 40% of the loss corporation stock and a warrant to acquire an additional 30% that has a fluctuating exercise price equal to the fair market value of the underlying stock on the date of exercise, assuming that, apart from the capital contribution, no other abuse Factors are present).

In certain circumstances, a loss corporation may want an option to be deemed exercised in order to accelerate an ownership change, for example, because it wants a new testing period to insulate anticipated losses from § 382. The proposed regulations do not appear to prevent that. An option could be crafted that possesses all of the abuse Factors and that is issued with an intent to alter the timing of an ownership change -- in this case to accelerate the ownership change. Final regulations should clarify whether the option would be deemed exercised in that circumstance.

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[44] See Temp. Treas. Reg. § l.382-2T(h)(4)(x)(B).

To determine whether an option is abusive, the proposed regulations look at whether it provides the holder with substantial attributes of ownership by its terms or through "related arrangements."[45] Final regulations should clarify that related arrangements do not include actual stock ownership of the loss corporation.[46] Otherwise, a shareholder might be prevented from receiving an option because of rights it holds in its capacity as a shareholder. Final regulations should expressly state that only the optionholder's managerial and economic rights in his capacity as an optionholder will be taken into account. For this purpose, final regulations should track the language of the § 1504(a) option rules. Those regulations provide that "managerial or economic rights in the issuing corporation possessed because of actual stock ownership in the issuing corporation are not taken into account.[47]

2. Factors Evidencing Abusive Principal Purpose

The proposed regulations set forth several Factors (listed above) that evidence an abusive principal purpose.[48] With the exception of Factor (5) (discussed below), the Committee believes the Factors are valid indicia of an abusive purpose and therefore has only a few comments with regard to them.

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[45] Prop. Treas. Reg. § 1.382-4(d)(2)(ii)(A).

[46] The preamble suggests reason for concern about this issue. It states:

> An option could also be used to transfer a substantial portion of the attributes of stock ownership, but defer a formal sale of stock until more than three years after earlier transactions that, in conjunction with the sale, would have caused an ownership change.

[47] Treas. Reg. § 1.1504-4(g)(1)(vii).

[48] The Factors are contained in Prop. Treas. Reg. § 1.382-4(d)(2)(iii)(B) and are set forth in the text accompanying note 10, supra.

Under Factor (1), an abusive purpose is evidenced by an option that entitles the holder to acquire stock at a fixed or determinable price that is substantially below fair market value (a "deep-in-the-money option"). The proposed regulations state that an option is not deep-in-the-money if the exercise price is at least 90% of the fair market value of the underlying stock. However, this rule applies only for purposes of the disclosure requirement, discussed below. The Committee believes that the 90% test should be a general safe harbor for Factor (1), rather than just a limitation on the disclosure requirement.[49]

The most significant problem with the Factors involves Factor (5). It treats a capital contribution in connection with the issuance or transfer of an option as evidence of an abusive purpose. This is quite overbroad. When a loss corporation issues options, the offering often will be accompanied by a capital contribution (i.e., the amount paid for the option). Factor (5) therefore does little to distinguish abusive and nonabusive options. Moreover, the abuse targeted by Factor (5) is adequately covered by Factor (6) which deals with transactions designed to accelerate income. The Committee therefore recommends that Factor (5) be eliminated or that it apply only to transfers, not issuances, of options. At a minimum, Factor (5) should apply only if at least one other Factor is present.

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[49] A similar safe harbor was provided for deep-in-the- money options in both the S corporation single-class-of- stock regulations and the consolidated return option attribution regulations. See Treas. Reg. § 1361 - 1(1)(4)(iii)(C); Treas. Reg. § 1.1504-4(g)(3)(i)(A). In determining whether the 90% test is satisfied, final regulations should respect a good-faith determination of fair market value unless the Service establishes that it was substantially in error or was not performed with reasonable diligence. See Treas. Reg. § 1.1361-1(1)(4)(iii)(C).

If Factor (5) is nevertheless retained, the Committee recommends that it be limited and clarified. First, an exception should be made for options with customary terms that are sold to less-than-5% shareholders, unless at least one other Factor is present. Second, although the Committee acknowledges that it would be difficult to construe a capital contribution as encompassing a loan, it is concerned about this issue because a cash infusion is a hallmark of both a loan and a capital contribution. Because the abuse targeted by Factor (5) appears to be the use of a cash infusion to accelerate the use of losses, the Committee believes it would be helpful if an example clarified that a capital contribution does not include a loan.

In a more general vein, the Committee recommends that final regulations presume that an option was not issued for an abusive purpose if none of the Factors is present.

D. Transfers Not Subject to the Abusive Purpose Test

Under the proposed regulations, options are not deemed exercised when they are transferred between persons who are not 5% shareholders and between members of separate public groups segregated under Temp. Treas. Reg. § 1.382-2T(j)(2) and (3)(iii).[50] If a transfer is exempt under this rule, it does not

[50] Prop. Treas. Reg. § 1.382-4(d)(5), the operative provision, reads as follows:

> Paragraph (d)(2) of this section does not apply to the transfer of an option
>
> > (i) Between persons who are not 5 percent shareholders;
> > (ii) Between members of separate public groups resulting from the application of the segregation rules of §§ 1.382-2T(j)(2) and (3)(iii); or
> > (iii)In any of the circumstances described in section 382(1)(3)(B) (relating to stock acquired by reason of death, gift, divorce, separation, etc.).

matter whether it was for an abusive purpose. This provision is similar to paragraphs (e)(1)(ii) and (h)(4)(xi) of the temporary regulations, which provide essentially the same treatment for transfers of stock and options under the temporary regulations.[51] Several problems with these provisions in the temporary regulations were carried over to the proposed regulations.

First, the rule exempting transfers between persons who are not 5% shareholders could be read to exempt transfers from one first tier entity to another or from a first tier entity to an individual less-than-5% shareholder -- a result that clearly was not intended, as evidenced by the elaborate aggregation and segregation rules of Temp. Treas. Reg. § 1.382-2T(j).

Second, the temporary and proposed regulations inexplicably omit public groups segregated under Temp. Treas. Reg. § 1.382-2T(j)(3)(i), as well as the loss corporation's direct public group aggregated under Temp. Treas. Reg. § 1.382-

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[51] Temp. Reg. § 1.382-2T(e)(1)(ii) provides as follows:

> Transfers of loss corporation stock between persons who are not 5-percent shareholders of such corporation (and between members of separate public groups resulting from the application of the segregation rules of paragraphs (j)(2) and (3)(iii) of this section) are not owner shifts and thus are not taken into account.

Temp. Reg. § 1.382-2T(h)(4)(xi) provides as follows:

> Transfers of options between persons who are not 5-percent shareholders (and between members of separate public groups resulting from the application of the segregation rules of paragraphs (j)(2) and (3)(iii) of this section) are not taken into account.

2T(j)(1)(iv)(C), from the list of public groups between which transfers are exempt.[52] If the broad exemption of transfers between less-than-5% shareholders were given its full reach, this omission would have no significance because transfers between groups would be exempt regardless of which rule resulted in segregation or aggregation. However, the listing of certain segregation provisions but not others could be misread as an intentional exclusion. Accordingly, final regulations should fix both the omission of public groups identified under paragraphs (j)(1)(iv)(C) and (3)(i) and the overbroad exemption of all transfers between less-than-5% shareholders (discussed in the previous paragraph). These changes should be made in both Prop. Treas. Reg. § 1.382-4(d)(5)(ii) and paragraphs (e)(1)(ii) and (h)(4)(xi) of the temporary regulations.

The easiest way to fix the proposed and temporary regulations on this point would be for the exemption of transfers between public groups to apply only to transfers between.less-than-5% shareholders that are direct shareholders of the same entity (e.g., the loss corporation or the same first or higher tier entity) or that would be direct shareholders of the same entity if their options were exercised. Such transfers should be exempt without regard to which rule results in segregation or aggregation. Transfers between persons that are less-than-5% shareholders of the loss corporation by attribution from different entities should not be exempt.

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[52] See letter from David M. Flynn to Thomas Wessel, Office of Tax Legislative Counsel, 88 TNT 61-42 (Feb. 24, 1988).

E. Disclosure Requirements

Prop. Treas. Reg. § 1.382-4(d)(6) requires that a loss corporation disclose the existence of an option that satisfies one or more of the Factors, but that the loss corporation does not treat as exercised. This disclosure requirement marks another addition to what is now a plethora of disclosure required under the various § 382 regulations. None of these disclosure requirements contains any apparent penalty for noncompliance. While the Committee does not necessarily think a penalty is appropriate, it believes taxpayers are entitled to know if one is intended. In considering whether a penalty is appropriate, attention should be given to the fact that failure to disclose an option that was not believed to be abusive in many cases will be inadvertent. In addition, regulations under § 382 should state that no negative inference will be drawn from an inadvertent failure to comply with one or more of the § 382 disclosure requirements.[53]

F. Principles Similar to Those of the Proposed Regulations Should Apply Under § 382(1)(5)

The Service and the Treasury requested comment on whether principles similar to those in the proposed regulations should apply for purposes of the § 382(1)(5) bankruptcy exception. Under § 382(1)(5), if an ownership change occurs pursuant to a bankruptcy plan and a continuity of ownership requirement is satisfied, certain tax attribute reductions will be made in lieu of the § 382(a) limitation. The § 382(1)(5)

[53] See Treas. Reg. § 1.108-2(c)(4)(v).

continuity of ownership requirement is satisfied if the loss corporation's pre-change shareholders and certain qualified creditors (“qualified persons”), as a result of such status, own at least 50% of the voting power and value of the loss corporation stock immediately after the ownership change. The Committee recommends that principles similar to those in the proposed regulations apply in determining whether this continuity of ownership requirement is satisfied.

Existing regulations provide generally that, in determining whether the continuity of ownership requirement is satisfied, options held by qualified persons are not deemed exercised while those held by others are deemed exercised.[54] The concern addressed by this rule is that options may be issued to nonqualified persons in lieu of stock in order to qualify for § 382(1)(5), although nonqualified persons in fact have a greater than 50% economic interest in the loss corporation as a result of their options.

Options designed to qualify a loss corporation for § 382(1)(5) often will contain one or more of the Factors. Still, the Committee believes an additional abuse factor is appropriate for purposes of § 382(1)(5). Under this factor, abuse would be indicated by the issuance or transfer of an option, other than to a qualified person, if the sum of the amount paid for the option and the exercise price is not at least 10% greater than the fair market value of the underlying stock on the effective date of the bankruptcy plan.[55] Because there may be many nonabusive reasons

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[54] Treas Reg. § 1.382-9(e).

[55] A 10% threshold was selected because that is threshold for deep-in-the-money options in Prop. Treas. Reg. § 1.382- 4(d)(6)(ii). See Treas. Reg. § 1.382-9(a)(3) (Ex. 2).

to issue such an option, however, the Committee believes that exceptions should be made for certain categories of nonabusive options, such as options issued to employees as compensation for services.[56]

G. Option Segregation

Under the temporary regulations, the deemed exercise of options issued to less-than-5% shareholders is a segregation event.[57] The newly proposed segregation rules apply the principles of the cash and small issuance exceptions[58] for purposes of option segregation under the temporary regulations.[59] No mention is made of the proposed option rules, however.[60]

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[56] Treas Reg. § 1.382-9(e) should apply only to testing dates before the effective date of the final option rules. However, elective transition rules should be provided for bankruptcy cases in which the petition was filed before then.

[57] Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(D).

[58] Prop. Treas. Reg. S 1.382-3(j).

[59] Prop. Treas. Reg. § 1.382-3(j)(9).

[60] The preamble to the proposed segregation rules notes that the actual knowledge rule for pro rata rights offerings, discussed below, is "consistent with the treatment of options under the revised deemed exercise rules that the Service is also proposing at this time. The revised rules disregard options unless they are issued or transferred for an abusive principal purpose." The preamble does not discuss whether and how the cash and small issuance exceptions would apply under the proposed option rules.

The preamble to the proposed segregation rules also provides that "the small issuance and cash issuance exceptions may apply to the issuance of stock on the exercise of an option, such as a stock right."

Option segregation will be less important if the proposed option rules are finalized because only abusive options will be deemed exercised. In light of this curtailed role for option attribution, it is unnecessary for the cash and small issuance exceptions to apply to abusive publicly issued options. This conclusion is bolstered by the numerous complexities that would arise in applying the cash and small issuance exceptions to options. For example, should qualification for the small issuance exception be tested when the options are issued or when they are deemed exercised? Likewise, when should the loss corporation measure the amount of stock owned by its direct public groups to determine the extent to which the cash issuance exception applies?

H. The Proposed Actual Knowledge Rule for Options Issued to Multiple Public Groups

The segregation rules of the temporary regulations contain what arguably could be called a "loophole." The source of the problem is the "pro rata exercise presumption". That rule -- which was apparently intended as a rule of convenience -- provides that when options are issued to multiple public groups and then are exercised, the exercise is presumed to be made pro rata by the different public groups.[61] This rule avoids the burden of tracing each exercise of an option to determine in which public group the person exercising the option belongs.

[61] Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(F). The temporary regulations do not say whether options are treated as exercised under this rule in proportion to the number of options issued to each group or in proportion to the percentage of stock owned by each group. This point should be clarified when the temporary regulations are finalized.

The “loophole” is that a loss corporation can accomplish the near equivalent of a public offering without segregation. This is done by distributing publicly traded options pro rata to multiple groups of less-than-5% shareholders who then trade the options.[62] So long as the deemed exercise of the options by one or more of the groups does not cause an ownership change and the option trading takes place only among less-than-5% shareholders, the options will be treated as exercised proportionately by the public groups.[63] Because nonshareholders can purchase the options and acquire newly issued stock upon exercise without being segregated, the segregation rule for public offerings can be successfully avoided.

The proposed segregation rules attempt to prevent this by changing the optional actual knowledge rule of the temporary regulations. That rule allows a loss corporation to reduce the owner shift that results from a public offering by showing cross-ownership between the segregated group that acquires stock in the offering and the loss corporation's pre-existing public group.[64] The proposed amendment of the actual knowledge rule provides that actual knowledge can be taken into account only if the loss corporation knows that the option holder was a pre-existing shareholder of the loss corporation.[65] According to the preamble to the proposed regulations, the purpose of this amendment is to insure “equal treatment for stock offerings and pro rata distributions of transferable stock rights.”

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[62] This accomplishes the near-equivalent, rather than the exact equivalent, of a public offering because the consideration for the options is received by shareholders rather than by the loss corporation.

[63] If the loss corporation has no first tier entities or individual 5% shareholders, no shift will occur when the options are exercised

[64] Temp. Treas. Reg. § 1.382-2T(k)(2).

[65] Prop. Treas. Reg. § 1.382-3(j)(5)(ii)(B).

Because the pro rata exercise presumption is the source of the supposedly disparate treatment of stock and rights offerings, it is perplexing that the proposed regulations try to fix the problem by amending the actual knowledge rule. As illustrated by the following example, the interaction of the pro rata exercise and actual knowledge rules was confusing under the temporary regulations and is not clarified by the proposed amendment of the actual knowledge rule.

Example: (i) A loss corporation has 80 shares of stock outstanding owned by 80 unrelated shareholders (the "pre-existing public"). It issues an additional 20 shares to 20 individuals who did not previously own any loss corporation stock (the "new public"). As a result of the offering, the loss corporation has two public groups. A year later, it distributes to each shareholder a separately transferable right to acquire 1 share of newly issued loss corporation stock. Transfer restrictions prevent anyone from becoming a 5% shareholder. The 20 share offering, together with the deemed exercise of the rights by either or both of the public groups, would cause at most a 33% owner shift (new public owned 0% at the beginning of the testing period and would own 40 of 120 shares if its rights were exercised). Accordingly, the rights would not be deemed exercised.

(ii) Assume that all of the rights are sold to nonshareholders and that 40 of the rights are exercised. For the sake of simplicity, assume that the exercises occur simultaneously.

(iii) Absent actual knowledge, the segregation rules of the temporary regulations would presume that the shares issued upon exercise of the rights were issued to a third public group that is unrelated to the preexisting and new publics (the “third public”). This would cause the third public's ownership to increase from 0 to 29% (40 of 140 shares). Together with the 14% shift in the ownership of new public (20 of 140 shares), total shifts would add up to 43%.

(iv) Instead, however, the loss corporation can take into account its actual knowledge of cross-ownership between the persons exercising the rights and the third, pre-existing and new public groups. It is unclear what role the pro rata exercise presumption plays in this process. Does the loss corporation take into account its actual knowledge that the rights were exercised by nonshareholders or does it take into account the pro rata exercise presumption that the rights were exercised proportionately by the preexisting and new public groups? The correct answer appears to be the latter. Thus, the loss corporation can presume that 32 rights were exercised by the pre-existing public and 8 rights were exercised by the new public. As a result, no owner shift occurs on the exercise of the rights. Total owner shifts are therefore 20% (new public's ownership increased from 0% to 20% in the stock offering).

While it is questionable whether the pro rata exercise presumption is supposed to interact with the actual knowledge rule in this fashion, it appears for several reasons that it is. First, the Service has privately ruled to that effect.[66] Second, it is unclear what purpose the pro rata exercise presumption would serve if it did not apply in this way. Finally, the stated purpose of the proposed amendment of the actual knowledge rule is to provide the same treatment for stock and transferable rights offerings. A change would not be necessary unless the pro rata exercise presumption worked as outlined in the example. The difficulty with this conclusion is that the proposed amendment of the actual knowledge rule does not fix the problem.

The proposed amendment provides that actual knowledge of cross-ownership can be taken into account only if the loss corporation knows that rights are being exercised by members of an existing public group. Under the original actual knowledge rule, the pro rata exercise presumption supplied the actual knowledge of crossownership. The proposed amendment does not change that. Technically, that means the loss corporation could still use the pro rata exercise presumption to show actual knowledge that rights are being exercised proportionately by preexisting shareholders. Thus, even under the proposed amendment of the actual knowledge rule, the pro rata exercise presumption could supply the requisite knowledge. The proposed actual knowledge rule therefore has not accomplished its objective — to insure that stock and transferable rights offerings receive the same treatment.

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[66] See PLR 9234034.

This can be remedied by preventing the pro rata exercise presumption from being used to supply actual knowledge of cross-ownership. Instead, the loss corporation should be allowed to take into account actual knowledge only if it has such knowledge independent of the pro rata exercise presumption. If that were the rule, the issuance of stock upon exercise of an option would be segregated and the person receiving the stock would be presumed not to have been a shareholder before exercise unless the loss corporation had actual, not presumed, knowledge of facts to the contrary.

If actual knowledge of cross-ownership exists, both the shares acquired on exercise of the option and the shares previously owned by the optionholder would be treated as owned by a separate public group whose ownership increases by the number of shares acquired on exercise.

This would force the loss corporation to determine how many shares the optionholder owned before exercising the option, a significant but hopefully not intolerable burden.[67] The more formidable task of determining from which public group the person exercising the option came could be accomplished by a rule similar to the pro rata exercise presumption, but that would have the limited function of acting as a tracing rule -- similar to the tracing presumption of Temp. Treas. Reg § 1.382—T(j)(2)(vi).[68] This rule would presume that the shares previously

[67] The loss corporation possibly could learn how many shares the optionholder owned before exercising the option by requesting that information in the notice of exercise of the option.

[68] The pro rata exercise presumption did not indicate whether it was rebuttable and, if so, by whom. The tracing presumption of Temp. Treas. Reg. § 1.382-2T(j)(2)(vi), on the other hand, is expressly rebuttable by the taxpayer or the Service. The rule proposed in the text similarly should be rebuttable by the taxpayer or the Service.

owned by a less-than-5% shareholder that acquires additional stock by exercising an option were owned proportionately by the public groups that existed immediately before the exercise of the option.[69]

I. Taking into Account the Effect of Exercising an Option in Measuring the Resulting Owner Shift

Fluctuation in value issues are some of the most intractable under § 382. The Committee is therefore reluctant to make suggestions in that area out of concern that finalization of the option rules will be bogged down by fluctuation in value issues. Nevertheless, one such issue is especially relevant to option attribution — how the relative value of different classes of stock should be determined in computing the amount of the owner shift that results from deeming an option exercised.

This issue raises many questions. Should the relative value of different classes of stock be adjusted to take into account the increased value of the loss corporation that would result from payment of the option exercise price? Should relative values be adjusted to reflect the expected value the loss corporation would have at the time exercise of the option would make economic sense? Should stock that is deemed to be issued upon exercise of an option be valued at the price it would fetch on the open market on the testing date? Should the testing date value be adjusted for the dilution that would result from exercise of the option or can it be presumed that dilution is

[69] This rule should apply not only to the exercise of an option, but any time actual knowledge of cross-ownership is taken into account in connection with a segregation transaction. In addition, final regulations should confirm the conclusion in PLR 9201023 -- that actual knowledge exists if the loss corporation knows that a person acquiring stock in a segregation transaction owned loss corporation stock immediately before the transaction.

already reflected in the stock price? In addressing these issues, consider the following example.

Assume that L has 400 shares of common stock outstanding with a fair market value of $25 per share. It issues warrants to an unrelated person to acquire 100 shares of a new class of voting preferred stock for $60 per share. The appraised value of the preferred stock is $50 on the day the warrant is issued.

There are at least three ways to measure the owner shift that would result from the deemed exercise of the warrants. The first is to value the preferred stock based on its testing date value of $50 per share on the date it is deemed exercised. This results in a 33.33% owner shift ($50 per share x 100 preferred shares = $5,000, plus $25 per share x 400 common shares = 10,000, for a total value of L of $15,000; thus, the deemed issuance of $5,000 of preferred stock would produce a 33.33% shift).

A second method would be to increase the value of the common stock by the capital contribution that would result from payment of the warrant exercise price (the amount of the capital contribution is the excess of the warrant exercise price over the fair market value of the preferred stock on the date it is issued). Under this approach, the value of the common stock would be increased by the capital contribution. Accordingly, the common stock would have an additional $1,000 of value (the excess of the $6,000 warrant exercise price over the $5,000 value of the preferred stock on the date it is issued). Under this approach, a 31.25% owner shift would result from the deemed exercise of the warrants (total value of L of $16,000; thus, the deemed issuance of $5,000 of preferred stock would produce a 31.25% shift).

A third alternative would be to calculate the owner shift based on the relative value the preferred and common stock would be expected to have at the point when exercise of the warrants would first make economic sense. Thus, if the common stock was expected to be worth $50 per share when the value of the preferred stock was equal the $60 warrant exercise price, the owner shift from the deemed exercise of the warrants would be 23.08% ($60 per share x 100 preferred shares = $6,000, plus $50 per share x 400 common shares = $20,000, for a total value of L of $26,000; thus, the deemed issuance of $6,000 of preferred stock would produce a 23.08% shift).

The Committee recommends that the first approach be adopted. Under that approach, the owner shift that results from deeming an option exercised would be measured on the assumption that all of the loss corporation's stock (including stock deemed to be issued on the deemed exercise of the option) has the value it would have if it were outstanding on the date the option is deemed exercised -- without adjustment for payment of the option exercise price and, in the case of publicly traded stock, without adjustment for dilution. The guiding principles in reaching this conclusion are ease of application and avoiding speculative predictions about the effect future events will have.

With regard to dilution, the result should depend on whether a trading price can be readily established. In the case of traded stock, it is impossible to determine the extent to which the dilution represented by an option is already reflected in the market price of outstanding stock. Thus, it should be assumed that a deemed issuance of shares would increase the value of the loss corporation by the value those shares would have if they were outstanding on the testing date on which the options are deemed exercised (based on the value of comparable shares

outstanding on that date, if any).[70] In the case of stock that is not publicly traded, however, there would be no market price that reflects dilution. In that case, an appraisal of value on the date the options are deemed exercised should take into account the effect that dilution would have on the value of both the outstanding shares and those that would be issued upon exercise of the option.

J. Transition Rules for Convertible Stock

It is unclear whether the proposed transition rules for convertible stock apply on testing dates after November 5, 1992. The problem is that the general effective date rule applies the proposed option rules -- including the provisions relating to convertible stock -- on any testing date after November 5, 1992. That is followed by a series of transition rules based not on when a testing date occurs, but on when the convertible stock was issued. Those rules do not indicate whether, on testing dates after November 5, the rule for convertible stock issued before November 5 is the general effective date rule of Prop. Treas. Reg. §§ 1.382-2(a)(3)(ii) and -4(d)(3)(ii) or the convertible stock transition rules of prop. Treas. Reg. § 1.382-4(h)(2)(ii)-(iii).

[70] Cf. Temp. Treas. Reg. § 1.382-2T(h)(4)(vii)(A) (loss corporation's outstanding stock is increased by the amount of stock treated as issued on the deemed exercise of an option). See also PLR 8841038 (ruling 10) (valuing the increase in outstanding stock that results from the deemed exercise of an option by using the value of outstanding shares of the same class as those subject to the option).

Notwithstanding this confusing language, it appears to have been intended that the transition rules for convertible stock would apply on testing dates after November 5, 1992. If that is the case, final regulations should say so. It also would be helpful if the reference to convertible stock in the definition of an option in the body of the proposed regulations[71] cross-referenced the transition rules. That way, the substantive rule for convertible stock would call attention to the fact that special rules apply if the stock was issued prior to November 5, 1992.

Another problem in the proposed convertible stock transition rules is the ambiguous use of the phrase "subject to" when the rules appear to mean "for purposes of." For example, one of the proposed transition rules provides that, under certain circumstances, "convertible stock issued prior to July 20, 1988, is treated as an option subject to" the deemed exercise rules of the temporary and proposed regulations. Notwithstanding the term "subject to," it does not appear that the deemed exercise rules were intended to be an exception to treatment as an option. Rather, what was meant is that the convertible stock is treated as an option and thus is subject to the deemed exercise rules. The ambiguity could be eliminated if, in the above example, the proposed rules said that "convertible stock issued prior to July 20, 1988, is treated as an option for purposes of the deemed exercise rules of the temporary and proposed regulations."[72]

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[71] Prop. Treas. Reg. § 1.382-4(d)(3)(ii).

[72] This ambiguity needs to be corrected in paragraphs (h)(2)(ii)(A), (h)(2)(ii)(B)(1), (h)(2)(ii)(B)(2) and (h)(2)(iii) of Prop. Treas. Reg. § 1.382-4.

Finally, the heading of the proposed transition rule for convertible pure preferred stock refers to “nonvoting convertible preferred stock.” The substantive rule, however, applies only to convertible pure preferred stock, rather than any nonvoting convertible preferred stock. Although the heading has no substantive significance, it adds unnecessary confusion to already complicated transition rules.