

**COMMENTS REGARDING THE INTERNAL REVENUE SERVICE AND TREASURY  
DEPARTMENT PROPOSAL ON INCENTIVE STOCK OPTIONS UNDER SECTIONS  
421, 422 AND 424 OF THE INTERNAL REVENUE CODE**

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Employee Benefits Committee of the Section of Taxation. Principal responsibility was exercised by Wayne R. Luepker. Substantive contributions were made by John E. Aguirre, Howard L. Clemons, Dennis B. Drapkin, Rob Fowler, Mark Jones, Andrew C. Liazos, Steven H. Sholk, and Marvin S. Swift. The comments were reviewed by Priscilla E. Ryan and Taina E. Edlund of the Section's Employee Benefits Committee; by the Quality Assurance Group of the Employee Benefits Committee, which is chaired by Thomas R. Hoecker and whose members are former chairs of the Committee; by T. David Cowart of the Section's Committee on Government Submissions; and by Thomas A. Jorgensen, Council Director for the Employee Benefits Committee.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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## I. EXECUTIVE SUMMARY

The following comments regarding the proposed regulations (the "Proposed Regulations") on incentive stock options (sometimes referred to in these comments as "ISOs") under sections 421, 422, and 424 of the Internal Revenue Code of 1986, as amended,<sup>1</sup> published by the U.S. Department of Treasury ("Treasury") on June 9, 2003 (68 Fed. Reg. 34344). Our recommendations regarding the Proposed Regulations are as follows:

1. We recommend that the requirement that a plan pursuant to which ISOs may be granted must designate the maximum number of shares that may be issued under the plan through ISOs, nonstatutory options and all other stock-based awards be modified to include only shares that may be issued through ISOs and nonstatutory options.
2. We recommend that the final regulations contain an alternative rule for applying the \$100,000 limit to an option with a value greater than \$100,000 which is administratively simpler to apply than the rule set forth in the Proposed Regulations (which provides for treating each share covered by the option as partially ISO stock and partially nonstatutory option stock).
3. We recommend that the final regulations provide that if discretion is reserved in the original grant to provide a particular benefit, the exercise of discretion to provide such a benefit not be a modification.
4. We recommend that the final regulations provide that a change to an ISO does not result in a modification unless, at the time the change is made, it is reasonable to expect that the optionee may benefit from the change in more than a *de minimis* manner.
5. We recommend that the final regulations provide that a change that is retracted within the same taxable year in which it is originally made does not result in a modification.
6. We recommend that the final regulations clarify that the acceleration of exercisability of an ISO will not be a modification regardless of whether such acceleration results in acceleration of vesting of the underlying option stock.
7. We recommend that the Treasury Department draft a model notice describing the federal income tax and alternative minimum tax consequences of exercising an incentive stock option.
8. The Proposed Regulations do not provide guidance regarding the possible effect of risk reduction strategies such as hedging on satisfying the ISO stock holding period requirements or address whether a disqualifying disposition of ISO stock has occurred when an optionee engages in a risk reduction strategy. We recommend that the Internal Revenue Service (the "Service") propose regulations under which a transaction resulting in a complete or near complete elimination of risk through a short sale, forward sale,

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<sup>1</sup> All section references are references to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

equity swap, deep-in-the-money call or put option or combination of puts and calls, or other financial instruments would be treated as a disposition, while a transaction resulting in the elimination of some risk while retaining meaningful risk through the use of financial instruments would not be treated as a disposition.

9. We recommend that the final regulations modify the effective date provisions of the Proposed Regulations in three respects. First, we recommend that the final regulations clarify that the rules proposed under Treasury Regulation section 1.421-7(c) apply for purposes of determining the date of grant of a statutory option for purposes of the effective date rule. Second, we recommend that the final regulations provide a delayed effective date for existing incentive stock option plans to comply until a new shareholder approval is required for other reasons. Alternatively, we recommend that the final regulations include a transition rule providing that an option granted after the effective date of the final regulations does not fail to be granted under a plan complying with the new maximum share rules of Proposed Regulation section 1.422-2(b)(3) and the shareholder approval requirement of section 422(b)(1), as interpreted in Proposed Regulation section 1.422-2(b)(2), if the plan is amended by the board of directors (or other party with authority to amend the plan) prior to the grant of such option to comply prospectively with Proposed Regulation section 1.422-2(b)(3). In addition, the amendment must not increase the number of shares that would otherwise be available under the plan. Third, we recommend that taxpayers be given the right to rely on the Proposed Regulations for options granted prior to the publication date of the final regulations.
10. We recommend that the final regulations provide that the shareholder approval by the seller's shareholders prior to a corporate transaction be recognized for both substituted and assumed statutory stock options for purposes of shareholder approval requirements under section 422. We recommend that substitute statutory stock options issued under an existing plan sponsored by the buyer to replace a seller's statutory stock options (that are otherwise in accordance with Proposed Regulation section 1.424-1(a)(4) and (5)), not count against the share reserve available for grants to employees of the buyer and its parent and subsidiary corporations.
11. We recommend that the Service issue proposed regulations providing that section 83(b) elections are effective, if there is a subsequent disqualifying disposition of the underlying stock, for ordinary income purposes (including for purposes of commencing the capital gains holding period) upon the later of the exercise of an incentive stock option or the date of the section 83(b) election.

## **II. BACKGROUND**

The Service and Treasury issued the Proposed Regulations, which replace proposed regulations published in 49 Fed. Reg. 4504 on February 7, 1984 (the "1984 Proposed Regulations"). The following text provides comments on the Proposed Regulations.

### III. COMMENTS

We appreciate the opportunity to comment on the Proposed Regulations. We commend the efforts of the Treasury Department and the Service to provide comprehensive rules under a new organizational structure in light of the statutory changes affecting incentive stock options since the 1984 Proposed Regulations.

#### MAXIMUM AGGREGATE NUMBER OF SHARES

##### 1. Summary.

Proposed Regulation section 1.422-2(b)(3)(i) provides that a plan under which incentive stock options are granted:

must designate the maximum aggregate number of shares that may be issued under the plan through incentive stock options, nonstatutory options, and all other stock-based awards to be granted thereunder. If nonstatutory options or other stock-based awards may be granted, the plan may separately designate terms for each type of option and other stock-based award and designate the maximum number of shares that may be issued under such option or other stock-based award. Unless otherwise specified, all terms of the plan apply to all options and other stock-based awards that may be granted under the plan.

##### 2. Recommendation.

We recommend that the final regulations require that a plan pursuant to which ISOs may be granted must designate the maximum number of shares that may be issued under the plan only through (i) ISOs or (ii) IOSs and nonstatutory options and not through other stock-based awards.

##### 3. Explanation.

Under section 422(b)(1), an incentive stock option must be granted "pursuant to a plan which includes the aggregate number of shares which may be issued under options." While the language of the statute might be read to require a limit only on ISO shares, we believe that it cannot be read to require a limit except with respect to ISOs and nonqualified options. Although it may be desirable to require the disclosure to and approval by shareholders of the maximum number of shares that may be granted pursuant to all types of awards that may be granted under a so-called "omnibus plan" and thus have the shareholders approve the maximum share dilution that could result, wording of the statute is limited to "options." Thus, there is a statutory basis for applying the maximum number of shares either to (i) ISOs or (ii) ISOs and nonqualified options (also because options originally granted as ISOs are taxed as nonqualified options if there is a disqualifying disposition). Because of the favorable tax treatment afforded to ISOs, the Treasury has an interest in addressing whether the maximum share requirement extends only to ISOs or to all options. There is no statutory basis, or tax policy reason, however, for extending the maximum number of shares requirement to all equity based awards that could be granted under an omnibus plan.

## **BIFURCATION OF OPTIONS AND THE \$100,000 LIMIT**

### 1. Summary.

Under section 422(d) options are treated as nonstatutory options to the extent that the aggregate fair market value of stock with respect to which incentive stock options first become exercisable by any individual in any calendar year exceeds \$100,000. If a corporation fails to issue separate stock certificates, however, Proposed Regulation section 1.422-4(c) provides that a pro-rata portion of each share of stock purchased under the option is treated as ISO stock and nonstatutory option stock.

### 2. Recommendation.

We recommend that the final regulations contain an alternative rule for applying the \$100,000 limit to an option with a value greater than \$100,000 which is administratively simpler to apply than the rule set forth in the Proposed Regulations (which provides for treating each share covered by the option as partially ISO stock and partially nonstatutory option stock).

### 3. Explanation.

Interpretive guidance regarding the \$100,000 limitation was initially published in Notice 87-49, 1987-2 C.B. 335. This guidance has been expanded in Proposed Regulation section 1.422-4. Where a single option grant straddles the \$100,000 threshold (referred to as a "bifurcated option"), both Notice 87-49 and the Proposed Regulation permit the corporation to issue "separate certificates" that designate the incentive stock option and nonstatutory option portions of the option stock. If the corporation fails to issue separate certificates, however, the proposed rule is that a pro-rata portion of each share of stock purchased is treated as ISO stock and nonstatutory option stock. Proposed Regulation section 1.422-4(c).

Example. An option otherwise qualifying as an incentive stock option is granted on March 1, 2004, for 1,000 shares. Assume that pursuant to section 422(d) and Proposed Regulation section 1.422-4(c), 40 percent of each option share is treated as an incentive stock option. The option is exercised in its entirety on March 1, 2006. On exercise of the option, 40 percent of the aggregate option spread is treated as alternative minimum taxable income, potentially subject to alternative minimum tax. Alternative minimum tax basis must be allocated to all the option shares, although the precise method is unclear. Assume that on January 1, 2007, 300 of the option shares are sold. The option holder must determine (i) the disqualifying disposition consequences as if 40 percent of each share sold was an ISO share, and (ii) the short-term capital gain or loss consequences as if 60 percent of each share sold was a nonstatutory option share.

Thus, under the proposed rule, the corporation and the taxpayer must account for all possible incentive stock option and nonstatutory option tax consequences each time a bifurcated option is exercised and each time a bifurcated option share is disposed of. It is likely that the recordkeeping burdens and complexity of the proposed rule will fall disproportionately on corporations without a sophisticated internal tax department and their employees because such

corporations are less likely to be informed of and take advantage of the opportunity to separately designate option shares. Therefore, we recommend that an alternative rule be adopted.

We recommend that the rule provide as simple a result as would be consistent with the original intent of the parties to receive incentive stock option treatment. We recommend that the rule be formulated in terms of whole shares rather than a ratable portion of each option share, and assign a priority as between ISO shares and nonstatutory option shares. In addition, we recommend that the rule address the tax consequences of a partial exercise of a bifurcated option, as well as a disposition of less than all of the shares subject to a bifurcated option. If a bifurcated option is partially exercised, we recommend that the rule treat the first shares received by the optionee as the ISO shares. This will facilitate satisfying the incentive stock option holding period requirements. In the above example, if the bifurcated option had been partially exercised for 250 shares out of the 1,000 shares subject to the option, then 250 shares would be treated in their entirety as ISO shares. Similarly, we recommend that the first shares disposed of that were acquired by exercising a bifurcated option be treated as the nonstatutory option shares since this ordering will minimize the risk of disqualifying dispositions. In the above example, if the bifurcated option had been entirely exercised on March 1, 2006, all 300 shares sold on January 1, 2007, would be treated as nonstatutory option shares

## **MODIFICATION OF ISOs**

### 1. Summary.

Section 1.424(e)(4)(i) of the Proposed Regulations provides that any change to an incentive stock option that provides additional benefits to the optionee regardless of whether the optionee in fact benefits is a modification of the option, with the result that the option must meet all the incentive stock option requirements at the time of the modification as if it were a grant of a new option.

### 2. Recommendations.

We recommend that the final regulations provide that if discretion is reserved in the original grant to provide a particular benefit, the exercise of discretion to provide such a benefit not be a modification. We recommend that the final regulations provide that a change to an ISO does not result in a modification unless, at the time the change is made, it is reasonable to expect that the optionee may benefit from the change in more than a *de minimis* manner. We recommend that the final regulations provide that a change that is retracted within the same taxable year in which it is originally made does not result in a modification.

### 3. Explanation.

The Proposed Regulations, in effect, provide that any modification to an incentive stock option that provides an additional benefit to the optionee, no matter how insignificant, is deemed to be the grant of a new option that must meet all the incentive stock option requirements. Thus, the date of the modification is considered the date of the deemed new option grant, with a common result being the loss of the option's ISO status. Although the Proposed Regulations make the welcome clarification that the mere offer of a benefit is not a modification, further clarification of what constitutes an additional benefit is needed.

Section 424(h)(3) provides that a modification means "any change in the terms of the option which gives the employee additional benefits under the option." The Proposed Regulations, in effect, provide that a change to an option that gives the optionee an additional opportunity to benefit in fact is a "modification" even if the optionee does not actually benefit from the change.

We recommend that the change in the terms of an option to give the employer discretion to provide additional benefits (other than the benefits specified in the next sentence) does not, in itself, result in a modification until the employer actually uses that discretion to give the optionee an additional benefit. The Proposed Regulations also provide that if an issuer reserves discretion to provide any of three specified benefits (cash bonus at exercise, loan at exercise, or right to exercise with previously owned shares), the exercise of such discretion by the issuer is not a modification. We recommend that where the employer, at the time of the grant of an ISO, has specifically contemplated the provision of rights or benefits to the participant, subject to the employer's later affirmative determination to provide those rights or benefits, and subject to the limitation that the rights or benefits do not involve the granting of additional shares, the exercise of such discretion should not constitute the modification of the option. Although one might argue that if an employer reserved discretion at the time of a award of an option to provide additional benefits to the optionee at a later date that the additional benefit is conferred at the time the discretion is exercised and thus the option is then modified, we believe that if the original award specifically states the additional benefits that may be conferred at the employer's discretion, then no modification occurs if the employer exercises that discretion. Under our recommendation, the maximum benefits that may be extended to an optionee would all be set forth in the original award. Our recommendation is based upon the three exceptions already included in the Proposed Regulations and is based upon the same condition, i.e., that the benefits as to which the employer reserves discretion to provide at a later date be set forth in the original award.

In addition, we recommend that the regulations provide an express *de minimis* exception to the "additional benefit" rule, formalizing the policy expressed in existing guidance that supports or implies the existence of a *de minimis* exception. *See, e.g.*, Rev. Rul. 69-648, 1969-2 C.B. 103 (amendment to option to provide the optionee an alternative method to designate a person who may exercise his option on death was not a modification); Notice 87-49, 1987-2 C.B. 355 (removal of plan limit on aggregate fair market value of stock with respect to which options first become exercisable in a calendar year was not a modification); and P.L.R. 9629028 (Apr. 24, 1996) (interpretation of plan to permit use of attestation procedure to effect cashless exchange was not a modification).

We also recommend that an exception be provided when the benefit conferred is not materially greater than benefits being provided to other shareholders. *See* Rev. Rul. 72-351, 1972-2 C.B. 229 (removal, in connection with a public offering, of issuer's right to repurchase stock at fair market value was not a modification when right to repurchase applied to both stock acquired by employees through options and stock held by non-employees); Rev. Rul. 69-328, 1969-1 C.B. 136 (release of investment representation after registration of stock was not a modification); Rev. Rul. 64-116, 1964-1 C.B. 165 (in a corporate merger, the substitution of options to purchase both common stock and preferred stock of surviving corporation for options to purchase common stock of the target corporation was not a modification).

We believe that an inadvertent change to an ISO that is promptly reversed should not constitute a modification. In administering option plans, changes are sometimes made in situations when the issuer is unaware that its actions would alter the tax treatment of an option. A corporation may unintentionally modify the option in the optionee's favor without thought to the consequences for the tax treatment of the option. Often, the corporation's tax advisors are not consulted prior to such changes, as it may not be obvious to the corporation that tax consequences may flow from the change. After the corporation's tax advisors are informed, a typical approach is to revoke the change to preserve ISO tax treatment. If this revocation occurs during the same tax year, there appears to be no tax policy impediment to respecting the revocation and treating the change as if it never occurred. In fact, the beneficial tax effect of a same-year rescission was recognized in Penn v. Robertson, 115 F.2d 167 (4th Cir. 1940). The Service accepted the basic principle of this case in Rev. Rul. 80-58, 1980-1 C.B. 181. The Penn case and the ruling are still good law. We recommend that the regulations clarify that if an "additional benefit" is rescinded in a manner consistent with Penn v. Robertson and Rev. Rul. 80-58, a modification is not considered to have occurred. This will also eliminate any uncertainty as to whether the ISO modification regulations are intended to overrule otherwise applicable rescission law. Expressly acknowledging the remedial effect of a qualifying rescission transaction will take some of the pressure off an inadvertent ISO modification that is discovered and corrected in a timely manner.

## **MODIFICATION OF ISOs - CLARIFICATIONS**

### 1. Summary.

The Proposed Regulations provide that an incentive stock option is not considered modified merely because its terms are changed to accelerate the time at which the option may be exercised.

### 2. Recommendation.

We recommend that the final regulations clarify that the acceleration of exercisability will not be considered a modification, regardless of whether such acceleration results in acceleration of vesting of the underlying option stock.

### 3. Explanation.

Proposed Regulation section 1.424-1(e)(4)(ii) states that "[i]f an option is not immediately exercisable in full, a change in the terms of the option to accelerate the time at which the option (or any portion thereof) may be exercised is not a modification for purposes of this section." It is unclear whether an amendment which accelerates both exercisability and vesting, such as might occur on a change of control transaction, would be covered under this provision. Published rulings suggest that vesting and exercisability are considered the same for these purposes but this issue has not been directly addressed previously. *See, e.g.*, Rev. Rul. 74-504, 1974-2 C.B. 141 (Jan. 01, 1974) (regarding qualified stock options). We recommend that exercisability include vesting for purpose of this provision, particularly because this change would not be subject to abuse because of the \$100,000 limit on stock that may be exercisable in one calendar year.

## ALTERNATIVE MINIMUM TAX

### 1. Summary.

Under section 56(b)(3), the excess of the fair market value of the stock at the time of exercise of an incentive stock option over the option price results in an adjustment in determining the optionee's alternative minimum taxable income.

### 2. Recommendation.

We recommend that the Treasury Department draft a model notice describing the consequences under both the regular income tax and the alternative minimum tax ("AMT") of exercising an incentive stock option.

### 3. Explanation.

The Proposed Regulations do not directly address the treatment of gain realized on the exercise of an incentive stock option under the alternative minimum tax. According to a report of the Office of Tax Analysis, the number of taxpayers subject to the AMT is growing at an annual rate of almost 30 percent,<sup>2</sup> and several legislative proposals have been introduced to redress very high personal income tax liabilities that arise from the application of the AMT to the exercise of an incentive stock option when the stock price has increased significantly over the option price.<sup>3</sup> The concern is that ISO holders are often unaware of the possibility of incurring tax on exercise because the AMT is poorly understood by most taxpayers. This is partially due to the fact that AMT treatment is not required to be included in the tax disclosure portion of the proxy statement describing a stock option plan or the prospectus accompanying the offer. In addition, it is often difficult for ISO holders who incur AMT liability to obtain assets with which to pay the tax. The holding requirements of section 422(a) prohibit an individual from selling the stock in the year of the option exercise without disqualifying the award, and, since incentive stock options are not subject to mandatory withholding, few employers have developed systems or made arrangements to offer cashless solutions to cover the liability.

The effects of the AMT are particularly severe when an individual sells the stock in a disqualifying disposition in a year later than the year he or she exercises the option because the individual incurs an AMT liability in the year of exercise and a regular income tax liability in the year of disposition. Although a minimum tax credit exists for the payment of AMT that may be available to offset the regular income tax, a portion of the credit may need to be carried over to later years if the value of the stock has decreased substantially. Moreover, the employee will incur a capital loss under the AMT that can be recovered only in the amount of \$3,000 a year and only in years that the employee has AMT liability. If the loss is substantial, these amounts may

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<sup>2</sup> Office of Tax Analysis, U.S. Dep't of Treas., Paper No. 87, *Who Pays the Individual AMT?* (2000).

<sup>3</sup> See S. 1324, 107th Cong., 147 Cong. Rec. 8704 (2001); H.R. 2794, 107th Cong., 147 Cong. Rec. 5336 (2001).

never be fully recouped and may give rise to a lifelong recordkeeping burden that most ISO recipients are ill-equipped to handle.

Until a solution for these problems is devised by Congress, we recommend that the Treasury Department draft a model notice that can be distributed to ISO grantees, describing the consequences under both the regular income tax and the AMT of exercising an incentive stock option and of selling the stock acquired upon exercise (whether in a disqualified disposition or after satisfying the statutory holding period). This statement, like the model notice prepared under section 402(f), would be designed to be easily understood by an average person and could be furnished by employers either at grant of an incentive stock option or immediately before the date on which the incentive stock option becomes exercisable.

## **EFFECT OF RISK REDUCTION STRATEGIES ON HOLDING PERIOD REQUIREMENTS AND DISQUALIFYING DISPOSITIONS**

### 1. Summary.

The Proposed Regulations do not provide guidance regarding the possible effect of risk reduction strategies such as hedging on satisfying the ISO stock holding period requirements and on whether a disqualifying disposition of ISO stock has occurred.

### 2. Recommendation.

We recommend that the Service propose regulations under which a transaction resulting in a complete or near complete elimination of risk through a short sale, forward sale, equity swap, deep-in-the-money call or put option or combination of puts and calls, or other financial instruments would be treated as a disposition, while a transaction resulting in the elimination of some risk while retaining meaningful risk would not be treated as a disposition.

### 3. Explanation.

ISO shares may involve sufficient down-side exposure to warrant taxpayers examining risk reduction strategies for dealing with the one- and two-year ISO stock holding periods. Neither the 1984 Proposed Regulations nor the Proposed Regulations, however, address the possible effect of risk reduction strategies, such as hedging, on satisfying the ISO stock holding period requirements or whether a disqualifying disposition of ISO stock has occurred. Because the limited guidance available was issued well before the growth of sophisticated financial products and the adoption of numerous amendments to the Internal Revenue Code in response to financial product developments, we recommend that the Service propose regulations that address these issues.

Two revenue rulings interpret the disposition provisions in effect prior to the enactment of the incentive stock option rules. Rev. Rul. 59-242 holds that the purchase of a put to sell stock acquired upon the exercise of a restricted stock option does not constitute a disposition. 1959-2 C.B. 125. Rev. Rul. 59-242 relies on Rev. Rul. 58-234 for the proposition that puts and calls are not closed transactions until exercised or terminated. Rev. Rul. 58-234, 1958-1 C.B. 279. Rev. Rul. 73-92, on the other hand, holds that a short sale within the then applicable three-year holding period of stock acquired by the exercise of a qualified stock option is a disposition of the

option stock. 1973-1 C.B. 208. Quoting the legislative history, the Service noted in Rev. Rul. 73-92 that the extension of the holding period requirement from six months to three years in 1964 was intended to "give assurance that the key employees actually are acquiring a 'stake in the business' and are not merely turning the stock over as fast as the options can be exercised." The Service concluded that the taxpayer's "stake in the business" terminated when he sold the stock that he borrowed from the broker which was issued by the same corporation that granted him the option "because subsequent market fluctuations with respect to the option stock (up to the time the short sale was closed) would have no effect on him."<sup>4</sup> The two revenue rulings suggest that the elimination of some, but not all, market risk (such as through the purchase of a put) does not result in a disposition of the option stock, while the elimination of all market risk (as through a short sale) does result in a disposition, notwithstanding that a taxable event would not otherwise occur (under the law then applicable).

The relevant incentive stock option provisions, enacted by the Economic Recovery Tax Act of 1981 ("ERTA"), are derived directly from the prior option provisions that were the subject of the two revenue rulings. The disposition language currently prescribed by section 424(c)(1) (formerly designated as section 425(c)(1)) was originally enacted by the Revenue Act of 1964, which replaced "restricted stock options" subject to a six-month holding period requirement with "qualified stock options" that had a three-year holding period requirement.<sup>5</sup> Furthermore, the legislative history of ERTA states that pre-ERTA stock option interpretations apply to the pre-ERTA Code provisions that were carried over to the new incentive stock option rules.<sup>6</sup> Thus, it is possible that the old interpretations described above continue to represent the position of the Service. In view of general income tax developments after ERTA, however, we recommend that the Service reexamine these prior interpretations of the ISO stock holding period and disposition rules. In particular, several Code provisions have been enacted to protect the policies underlying holding period requirements related to obtaining a specific tax benefit. *See* section 1233(b) (certain short sales impair the general capital asset holding period under section 1223); section 246(c)(4) (loss reduction impairs holding period for dividend received deduction); section 901(k)(5) (applies section 246(c)(4) principles to foreign

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<sup>4</sup> Rev. Rul. 73-92 was considered in G.C.M. 34967 (July 31, 1972). The G.C.M. rejected the reasoning and the result in a proposed revenue ruling that was based on P.L.R. 710080440A (Oct. 8, 1971), which, relying on Rev. Rul. 59-242, analogized a short sale to a put and held that a short sale did not result in a disposition. The G.C.M. makes clear that "[t]o hold otherwise would circumvent the Congressional intent that the optionee acquire and maintain a 'stake in the business' for a minimum of three years."

<sup>5</sup> Treas. Reg. § 1.425-1(c) repeats the statutory language, but does not elaborate further in any relevant respect.

<sup>6</sup> "In general, to the extent that provisions of law have been included in the incentive stock option provisions, interpretations of prior law are to apply to incentive stock options." ERTA Blue Book 159 n.2.

tax credit holding periods); and sections 1092(b) and 1092(f)(2) (straddle positions impair general capital asset holding periods).<sup>7</sup>

Section 1259 was enacted in 1997 in response to perceived abuses that financial transactions that largely eliminated risk with respect to further ownership of related property, such as short sales and equity swaps, were treated (or were so interpreted) as not constituting realization events for general income tax purposes. Section 1259(c)(1) deems a "constructive sale" to occur with respect to appreciated property in certain enumerated circumstances, including a short sale and offsetting notional principal contracts.<sup>8</sup> The Service may therefore want to consider whether a disposition of ISO shares should include a "constructive sale" within the meaning of section 1259.

Section 1092 provides rules regarding the tax effect of entering into certain straddle transactions. In particular, the Service may want to consider suspending an ISO stock holding period in the same manner as a holding period is suspended under section 1092 when a taxpayer holds offsetting positions and positions that are successor positions to the initial offsetting position. *See* Temp. Treas. Reg. section 1.1092(b)-2T(a)(1).

Section 424(c)(1) specifically excludes a "mere pledge" from a disposition of ISO shares. We believe a pledge of ISO shares to secure a recourse loan should not be considered a disposition. *See, e.g.,* P.L.R. 8636055 (June 10, 1986) (margin account stock pledge not a disposition). A pledge of stock to secure a nonrecourse loan, however, may be a disposition, depending on the substance of the transaction. For example, a pledge of stock to secure 100 percent of a nonrecourse loan to purchase the stock closely resembles an immediate sale combined with the grant of a call option with the exercise price equal to the amount of the loan. *See* Treas. Reg. section 1.83-3(a)(2). Thus, the Service may want to review the scope of the pledge exception to a disposition.

We recommend that the Service propose regulations under which a transaction resulting in a complete or near complete elimination of risk through a short sale, forward sale, equity swap, deep-in-the-money call or put option or combination of puts and calls, or other financial instruments would be treated as a disposition, while a transaction resulting in the elimination of some risk while retaining meaningful risk through the use of financial instruments would not be treated as a disposition.

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<sup>7</sup> The enactment of these Code provisions raises the issue of whether there is statutory authority under the ISO Code provisions for promulgating similar rules as regulations. By publishing Rev. Rul. 59-242 and Rev. Rul. 73-92, the Service indicated its view that the predecessors of the current ISO disposition rule provided sufficient authority. The legislative history of ERTA, cited above, provides some support for the existence of authority under current law. In any event, publishing proposed regulations for public comment is a preferable means to develop guidance than issuing further revenue rulings.

<sup>8</sup> Regulations under section 1259 have not yet been published. Some guidance is contained in the legislative history. *See* Blue Book for 1997 Tax Legislation 172-180.

## EFFECTIVE DATE

### 1. Summary.

The Proposed Regulations are proposed to be effective as of the date which is 180 days after publication of the final regulations in the Federal Register and apply to any statutory option that is granted after that date. The proposal provides that taxpayers may rely on the Proposed Regulations for the tax treatment of any statutory option granted after June 9, 2003, the date of publication of the Proposed Regulations.

### 2. Recommendations.

We recommend that the final regulations modify the effective date provisions of the Proposed Regulations in three respects. First, we recommend that the final regulations clarify that the rules proposed under Treasury Regulation section 1.421-7(c) apply for purposes of determining the date of grant of a statutory option for purposes of the effective date rule. Second, we recommend that the final regulations provide a delayed effective date for existing incentive stock option plans to comply until a new shareholder approval is required for other reasons. Alternatively, we recommend that the regulations include a transition rule providing that an option granted after the effective date of the final regulations does not fail to be granted under a plan complying with the new maximum share rules of Proposed Regulation section 1.422-2(b)(3) and the shareholder approval requirement of section 422(b)(1), as interpreted in Proposed Regulation section 1.422-2(b)(2), if the plan is amended by the board of directors (or other party with authority to amend the plan) prior to the grant of such option to comply prospectively with Proposed Regulation section 1.422-2(b)(3). In addition, the amendment must not increase the number of shares that would otherwise be available under the plan. Third, we recommend that the provisions of the Proposed Regulations which allow for reliance on the Proposed Regulations be continued so that taxpayers will have the right to rely on the Proposed Regulations for options granted prior to the publication date of the final regulations.

### 3. Discussion.

The effective date rule is to be based on the date of grant of the option. Treasury Regulation section 1.421-7(a), in its current and proposed amended form, specifically addresses when a statutory option is treated as granted. Accordingly, it would be appropriate to reference this regulation for purposes of the effective date rule.

The plans under which statutory options are granted are typically effective and continue in operation for many years. Under section 422, incentive stock options may be granted under a plan up to ten years after the earlier of the date the plan is adopted, and the plan is approved by the shareholders. Consequently, Congress decided in section 422 to mandate shareholder approval only once every ten years. Certain shareholder-approved methods for determining the maximum number of shares available for an incentive stock options under many outstanding plans would no longer be permitted if the regulations are adopted in the proposed form. As discussed above, existing plans may have designated a share limit solely for incentive stock options. Also, existing plans may be using methods for determining the maximum number of

shares that would not comply with the rules of Proposed Regulation section 1.422-2(b)(3)(ii) regarding "evergreen" provisions or Proposed Regulation section 1.422-2(b)(3)(iii) regarding adding shares back to the plan. Since these plan provisions were approved by shareholders prior to the final regulations, we recommend that the plans be permitted to continue to operate as approved by the shareholders until such time as a new shareholder approval is otherwise required. Thus, we recommend delaying the effective date of Proposed Regulation section 1.422-2(b)(3) until the earlier of (i) the first shareholder meeting that occurs three years after the publication date of the Proposed Regulations and (ii) the date that new shareholder approval is required for other reason. This approach is similar to the transition rule adopted by the Service in the section 162(m) regulations under Treasury Regulation section 1.162-27(h)(3).

Our alternative recommendation is that if no limited grandfather from the effective date of Proposed Regulation section 1.422-2(b)(3) is provided, then a transition rule be provided that permits the board of directors (or other party with authority to amend the plan) to amend the plan, without shareholder approval being required, to bring the plan into compliance with the maximum share rules, provided that the amendment must not increase the number of shares that would otherwise have been available. Such an amendment will almost always have the effect of reducing the number of shares that would otherwise be available. For example, a board of directors could amend a plan to provide that the maximum number of shares available for all types of future grants under the plan is the number of shares then available for incentive stock option grants, as adjusted in accordance with the plan and the provisions of the regulations. (*See, e.g.,* Prop. Reg. section 1.422(b)(3)(iii) (regarding forfeited shares added back). Similarly, if the offending provision added back shares to the plan under circumstances not permitted by the new regulations, the board of directors could amend the plan prospectively to stop adding the shares back under those circumstances. While this transition rule would be available for purposes of determining whether an option is a statutory option, other requirements, such as the terms of the plan, state laws or, in the case of listed companies, stock exchange listing rules, nonetheless might require the corporation to seek new shareholder approval.

Finally, the Proposed Regulations provide additional and helpful guidance in areas for which there was no previous guidance. Since options with maximum exercise periods of ten years (as permitted under section 422(b)(3)) that were granted prior to the Proposed Regulations' June 9, 2003 reliance effective date can be exercised as late as June 9, 2013, we recommend that taxpayers be given the right to rely on the Proposed Regulations for options granted prior to the June 9, 2003 publication date. In some circumstances, such as in applying the rules dealing with the application of the \$100,000 limit to performance-accelerated vesting of options, we believe that reliance on the new regulations is appropriate for pre-June 9, 2003 options since a consistent application of the \$100,000 limit rule to all options held by an individual is necessary to determine the status of options granted after June 9, 2003 or after the effective date of the final regulations.

## **STATUTORY OPTIONS ASSUMED IN A CORPORATE TRANSACTION**

### **1. Summary.**

Proposed Regulation section 1.424-1(a)(5)(vi) states that a "new or assumed option [in a corporate transaction] must otherwise comply with the requirements of Section

1.422-2. . . . Thus, for example, the old option must be assumed or the new option must be issued under a plan approved by the stockholders of the corporation changing the option or issuing the new option as described in section 1.422-2(b)(2). . . ." Proposed Regulation section 1.422-2(b)(2)(iii) provides that a change in the granting corporation or the stock available for purchase under a plan (as may be the case in the context of a corporate transaction whereby statutory options are assumed) is deemed the adoption of a new plan requiring shareholder approval. These provisions appear to require a buyer to account for assumed options under one of its existing shareholder approved plans in order to avoid a "modification" under section 424 of the Code. This interpretation is consistent with Proposed Regulation section 1.424-1(a)(10), Examples 8 and 9, which imply that the assumption of statutory options is a modification to a statutory option if, after the assumption, the option holder is entitled to receive common stock of the acquiring company rather than the acquired company.

## 2. Recommendation.

We recommend that the final regulations provide that the shareholder approval by the seller's (or target's) shareholders prior to a corporate transaction be recognized for both substituted and assumed statutory stock options for purposes of shareholder approval requirements under section 422. Where a buyer does not maintain a shareholder approved plan permitting ISOs, we believe it should not be required to seek shareholder approval for such a plan as a condition for assuming the target company's ISOs or issuing replacement ISOs. Further, we believe that if replacement ISOs are issued under an existing plan sponsored by the buyer to replace a seller's statutory stock options (that are otherwise in accordance with Proposed Regulation section 1.424-1(a)(4) and (5)), the final regulations should clarify that the shares covered by the replacement ISOs should not count against the shares available for grants to employees of the buyer and its parent and subsidiary corporations.

## 3. Explanation.

If the Proposed Regulations are finalized in their current form, it appears that a buyer that seeks to continue the seller's ISOs following a corporate transaction must treat them as issued under a shareholder approved plan of the buyer, which plan may have been previously approved by shareholders or approved at the time of the transaction, to avoid a modification under section 424. We believe this result conflicts with the Service's longstanding guidance that qualified stock options assumed by a corporation in a merger retain their status as qualified stock options without approval of the assuming corporation's shareholders.<sup>9</sup> The Service specifically indicated that approval of the persons who owned stock of the granting corporation at the time the plan was approved was sufficient to satisfy the shareholder approval requirement.

We believe that this recommendation is consistent with the statute and its legislative history and with the historical practice of most corporations. Standard practice has generally been that the buyer's shareholders do not re-approve the target's plan, and that assumed or

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<sup>9</sup> See Rev. Rul. 71-474, 1971-2 C.B. 215; P.L.R. 9108062 (Nov. 30, 1990); P.L.R. 9047030 (Aug. 27, 1990); P.L.R. 9031009 (May 3, 1990); P.L.R. 7828041 (Apr. 13, 1978).

substituted statutory options do not count against the buyer's share reserve under one of its own plans that provides for statutory stock options. We note that this approach is also consistent with the recently approved equity compensation shareholder approval rules approved by the SEC for NYSE and Nasdaq companies, which generally do not require new shareholder approval for assumed options. We believe that, at a minimum, shareholders should be allowed to approve plan provisions in advance that allow for the Board or its designee to substitute statutory stock options of a target company with its own statutory stock options under an existing plan without a charge to that plan's existing share reserve.

## **PROTECTIVE 83(b) ELECTIONS**

### 1. Summary.

The Proposed Regulations do not address how a section 83(b) election affects the treatment of a disqualifying disposition of shares that were not vested at the time of ISO exercise.

### 2. Recommendation.

We recommend that the Service issue proposed regulations providing that, if there is a subsequent disqualifying disposition of the underlying stock, section 83(b) elections are effective for ordinary income purposes (including for purposes of commencing the capital gains holding period) upon the later of the exercise of the incentive stock option or the 83(b) election.

### 3. Explanation.

It is commonly believed that if an optionee "early exercises" an incentive stock option (i.e., receives restricted stock upon the exercise of an unvested option), and disposes of the stock underlying the exercised option in a disqualifying disposition, the optionee will recognize ordinary income on the difference between the value of the stock on the option's vesting date and the option exercise price, and the optionee will recognize capital gain, equal to the difference between the amount realized on the sale and the value of the stock on the vesting date. In addition, it is commonly believed that the capital gain holding period begins on the vesting dates, and not on the date of exercise. The following example illustrates these tax consequences of filing a section 83(b) election with respect to the early exercise of an incentive stock option.

On January 1, 2004, a corporation grants its employee an incentive stock option to purchase 10,000 shares of common stock of the corporation. The fair market value of the stock at the time of grant and the option exercise price are \$1.00 per share. The incentive stock option has a standard 4-year vesting schedule (25% of the shares become vested after one year and then 1/48<sup>th</sup> of the shares become vested each month thereafter) and provides that the option may be exercised in whole or in part before any of the vesting dates. The optionee "early exercises" the incentive stock option on January 1, 2004, and files a section 83(b) election. The optionee vests in 2,500 of the option shares on January 1, 2005 when the company's fair market value is \$2.00 per share. The optionee sells those 2,500 shares on May 1, 2005 when the company's fair market value is \$5.00 per share.

The tax results would, under this interpretation, be as follows: (i) The grant of the option is not a taxable event to the optionee. (ii) The exercise of the incentive stock option also is not a taxable event to the optionee. Because the optionee filed an election under section 83(b), the optionee has no tax adjustment for AMT purposes since the exercise price of the option is equal to its fair market value. (iii) Upon a sale of the stock on May 1, 2005, the optionee recognizes ordinary income equal to \$2,500 [2,500 vested shares \* the "spread" on the vesting date (\$2.00 - \$1.00)] and short-term capital gain of \$7,500 [2,500 \* (\$5.00 - \$2.00)] as the optionee did not hold the shares for more than one year from the vesting date (when the capital gain holding period starts).

We recommend that the final regulations clarify that when an individual "early exercises" an incentive stock option and makes a section 83(b) election, upon any disqualifying disposition of the exercised shares, the individual will recognize ordinary income equal to the difference, if any, between the fair market value of the stock at the time of exercise less the exercise price. Any additional gain or loss as a result of the disposition is capital gain or loss equal to the difference between the amount realized on the disposition and the value of the stock on the exercise date (with the capital gain holding period beginning on the exercise date). The following example illustrates these tax consequences of filing a section 83(b) election with respect to the early exercise of an incentive stock option.

Assume the same facts as in the above example. The tax results would be as follows: (i) The grant of the option is not a taxable event to the optionee. (ii) The exercise of the incentive stock option also is not a taxable event to the optionee. Moreover, the optionee has no tax adjustment for AMT purposes since the exercise price of the option is equal to its fair market value. (iii) Upon a sale of the stock on May 1, 2005, the optionee recognizes long-term capital gain of \$10,000 [2,500 \* (\$5.00 - \$1.00)].

We believe this position is consistent with Proposed Regulation section 1.421-2(b), which states that Proposed Regulation section 1.421-2(a) is inapplicable on a disqualifying disposition and strongly implies, by its express reference to Treasury Regulation section 1.83-7, that the original transfer of the shares on exercise should be governed by section 83. Treasury Regulation section 1.83-2 provides that (a) a person may elect to include in gross income, at the time of transfer, the excess of the fair market value of property over the price paid for the property even if the property is substantially nonvested, and (b) if such an election is made, no compensation will be included in gross income when the property becomes substantially vested. If Proposed Regulation section 1.421-2(a) is inapplicable to a disqualifying disposition and section 83 is deemed to have applied on the date of exercise, then assuming an effective 83(b) election was filed within 30 days of the date of transfer, we believe it should be effective for ordinary income purposes.