Internal Revenue
bulletin

Bulletin No. 2004-36
September 7, 2004

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2004–69, page 445.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for September 2004.

T.D. 9143, page 442.
REG–208246–90, page 450.

Temporary, final, and proposed regulations under section 861 of the Code provide that deductions for charitable contributions (as defined in section 170(c)) are definitely related and allocable to all of the taxpayer's gross income and are apportioned on the basis of income from sources within the United States. The final regulations, which provide that deductions for charitable contributions are not definitely related to any gross income and therefore are ratably apportioned between or among the statutory and residual groupings, are removed. The proposed regulations withdraw proposed regulations, INTL-116–90, 1991–1 C.B. 949. A public hearing on the proposed regulations is scheduled for December 2, 2004. INTL-116–90 withdrawn.

T.D. 9144, page 413.

Final regulations under section 421 of the Code provide guidance to taxpayers who are granted statutory stock options (*i.e.*, incentive stock options and options granted under an employee stock purchase plan) and corporations who grant such options. The regulations also provide rules for the creation and operation of a statutory stock option plan.

T.D. 9146, page 408.
REG–152549–03, page 451.

Final, temporary, and proposed regulations under section 179 of the Code provide rules for making and revoking elections to expense the cost of certain depreciable business property. The regulations apply for property placed in service in taxable years beginning after 2002 and before 2006. A public hearing on the proposed regulations is scheduled for November 30, 2004.

REG–129771–04, page 453.

Proposed regulations under section 951(a) of the Code provide guidance for determining a United States shareholder's *pro rata* share of a controlled foreign corporation's (CFC's) subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from foreign base company shipping operations, and amounts determined under section 956. A public hearing is scheduled for November 18, 2004.

Announcement 2004–67, page 459.

This document contains corrections to A-14 in Notice 2004–2, 2004–2 I.R.B. 269, relating to Health Savings Accounts. Notice 2004–2 corrected.

EMPLOYEE PLANS

Notice 2004–59, page 447.

Alternative deficit reduction election; amendment following election. This notice provides guidance on the restrictions that are placed on plan amendments following an employer's election of the alternative deficit reduction contribution under § 412(l)(12) of the Code and section 302(d)(12) of the Employee Retirement Income Security Act of 1974, as added by section 102 of the Pension Funding Equity Act of 2004.

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 179.—Election to Expense Certain Depreciable Business Assets

26 CFR 1.179–2: Limitations on amount subject to section 179 election.

T.D. 9146

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Section 179 Elections

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations relating to the election to expense the cost of property subject to section 179 of the Internal Revenue Code. The regulations reflect changes to the law made by section 202 of the Jobs and Growth Tax Relief Reconciliation Act of 2003. The text of these temporary regulations also serves as the text of the proposed regulations (REG–152549–03) set forth in the notice of proposed rulemaking in this issue of the Bulletin.

DATES: *Effective Dates:* These regulations are effective August 4, 2004.

Applicability Dates: For dates of applicability, see §1.179–6T.

FOR FURTHER INFORMATION CONTACT: Winston H. Douglas, (202) 622–3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the **Office of Management and Budget** under control number 1545–1201. Responses to this collection of information are required to obtain a benefit.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

For further information concerning this collection of information, where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, Federal tax returns and tax return information are confidential pursuant to 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR part 1 to provide regulations under section 179 of the Internal Revenue Code (Code). These amendments reflect the changes to the law made by section 202 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Public Law 108–27 (117 Stat. 752).

Prior to the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) (117 Stat. 752), section 179 provided that, in lieu of depreciation under section 168 (MACRS depreciation) for taxable years beginning in 2003 and thereafter, a taxpayer with a sufficiently small amount of current year investment in section 179 property could elect to deduct up to $25,000 of the cost of section 179 property placed in service by the taxpayer for the taxable year. In general, section 179 property was defined as depreciable tangible personal property that was purchased for use in the active conduct of a trade or business. The $25,000 amount was reduced (but not below zero) by the amount by which the cost of section 179 property placed in service by the taxpayer during the taxable year exceeded $200,000. The election under section 179 generally was made on the taxpayer's original Federal tax return for the taxable year to which the election related, required specific information to be provided at the time the election was made, and could only be revoked with the consent of the Commissioner of Internal Revenue.

The changes made to section 179 by section 202 of JGTRRA are applicable for section 179 property placed in service by a taxpayer in taxable years beginning after 2002 and before 2006. Section 202 of JGTRRA expands the definition of section 179 property to include off-the-shelf computer software (a category of intangible property) and increases the $25,000 and $200,000 amounts to $100,000 and $400,000, respectively. In addition, the $100,000 and $400,000 amounts are indexed annually for inflation for taxable years beginning after 2003 and before 2006. JGTRRA also modifies section 179 to provide that any election or specification for taxable years beginning after 2002 and before 2006 may be revoked by the taxpayer with respect to any section 179 property, and that such revocation, once made, shall be irrevocable. The conference agreement (H.R. Conf. Rep. No. 108–126, at 35 (2003)) states that a taxpayer may make or revoke an expensing election on an amended Federal tax return without the consent of the Commissioner.

Explanation of Provisions

For taxable years beginning after 2002 and before 2006, the regulations reflect the change to section 179(d)(1) by including off-the-shelf computer software in the definition of section 179 property,

and the changes to sections 179(b)(1) and (2) by increasing the respective amounts to $100,000 and $400,000. The regulations also provide guidance for making and revoking elections under section 179 for those taxable years. Several examples are provided to illustrate how taxpayers may make and revoke their section 179 elections. Additionally, each year the IRS will publish the annual inflation indexed amounts for sections 179(b)(1) and (2). For the inflation indexed amounts for taxable years beginning in 2004, see Rev. Proc. 2003–85, 2003–49 I.R.B. 1184.

Making or Revoking Section 179 Elections on Amended Federal Tax Returns

Prior to the enactment of JGTRRA, an election to expense the cost of property under section 179 generally was made on the taxpayer's original federal tax return for the taxable year to which the election applied. An election could only be revoked with the consent of the Commissioner. The section 179 regulations (pre-JGTRRA) provided that a revocation of an election would only be granted in extraordinary circumstances.

Small business taxpayers are often unaware of the advantages or disadvantages of section 179 expensing. Some taxpayers may not have been aware of the section 179 election until after filing an original Federal tax return. In addition, making the section 179 election is not always to a taxpayer's advantage. For example, the section 179 election may prevent the taxpayer from fully using exemptions and deductions, reduce a taxpayer's coverage under the social security system, and make various tax credits unusable. See Internal Revenue Service, Publication 946, *"How to Depreciate Property (For use in preparing 2003 Returns)"*, p. 14, and "General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals", Department of the Treasury, p. 23 (February 2003).

Permitting taxpayers to make or revoke section 179 elections on amended Federal tax returns without the consent of the Commissioner reflects Congress' intent "that the process of making and revoking section 179 elections should be made simpler and more efficient for taxpayers." H.R. Rep. No. 108–94, at 25 and 26 (2003) and S. Prt. No. 108–26, at 10 (2003). Such a process will provide flexibility to small business taxpayers in determining whether the section 179 election is to their advantage or disadvantage.

Section 1.179–5T(c)(1) establishes the time period during which a taxpayer may make or revoke a section 179 election on an amended Federal tax return.

Section 1.179–5T(c)(2) provides that a section 179 election made on an amended Federal tax return must specify the item of section 179 property to which the election applies and the portion of the cost of each such item to be taken into account under section 179. Further, if a taxpayer elected to expense only a portion of the cost basis of an item of section 179 property for a particular taxable year (or did not elect to expense any portion of the cost basis of an item of section 179 property), §1.179–5T(c)(2) allows the taxpayer to file an amended Federal tax return and expense any portion of the cost basis of an item of section 179 property that was not expensed pursuant to a prior section 179 election. Any such increase in the amount expensed under section 179 is not deemed to be a revocation of the prior election for that particular taxable year.

Section 1.179–5T(c)(3) provides that any election under section 179, or specification of such election, for any taxable year beginning after 2002 and before 2006 for any item of section 179 property may be revoked by the taxpayer on an amended Federal tax return without the Commissioner's consent and that such revocation, once made, is irrevocable. For this purpose, a *specification* refers to both the selected specific item of section 179 property subject to a section 179 election and a selected dollar amount allocable to the specific item of section 179 property. In addition, §1.179–5T(c)(3) describes the circumstances under which partial and entire revocations of elections and specifications occur. Section 1.179–5T(c)(3) also discusses the effect of a revocation of an election under section 179 or a revocation of any specification of such election.

Section 1.179–5T(c)(4) sets forth examples illustrating the rules of paragraphs (c)(1), (2), and (3).

Section 1.179–6T provides the applicability dates for the provisions of §§1.179–2T, 1.179–4T, and 1.179–5T.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the cross-reference notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Winston H. Douglas, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.179–0 is amended as follows:

1. Paragraphs (b)(1) and (b)(2) of §1.179–2 are revised.
2. Section 1.179–2T is added.
3. Paragraph (a) of §1.179–4 is revised.
4. Section 1.179–4T is added.
5. Paragraph (c) of §1.179–5 is added.
6. Section 1.179–5T is added.
7. Section 1.179–6T is added.

The revisions and additions read as follows:

§1.179–0 Table of contents for section 179 expensing rules.

* * * * *

§1.179–2 Limitations on amount subject to section 179 election.

* * * * *

(b) * * *

(1) [Reserved].

(2) [Reserved].

* * * * *

§1.179–2T Limitations on amount subject to section 179 election (temporary).

(a) [Reserved].

(b) Dollar Limitation.

(1) In general.

(2) Excess section 179 property.

(3) through (d) [Reserved].

* * * * *

§1.179–4 Definitions.

(a) Section 179 property [Reserved].

* * * * *

§1.179–4T Definitions.

(a) Section 179 property.

(b) through (f) [Reserved].

§1.179–5 Time and manner of making election.

* * * * *

(c) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006.

§1.179–5T Time and manner of making election.

(a) and (b) [Reserved].

(c) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006.

* * * * *

§1.179–6T Effective dates.

(a) In general.

(b) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006.

Par. 3. Section 1.179–2 is amended by revising paragraphs (b)(1) and (b)(2)(ii) to read as follows:

§1.179–2 Limitations on amount subject to section 179 election.

* * * * *

(b) * * *

(1) [Reserved]. For further guidance, see §1.179–2T(b)(1).

(2) * * *

(i) * * *

(ii) [Reserved]. For further guidance, see §1.179–2T(b)(2)(ii).

* * * * *

Par. 4. Section 1.179–2T is added to read as follows:

§1.179–2T Limitations on amount subject to section 179 election (temporary).

(a) [Reserved]. For further guidance, see §1.179–2(a).

(b) *Dollar limitation*—(1) *In general*. The aggregate cost of section 179 property that a taxpayer may elect to expense under section 179 for any taxable year beginning in 2003 and thereafter is $25,000 ($100,000 in the case of taxable years beginning after 2002 and before 2006 under section 179(b)(1), indexed annually for inflation under section 179(b)(5) for taxable years beginning after 2003 and before 2006), reduced (but not below zero) by the amount of any excess section 179 property (described in paragraph (b)(2) of this section) placed in service during the taxable year.

(b)(2) and (b)(2)(i) [Reserved]. For further guidance, see §1.179–2(b)(2) and (b)(2)(i).

(ii) $200,000 ($400,000 in the case of taxable years beginning after 2002 and before 2006 under section 179(b)(2), indexed annually for inflation under section 179(b)(5) for taxable years beginning after 2003 and before 2006).

(b)(3) through (d) [Reserved]. For further guidance, see §1.179–2(b)(3) through (d).

Par. 5. Section 1.179–4 is amended by revising paragraph (a) to reads as follows:

§1.179–4 Definitions.

* * * * *

(a) [Reserved]. For further guidance, see §1.179–4T(a).

* * * * *

Par. 6. Section 1.179–4T is added to read as follows:

§1.179–4T Definitions (temporary).

The following definitions apply for purposes of section 179, §§1.179–1 through 1.179–6, and §§1.179–2T, 5T, and 6T:

(a) *Section 179 property*. The term *section 179 property* means any tangible property described in section 179(d)(1) that is acquired by purchase for use in the active conduct of the taxpayer's trade or business (as described in §1.179–2(c)(6)). For taxable years beginning after 2002 and before 2006, the term *section 179 property* includes computer software described in section 179(d)(1) that is placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006 and is acquired by purchase for use in the active conduct of the taxpayer's trade or business (as described in §1.179–2(c)(6)). For purposes of this paragraph (a), the term *trade or business* has the same meaning as in section 162 and the regulations thereunder.

(b) through (f) [Reserved]. For further guidance, see §1.179–4(b) through (f).

Par. 7. Section 1.179–5 is amended by adding paragraph (c) to read as follows:

§1.179–5 Time and manner of making election.

* * * * *

(c) *Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006*. [Reserved]. For further guidance, see §1.179–5T(c).

Par. 8. Section 1.179–5T is added to read as follows:

§1.179–5T Time and manner of making election (temporary).

(a) and (b) [Reserved]. For further guidance, see §1.179–5(a) and (b).

(c) *Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006*—(1) *In general*. For any taxable year beginning after 2002 and before 2006, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for such taxable year.

(2) *Election*—(i) *In general*. For any taxable year beginning after 2002 and

before 2006, a taxpayer is permitted to make an election under section 179 on an amended Federal tax return for that taxable year without the consent of the Commissioner. Thus, the election under section 179 and §1.179–1 to claim a section 179 expense deduction for section 179 property may be made on an amended Federal tax return for the taxable year to which the election applies. The amended Federal tax return must include the adjustment to taxable income for the section 179 election and any collateral adjustments to taxable income or to the tax liability (for example, the amount of depreciation allowed or allowable in that taxable year for the item of section 179 property to which the election pertains). Such adjustments must also be made on amended Federal tax returns for any affected succeeding taxable years.

(ii) *Specifications of election*. Any election under section 179 must specify the items of section 179 property and the portion of the cost of each such item to be taken into account under section 179(a). Any election under section 179 must comply with the specification requirements of section 179(c)(1)(A), §1.179–1(b), and §1.179–5(a). If a taxpayer elects to expense only a portion of the cost basis of an item of section 179 property for a taxable year beginning after 2002 and before 2006 (or did not elect to expense any portion of the cost basis of the item of section 179 property), the taxpayer is permitted to file an amended Federal tax return for that particular taxable year and increase the portion of the cost of the item of section 179 property to be taken into account under section 179(a) (or elect to expense any portion of the cost basis of the item of section 179 property if no prior election was made) without the consent of the Commissioner. Any such increase in the amount expensed under section 179 is not deemed to be a revocation of the prior election for that particular taxable year.

(3) *Revocation*—(i) *In general*. Section 179(c)(2) permits the revocation of an entire election or specification, or a portion of the selected dollar amount of a specification. The term *specification* in section 179(c)(2) refers to both the selected specific item of section 179 property subject to a section 179 election and the selected dollar amount allocable to the specific item of section 179 property. Any portion of the cost basis of an item of section 179 property subject to an election under section 179 for a taxable year beginning after 2002 and before 2006 may be revoked by the taxpayer without the consent of the Commissioner by filing an amended Federal tax return for that particular taxable year. The amended Federal tax return must include the adjustment to taxable income for the section 179 revocation and any collateral adjustments to taxable income or to the tax liability (for example, allowable depreciation in that taxable year for the item of section 179 property to which the revocation pertains). Such adjustments must also be made on amended Federal tax returns for any affected succeeding taxable years. Reducing or eliminating a specified dollar amount for any item of section 179 property with respect to any taxable year beginning after 2002 and before 2006 results in a revocation of that specified dollar amount.

(ii) *Effect of revocation*. Such revocation, once made, shall be irrevocable. If the selected dollar amount reflects the entire cost of the item of section 179 property subject to the section 179 election, a revocation of the entire selected dollar amount is treated as a revocation of the section 179 election for that item of section 179 property and the taxpayer is unable to make a new section 179 election with respect to that item of property. If the selected dollar amount is a portion of the cost of the item of section 179 property, revocation of a selected dollar amount shall be treated as a revocation of only that selected dollar amount. The revoked dollars cannot be the subject of a new section 179 election for the same item of property.

(4) *Examples*. The following examples illustrate the rules of this paragraph (c):

Example 1. Taxpayer, a sole proprietor, owns and operates a jewelry store. During 2003, Taxpayer purchased and placed in service two items of section 179 property — a cash register costing $4,000 (5-year MACRS property) and office furniture costing $10,000 (7-year MACRS property). On his 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 the full cost of the cash register and, with respect to the office furniture, claimed the depreciation allowable. In November 2004, Taxpayer determines it would have been more advantageous to have made an election under section 179 to expense the full cost of the office furniture rather than the cash register. Pursuant to paragraph (c)(1) of this section, Taxpayer is permitted to file an amended Federal tax return for 2003 revoking the section 179 election for the cash register, claiming the depreciation allowable in 2003 for the cash register, and making an election to expense under section 179 the cost of the office furniture. The amended return must include an adjustment for the depreciation previously claimed in 2003 for the office furniture, an adjustment for the depreciation allowable in 2003 for the cash register, and any other collateral adjustments to taxable income or to the tax liability. In addition, once Taxpayer revokes the section 179 election for the entire cost basis of the cash register, Taxpayer can no longer expense under section 179 any portion of the cost of the cash register.

Example 2. Taxpayer, a sole proprietor, owns and operates a machine shop that does specialized repair work on industrial equipment. During 2003, Taxpayer purchased and placed in service one item of section 179 property — a milling machine costing $135,000. On Taxpayer's 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 $5,000 of the cost of the milling machine and claimed allowable depreciation on the remaining cost. Subsequently, Taxpayer determines it would have been to Taxpayer's advantage to have elected to expense $100,000 of the cost of the milling machine on Taxpayer's 2003 Federal tax return. In November 2004, Taxpayer files an amended Federal tax return for 2003, increasing the amount of the cost of the milling machine that is to be taken into account under section 179(a) to $100,000, decreasing the depreciation allowable in 2003 for the milling machine, and making any other collateral adjustments to taxable income or to the tax liability. Pursuant to paragraph (c)(2)(ii) of this section, increasing the amount of the cost of the milling machine to be taken into account under section 179(a) supplements the portion of the cost of the milling machine that was already taken into account by the original section 179 election made on the 2003 Federal tax return and no revocation of any specification with respect to the milling machine has occurred.

Example 3. Taxpayer, a sole proprietor, owns and operates a real estate brokerage business located in a rented storefront office. During 2003, Taxpayer purchases and places in service two items of section 179 property — a laptop computer costing $2,500 and a desktop computer costing $1,500. On Taxpayer's 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 the full cost of the laptop computer and the full cost of the desktop computer. Subsequently, Taxpayer determines it would have been to Taxpayer's advantage to have originally elected to expense under section 179 only $1,500 of the cost of the laptop computer on Taxpayer's 2003 Federal tax return. In November 2004, Taxpayer files an amended Federal tax return for 2003 reducing the amount of the cost of the laptop computer that was taken into account under section 179(a) to $1,500, claiming the depreciation allowable in 2003 on the remaining cost of $1,000 for that item, and making any other collateral adjustments to taxable income or to the tax liability. Pursuant to paragraph (c)(3)(ii) of this section, the $1,000 reduction represents a revocation of a portion of the selected dollar amount and no portion of those revoked dollars may be the subject of a new section 179 election for the laptop computer.

Example 4. Taxpayer, a sole proprietor, owns and operates a furniture making business. During 2003, Taxpayer purchases and places in service one item of section 179 property — an industrial-grade cabinet table saw costing $5,000. On Taxpayer's 2003 Federal tax return filed on April 15, 2004, Taxpayer

elected to expense under section 179 $3,000 of the cost of the saw and, with respect to the remaining $2,000 of the cost of the saw, claimed the depreciation allowable. In November 2004, Taxpayer files an amended Federal tax return for 2003 revoking the selected $3,000 amount for the saw, claiming the depreciation allowable in 2003 on the $3,000 cost of the saw, and making any other collateral adjustments to taxable income or to the tax liability. Subsequently, in December 2004, Taxpayer files a second amended Federal tax return for 2003 selecting a new dollar amount of $2,000 for the saw, including an adjustment for the depreciation previously claimed in 2003 on the $2,000, and making any other collateral adjustments to taxable income or to the tax liability. Pursuant to paragraph (c)(2)(ii) of this section, Taxpayer is permitted to select a new selected dollar amount to expense under section 179 encompassing all or a part of the initially non-elected portion of the cost of the elected item of section 179 property. However, no portion of the revoked $3,000 may be the subject of a new section 179 dollar amount selection for the saw. In December 2005, Taxpayer files a third amended Federal tax return for 2003 revoking the entire selected $2,000 amount with respect to the saw, claiming the depreciation allowable in 2003 for the $2,000, and making any other collateral adjustments to taxable income or to the tax liability. Because Taxpayer elected to expense, and subsequently revoke, the entire cost basis of the saw, the section 179 election for the saw has been revoked and Taxpayer is unable to make a new section 179 election with respect to the saw.

Par. 9. Section 1.179–6T is added to read as follows:

§1.179–6T Effective dates.

(a) *In general.* Except as provided in paragraph (b) of this section, the provisions of §§1.179–1 through 1.179–5 apply for property placed in service by the taxpayer in taxable years ending after January 25, 1993. However, a taxpayer may apply the provisions of §§1.179–1 through 1.179–5 to property placed in service by the taxpayer after December 31, 1986, in taxable years ending on or before January 25, 1993. Otherwise, for property placed in service by the taxpayer after December 31, 1986, in taxable years ending on or before January 25, 1993, the final regulations under section 179 as in effect for the year the property was placed in service apply, except to the extent modified by the changes made to section 179 by the Tax Reform Act of 1986 (100 Stat. 2085), the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3342) and the Revenue Reconciliation Act of 1990 (104 Stat. 1388–400). For that property, a taxpayer may apply any reasonable method that clearly reflects income in applying the changes to section 179, provided the taxpayer consistently applies the method to the property.

(b) *Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006.* The provisions of §§1.179–2T, 1.179–4T, and 1.179–5T, reflecting changes made to section 179 by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (117 Stat. 752), apply for property placed in service in taxable years beginning after 2002 and before 2006.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 10. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 11. In §602.101, paragraph (b) is amended by adding the following entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
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1.179–2T	1545–1201
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1.179–5T	1545–1201
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Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved July 21, 2004.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on August 3, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 4, 2004, 69 F.R. 46982)

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 421.—General Rules

26 CFR 1.421–1: Meaning and use of certain terms.

T.D. 9144

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1 and 14a

Statutory Options

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to statutory options. These final regulations affect certain taxpayers who participate in the transfer of stock pursuant to the exercise of incentive stock options and the exercise of options granted pursuant to an employee stock purchase plan (statutory options). These regulations provide guidance to assist these taxpayers in complying with the law in addition to clarifying rules regarding statutory options.

DATES: *Effective Date:* These regulations are effective on August 3, 2004. For rules concerning reliance and transition period, see §§1.421–1(j)(2), 1.421–2(f)(2), 1.422–5(f)(2), and 1.424–1(g)(2).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, please contact Erinn Madden at (202) 622–6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations (see §1.6039–1) has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–0820. Responses to this collection of information are required to assist taxpayers with the completion of their income tax returns for the taxable year in which a disposition of statutory option stock occurs.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent varies from 15 minutes to 25 minutes, depending on individual circumstances, with an estimated average of 20 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR part 1 under sections 421, 422, and 424 of the Internal Revenue Code (Code). Changes to the applicable tax law concerning section 421 were made by sections 11801 and 11821 of the Omnibus Budget Reconciliation Act of 1990 (OBRA 90), Public Law 101–508 (104 Stat. 1388). Changes to the applicable tax law concerning section 424 were made by section 1003 of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Public Law 100–647 (102 Stat. 3342), sections 11801 and 11821 of OMBRA 90, which included re-designating section 425 as section 424 of the Code, and section 1702(h) of the Small Business Job Protection Act of 1996, Public Law 104–88 (110 Stat. 1755). Changes concerning section 422 were made by section 251 of the Economic Recovery Tax Act of 1981, Public Law 97–34 (95 Stat. 172), which added section 422A to the Code. Related changes to section 422A were made by section 102(j) of the Technical Corrections Act of 1982, Public Law 97–448 (96 Stat. 2365), section 321(a) of Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085), section 1003(d) of TAMRA, and sections 11801 and 11821 of OBRA 90, which included re-designating section 422A as section 422 of the Code.

Regulations under section 421 governing the requirements for restricted stock options and qualified stock options, as well as options granted under an employee stock purchase plan, were published in the **Federal Register** on December 9, 1957 (T.D. 6276, 1957–2 C.B. 271), November 26, 1960 (T.D. 6500), January 19, 1961 (T.D. 6527, 1961–1 C.B. 153), January 20, 1961 (T.D. 6540, 1961–1 C.B. 161), December 12, 1963 (T.D. 6696, 1963–2 C.B. 23), June 24, 1966 (T.D. 6887, 1966–2 C.B. 129), July 24, 1978 (T.D. 7554, 1981–1 C.B. 56), and November 3, 1980 (T.D. 7728, 1980–2 C.B. 236). Temporary regulations under section 422A providing guidance and transitional rules related to incentive stock options were published in the **Federal Register** on December 17, 1981 (T.D. 7799, 1982–1 C.B. 67) and September 18, 1992 (T.D. 8435, 1992–2 C.B. 324). Final regulations under section 422 related to stockholder approval were published in the **Federal Register** on December 1, 1988 (T.D. 8235, 1989–1 C.B. 117) and November 29, 1991 (T.D. 8374, 1991–2 C.B. 320). Regulations under section 425 were published in the **Federal Register** on June 23, 1966 (T.D. 6887, 1966–2 C.B. 129).

Proposed changes to the final regulations under sections 421, 424, and 6039 and proposed regulations under section 422A were previously published in the **Federal Register** at 49 FR 4504 (LR–279–81, 1984–1 C.B. 714) on February 7, 1984 (the 1984 proposed regulations). With the exception of certain stockholder approval rules, the 1984 proposed regulations provided a comprehensive set of rules under section 422 of the Code. The 1984 proposed regulations and the temporary regulations have been withdrawn. See 68 FR 34344.

On June 9, 2003, a notice of proposed rulemaking (REG–122917–02, 2003–27 I.R.B. 15) was published in the **Federal Register** at 68 FR 34344 (the 2003 proposed regulations). No hearing concerning the 2003 proposed regulations was held; however, the IRS received written and electronic comments responding to

this notice. After consideration of these comments, the 2003 proposed regulations are adopted as amended by this Treasury decision. The significant revisions are discussed below.

Explanation of Provisions

Overview

In general, the income tax treatment of the grant of an option to purchase stock in connection with the performance of services and of the transfer of stock pursuant to the exercise of such option is determined under section 83 of the Code and the regulations thereunder. However, section 421 of the Code provides special rules for determining the income tax treatment of the transfer of shares of stock pursuant to the exercise of an option if the requirements of section 422(a) or 423(a), as applicable, are met. Section 422 applies to incentive stock options, and section 423 applies to options granted under an employee stock purchase plan (collectively, statutory options).

Under section 421, if a share of stock is transferred to an individual pursuant to the exercise of a statutory option, there is no income at the time of exercise of the option with respect to such transfer, and no deduction under section 162 is allowed to the employer corporation with respect to such transfer. However, pursuant to section 56(b)(3), section 421 does not apply with respect to the exercise of an incentive stock option for purposes of the individual alternative minimum tax.

Section 422(a) of the Code provides that section 421 applies to the transfer of stock to an individual pursuant to the exercise of an incentive stock option if (i) no disposition of the share is made within 2 years from the date of grant of the option or within 1 year from the date of transfer of the share, and (ii) at all times during the period beginning on the date of grant and ending on the day 3 months before the exercise of the option, the individual is an employee of either the corporation granting the option or a parent or subsidiary of such corporation, or a corporation (or a parent or subsidiary of such corporation) issuing or assuming a stock option in a transaction to which section 424(a) applies. Section 422(b) provides several requirements that must be met for an option to qualify as an incentive stock option. Section 422(c) provides special rules applicable to incentive stock options, and section 422(d) provides a $100,000 per year limitation with respect to incentive stock options.

Section 424 of the Code provides special rules applicable to statutory options, including rules concerning the modification of statutory options and the substitution or assumption of an option by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation. Section 424 also contains definitions of certain terms, including *disposition*, *parent corporation*, and *subsidiary corporation*. Finally, section 424 provides special rules related to attribution of stock ownership and the effect of stockholder approval on the date of grant of a statutory option.

These final regulations provide comprehensive rules governing incentive stock options that, as did the 2003 proposed regulations, incorporate many of the rules contained in the 1984 proposed regulations. However, the 2003 proposed regulations are re-numbered, and these final regulations adopt that reorganization. These final regulations also make changes to the final regulations under sections 421 and 424 to provide additional guidance, as discussed below, in certain areas, to reflect the new organizational structure of the statutory option rules (including the re-designation of §1.425–1 as §1.424–1), and to remove obsolete rules and cross-references.

Section 421: General Rules

Sections 422 and 423 provide that a statutory option may be granted to an individual who is an employee of the corporation granting the option, a parent or subsidiary of such corporation, or a corporation or a parent or subsidiary of such corporation issuing or assuming a stock option in a transaction to which section 424(a) applies.

Section 1.421–1(h) of the 2003 proposed regulations further describes the requisite employment relationship for purposes of a statutory option. The 2003 proposed regulations provide that an option is a statutory option only if, at the time the option is granted, the optionee is an employee of the corporation granting the option or a related corporation of such corporation. In the case of an assumption or substitution under §1.424–1(a), the optionee must, at the time of the assumption or substitution, be an employee of the corporation assuming or substituting the option or a related corporation of such corporation. In response to comments, these final regulations provide that in the case of an assumption or substitution under §1.424–1(a) an option also will be treated as granted to an employee of the granting corporation if the optionee is an individual who is in the 3-month period following termination of the employment relationship.

Section §1.421–1(h)(2) of the 2003 proposed regulations also provides that the employment relationship is considered to continue intact while an individual is on military leave, sick leave, or other *bona fide* leave of absence if the period of leave does not exceed 3 months, or if longer, so long as the individual's right to reemployment with the corporation granting the option (or a related corporation of such corporation) or a corporation assuming or substituting an option under §1.424–1(a) is guaranteed by statute or contract. Commentors requested clarification in the final regulations concerning whether the right to reemployment must be absolute and whether the right to reemployment provided by the Family Medical Leave Act or the Uniformed Services Employment and Reemployment Rights Act satisfies the requirements of this section. These final regulations provide that the right to reemployment must be provided by statute or contract. Thus, for example, if an optionee is on leave pursuant to the Family Medical Leave Act, the Uniformed Services Employment and Reemployment Rights Act, or any similar statute providing for continued employment rights for an extended period of time, the employment relationship is considered intact.

Section 422: Incentive Stock Options

1. Special rules regarding disqualifying dispositions

The general rules concerning disqualifying dispositions are described in §1.421–2(b) of the 2003 proposed regulations. Under these rules, if there is a disqualifying disposition of a share of stock, the special tax treatment provided by sec-

tion 421 and §1.421–2(a) does not apply to the transfer of the share. The effects of a disqualifying disposition are determined under section 83(a). Thus, in the taxable year in which the disqualifying disposition occurs, the individual must recognize compensation income equal to the fair market value of the stock (determined without regard to any lapse restriction and without regard to any reduction for any brokerage fees or other costs paid in connection with the disposition) on the date the stock is substantially vested less the exercise price. (See section 422(c)(2) concerning special rules that are applicable where the amount realized in a disposition is less than this difference.) A deduction is allowable for the taxable year in which such disqualifying disposition occurs to the employer corporation, its parent or subsidiary corporation, or a corporation substituting or assuming an option in a transaction to which §1.424–1(a) applies. Section 422(c)(2) and §1.422–1(b) of the 2003 proposed regulations provide special rules concerning disqualifying dispositions.

The application of the disqualifying disposition rules is described in several examples in §1.422–1(b)(3) of the 2003 proposed regulations. In *Example 1* of §1.422–1(b)(3) of the 2003 proposed regulations, on exercise of an incentive stock option, the optionee receives vested stock and disposes of the stock before meeting the applicable holding period. In this example, the amount of compensation income is based on the fair market value of the stock on the date of exercise less the exercise price, and the section 422(a)(1) holding period is based on the date of exercise.

However, in *Example 2* of §1.422–1 (b)(3) of the 2003 proposed regulations, the optionee receives nonvested stock on exercise of an incentive stock option. This example retains the same holding period for the receipt of nonvested stock, but computes the amount of compensation income based on the date of vesting of the underlying stock (rather than the date of exercise).

Several commentors suggested that if the option is exercised for nonvested stock the compensation income should not be calculated on the date of vesting because section 83 does not apply to a transaction to which section 421 applies (and section 421(b) applies to a disqualifying disposition). Instead, the compensation income should be computed on the date of exercise. Alternatively, if the proposed rule is retained, commentors suggest that the final regulations and examples provide that an optionee may make a protective section 83(b) election on exercise of the option.

These final regulations retain the rules described in the 2003 proposed regulations, however, the examples in §1.422–1(b)(3) of the final regulations more fully describe the application of the disqualifying disposition rules. Specifically, *Example 2* indicates that pursuant to section 83(e)(1) of the Code, section 83 does not apply to a transaction to which section 421 applies. Thus, on exercise of a statutory option section 83 does not apply, and an optionee cannot make an effective election under section 83(b) for purposes of the income tax consequences on the date of exercise. However, an effective election under section 83(b) may be made for purposes of the alternative minimum tax, which calculates income as if section 83 applies. *Example 2* also illustrates that on a disqualifying disposition, the rules of section 83 and the regulations thereunder (rather than section 422 and the regulations thereunder) are used to determine the amount of compensation includible in income. Applying the rules under section 83(a), the amount of compensation includible is the difference between the fair market value of the stock on the date the substantial risk of forfeiture lapses less the fair market value on the date of exercise. Additionally, *Example 2* demonstrates that there is a transfer (as defined in §1.421–1(g) of the final regulations) of the stock on the date of exercise for purposes of the holding period requirement of section 422(a)(1). Thus, the holding period for the transfer of the stock for purposes of section 422 and the holding period requirements begins on the date of exercise (rather than the date of vesting). See also, §1.422–1(b)(3), *Example 3*. However, in the event of a disqualifying disposition, the amount of capital gain (if any) and the holding period for purposes of determining capital gain is computed from the date of vesting.

2. Shareholder approval

Among other requirements, to qualify as an incentive stock option, the option must be granted pursuant to a plan which is approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted. See section 422(b) and §1.422–2(b)(2)(i) of the 2003 proposed regulations.

These final regulations retain the rules contained in the 2003 proposed regulations concerning shareholder approval. However, an additional example in §1.422–2(b)(6) illustrates the shareholder approval requirements where an incentive stock option plan is assumed in connection with a corporate transaction. See §1.422–2(b)(6), *Example 3*.

In *Example 3* of §1.422–2(b)(6) of these final regulations, Corporation X maintains an incentive stock option plan, but Corporation Y does not maintain such a plan. The companies combine to form one corporation that will be named Y, the plan will be continued by Y, and future grants under the plan will be made by Y (the new combined entity). The consolidation agreement describes the plan, including the maximum aggregate number of shares available for issuance pursuant to incentive stock options under the plan after the consolidation and the employees eligible to receive options under the plan. Because there is a change in the granting corporation under §1.422–2(b)(3)(iii), Y is considered to have adopted a new plan that must satisfy the shareholder approval requirements. In this example, because the consolidation agreement describes the plan and indicates that it will continue after the consolidation, the shareholder approval requirements of §1.422–2(b)(3) are satisfied, and the plan is considered adopted and approved on the date the consolidation agreement is approved. See Rev. Rul. 68–233, 1968–1 C.B. 187.

3. Maximum aggregate number of shares

Section 422(b)(1) provides that an incentive stock option must be granted pursuant to a plan that includes the aggregate number of shares which may be issued under options. Section 1.422–2(b)(3)(i) of the 2003 proposed regulations provides that the plan 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 under the plan.

In response to comments, these final regulations provide that the plan must designate the maximum aggregate number of shares that may be issued under the plan through incentive stock options. Thus, for example, if a corporation maintains an omnibus plan under which incentive stock options, nonstatutory options, and other stock-based awards may be made, the plan must contain a maximum number of shares that may be issued as incentive stock options under the plan. Such a number may be expressed as a limit specific to incentive stock options or as a limit on all awards under the plan, including incentive stock options. These final regulations do not require the plan to include the maximum number of shares that may be issued pursuant to nonstatutory options or other stock-based awards.

Commentators also asked whether the maximum aggregate number of shares that may be issued under an incentive stock option plan is affected by the use of outstanding shares used to exercise an option. Under these final regulations, only the net number of shares that are issued pursuant to the exercise of a statutory option are counted against the maximum aggregate number of shares. For example, if the exercise price of an option to purchase 100 shares equals the value of 20 shares, and the corporation permits the employee to use those 20 of the 100 shares to pay the exercise price of the option, and the corporation only issues 80 shares to the optionee, then 80 shares are counted against the maximum aggregate number of shares (rather than 100).

4. Option price

Under section 422(b)(4), the option price of an incentive stock option must not be less than the fair market value of the stock at the time the option is granted. The 2003 proposed regulations retain this rule, but also provide that the option price may be determined in any reasonable manner, including the valuation methods permitted under §20.2031–2 (Estate Tax Regulations), so long as the minimum price possible under the terms of the option is not less than the fair market value of the stock on the date of grant.

Section 1.422–2(e)(2)(i) of the 2003 proposed regulations provides that if a share of stock is transferred to an individual pursuant to the exercise of an incentive stock option, which fails to qualify as an incentive stock option because the exercise price is less than the fair market value of the underlying stock on the date of grant, such requirement is still considered to have been met if there was an attempt, made in good faith, to meet the option price requirements of §1.422–2(e)(1).

For nonpublicly traded stock, §1.422–2(e)(2)(iii) provides that if it is demonstrated that the fair market value of the stock on the date of grant was based on an average of the fair market values as of such date set forth in the opinions of completely independent and well-qualified experts, such a determination establishes that a good-faith attempt to meet the option price requirements of §1.422–2(e) was made. Taxpayers are required to retain adequate books and records to demonstrate that the option price requirements are satisfied. See section 6001.

Commentors suggested that the final regulations be revised to provide that a good-faith attempt to meet the option price requirements is demonstrated if the value of the stock is determined by a qualified appraiser (as defined in §1.170A–13(c)(5)), by an individual (rather than more than one individual) who is not a qualified appraiser, or by the corporation at the date of grant. Because of concerns that the value determined under these approaches may not reliably reflect the fair market value of the stock on the date of grant, these final regulations retain the rules described in the 2003 proposed regulations.

5. $100,000 limitation

Section 422(d)(1) provides that, to the extent that the aggregate fair market value of stock with respect to which incentive stock options (determined without regard to section 422(d)) are exercisable for the first time by an individual during the calendar year (under all of the plans of the employer corporation and any related corporation) exceeds $100,000, such options are not treated as incentive stock options. Under section 422(d)(2), options are taken into account in the order in which they are granted. Section 422(d)(3) provides that the fair market value of stock is determined at the time the option is granted.

Section 1.422–4(b)(5)(ii) of the 2003 proposed regulations provides that if the option is not canceled, modified, or transferred prior to the year in which it would first become exercisable, it is treated as outstanding until the end of the year in which it first becomes exercisable. Commentors suggested that the final regulations permit an individual to cancel, modify, or transfer an option at any time prior to the date of exercise (rather than the year it first becomes exercisable). Because of concerns about the administrability of a rule that, for purposes of the $100,000 limitation, would permit an individual to determine the status of an option as statutory or nonstatutory until the date of exercise, these final regulations retain the rule described in the 2003 proposed regulations.

Section 1.422–4(c) of the 2003 proposed regulations provides that the application of the $100,000 limitation may result in an option being treated, in part, as an incentive stock option and, in part, as a nonstatutory option. In response to comments, these final regulations provide additional guidance concerning the treatment of options (and the stock purchasable thereunder) that are bifurcated into an incentive stock option and nonstatutory option as a result of the application of the $100,000 limitation.

These final regulations provide that a corporation may issue a separate certificate for incentive stock option stock or designate such stock as incentive stock option stock in the corporation's transfer records or the plan records. The issuance of separate certificates or designation in plan records is not considered a modification under §1.424–1(e). However, in the absence of such an issuance or designation, shares are deemed purchased under an incentive stock option first to the extent of the $100,000 limitation, and then the excess shares are deemed purchased under a nonstatutory option.

Section 424: Definitions and Special Rules

1. Substitution, Assumption, and Modification of Options

Section 424(h)(1) provides that if the terms of an option are modified, extended, or renewed, such modification, renewal, or extension is treated as the grant of a new option. Under section 424(h)(3), the term *modification* (with certain exceptions) means any change in the terms of an option which gives the optionee additional benefits under the option. One exception to this definition is that a change in the terms of an option attributable to a substitution or an assumption that meets the requirements of section 424(a) is not a modification of an option.

The 2003 proposed regulations provide that an *eligible corporation* (as defined in §1.424–1(a)(2)) may, by reason of a *corporate transaction* (as defined in §1.424–1(a)(3)), substitute a new statutory option (new option) for an outstanding statutory option (old option) or assume an old option without the substitution or assumption being considered a modification of the old option under section 424(h). These final regulations retain most of the rules contained in the 2003 proposed regulations, with certain changes.

Under the 2003 proposed regulations, a *corporate transaction* is (i) a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation; (ii) a distribution (excluding ordinary dividends), or change in the terms or number of outstanding shares of such corporation, such as a stock split or stock dividend (a change in capital structure); (iii) a change in the name of a corporation whose stock is purchasable under the old option; and (iv) such other corporate events as may be prescribed by the Commissioner in published guidance.

In response to comments, these final regulations provide that a "distribution" does not include a stock dividend or stock split (including a reverse stock split) that merely changes the number of outstanding shares of a corporation. Thus, an outstanding option is not treated as substituted or assumed under section 424(a) and §1.424–1(a) in connection with a stock dividend or stock split that merely changes the number of outstanding shares. Instead, the exercise price of an outstanding option may be proportionally adjusted to reflect a stock dividend or stock split that merely changes the number of outstanding shares of a corporation under §1.424–1(e). This adjustment is not a modification of the option, and because the stock dividend or stock split is not a corporate transaction, the requirements of §1.424–1(a), including the spread and ratio tests, do not have to be satisfied.

The 2003 proposed regulations also provide that a new or assumed option must otherwise qualify as a statutory option. See §1.424–1(a)(5)(vi) of the 2003 proposed regulations. The 2003 proposed regulations provide that, except as necessary to comply with the specific requirements regarding substitution or assumption, such as the rules concerning ratio and spread, the option must comply with the requirements of §1.422–2 of the 2003 proposed regulations or 1.423–2, as applicable. Thus, under the 2003 proposed regulations, for example, the new option must be substituted, or the old option must be assumed, under a plan approved by the stockholders of the corporation substituting or assuming the option.

In Rev. Rul. 71–474, 1971–2 C.B. 215, involving qualified stock options, the IRS held that qualified stock options assumed by a corporation in a merger with the granting corporation retained their status as qualified stock options without approval of the assuming corporation's stockholders. In the ruling, the IRS indicated that approval of the persons who owned stock of the granting corporation at the time the plan originally was approved was sufficient to satisfy the stockholder approval requirements.

In response to comments, these final regulations refrain from imposing an additional stockholder approval requirement for statutory options that have been granted and are outstanding at the time of a corporate transaction. Thus, the requirement in §1.424–1(a)(5)(vi) of the 2003 proposed regulations is removed. Further, the examples in §1.424–1(a)(10) of these final regulations demonstrate that if the shareholder approval requirements are met on the date of grant, a subsequent substitution or assumption of an outstanding option (old option) by an acquiring corporation does not require additional stockholder approval for the substituted or assumed option (new option) to continue to qualify as a statutory option. See, §1.424–1(a)(10), *Example 9*. For example, assume Corporation X maintains an incentive stock option plan that meets the requirements of §1.422–2 on the date of grant. E, an employee of X, holds outstanding incentive stock options to acquire X stock on exercise of the options. If Corporation Y acquires X and substitutes new options to acquire Y stock for the old options to acquire X stock held by E, the substitution of the new Y options does not require new stockholder approval. The result is the same if the options are assumed by Y. However, for future options granted under the plan to qualify as incentive stock options, the plan must be approved by the Y shareholders. (See, §1.422–2(b)(6) *Example 3*, for guidance concerning future grants under an option plan that is assumed in a corporate transaction.)

Finally, commentors requested guidance concerning the treatment of earn-out payments received by option holders in connection with a corporate transaction. Because of the factual nature of these transactions, these final regulations do not address the issues raised by these transactions. However, this area is currently under study and may be the subject of future guidance of general applicability under § 601.601(d)(2).

2. Modification, extension, or renewal of option

Section 424(h)(3) provides that a modification is any change in the terms of an option which gives the optionee additional benefits under the option, with certain specified exceptions.

Under §1.424–1(e)(4)(iii) of the 2003 proposed regulations, a change to an option providing that the optionee may receive an additional benefit under the option at the future discretion of the granting corporation is a modification of the option at the time the option is changed to provide the discretion. Additionally, the exercise of such discretion is a modification of the option. Although several commentors suggested that the final regulations provide that the later exercise of the discretion is not a modification of the option, these final regulations retain the rule contained in the 2003 proposed regulations.

However, as under the 2003 proposed regulations, it is not a modification for the granting corporation to exercise discretion specifically reserved under an option related to the payment of a bonus at the time of the exercise of the option, the availability of a loan at exercise, or the right to tender previously-owned stock for the stock purchasable under the option. A change to an option adding such discretion, however, is a modification.

Commentors suggested broadening this rule to include the exercise of any reserved discretion under the option. These final regulations, however, only expand this rule to provide that it is not a modification to exercise discretion specifically reserved under an option with respect to the payment of employment taxes and/or withholding taxes resulting from the exercise of a statutory option.

The 2003 proposed regulations also provide that an option is not modified merely because an optionee is offered a change in the terms of the option if the change is not made. These final regulations retain this rule, but also provide that if an offer to change the terms of the option remains outstanding for less than 30 days, the option is not modified. However, if the offer to change the terms of the option remains outstanding for 30 days or more, the option is treated as modified as of the date the offer to change the terms of the option is made.

Finally, commentors suggested that these final regulations provide an exception to the modification rule for an inadvertent change to a statutory option where the change is promptly reversed. In response, these final regulations provide that any inadvertent modification of an option is not treated as a modification to the extent the modification is reversed by the earlier of the date the option is exercised or the last day of the calendar year during which such change occurred.

Section 6039

Under section 1.6039–1(f) of the 2003 proposed regulations, the issue of furnishing electronic statements was reserved. These final regulations provide that the furnishing of statements in electronic form is permitted, provided the recipient consents to that means of delivery.

Effective date and reliance

These final regulations are effective on August 3, 2004. However, these final regulations provide special transitional and reliance rules.

For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR–279–81, 49 FR 4504, the 2003 proposed regulations REG–122917–02, 68 FR 34344, or these final regulations until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring at least 6 months after August 3, 2004, taxpayers may rely on either the REG–122917–02 or the final regulations. Taxpayers may not rely on LR–279–81 or REG–122917–02 after December 31, 2005. Reliance on LR–279–81, REG–122917–02, or the final regulations must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the provision of employee statements provided under these proposed regulations will impose a minimal paperwork burden on most small entities (see the discussion under the heading "Paperwork Reduction Act" earlier in this preamble). Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these final regulations is being submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these proposed regulations is Erinn Madden, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 14a are amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

§§1.421–1 through 1.421–6 [Removed]

Par. 2. Sections 1.421–1 through 1.421–6 are removed.

Par. 3. Section 1.421–7 is re-designated as §1.421–1 and is amended as follows:

1. In paragraph (a)(1), first sentence, the language "sections 421 through 425" is removed and "this §§1.421–1 through 1.424–1" is added in its place.

2. In paragraph (a)(1), first sentence, the language "includes" is removed, and "means" is added in its place.

3. In paragraph (a)(1), removing the second sentence.

4. Removing the last sentence of paragraph (a)(1) and adding two sentences in its place.

5. Revising paragraph (a)(3).

6. Revising paragraphs (b)(1) and (b)(2).

7. In paragraph (b)(3)(i), third sentence, removing the language "1.425–1" and inserting "1.424–1" in its place.

8. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Newly Designated Section	Remove	Add
1.421-1(b)(3)(ii) *Example 1*, first, second, third, and fourth sentences	S-1	X
1.421-1(b)(3)(ii) *Example 1*, second sentence	1964	2004
1.421-1(b)(3)(ii) *Example 1*, third and fourth sentences	1965	2005
1.421-1(b)(3)(ii), *Example 2*, first and second sentences	1964	2004
1.421-1(b)(3)(ii) *Example 2*, first, third, and fourth sentences	S-1	X
1.421-1(b)(3)(ii) *Example 2*, third and fourth sentences	1965	2005

9. Revising the last sentence of paragraph (b)(3)(ii) *Example 1*.

10. Removing the last sentence of paragraph (b)(3)(ii) *Example 2*, and adding two sentences in its place.

11. Removing the first sentence of paragraph (c)(1) and adding two new sentences in its place.

12. In paragraph (c)(2), second sentence, the language "425" is removed and "424" is added in its place.

13. In paragraph (c)(3), second and last sentences, the language "1964" is removed and "2004" is added in its place.

14. In paragraph (c)(3), second sentence, the language "1965" is removed wherever it appears and "2005" is added in its place.

15. Revising paragraphs (d) and (e).

16. In paragraph (f), in the first sentence, the language "sections 421 through 425" is removed and "this section and §§1.421–2 through 1.424–1" is added in its place.

17. Revising the last sentence of paragraph (f).

18. In paragraph (g), first sentence, the language "sections 421 through 425" is removed and "this section and §§1.421–2 through 1.424–1" is added in its place.

19. Adding a new third, fourth, and fifth sentences to paragraph (g).

20. Revising the first, second, and third sentences of paragraph (h)(1).

21. Revising paragraph (h)(2).

22. In paragraph (h)(3), first sentence, the language "425" is removed and "424" is added in its place.

23. In paragraph (h)(3), last sentence, the language "or assuming" is removed and "the option or substituting or assuming the option" is added in its place.

24. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Newly Designated Section	Remove	Add
1.421-1(h)(4) *Example 1*, first sentence	1964	2004
1.421-1(h)(4) *Example 1*, second and last sentences	1965	2005
1.421-1(h)(4) *Example 2*, first sentence	425	424
1.421-1(h)(4) *Example 2*, first sentence	issuing	substituting
1.424-1(h)(4) *Example 2*, last sentence	1965	2005

Newly Designated Section	Remove	Add
1.421-1(h)(4) *Example 2*, last sentence	for A is then employed by a corporation which issued an option under section 425(a).	to the transfer of the M stock because, at all times during the period beginning with the date of grant of the X option and ending with the date of exercise of the M option, A was an employee of the corporation granting the option or substituting or assuming the option under §1.424-1(a).
1.421-1(h)(4) *Example 3*, second sentence	1964	2004
1.421-1(h)(4) *Example 3*, third, fourth, and fifth sentences	1965	2005
1.421-1(h)(4) Example 4, first sentence	425(a)	424(a)
1.421-1(h)(4) *Example 5*, first sentence	qualified stock	statutory
1.421-1(h)(4) *Example 6*, first sentence	an employment contract with M which provides that upon the termination of any military duty E may be required to serve, E will be entitled to reemployment with M or a parent or subsidiary of M.	a right to reemployment with M or a related corporation on the termination of any military duty E may be required to serve.
1.421-1(h)(4) *Example 6*, third sentence	of M	of M or a related corporation
1.421-1(h)(4) *Example 6*, last sentence	can apply	applies
1.421-1(h)(4) *Example 7*, first and last sentences	a qualified stock	an incentive
1.421-1(h)(4) *Example 7*, first sentence	parent or subsidiary	related corporation
1.421-1(h)(4) *Example 7*, last sentence	its parent and subsidiary corporation	related corporations
1.421-1(h)(4) *Example 7*, last sentence	terminated	deemed terminated

25. Revising paragraph (i).

26. Adding paragraph (j).

The additions and revisions read as follows:

§1.421–1 Meaning and use of certain terms.

(a) * * * (1) * * * While no particular form of words is necessary, the option must express, among other things, an offer to sell at the option price, the maximum number of shares purchasable under the option, and the period of time during which the offer remains open. The term *option* includes a warrant that meets the requirements of this paragraph (a)(1).

* * * * *

(3) An option must be in writing (in paper or electronic form), provided that such writing is adequate to establish an option right or privilege that is enforceable under applicable law.

(b) *Statutory options*. (1) The term *statutory option*, for purposes of this section and §§1.421–2 through 1.424–1, means an *incentive stock option*, as defined in §1.422–2(a), or an option granted under an *employee stock purchase plan*, as defined in §1.423–2.

(2) An option qualifies as a statutory option only if the option is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom the option was granted, and is exercisable, during the lifetime of such individual, only by such individual. See §§1.422–2(a)(2)(v) and 1.423–2(j). Accordingly, an option which is transferable or transferred by the individual to whom the option is granted during such individual's lifetime, or is exercisable during such individual's lifetime by another person, is not a statutory option. However, if the option or the plan under which the option

was granted contains a provision permitting the individual to designate the person who may exercise the option after such individual's death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a statutory option. A pledge of the stock purchasable under an option as security for a loan that is used to pay the option price does not cause the option to violate the nontransferability requirements of this paragraph (b). Also, the transfer of an option to a trust does not disqualify the option as a statutory option if, under section 671 and applicable State law, the individual is considered the sole beneficial owner of the option while it is held in the trust. If an option is transferred incident to divorce (within the meaning of section 1041) or pursuant to a domestic relations order, the option does not qualify as a statutory option as of the day of such transfer. For the treatment of nonstatutory options, see §1.83–7.

(3) * * *

(ii) * * *

Example 1. * * * Because X was a subsidiary of P on the date of the grant of the statutory option, the option does not fail to be a statutory option even though X ceases to be a subsidiary of P.

Example 2. * * * Because X was not a subsidiary of S or P on the date of the grant of the option, the option is not a statutory option even though X later becomes a subsidiary of P. See §§1.422–2(a)(2) and 1.423–2(b).

(c) *Time and date of granting option.* (1) For purposes of this section and §§1.421–2 through 1.424–1, the language "the date of the granting of the option" and "the time such option is granted," and similar phrases refer to the date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. A corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable. * * *

* * * * *

(d) *Stock and voting stock.* (1) For purposes of this section and §§1.421–2 through 1.424–1, the term *stock* means capital stock of any class, including voting or nonvoting common or preferred stock. Except as otherwise provided, the term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term *stock* as used in such sections, provided such stock otherwise possesses the rights and characteristics of capital stock.

(2) For purposes of determining what constitutes voting stock in ascertaining whether a plan has been approved by stockholders under §1.422–2(b) or 1.423–2(c) or whether the limitations pertaining to voting power contained in §§1.422–2(f) and 1.423–2(d) have been met, stock which does not have voting rights until the happening of an event, such as the default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Generally, stock which does not possess a general voting power, and may vote only on particular questions, is not voting stock. However, if such stock is entitled to vote on whether a stock option plan may be adopted, it is voting stock.

(3) In general, for purposes of this section and §§1.421–2 through 1.424–1, ownership interests other than capital stock are considered stock.

(e) *Option price.* (1) For purposes of this section and §§1.421–2 through 1.424–1, the term *option price*, *price paid under the option*, or *exercise price* means the consideration in cash or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term *option price* does not include any amounts paid as interest under a deferred payment arrangement or treated as interest.

(2) Any reasonable valuation method may be used to determine whether, at the time the option is granted, the option price satisfies the pricing requirements of sections 422(b)(4), 422(c)(5), 422(c)(7), and 423(b)(6) with respect to the stock subject to the option. Such methods include, for example, the valuation method described in §20.2031–2 of this chapter (Estate Tax Regulations).

(f) *Exercise.* * * * An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option to the extent the payments made remain subject to withdrawal by or refund to the employee.

(g) *Transfer.* * * * For purposes of section 422, a transfer may occur even if a share of stock is subject to a substantial risk of forfeiture or is not otherwise transferable immediately after the date of exercise. See §1.422–1(b)(3) *Example 2.* A transfer does not fail to occur merely because, under the terms of the arrangement, the individual may not dispose of the share for a specified period of time, or the share is subject to a right of first refusal or a right to reacquire the share at the share's fair market value at the time of sale.

(h) *Employment relationship.* (1) An option is a statutory option only if, at the time the option is granted, the optionee is an employee of the corporation granting the option, or a related corporation of such corporation. If the option has been assumed or a new option has been substituted in its place under §1.424–1(a), the optionee must, at the time of such substitution or assumption, be an employee (or a former employee within the 3-month period following termination of the employment relationship) of the corporation so substituting or assuming the option, or a related corporation of such corporation. The determination of whether the optionee is an employee at the time the option is granted (or at the time of the substitution or assumption under §1.424–1(a)) is made in accordance with section 3401(c) and the regulations thereunder. * * *

(2) In addition, §1.421–2(a) is applicable to the transfer of a share pursuant to the exercise of the statutory option only if the optionee is, at all times during the period beginning with the date of the granting of such option and ending on the day 3 months before the date of such exercise, an employee of either the corporation granting such option, a related corporation of such corporation, or a corporation (or a related corporation of such corporation) substituting or assuming a stock option in a transaction to which §1.424–1(a) applies. For purposes of the preceding sentence, the employment relationship is treated as continuing intact while the individual is on military leave, sick leave, or other *bona fide* leave of absence (such as temporary employment by the Government) if the period of such leave does not exceed 3 months, or if longer, so long as the individual's right to reemployment with the corporation granting the option (or a related corporation of such corporation) or a corporation (or a related corporation of such corporation) substituting or assuming a stock option in a transaction to

which §1.424–1(a) applies, is provided either by statute or by contract. If the period of leave exceeds 3 months and the individual's right to reemployment is not provided either by statute or by contract, the employment relationship is deemed to terminate on the first day immediately following such three-month period. Thus, if the option is not exercised before such deemed termination of employment, §1.421–2(a) applies to the transfer of a share pursuant to an exercise of the option only if the exercise occurs within 3 months from the date the employment relationship is deemed terminated.

* * * *

(i) *Additional definitions*. (1) *Corporation*. For purposes of this section and §§1.421–2 through 1.424–1, the term *corporation* has the meaning prescribed by section 7701(a)(3) and §301.7701–2(b) of this chapter. For example, a *corporation* for purposes of the preceding sentence includes an S corporation (as defined in section 1361), a foreign corporation (as defined in section 7701(a)(5)), and a limited liability company that is treated as a corporation for all Federal tax purposes.

(2) *Parent corporation and subsidiary corporation*. For the definition of the terms *parent corporation* (and *parent*) and *subsidiary corporation* (and *subsidiary*), for purposes of this section and §§1.421–2 through 1.424–1, see §1.424–1(f)(i) and (ii), respectively. *Related corporation* as used in this section and in §§1.421–2 through 1.424–1 means either a parent corporation or subsidiary corporation.

(j) *Effective date*— (1) *In general*. These regulations are effective on August 3, 2004.

(2) *Reliance and transition period*. For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR–279–81 (49 FR 4504), the 2003 proposed regulations REG–122917–02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring at least 6 months after August 3, 2004, taxpayers may rely on either the REG–122917–02 or this section. Taxpayers may not rely on LR–279–81 or REG–122917–02 after December 31, 2005. Reliance on LR–279–81, REG–122917–02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

Par. 4. Section 1.421–8 is re-designated as 1.421–2 and is amended by:

1. Revising paragraphs (a)(1), (b), and (c)(1).

2. In paragraph (c)(2), first sentence, add the phrase "for purposes of section 423(c)" at the end of the first sentence.

3. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Newly Designated Section	*Remove*	*Add*
1.421-2(c)(2), second sentence	, or 424(c)(1)	
1.421-2(c)(2), third sentence	or 424(c)(1)	
1.421-2(c)(3)(i), first, second, and third sentences	422(c)(1), 423(c), or 424(c)(1)	423(c)
1.421-2(c)(3)(ii) *Example*, first sentence	1964	2004
1.421-2(c)(3)(ii) *Example*, third, fifth, and sixth sentences	1966	2006

4. Removing paragraph (c)(4)(i) and redesignating paragraphs (c)(4)(ii) through (c)(4)(iv) as paragraphs (c)(4)(i) through (c)(4)(iii), respectively.

5. In newly designated paragraph (c)(4)(i)(*a*), first sentence, removing the phrase "In the case of an employee dying after December 31, 1956" and adding "In the case of the death of an optionee" in its place.

6. Removing *Example (1)* in newly designated paragraph (c)(4)(iii) and redesignating *Examples (2)* through (5) as *Examples (1)* through (4), respectively.

7. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Newly Designated Section	*Remove*	*Add*
1.421-2(c)(4)(i)(*a*), last sentence	422(c)(1), 423(c), or 424(c)(1)	423(c)
1.421-2(c)(4)(i)(*b*), first, second, and last sentences	422(c)(1), 423(c), or 424(c)(1)	423(c)
1.421-2(c)(4)(i)(*c*), first sentence	422(c)(1), 423(c), or 424(c)(1)	423(c)
1.421-2(c)(4)(iii) *Example 1*, first sentence	1964	2005
1.421-2(c)(4)(iii), *Example 1*, eighth sentence	subdivision (ii)(*b*) of this subparagraph	paragraph (c)(4)(i)(*b*) of this section
1.421-2(c)(4)(iii), *Example 1*, third and fifth sentences	1966	2006
1.421-2(c)(4)(iii) *Example 1*, ninth sentence	subdivision (ii)(*c*) of this subparagraph	paragraph (c)(4)(i)(*c*) of this section
1.421-2(c)(4)(iii) *Example 2*, second and fifth sentences	subdivision (ii)(*a*) of this subparagraph	paragraph (c)(4)(i)(*a*) of this section
1.421-2(c)(4)(iii) *Example 2*, fifth sentence	subdivision (ii)(*b*) of this subparagraph	paragraph (c)(4)(i)(*b*) of this section
1.421-2(c)(4)(iii) *Example 2*, first sentence	*example (2)*	*Example 1*
1.421-2(c)(4)(iii) *Example 3*, first sentence	*example (2)*	*Example 1*
1.421-2(c)(4)(iii), *Example 3*, second and fourth sentences	subdivision (ii)(*a*) of this subparagraph	paragraph (c)(4)(i)(*a*) of this section
1.421-2(c)(4)(iii) *Example 3*, fourth sentence	subdivision (ii)(*c*) of this subparagraph	paragraph (c)(4)(i)(*c*) of this section
1.421-2(c)(4)(iii) *Example 4*, first sentence	*example (2)*	*Example 1*
1.421-2(c)(4)(iii) *Example 4*, first sentence	1966	2006
1.421-2(c)(4)(iii) *Example 4*, first and second sentences	1967	2007
1.421-2(c)(iii) *Example 4*, third, fifth, and sixth sentences	subdivision (ii)(*a*) of this subparagraph	paragraph (c)(4)(i)(*a*) of this section
1.421-2(c)(4)(iii) *Example 4*, fifth and sixth sentences	subdivision (ii)(*b*) of this subparagraph	paragraph (c)(4)(i)(*b*) of this section
1.421-2(c)(4)(iii) *Example 4*, sixth sentence	subdivision (ii)(*c*) of this subparagraph	paragraph (c)(4)(i)(*c*) of this section

8. Revising paragraph (d).

9. Adding paragraph (f).

The revisions read as follows:

§ 1.421–2 General rules.

(a) *Effect of qualifying transfer.* (1) If a share of stock is transferred to an individual pursuant to the individual's exercise of a statutory option, and if the requirements of §1.422–1(a) (relating to incentive stock options) or §1.423–1(a) (relating to employee stock purchase plans) whichever is applicable, are met, then—

(i) No income results under section 83 at the time of the transfer of such share to the individual upon the exercise of the option with respect to such share;

(ii) No deduction under sections 83(h) or 162 or the regulations thereunder (relating to trade or business expenses) is allowable at any time with respect to the share so transferred; and

(iii) No amount other than the price paid under the option is considered as received by the employer corporation, a related corporation of such corporation, or a corporation substituting or assuming a stock option in a transaction to which §1.424–1(a) (relating to corporate reorganizations, liquidations, etc.) applies, for the share so transferred.

* * * * *

(b) *Effect of disqualifying disposition*. (1)(i) The disposition (as defined in §1.424–1(c)) of a share of stock acquired by the exercise of a statutory option before the expiration of the applicable holding periods as determined under §1.422–1(a) or 1.423–1(a) is a disqualifying disposition and makes paragraph (a) of this section inapplicable to the transfer of such share. See section 83(a) to determine the amount includible on a disqualifying disposition. The income attributable to such transfer (determined without reduction for any brokerage fees or other costs paid in connection with the disposition) is treated by the individual as compensation income received in the taxable year in which such disqualifying disposition occurs. A deduction attributable to such transfer is allowable, to the extent otherwise allowable under section 162, for the taxable year in which such disqualifying disposition occurs to the employer corporation, or a related corporation of such corporation, or a corporation substituting or assuming an option in a transaction to which §1.424–1(a) applies. Additionally, the amount allowed as a deduction must be determined as if the requirements of section 83(h) and §1.83–6(a) apply. No amount is treated as income, and no amount is allowed as a deduction, for any taxable year other than the taxable year in which the disqualifying disposition occurs. If the amount realized on the disposition exceeds (or is less than) the sum of the amount paid for the share and the amount of compensation income recognized as a result of such disposition, the extent to which the difference is treated as gain (or loss) is determined under the rules of section 302 or 1001, as applicable.

(ii) The following examples illustrate the principles of this paragraph (b):

Example 1. On June 1, 2006, X Corporation grants an incentive stock option to A, an employee of X, entitling A to purchase 100 shares of X stock at $10 per share. On August 1, 2006, A exercises the option when the fair market value of X stock is $20 per share, and 100 shares of X stock are transferred to A on that date. On December 15, 2007, A sells the stock for $20 per share. Because A disposed of the stock before June 2, 2008, A did not satisfy the holding period requirements of §1.422–1(a). Under paragraph (b)(1)(i) of this section, A therefore made a disqualifying disposition of the stock. Thus, paragraph (a) of this section is inapplicable to the transfer of the shares, and A must include the compensation income attributable to the transfer of the shares in gross income in the year of the disqualifying disposition. The amount of compensation income A must include in income is $1,000 ($2,000, the fair market value of X stock on transfer less $1,000, the exercise price per share). If the requirements of §83(h) and §1.83–6(a) are satisfied and otherwise allowable under section 162, X is allowed a deduction of $1,000 for its taxable year in which the disqualifying disposition occurs.

Example 2. Y Corporation grants an incentive stock option for 100 shares of its stock to E, an employee of Y. The option has an exercise price of $10 per share. E exercises the option and is transferred the shares when the fair market value of a share of Y stock is $30. Before the applicable holding periods are met, Y redeems the shares for $70 per share. Because the holding period requirements of §1.422–1(a) are not met, the redemption of the shares is a disqualifying disposition of the shares. Under paragraph (b)(1)(i) of this section, A made a disqualifying disposition of the stock. Thus, paragraph (a) of this section is inapplicable to the transfer of the shares, and E must include the compensation income attributable to the transfer of the shares in gross income in the year of the disqualifying disposition. The amount of compensation income that E must include in income is $2,000 ($3,000, the fair market value of Y stock on transfer, less $1,000, the exercise price paid by E). The character of the additional gain that is includible in E's income as a result of the redemption is determined under the rules of section 302. If the requirements of §83(h) and §1.83–6(a) are satisfied and otherwise allowable under section 162, Y is allowed a deduction for the taxable year in which the disqualifying disposition occurs for the compensation income of $2,000. Y is not allowed a deduction for the additional gain includible in E's income as a result of the redemption.

(2) If an optionee transfers stock acquired through the optionee's exercise of a statutory option prior to the expiration of the applicable holding periods, paragraph (a) of this section continues to apply to the transfer of the stock pursuant to the exercise of the option if such transfer is not a disposition of the stock as defined in §1.424–1(c) (for example, a transfer from a decedent to the decedent's estate or a transfer by bequest or inheritance). Similarly, a subsequent transfer by the executor, administrator, heir, or legatee is not a disqualifying disposition by the decedent. If a statutory option is exercised by the estate of the optionee or by a person who acquired the option by bequest or inheritance or by reason of the death of such optionee, see paragraph (c) of this section. If a statutory option is exercised by the individual to whom the option was granted and the individual dies before the expiration of the holding periods, see paragraph (d) of this section.

(3) For special rules relating to the disqualifying disposition of a share of stock acquired by exercise of an incentive stock option, see §§1.422–5(b)(2) and 1.424–1(c)(3).

(c) *Exercise by estate*. (1) If a statutory option is exercised by the estate of the individual to whom the option was granted (or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual), paragraph (a) of this section applies to the transfer of stock pursuant to such exercise in the same manner as if the option had been exercised by the deceased optionee. Consequently, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to the exercise of the option. Paragraph (a) of this section applies even if the executor, administrator, or such person disposes of the stock so acquired before the expiration of the applicable holding periods as determined under §1.422–1(a) or 1.423–1(a). This special rule does not affect the applicability of section 423(c), relating to the estate's or other qualifying person's recognition of compensation income, or section 1222, relating to what constitutes a short-term and long-term capital gain or loss. Paragraph (a) of this section also applies even if the executor, administrator, or such person does not exercise the option within three months after the death of the individual or is not employed as described in §1.421–1(h), either when the option is exercised or at any time. However, paragraph (a) of this section does not apply to a transfer of shares pursuant to an exercise of the option by the estate or by such person unless the individual met the employment requirements described in §1.421–1(h) either at the time of the individual's death or within three months before such time (or, if applicable, within the period described in §1.422–1(a)(3)). Additionally, paragraph (a) of this section does not apply if the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of

such deceased individual. For example, if the option is sold by the estate, paragraph (a) of this section does not apply to the transfer of stock pursuant to an exercise of the option by the buyer, but if the option is distributed by the administrator to an heir as part of the estate, paragraph (a) of this section applies to the transfer of stock pursuant to an exercise of the option by such heir.

* * * * *

(d) *Option exercised by the individual to whom the option was granted if the individual dies before expiration of the applicable holding periods*. If a statutory option is exercised by the individual to whom the option was granted and such individual dies before the expiration of the applicable holding periods as determined under §1.422–1(a) or 1.423–1(a), paragraph (a) of this section does not become inapplicable if the executor or administrator of the estate of such individual, or any person who acquired such stock by bequest or inheritance or by reason of the death of such individual, disposes of such stock before the expiration of such applicable holding periods. This rule does not affect the applicability of section 423(c), relating to the individual's recognition of compensation income, or section 1222, relating to what constitutes a short-term and long-term capital gain or loss.

* * * * *

(f) *Effective date*— (1) *In general*. These regulations are effective on August 3, 2004.

(2) *Reliance and transition period*. For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR–279–81 (49 FR 4504), the 2003 proposed regulations REG–122917–02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring at least 6 months after August 3, 2004, taxpayers may rely on either the REG–122917–02 or this section. Taxpayers may not rely on LR–279–81 or REG–122917–02 after December 31, 2005. Reliance on LR–279–81, REG–122917–02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

Par. 5. Section 1.422–1 is added to read as follows:

§1.422–1 Incentive stock options; general rules.

(a) *Applicability of section 421(a)*. (1)(i) Section 1.421–2(a) applies to the transfer of a share of stock to an individual pursuant to the individual's exercise of an incentive stock option if the following conditions are satisfied—

(A) The individual makes no disposition of such share before the later of the expiration of the 2-year period from the date of grant of the option pursuant to which such share was transferred, or the expiration of the 1-year period from the date of transfer of such share to the individual; and

(B) At all times during the period beginning on the date of grant of the option and ending on the day 3 months before the date of exercise, the individual was an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation (or a related corporation of such corporation) substituting or assuming a stock option in a transaction to which §1.424–1(a) applies.

(ii) For rules relating to the disposition of shares of stock acquired pursuant to the exercise of a statutory option, see §1.424–1(c). For rules relating to the requisite employment relationship, see §1.421–1(h).

(2)(i) The holding period requirement of section 422(a)(1), described in paragraph (a)(1)(i)(A) of this section, does not apply to the transfer of shares by an insolvent individual described in this paragraph (a)(2). If an insolvent individual holds a share of stock acquired pursuant to the individual's exercise of an incentive stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary in any proceeding under the Bankruptcy Act or any other similar insolvency proceeding, neither such transfer, nor any other transfer of such share for the benefit of the individual's creditors in such proceeding is a disposition of such share for purposes of this paragraph (a). For purposes of this paragraph (a)(2), an individual is insolvent only if the individual's liabilities exceed the individual's assets or the individual is unable to satisfy the individual's liabilities as they become due. See section 422(c)(3).

(ii) A transfer by the trustee or other fiduciary that is not treated as a disposition for purposes of this paragraph (a) may be a sale or exchange for purposes of recognizing capital gain or loss with respect to the share transferred. For example, if the trustee transfers the share to a creditor in an insolvency proceeding, capital gain or loss must be recognized by the insolvent individual to the extent of the difference between the amount realized from such transfer and the adjusted basis of such share.

(iii) If any transfer by the trustee or other fiduciary (other than a transfer back to the insolvent individual) is not for the exclusive benefit of the creditors in an insolvency proceeding, then whether such transfer is a disposition of the share by the individual for purposes of this paragraph (a) is determined under §1.424–1(c). Similarly, if the trustee or other fiduciary transfers the share back to the insolvent individual, any subsequent transfer of the share by such individual which is not made in respect of the insolvency proceeding may be a disposition of the share for purposes of this paragraph (a).

(3) If the employee exercising an option ceased employment because of permanent and total disability, within the meaning of section 22(e)(3), 1 year is used instead of 3 months in the employment period requirement of paragraph (a)(1)(i)(B) of this section.

(b) *Failure to satisfy holding period requirements*—(1) *General rule*. For general rules concerning a disqualifying disposition of a share of stock acquired pursuant to the exercise of an incentive stock option, see §1.421–2(b)(1).

(2)(i) *Special rule*. If an individual makes a disqualifying disposition of a share of stock acquired by the exercise of an incentive stock option, and if such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to the individual, then, under this paragraph (b)(2)(i), the amount includible (determined without reduction for brokerage fees or other costs paid in connection with the disposition) in the gross income of such individual, and deductible from the income of the employer corporation (or a related corporation of such corpo-

ration, or of a corporation substituting or assuming the option in a transaction to which §1.424–1(a) applies) as compensation attributable to the exercise of such option, shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of such share. Subject to the special rule provided by this paragraph (b)(2)(i), the amount of compensation attributable to the exercise of the option is determined under section 83(a); see §1.421–2(b)(1)(i).

(ii) *Limitation to special rule*. The special rule described in paragraph (b)(2)(i) of this section does not apply if the disposition is a sale or exchange with respect to which a loss (if sustained) would not be recognized by the individual. Thus, for example, if a disqualifying disposition is a sale described in section 1091 (relating to loss from wash sales of stock or securities), a gift (or any other transaction which is not at arm's length), or a sale described in section 267(a)(1) (relating to sales between related persons), the special rule described in paragraph (b)(2)(i) of this section does not apply because a loss sustained in any such transaction would not be recognized.

(3) *Examples*. The following examples illustrate the principles of this paragraph (b):

Example 1. Disqualifying disposition of vested stock. On June 1, 2006, X Corporation grants an incentive stock option to A, an employee of X Corporation, entitling A to purchase one share of X Corporation stock. On August 1, 2006, A exercises the option, and the share of X Corporation stock is transferred to A on that date. The option price is $100 (the fair market value of a share of X Corporation stock on June 1, 2006), and the fair market value of a share of X Corporation stock on August 1, 2006 (the date of transfer), is $200. The share transferred to A is transferable and not subject to a substantial risk of forfeiture. A makes a disqualifying disposition by selling the share on June 1, 2007, for $250. The amount of compensation attributable to A's exercise is $100 (the difference between the fair market value of the share at the date of transfer, $200, and the amount paid for the share, $100). Because the amount realized ($250) is greater than the value of the share at transfer ($200), paragraph (b)(2)(i) of this section does not apply and thus does not affect the amount includible as compensation in A's gross income and deductible by X. A must include in gross income for the taxable year in which the sale occurred $100 as compensation and $50 as capital gain ($250, the amount realized from the sale, less A's basis of $200 (the $100 paid for the share plus the $100 increase in basis resulting from the inclusion of that amount in A's gross income as compensation attributable to the exercise of the option)). If the requirements of section 83(h) and §1.83–6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of $100 for compensation attributable to A's exercise of the incentive stock option.

Example 2. Disqualifying disposition of unvested stock. Assume the same facts as in *Example 1*, except that the share of X Corporation stock received by A is subject to a substantial risk of forfeiture and not transferable for a period of six months after such exercise. Assume further that the fair market value of X Corporation stock is $225 on February 1, 2007, the date on which the six-month restriction lapses. Because section 83 does not apply for ordinary income tax purposes on the date of exercise, A cannot make an effective section 83(b) election at that time (although such an election is permissible for alternative minimum tax purposes). Additionally, at the time of the disposition, section 422 and §1.422–1(a) no longer apply, and thus, section 83(a) is used to measure the consequences of the disposition, and the holding period for capital gain purposes begins on the vesting date, six months earlier. The amount of compensation attributable to A's exercise of the option and disqualifying disposition of the share is $125 (the difference between the fair market value of the share on the date that the restriction lapsed, $225, and the amount paid for the share, $100). Because the amount realized ($225) is greater than the value of the share at transfer ($200), paragraph (b)(2)(i) of this section does not apply and thus does not affect the amount includible as compensation in A's gross income and deductible by X. A must include $125 of compensation income and $25 of capital gain in gross income for the taxable year in which the disposition occurs ($250, the amount realized from the sale, less A's basis of $225 (the $100 paid for the share plus the $125 increase in basis resulting from the inclusion of that amount of compensation in A's gross income)). If the requirements of section 83(h) and §1.83–6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of $125 for the compensation attributable to A's exercise of the option.

Example 3. (i) *Disqualifying disposition and application of special rule*. Assume the same facts as in *Example 1*, except that A sells the share for $150 to M.

(ii) If the sale to M is a disposition that meets the requirements of paragraph (b)(2)(i) of this section, instead of $100 which otherwise would have been includible as compensation under §1.83–7, under paragraph (b)(2)(i) of this section, A must include only $50 (the excess of the amount realized on such sale, $150, over the adjusted basis of the share, $100) in gross income as compensation attributable to the exercise of the incentive stock option. Because A's basis for the share is $150 (the $100 which A paid for the share, plus the $50 increase in basis resulting from the inclusion of that amount in A's gross income as compensation attributable to the exercise of the option), A realizes no capital gain or loss as a result of the sale. If the requirements of section 83(h) and §1.83–6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of $50 for the compensation attributable to A's exercise of the option and disqualifying disposition of the share.

(iii) Assume the same facts as in paragraph (i) of this *Example 3*, except that 10 days after the sale to M, A purchases substantially identical stock. Because under section 1091(a) a loss (if it were sustained on the sale) would not be recognized on the sale, under paragraph (b)(2)(ii) of this section, the special rule described in paragraph (b)(2)(i) of this section does not apply. A must include $100 (the difference between the fair market value of the share on the date of transfer, $200, and the amount paid for the share, $100) in gross income as compensation attributable to the exercise of the option for the taxable year in which the disqualifying disposition occurred. A recognizes no capital gain or loss on the transaction. If the requirements of section 83(h) and §1.83–6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs X Corporation is allowed a $100 deduction for compensation attributable to A's exercise of the option and disqualifying disposition of the share.

(iv) Assume the same facts as in paragraph (ii) of this *Example 3*, except that A sells the share for $50. Under paragraph (b)(2)(i) of this section, A is not required to include any amount in gross income as compensation attributable to the exercise of the option. A is allowed a capital loss of $50 (the difference between the amount realized on the sale, $50, and the adjusted basis of the share, $100). X Corporation is not allowed any deduction attributable to A's exercise of the option and disqualifying disposition of the share.

(c) *Failure to satisfy employment requirement*. Section 1.421–2(a) does not apply to the transfer of a share of stock pursuant to the exercise of an incentive stock option if the employment requirement, as determined under paragraph (a)(1)(i)(B) of this section, is not met at the time of the exercise of such option. Consequently, the effects of such a transfer are determined under the rules of §1.83–7. For rules relating to the employment relationship, see §1.421–1(h).

Par. 6. Section 1.422–2 is added to read as follows:

§1.422–2 Incentive stock options defined.

(a) *Incentive stock option defined*—(1) *In general*. The term *incentive stock option* means an option that meets the requirements of paragraph (a)(2) of this section on the date of grant. An incentive stock option is also subject to the $100,000 limitation described in §1.422–4. An incentive stock option may contain a number of permissible provisions that do not affect the status of the option as an incentive stock option. See §1.422–5 for rules relating to permissible provisions of an incentive stock option.

(2) *Option requirements*. To qualify as an incentive stock option under this section, an option must be granted to an individual in connection with the individual's employment by the corporation granting such option (or by a related corporation as defined in §1.421–1(i)(2)), and granted only for stock of any of such corporations. In addition, the option must meet all of the following requirements—

(i) It must be granted pursuant to a plan that meets the requirements described in paragraph (b) of this section;

(ii) It must be granted within 10 years from the date of the adoption of the plan or the date such plan is approved by the stockholders, whichever is earlier (see paragraph (c) of this section);

(iii) It must not be exercisable after the expiration of 10 years from the date of grant (see paragraph (d) of this section);

(iv) It must provide that the option price per share is not less than the fair market value of the share on the date of grant (see paragraph (e) of this section);

(v) By its terms, it must not be transferrable by the individual to whom the option is granted other than by will or the laws of descent and distribution, and must be exercisable, during such individual's lifetime, only by such individual (see §§1.421–1(b)(2) and 1.421–2(c)); and

(vi) Except as provided in paragraph (f) of this section, it must be granted to an individual who, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the corporation employing such individual or of any related corporation of such corporation.

(3) *Amendment of option terms*. Except as otherwise provided in §1.424–1, the amendment of the terms of an incentive stock option may cause it to cease to be an option described in this section. If the terms of an option that has lost its status as an incentive stock option are subsequently changed with the intent to re-qualify the option as an incentive stock option, such change results in the grant of a new option on the date of the change. See §1.424–1(e).

(4) *Terms provide option not an incentive stock option*. If the terms of an option, when granted, provide that it will not be treated as an incentive stock option, such option is not treated as an incentive stock option.

(b) *Option plan*—(1) *In general*. An incentive stock option must be granted pursuant to a plan that meets the requirements of this paragraph (b). The authority to grant other stock options or other stock-based awards pursuant to the plan, where the exercise of such other options or awards does not affect the exercise of incentive stock options granted pursuant to the plan, does not disqualify such incentive stock options. The plan must be in writing or electronic form, provided that such writing or electronic form is adequate to establish the terms of the plan. See §1.422–5 for rules relating to permissible provisions of an incentive stock option.

(2) *Stockholder approval*. (i) The plan required by this paragraph (b) must be approved by the stockholders of the corporation granting the incentive stock option within 12 months before or after the date such plan is adopted. Ordinarily, a plan is adopted when it is approved by the granting corporation's board of directors, and the date of the board's action is the reference point for determining whether stockholder approval occurs within the applicable 24-month period. However, if the board's action is subject to a condition (such as stockholder approval) or the happening of a particular event, the plan is adopted on the date the condition is met or the event occurs, unless the board's resolution fixes the date of approval as the date of the board's action.

(ii) For purposes of paragraph (b)(2)(i) of this section, the stockholder approval must comply with the rules described in §1.422–3.

(iii) The provisions relating to the maximum aggregate number of shares to be issued under the plan (described in paragraph (b)(3) of this section) and the employees (or class or classes of employees) eligible to receive options under the plan (described in paragraph (b)(4) of this section) are the only provisions of a stock option plan that, if changed, must be re-approved by stockholders for purposes of section 422(b)(1). Any increase in the maximum aggregate number of shares that may be issued under the plan (other than an increase merely reflecting a change in the number of outstanding shares, such as a stock dividend or stock split), or change in the designation of the employees (or class or classes of employees) eligible to receive options under the plan is considered the adoption of a new plan requiring stockholder approval within the prescribed 24-month period. In addition, a change in the granting corporation or the stock available for purchase or award under the plan is considered the adoption of a new plan requiring new stockholder approval within the prescribed 24-month period. Any other changes in the terms of an incentive stock option plan are not considered the adoption of a new plan and, thus, do not require stockholder approval.

(3) *Maximum aggregate number of shares*. (i) The plan required by this paragraph (b) must designate the maximum aggregate number of shares that may be issued under the plan through incentive stock options. If nonstatutory options or other stock-based awards may be granted, the plan may separately designate terms for each type of option or other stock-based awards and designate the maximum number of shares that may be issued under such option or other stock-based awards. Unless otherwise specified, all terms of the plan apply to all options and other stock-based awards that may be granted under the plan.

(ii) A plan that merely provides that the number of shares that may be issued as incentive stock options under such plan may not exceed a stated percentage of the shares outstanding at the time of each offering or grant under such plan does not satisfy the requirement that the plan state the maximum aggregate number of shares that may be issued under the plan. However, the maximum aggregate number of shares that may be issued under the plan may be stated in terms of a percentage of the authorized, issued, or outstanding shares at the date of the adoption of the plan. The plan may specify that the maximum aggregate number of shares available for grants under the plan may increase annually by a specified percentage of the authorized, issued, or outstanding shares at the date of the adoption of the plan. A plan which provides that the maximum aggregate number of shares that may be issued as incentive stock options under the plan may change based on any other specified circumstances satisfies the requirements of this paragraph (b)(3) only if the stockholders approve an immediately determinable

maximum aggregate number of shares that may be issued under the plan in any event.

(iii) It is permissible for the plan to provide that, shares purchasable under the plan may be supplied to the plan through acquisitions of stock on the open market; shares purchased under the plan and forfeited back to the plan; shares surrendered in payment of the exercise price of an option; shares withheld for payment of applicable employment taxes and/or withholding obligations resulting from the exercise of an option.

(iv) If there is more than one plan under which incentive stock options may be granted and stockholders of the granting corporation merely approve a maximum aggregate number of shares that are available for issuance under such plans, the stockholder approval requirements described in paragraph (b)(2) of this section are not satisfied. A separate maximum aggregate number of shares available for issuance pursuant to incentive stock options must be approved for each plan.

(4) *Designation of employees.* The plan described in this paragraph (b), as adopted and approved, must indicate the employees (or class or classes of employees) eligible to receive the options or other stock-based awards to be granted under the plan. This requirement is satisfied by a general designation of the employees (or the class or classes of employees) eligible to receive options or other stock-based awards under the plan. Designations such as "key employees of the grantor corporation"; "all salaried employees of the grantor corporation and its subsidiaries, including subsidiaries which become such after adoption of the plan;" or "all employees of the corporation" meet this requirement. This requirement is considered satisfied even though the board of directors, another group, or an individual is given the authority to select the particular employees who are to receive options or other stock-based awards from a described class and to determine the number of shares to be optioned or granted to each such employee. If individuals other than employees may be granted options or other stock-based awards under the plan, the plan must separately designate the employees or classes of employees eligible to receive incentive stock options.

(5) *Conflicting option terms.* An option on stock available for purchase or grant under the plan is treated as having been granted pursuant to a plan even if the terms of the option conflict with the terms of the plan, unless such option is granted to an employee who is ineligible to receive options under the plan, options have been granted on stock in excess of the aggregate number of shares which may be issued under the plan, or the option provides otherwise.

(6) The following examples illustrate the principles of this paragraph (b):

Example 1. Stockholder approval. (i) S Corporation is a subsidiary of P Corporation, a publicly traded corporation. On January 1, 2006, S adopts a plan under which incentive stock options for S stock are granted to S employees.

(ii) To meet the requirements of paragraph (b)(2) of this section, the plan must be approved by the stockholders of S (in this case, P) within 12 months before or after January 1, 2006.

(iii) Assume the same facts as in paragraph (i) of this *Example 1*. Assume further that the plan was approved by the stockholders of S (in this case, P) on March 1, 2006. On January 1, 2008, S changes the plan to provide that incentive stock options for P stock will be granted to S employees under the plan. Because there is a change in the stock available for grant under the plan, the change is considered the adoption of a new plan that must be approved by the stockholders of P within 12 months before or after January 1, 2008.

Example 2. Stockholder approval. (i) Assume the same facts as in paragraph (i) of *Example 1*, except that on March 15, 2007, P completely disposes of its interest in S. Thereafter, S continues to grant options for S stock to S employees under the plan.

(ii) The new S options are granted under a plan that meets the stockholder approval requirements of paragraph (b)(2) of this section without regard to whether S seeks approval of the plan from the stockholders of S after P disposes of its interest in S.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*, except that under the plan as adopted on January 1, 2006, only options for P stock are granted to S employees. Assume further that after P disposes of its interest in S, S changes the plan to provide for the grant of options for S stock to S employees. Because there is a change in the stock available for purchase or grant under the plan, under paragraph (b)(2)(iii) of this section, the stockholders of S must approve the plan within 12 months before or after the change to the plan to meet the stockholder approval requirements of paragraph (b) of this section.

Example 3. Stockholder approval. (i) Corporation X maintains a plan under which incentive stock options may be granted to all eligible employees. Corporation Y does not maintain an incentive stock option plan. On May 15, 2006, Corporation X and Corporation Y consolidate under state law to form one corporation. The new corporation will be named Corporation Y. The consolidation agreement describes the Corporation X plan, including the maximum aggregate number of shares available for issuance pursuant to incentive stock options after the consolidation and the employees eligible to receive options under the plan. Additionally, the consolidation agreement states that the plan will be continued by Corporation Y after the consolidation and incentive stock options will be issued by Corporation Y. The consolidation agreement is unanimously approved by the shareholders of Corporations X and Y on May 1, 2006. Corporation Y assumes the plan formerly maintained by Corporation X and continues to grant options under the plan to all eligible employees.

(ii) Because there is a change in the granting corporation (from Corporation X to Corporation Y), under paragraph (b)(2)(iii) of this section, Corporation Y is considered to have adopted a new plan. Because the plan is fully described in the consolidation agreement, including the maximum aggregate number of shares available for issuance pursuant to incentive stock options and employees eligible to receive options under the plan, the approval of the consolidation agreement by the shareholders constitutes approval of the plan. Thus, the shareholder approval of the consolidation agreement satisfies the shareholder approval requirements of paragraph (b)(2) of this section, and the plan is considered to be adopted by Corporation Y and approved by its shareholders on May 1, 2006.

Example 4. Maximum aggregate number of shares. X Corporation maintains a plan under which statutory options and nonstatutory options may be granted. The plan designates the number of shares that may be used for incentive stock options. Because the maximum aggregate number of shares that will be used for incentive stock options is designated in the plan, the requirements of paragraph (b)(3) of this section are satisfied.

Example 5. Maximum aggregate number of shares. Y Corporation adopts an incentive stock option plan on November 1, 2006. On that date, there are two million outstanding shares of Y Corporation stock. The plan provides that the maximum aggregate number of shares that may be issued under the plan may not exceed 15% of the outstanding number of shares of Y Corporation on November 1, 2006. Because the maximum aggregate number of shares that may be issued under the plan is designated in the plan, the requirements of paragraph (b)(3) of this section are met.

Example 6. Maximum aggregate number of shares. (i) B Corporation adopts an incentive stock option plan on March 15, 2005. The plan provides that the maximum aggregate number of shares available for issuance under the plan is 50,000, increased on each anniversary date of the adoption of the plan by 5 percent of the then-outstanding shares.

(ii) Because the maximum aggregate number of shares is not designated under the plan, the requirements of paragraph (b)(3) of this section are not met.

(iii) Assume the same facts as in paragraph (i) of this *Example 6*, except that the plan provides that the maximum aggregate number of shares available under the plan is the lesser of (a) 50,000 shares, increased each anniversary date of the adoption of the plan by 5 percent of the then-outstanding shares, or (b) 200,000 shares. Because the maximum aggregate number of shares that may be issued under the plan is designated as the lesser of one of two numbers, one of which provides an immediately determinable maximum aggregate number of shares that may be issued

under the plan in any event, the requirements of paragraph (b)(3) of this section are met.

(c) *Duration of option grants under the plan*. An incentive stock option must be granted within 10 years from the date that the plan under which it is granted is adopted or the date such plan is approved by the stockholders, whichever is earlier. To grant incentive stock options after the expiration of the 10-year period, a new plan must be adopted and approved.

(d) *Period for exercising options*. An incentive stock option, by its terms, must not be exercisable after the expiration of 10 years from the date such option is granted, or 5 years from the date such option is granted to an employee described in paragraph (f) of this section. An option that does not contain such a provision when granted is not an incentive stock option.

(e) *Option price*. (1) Except as provided by paragraph (e)(2) of this section, the option price of an incentive stock option must not be less than the fair market value of the stock subject to the option at the time the option is granted. The option price may be determined in any reasonable manner, including the valuation methods permitted under §20.2031–2 of this chapter, so long as the minimum price possible under the terms of the option is not less than the fair market value of the stock on the date of grant. For general rules relating to the option price, see §1.421–1(e). For rules relating to the determination of when an option is granted, see §1.421–1(c).

(2)(i) If a share of stock is transferred to an individual pursuant to the exercise of an option which fails to qualify as an incentive stock option merely because there was a failure of an attempt, made in good faith, to meet the option price requirements of paragraph (e)(1) of this section, the requirements of such paragraph are considered to have been met. Whether there was a good-faith attempt to set the option price at not less than the fair market value of the stock subject to the option at the time the option was granted depends on the relevant facts and circumstances.

(ii) For publicly held stock that is actively traded on an established market at the time the option is granted, determining the fair market value of such stock by the appropriate method described in §20.2031–2 of this chapter establishes that a good-faith attempt to meet the option price requirements of this paragraph (e) was made.

(iii) For non-publicly traded stock, if it is demonstrated, for example, that the fair market value of the stock at the date of grant was based upon an average of the fair market values as of such date set forth in the opinions of completely independent and well-qualified experts, such a demonstration generally establishes that there was a good-faith attempt to meet the option price requirements of this paragraph (e). The optionee's status as a majority or minority stockholder may be taken into consideration.

(iv) Regardless of whether the stock offered under an option is publicly traded, a good-faith attempt to meet the option price requirements of this paragraph (e) is not demonstrated unless the fair market value of the stock on the date of grant is determined with regard to *nonlapse restrictions* (as defined in §1.83–3(h)) and without regard to *lapse restrictions* (as defined in §1.83–3(i)).

(v) Amounts treated as interest and amounts paid as interest under a deferred payment arrangement are not includible as part of the option price. See §1.421–1(e)(1). An attempt to set the option price at not less than fair market value is not regarded as made in good faith where an adjustment of the option price to reflect amounts treated as interest results in the option price being lower than the fair market value on which the option price was based.

(3) Notwithstanding that the option price requirements of paragraphs (e)(1) and (2) of this section are satisfied by an option granted to an employee whose stock ownership exceeds the limitation provided by paragraph (f) of this section, such option is not an incentive stock option when granted unless it also complies with paragraph (f) of this section. If the option, when granted, does not comply with the requirements described in paragraph (f) of this section, such option can never become an incentive stock option, even if the employee's stock ownership does not exceed the limitation of paragraph (f) of this section when such option is exercised.

(f) *Options granted to certain stockholders*. (1) If, immediately before an option is granted, an individual owns (or is treated as owning) stock possessing more than 10 percent of the total combined voting power of all classes of stock of the corporation employing the optionee or of any related corporation of such corporation, then an option granted to such individual cannot qualify as an incentive stock option unless the option price is at least 110 percent of the stock's fair market value on the date of grant and such option by its terms is not exercisable after the expiration of 5 years from the date of grant. For purposes of determining the minimum option price for purposes of this paragraph (f), the rules described in paragraph (e)(2) of this section, relating to the good-faith determination of the option price, do not apply.

(2) For purposes of determining the stock ownership of the optionee, the stock attribution rules of §1.424–1(d) apply. Stock that the optionee may purchase under outstanding options is not treated as stock owned by the individual. The determination of the percentage of the total combined voting power of all classes of stock of the employer corporation (or of its related corporations) that is owned by the optionee is made with respect to each such corporation in the related group by comparing the voting power of the shares owned (or treated as owned) by the optionee to the aggregate voting power of all shares of each such corporation actually issued and outstanding immediately before the grant of the option to the optionee. The aggregate voting power of all shares actually issued and outstanding immediately before the grant of the option does not include the voting power of treasury shares or shares authorized for issue under outstanding options held by the individual or any other person.

(3) *Examples*. The rules of this paragraph (f) are illustrated by the following examples:

Example 1. (i) E, an employee of M Corporation, owns 15,000 shares of M Corporation common stock, which is the only class of stock outstanding. M has 100,000 shares of its common stock outstanding. On January 1, 2005, when the fair market value of M stock is $100, E is granted an option with an option price of $100 and an exercise period of 10 years from the date of grant.

(ii) Because E owns stock possessing more than 10 percent of the total combined voting power of all classes of M Corporation stock, M cannot grant an incentive stock option to E unless the option is granted at an option price of at least 110 percent of the fair market value of the stock subject to the option and the option, by its terms, expires no later than 5 years from its date of grant. The option granted to E fails to meet the option-price and term requirements de-

scribed in paragraph (f)(1) of this section and, thus, the option is not an incentive stock option.

(iii) Assume the same facts as in paragraph (i) of this *Example 1*, except that E's father and brother each owns 7,500 shares of M Corporation stock, and E owns no M stock in E's own name. Because under the attribution rules of §1.424–1(d), E is treated as owning stock held by E's parents and siblings, M cannot grant an incentive stock option to E unless the option price is at least 110 percent of the fair market value of the stock subject to the option, and the option, by its terms, expires no later than 5 years from the date of grant.

Example 2. Assume the same facts as in paragraph (i) of this *Example 1*. Assume further that M is a subsidiary of P Corporation. Regardless of whether E owns any P stock and the number of P shares outstanding, if P Corporation grants an option to E which purports to be an incentive stock option, but which fails to meet the 110-percent-option-price and 5-year-term requirements, the option is not an incentive stock option because E owns more than 10 percent of the total combined voting power of all classes of stock of a related corporation of P Corporation (*i.e.*, M Corporation). An individual who owns (or is treated as owning) stock in excess of the ownership specified in paragraph (f)(1) of this section, in any corporation in a group of corporations consisting of the employer corporation and its related corporations, cannot be granted an incentive stock option by any corporation in the group unless such option meets the 110-percent-option-price and 5-year-term requirements of paragraph (f)(1) of this section.

Example 3. (i) F is an employee of R Corporation. R has only one class of stock, of which 100,000 shares are issued and outstanding. F owns no stock in R Corporation or any related corporation of R Corporation. On January 1, 2005, R grants a 10-year incentive stock option to F to purchase 50,000 shares of R stock at $3 per share, the fair market value of R stock on the date of grant of the option. On April 1, 2005, F exercises half of the January option and receives 25,000 shares of R stock that previously were not outstanding. On July 1, 2005, R grants a second 50,000 share option to F which purports to be an incentive stock option. The terms of the July option are identical to the terms of the January option, except that the option price is $3.25 per share, which is the fair market value of R stock on the date of grant of the July option.

(ii) Because F does not own more than 10% of the total combined voting power of all classes of stock of R Corporation or any related corporation on the date of the grant of the January option and the pricing requirements of paragraph (e) of this section are satisfied on the date of grant of such option, the unexercised portion of the January option remains an incentive stock option regardless of the changes in F's percentage of stock ownership in R after the date of grant. However, the July option is not an incentive stock option because, on the date that it is granted, F owns 20 percent (25,000 shares owned by F divided by 125,000 shares of R stock issued and outstanding) of the total combined voting power of all classes of R Corporation stock and, thus the pricing requirements of paragraph (f)(1) of this section are not met.

(iii) Assume the same facts as in paragraph (i) of this *Example 3* except that the partial exercise of the January incentive stock option on April 1, 2003, is for only 10,000 shares. Under these circumstances, the July option is an incentive stock option, because, on the date of grant of the July option, F does not own more than 10 percent of the total combined voting power (10,000 shares owned by F divided by 110,000 shares of R issued and outstanding) of all classes of R Corporation stock.

§1.422–4 [Removed]

Par. 7. Section 1.422–4 is removed.

§1.422–5 [Redesignated as §1.422–3]

Par. 8. Section 1.422–5 is re-designated as §1.422–3.

Par. 9. New §1.422–4 is added to read as follows:

§1.422–4 $100,000 limitation for incentive stock options.

(a) *$100,000 per year limitation*—(1) *General rule*. An option that otherwise qualifies as an incentive stock option nevertheless fails to be an incentive stock option to the extent that the $100,000 limitation described in paragraph (a)(2) of this section is exceeded.

(2) *$100,000 per year limitation*. To the extent that the aggregate fair market value of stock with respect to which an incentive stock option (determined without regard to this section) is exercisable for the first time by any individual during any calendar year (under all plans of the employer corporation and related corporations) exceeds $100,000, such option is treated as a nonstatutory option. See §1.83–7 for rules applicable to nonstatutory options.

(b) *Application*. To determine whether the limitation described in paragraph (a)(2) of this section has been exceeded, the following rules apply:

(1) An option that does not meet the requirements of §1.422–2 when granted (including an option which, when granted, contains terms providing that it will not be treated as an incentive stock option) is disregarded. See §1.422–2(a)(4).

(2) The fair market value of stock is determined as of the date of grant of the option for such stock.

(3) Except as otherwise provided in paragraph (b)(4) of this section, options are taken into account in the order in which they are granted.

(4) For purposes of this section, an option is considered to be first exercisable during a calendar year if the option will become exercisable at any time during the year assuming that any condition on the optionee's ability to exercise the option related to the performance of services is satisfied. If the optionee's ability to exercise the option in the year is subject to an acceleration provision, then the option is considered first exercisable in the calendar year in which the acceleration provision is triggered. After an acceleration provision is triggered, the options subject to such provision are then taken into account in accordance with paragraph (b)(3) of this section for purposes of applying the limitation described in paragraph (a)(2) of this section to all options first exercisable during a calendar year. However, because an acceleration provision is not taken into account prior to its triggering, an incentive stock option that becomes exercisable for the first time during a calendar year by operation of such a provision does not affect the application of the $100,000 limitation with respect to any option (or portion thereof) exercised prior to such acceleration. For purposes of this paragraph (b)(4), an acceleration provision includes, for example, a provision that accelerates the exercisability of an option on a change in ownership or control or a provision that conditions exercisability on the attainment of a performance goal. See paragraph (d), *Example 4* of this section.

(5)(i) An option (or portion thereof) is disregarded if, prior to the calendar year during which it would otherwise have become exercisable for the first time, the option (or portion thereof) is modified and thereafter ceases to be an incentive stock option described in §1.422–2, is canceled, or is transferred in violation of §1.421–1(b)(2).

(ii) If an option (or portion thereof) is modified, canceled, or transferred at any other time, such option (or portion thereof) is treated as outstanding according to its original terms until the end of the calendar year during which it would otherwise have become exercisable for the first time.

(6) A disqualifying disposition has no effect on the determination of whether an option exceeds the $100,000 limitation.

(c) *Bifurcation*— (1) *Options*. The application of the rules described in paragraph (b) of this section may result in an option being treated, in part, as an incentive stock option and, in part, as a nonstatu-

tory option. See §1.83–7 for the treatment of nonstatutory options.

(2) *Stock*. A corporation may issue a separate certificate for incentive option stock or designate such stock as incentive stock option stock in the corporation's transfer records or plan records. In such a case, the issuance of separate certificates or designation in the corporation's transfer records or plan records is not a modification under §1.424–1(e). In the absence of such an issuance or designation, shares are treated as first purchased under an incentive stock option to the extent of the $100,000 limitation, and the excess shares are treated as purchased under a nonstatutory option. See §1.83–7 for the treatment of nonstatutory options.

(d) *Examples*. The following examples illustrate the principles of this section. In each of the following examples E is an employee of X Corporation. The examples are as follows:

Example 1. General rule. Effective January 1, 2004, X Corporation adopts a plan under which incentive stock options may be granted to its employees. On January 1, 2004, and each succeeding January 1 through January 1, 2013, E is granted immediately exercisable options for X Corporation stock with a fair market value of $100,000 determined on the date of grant. The options qualify as incentive stock options (determined without regard to this section). On January 1, 2014, E exercises all of the options. Because the $100,000 limitation has not been exceeded during any calendar year, all of the options are treated as incentive stock options.

Example 2. Order of grant. X Corporation is a parent corporation of Y Corporation, which is a parent corporation of Z Corporation. Each corporation has adopted its own separate plan, under which an employee of any member of the corporate group may be granted options for stock of any member of the group. On January 1, 2004, X Corporation grants E an incentive stock option (determined without regard to this section) for stock of Y Corporation with a fair market value of $100,000 on the date of grant. On December 31, 2004, Y Corporation grants E an incentive stock option (determined without regard to this section) for stock of Z Corporation with a fair market value of $75,000 as of the date of grant. Both of the options are immediately exercisable. For purposes of this section, options are taken into account in the order in which granted using the fair market value of stock as of the date on the option is granted. During calendar year 2004, the aggregate fair market value of stock with respect to which E's options are exercisable for the first time exceeds $100,000. Therefore, the option for Y Corporation stock is treated as an incentive stock option, and the option for Z Corporation stock is treated as a nonstatutory option.

Example 3. Acceleration provision. (i) In 2004, X Corporation grants E three incentive stock options (determined without regard to this section) to acquire stock with an aggregate fair market value of $150,000 on the date of grant. The dates of grant, the fair market value of the stock (as of the applicable date of grant) with respect to which the options are exercisable, and the years in which the options are first exercisable (without regard to acceleration provisions) are as follows:

	Date of Grant	*Fair Market Value of Stock*	*First Exercisable*
Option 1	April 1, 2004	$60,000	2004
Option 2	May 1, 2004	$50,000	2006
Option 3	June 1, 2004	$40,000	2004

(ii) In July of 2004, a change in control of X Corporation occurs, and, under the terms of its option plan, all outstanding options become immediately exercisable. Under the rules of this section, Option 1 is treated as an incentive stock option in its entirety; Option 2 exceeds the $100,000 aggregate fair market value limitation for calendar year 2004 by $10,000 (Option 1's $60,000 + Option 2's $50,000 = $110,000) and is, therefore, bifurcated into an incentive stock option for stock with a fair market value of $40,000 as of the date of grant and a nonstatutory option for stock with a fair market value of $10,000 as of the date of grant. Option 3 is treated as a nonstatutory option in its entirety.

Example 4. Exercise of option and acceleration provision. (i) In 2004, X Corporation grants E three incentive stock options (determined without regard to this section) to acquire stock with an aggregate fair market value of $120,000 on the date of grant. The dates of grant, the fair market value of the stock (as of the applicable date of grant) with respect to which the options are exercisable, and the years in which the options are first exercisable (without regard to acceleration provisions) are as follows:

	Date of Grant	*Fair Market Value of Stock*	*First Exercisable*
Option 1	April 1, 2004	$60,000	2005
Option 2	May 1, 2004	$40,000	2006
Option 3	June 1, 2004	$20,000	2005

(ii) On June 1, 2005, E exercises Option 3. At the time of exercise of Option 3, the fair market value of X stock (at the time of grant) with respect to which options held by E are first exercisable in 2005 does not exceed $100,000. On September 1, 2005, a change of control of X Corporation occurs, and, under the terms of its option plan, Option 2 becomes immediately exercisable. Under the rules of this section, because E's exercise of Option 3 occurs before the change of control and the effects of an acceleration provision are not taken into account until it is triggered, Option 3 is treated as an incentive stock option in its entirety. Option 1 is treated as an incentive stock option in its entirety. Option 2 is bifurcated into an incentive stock option for stock with a fair market value of $20,000 on the date of grant and a nonstatutory option for stock with a fair market value of $20,000 on the date of grant because it exceeds the $100,000 limitation for 2003 by $20,000 (Option 1 for $60,000 + Option 3 for $20,000 + Option 2 for $40,000 = $120,000).

(iii) Assume the same facts as in paragraph (ii) of this *Example 4*, except that the change of control occurs on May 1, 2005. Because options are taken into account in the order in which they are granted, Option 1 and Option 2 are treated as incentive stock options in their entirety. Because the exercise of Option 3 (on June 1, 2005) takes place after the acceleration provision is triggered, Option 3 is treated as a nonstatutory option in its entirety.

Example 5. Cancellation of option. (i) In 2004, X Corporation grants E three incentive stock options (determined without regard to this section) to acquire stock with an aggregate fair market value of $140,000 as of the date of grant. The dates of grant, the fair market value of the stock (as of the applicable date of grant) with respect to which the options are exercisable, and the years in which the options are first exercisable (without regard to acceleration provisions) are as follows:

	Date of Grant	*Fair Market Value of Stock*	*First Exercisable*
Option 1	April 1, 2004	$60,000	2005
Option 2	May 1, 2004	$40,000	2005
Option 3	June 1, 2004	$40,000	2005

(ii) On December 31, 2004, Option 2 is canceled. Because Option 2 is canceled before the calendar year during which it would have become exercisable for the first time, it is disregarded. As a result, Option 1 and Option 3 are treated as incentive stock options in their entirety.

(iii) Assume the same facts as in paragraph (ii) of this *Example 5*, except that Option 2 is canceled on January 1, 2005. Because Option 2 is not canceled prior to the calendar year during which it would have become exercisable for the first time (2005), it is treated as an outstanding option for purposes of determining whether the $100,000 limitation for 2005 has been exceeded. Because options are taken into account in the order in which granted, Option 1 is treated as an incentive stock option in its entirety. Because Option 3 exceeds the $100,000 limitation by $40,000 (Option 1 for $60,000 + Option 2 for $40,000 + Option 3 for $40,000 = $140,000), it is treated as a nonstatutory option in its entirety.

(iv) Assume the same facts as in paragraph (i) of this *Example 5*, except that on January 1, 2005, E exercises Option 2 and immediately sells the stock in a disqualifying disposition. A disqualifying disposition has no effect on the determination of whether the underlying option is considered outstanding during the calendar year during which it is first exercisable. Because options are taken into account in the order in which granted, Option 1 is treated as an incentive stock option in its entirety. Because Option 3 exceeds the $100,000 limitation by $40,000 (Option 1 for $60,000 + Option 2 for $40,000 + Option 3 for $40,000 = $140,000), it is treated as a nonstatutory option in its entirety.

Example 6. Designation of stock. On January 1, 2004, X grants E an immediately exercisable incentive stock option (determined without regard to this section) to acquire X stock with a fair market value of $150,000 on that date. Under the rules of this section, the option is bifurcated and treated as an incentive stock option for X stock with a fair market value of $100,000 and a nonstatutory option for X stock with a fair market value of $50,000. In these circumstances, X may designate the stock that is treated as stock acquired pursuant to the exercise of an incentive stock option by issuing a separate certificate (or certificates) for $100,000 of stock and identifying such certificates as Incentive Stock Option Stock in its transfer records. In the absence of such a designation (or a designation in the corporation's transfer records or the plan records) shares with a fair market value of $100,000 are deemed purchased first under an incentive stock option, and shares with a fair market value of $50,000 are deemed purchased under a nonstatutory option.

Par. 10. Section 1.422–5 is added to read as follows:

§1.422–5 Permissible provisions.

(a) *General rule.* An option that otherwise qualifies as an incentive stock option does not fail to be an incentive stock option merely because such option contains one or more of the provisions described in paragraphs (b), (c), and (d) of this section.

(b) *Cashless exercise.* (1) An option does not fail to be an incentive stock option merely because the optionee may exercise the option with previously acquired stock of the corporation that granted the option or stock of the corporation whose stock is being offered for purchase under the option. For special rules relating to the use of statutory option stock to pay the option price of an incentive stock option, see §1.424–1(c)(3).

(2) All shares acquired through the exercise of an incentive stock option are individually subject to the holding period requirements described in §1.422–1(a) and the disqualifying disposition rules of §1.422–1(b), regardless of whether the option is exercised with previously acquired stock of the corporation that granted the option or stock of the corporation whose stock is being offered for purchase under the option. If an incentive stock option is exercised with such shares, and the exercise results in the basis allocation described in paragraph (b)(3) of this section, the optionee's disqualifying disposition of any of the stock acquired through such exercise is treated as a disqualifying disposition of the shares with the lowest basis.

(3) If the exercise of an incentive stock option with previously acquired shares is comprised in part of an exchange to which section 1036 (and so much of section 1031 as relates to section 1036) applies, then:

(i) The optionee's basis in the incentive stock option shares received in the section 1036 exchange is the same as the optionee's basis in the shares surrendered in the exchange, increased, if applicable, by any amount included in gross income as compensation pursuant to sections 421 through 424 or section 83. Except for purposes of §1.422–1(a), the holding period of the shares is determined under section 1223. For purposes of §1.422–1 and sections 421(b) and 83 and the regulations thereunder, the amount paid for the shares purchased under the option is the fair market value of the shares surrendered on the date of the exchange.

(ii) The optionee's basis in the incentive stock option shares not received pursuant to the section 1036 exchange is zero. For all purposes, the holding period of such shares begins as of the date that such shares are transferred to the optionee. For purposes of §1.422–1(b) and sections 421(b) and 83 and the regulations thereunder, the amount paid for the shares is considered to be zero.

(c) *Additional compensation.* An option does not fail to be an incentive stock option merely because the optionee has the right to receive additional compensation, in cash or property, when the option is exercised, provided such additional compensation is includible in income under section 61 or section 83. The amount of such additional compensation may be determined in any manner, including by reference to the fair market value of the stock at the time of exercise or to the option price.

(d) *Option subject to a condition.* (1) An option does not fail to be an incentive stock option merely because the option is subject to a condition, or grants a right, that is not inconsistent with the requirements of §§1.422–2 and 1.422–4.

(2) An option that includes an alternative right is not an incentive stock option if the requirements of §1.422–2 are effectively avoided by the exercise of the alternative right. For example, an alternative right extending the option term beyond ten years, setting an option price below fair market value, or permitting transferability prevents an option from qualifying as an incentive stock option. If either of two options can be exercised, but not both, each such option is a disqualifying alternative right with respect to the other,

even though one or both options would individually satisfy the requirements of §§1.422–2, 1.422–4, and this section.

(3) An alternative right to receive a taxable payment of cash and/or property in exchange for the cancellation or surrender of the option does not disqualify the option as an incentive stock option if the right is exercisable only when the then fair market value of the stock exceeds the exercise price of the option and the option is otherwise exercisable, the right is transferable only when the option is otherwise transferable, and the exercise of the right has economic and tax consequences no more favorable than the exercise of the option followed by an immediate sale of the stock. For this purpose, the exercise of the alternative right does not have the same economic and tax consequences if the payment exceeds the difference between the then fair market value of the stock and the exercise price of the option.

(e) *Examples*. The principles of this section are illustrated by the following examples:

Example 1. On June 1, 2004, X Corporation grants an incentive stock option to A, an employee of X Corporation, entitling A to purchase 100 shares of X Corporation common stock at $10 per share. The option provides that A may exercise the option with previously acquired shares of X Corporation common stock. X Corporation has only one class of common stock outstanding. Under the rules of section 83, the shares transferable to A through the exercise of the option are transferable and not subject to a substantial risk of forfeiture. On June 1, 2005, when the fair market value of an X Corporation share is $25, A uses 40 shares of X Corporation common stock, which A had purchased on the open market on June 1, 2002, for $5 per share, to pay the full option price. After exercising the option, A owns 100 shares of incentive stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), 40 of the shares have a $200 aggregate carryover basis (the $5 purchase price x 40 shares) and a three-year holding period for purposes of determining capital gain, and 60 of the shares have a zero basis and a holding period beginning on June 1, 2005, for purposes of determining capital gain. All 100 shares have a holding period beginning on June 1, 2005, for purposes of determining whether the holding period requirements of §1.422–1(a) are met.

Example 2. Assume the same facts as in *Example 1*. Assume further that, on September 1, 2005, A sells 75 of the shares that A acquired through exercise of the incentive stock option for $30 per share. Because the holding period requirements were not satisfied, A made a disqualifying disposition of the 75 shares on September 1, 2005. Under the rules of paragraph (b)(2) and (b)(3) of this section, A has sold all 60 of the non-section-1036 shares and 15 of the 40 section-1036 shares. Therefore, under paragraph (b)(3) of this section and section 83(a), the amount of compensation attributable to A's exercise of the option and subsequent disqualifying disposition of 75 shares is $1,500 (the difference between the fair market value of the stock on the date of transfer, $1,875 (75 shares at $25 per share), and the amount paid for the stock, $375 (60 shares at $0 per share plus 15 shares at $25 per share)). In addition, A must recognize a capital gain of $675, which consists of $375 ($450, the amount realized from the sale of 15 shares, less A's basis of $75) plus $300 ($1,800, the amount realized from the sale of 60 shares, less A's basis of $1,500 resulting from the inclusion of that amount in income as compensation). Accordingly, A must include in gross income for the taxable year in which the sale occurs $1,500 as compensation and $675 as capital gain. For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under section 162 and if the requirements of §1.83–6(a) are met, X Corporation is allowed a deduction of $1,500 for the compensation paid to A.

Example 3. Assume the same facts as in *Example 2*, except that, instead of selling the 75 shares of incentive stock option stock on September 1, 2005, A uses those shares to exercise a second incentive stock option. The second option was granted to A by X Corporation on January 1, 2005, entitling A to purchase 100 shares of X Corporation common stock at $22.50 per share. As in *Example 2*, A has made a disqualifying disposition of the 75 shares of stock pursuant to §1.424–1(c). Under paragraph (b) of this section, A has disposed of all 60 of the non-section-1036 shares and 15 of the 40 section-1036 shares. Therefore, pursuant to paragraph (b)(3) of this section and section 83(a), the amount of compensation attributable to A's exercise of the first option and subsequent disqualifying disposition of 75 shares is $1,500 (the difference between the fair market value of the stock on the date of transfer, $1,875 (75 shares at $25 per share), and the amount paid for the stock, $375 (60 shares at $0 per share plus 15 shares at $25 per share)). Unlike *Example 2*, A does not recognize any capital gain as a result of exercising the second option because, for all purposes other than the determination of whether the exercise is a disposition pursuant to section 424(c), the exercise is considered an exchange to which section 1036 applies. Accordingly, A must include in gross income for the taxable year in which the disqualifying disposition occurs $1,500 as compensation. If the requirements of §83(h) and §1.83–6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of $1,500 for the compensation paid to A. After exercising the second option, A owns a total of 125 shares of incentive stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), the 100 "new" shares of incentive stock option stock have the following bases and holding periods: 15 shares have a $75 carryover basis and a three-year-and-three-month holding period for purposes of determining capital gain, 60 shares have a $1,500 basis resulting from the inclusion of that amount in income as compensation and a three-month holding period for purposes of determining capital gain, and 25 shares have a zero basis and a holding period beginning on September 1, 2005, for purposes of determining capital gain. All 100 shares have a holding period beginning on September 1, 2005, for purposes of determining whether the holding period requirements of §1.422–1(a) are met.

Example 4. Assume the same facts as in *Example 2*, except that, instead of selling the 75 shares of incentive stock option stock on September 1, 2005, A uses those shares to exercise a nonstatutory option. The nonstatutory option was granted to A by X Corporation on January 1, 2005, entitling A to purchase 100 shares of X Corporation common stock at $22.50 per share. Unlike *Example 3*, A has not made a disqualifying disposition of the 75 shares of stock. After exercising the nonstatutory option, A owns a total of 100 shares of incentive stock option stock and 25 shares of nonstatutory stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), the 75 new shares of incentive stock option stock have the same basis and holding period as the 75 old shares used to exercise the nonstatutory option. The additional 25 shares of stock received upon exercise of the nonstatutory option are taxed under the rules of section 83(a). Accordingly, A must include in gross income for the taxable year in which the transfer of such shares occurs $750 (25 shares at $30 per share) as compensation. A's basis in such shares is the same as the amount included in gross income. For its taxable year in which the transfer occurs, X Corporation is allowed a deduction of $750 for the compensation paid to A to the extent the requirements of section 83(h) and §1.83–6(a) are satisfied and the deduction is otherwise allowable under section 162.

Example 5. Assume the same facts in *Example 1*, except that the shares transferred pursuant to the exercise of the incentive stock option are subject to a substantial risk of forfeiture and not transferable (substantially nonvested) for a period of six months after such transfer. Assume further that the shares that A uses to exercise the incentive stock option are similarly restricted. Such shares were transferred to A on January 1, 2005, through A's exercise of a nonstatutory stock option which was granted to A on January 1, 2004. A paid $5 per share for the stock when its fair market value was $22.50 per share. A did not file a section 83(b) election to include the $700 spread (the difference between the option price and the fair market value of the stock on date of exercise of the nonstatutory option) in gross income as compensation. After exercising the incentive stock option with the 40 substantially-nonvested shares, A owns 100 shares of substantially-nonvested incentive stock option stock. Section 1036 (and so much of section 1031 as relates to section 1036) applies to the 40 shares exchanged in exercise of the incentive stock option. However, pursuant to section 83(g), the stock received in such exchange, because it is incentive stock option stock, is not subject to restrictions and conditions substantially similar to those to which the stock given in such exchange was subject. For purposes of section 83(a) and §1.83–1(b)(1), therefore, A has disposed of the 40 shares of substantially-nonvested stock on June 1, 2005, and must include in gross income as compensation $800 (the difference between the amount realized upon such disposition, $1,000, and the amount paid for the stock, $200). Accordingly, 40 shares of the incentive stock option stock have a $1,000 basis (the $200 original basis plus the $800 included in income as compensation) and 60 shares of the incentive stock option stock have a zero basis. For its taxable year in which the disposition of

the substantially-nonvested stock occurs, X Corporation is allowed a deduction of $800 for the compensation paid to A, provided the requirements of section 83(h) and §1.83–6(a) are satisfied and the deduction is otherwise allowable under section 162.

(f) *Effective date*— (1) *In general*. These regulations are effective on August 3, 2004.

(2) *Reliance and transition period*. For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR–279–81 (49 FR 4504), the 2003 proposed regulations REG–122917–02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring at least 6 months after August 3, 2004, taxpayers may rely on either the REG–122917–02 or this section. Taxpayers may not rely on LR–279–81 or REG–122917–02 after December 31, 2005. Reliance on LR–279–81, REG–122917–02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

§1.423–1 [Amended]

Par. 11. Section 1.423–1 is amended as follows:

1. In paragraph (a)(2), the language "425(a)" is removed and "424(a)" is added in its place.

2. In paragraph (b), first sentence, the language "§1.421–7" is removed and "§1.421–1" is added in its place.

3. In paragraph (b), second sentence, the language "§1.421–8" is removed and "§1.421–2" is added in its place.

4. In paragraph (b), last sentence, the language "425(c)" is removed and "424(c)" is added in its place.

5. In paragraph (b), last sentence, the language "§1.425–1" is removed and "§1.424–1" is added in its place.

§1.423–2 [Amended]

Par. 12. Section 1.423–2 is amended by:

1. In paragraph (b), last sentence, the language "§1.421–7" is removed and "§1.421–1" is added in its place.

2. In paragraph (d)(1), second sentence, the language "425(d)" is removed and "424(d)" is added in its place.

3. In paragraph (d)(3), *Example 1*, fourth sentence, the language "425(d)" is removed and "424(d)" is added in its place.

4. In paragraph (e)(2), the language "§1.421–7" is removed and "§1.421–1" is added in its place.

5. In paragraph (g)(1), the first sentence of the concluding text, the language "§1.421–7" is removed and "§1.421–1" is added in its place.

6. In paragraph (g)(1), the second sentence of the concluding text, the language "§1.421–7" is removed and "§1.421–1" is added in its place.

7. In paragraph (j), second sentence, the language "§1.421–7" is removed and "§1.421–1" is added in its place.

8. In paragraph (j), last sentence, the language "425" is removed and "424" is added in its place.

9. In paragraph (k)(2), second sentence, the language "§1.421–8" is removed and "§1.421–2" is added in its place.

§1.425–1 [Redesignated as §1.424–1]

Par. 13. Section 1.425–1 is redesignated as §1.424–1 and is amended by:

1. Revising paragraphs (a)(1) through (a)(6).

2. Redesignating paragraph (a)(7) as paragraph (a)(9).

3. Adding a new paragraph (a)(7).

4. Revising paragraph (a)(8).

5. Adding paragraph (a)(10).

6. In paragraph (b)(1), first, second, and last sentences, the language "425" is removed wherever it appears, and "424" is added in their places.

7. In paragraph (c)(1), first sentence, the language "425" is removed and "424" is added in its place.

8. In paragraph (c)(1), first sentence, the language "*disposition*" is removed and "*disposition of stock*" is added in its place.

9. Adding paragraph (c)(1)(iv).

10. Redesignating paragraph (c)(3) as (c)(4).

11. Adding new paragraph (c)(3).

12. Adding newly designated paragraph (c)(4) *Examples 7* through *9*.

13. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Newly Designated Section	Remove	Add
1.424-1(c)(4) *Example 1*, first sentence	1964	2004
1.424-1(c)(4) *Example 1*, first sentence	qualified stock option	statutory option
1.424-1(c)(4) *Example 1*, second and fourth sentences	1965	2005
1.424-1(c)(4) *Example 1*, third sentence	1968	2006
1.424-1(c)(4) *Example 2*, first sentence	1968	2006

Newly Designated Section	Remove	Add
1.424-1(c)(4) *Example 2*, last sentence	long-term	
1.424-1(c)(4) *Example 3*, first sentence	1968	2006
1.424-1(c)(4) *Example 4*, first sentence	1968, two years and 11 months after the transfer of shares to him	2006
1.424-1(c)(4) *Example 4*, last sentence	three years from the date	two years from the date the options were granted and within one year of the date that
1.424-1(c)(4) *Example 5*, first sentence	1965	2005
1.424-1(c)(4) *Example 5*, first sentence	qualified stock option	statutory option
1.424-1(c)(4) *Example 6*, first sentence	1965	2005
1.424-1(c)(4) *Example 6*, third sentence	three years	2 years
1.424-1(c)(4) *Example 6*, third sentence	income	compensation income
1.424-1(c)(4) *Example 6*, third sentence	a qualified stock option	the option
1.424-1(c)(4) *Example 6*, last sentence	paragraph (b)(2) of §1.421-8	§1.421-2(b)(2)

14. Revising paragraph (d).

15. Revising paragraphs (e)(1) and (e)(2).

16. In paragraph (e)(3), first sentence, remove the phrase "Except as otherwise provided in subparagraph (4) of this paragraph" and add "If section 423(c) applies to an option then,".

17. In paragraph (e)(3), first sentence, remove the language ", and 424(b)(1)."

18. Removing paragraph (e)(4).

19. Redesignating paragraph (e)(5) as paragraph (e)(4).

20. Revising newly designated paragraph (e)(4).

21. Redesignating paragraph (e)(6) as paragraph (e)(5) and removing the second and third sentences.

22. Adding and reserving a new paragraph (e)(6).

23. In list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

Section	Remove	Add
1.424-1(e)(7) *Example 1*, first and sixth sentences	1964	2004
1.424-1(e)(7) *Example 1*, first sentence	1966	2006
1.424-1(e)(7) *Example 1*, third, fourth, fifth, sixth and last sentences	1965	2005
1.424-1(e)(7) *Example 1*, fifth sentence	425(h)	424(h)
1.424-1(e)(7) *Example 1*, last sentence	The exercise of such	Because the requirements of §1.424-1(e)(3) and §1.423-2(g) have not been met, the exercise of such

Section	Remove	Add
1.424-1(e)(7) *Example 2*, first, second, and fifth sentences	1964	2004
1.424-1(e)(7) *Example 2*, first, third, fourth, and fifth sentences, wherever it appears	1965	2005
1.424-1(e)(7) *Example 2*, first and third sentences	1966	2006
1.424-1(e)(7) *Example 2*, fifth sentence	425(h)	424(h)
1.424-1(e)(7) *Example 2*, last sentence	The exercise of such	Because the requirements of §1.424-1(e)(3) and §1.423-2(g) have not been met, the exercise of such
1.424-1(e)(7) *Example 3*, first, second, and last sentences	1965	2005

24. In paragraph (e)(7), remove *Example 4*.

25. Adding paragraphs (f) and (g).

The additions and revisions are as follows:

§ 1.424–1 Definitions and special rules applicable to statutory options.

(a) *Substitutions and assumptions of options*—(1) *In general*. (i) This paragraph (a) provides rules under which an *eligible corporation* (as defined in paragraph (a)(2) of this section) may, by reason of a *corporate transaction* (as defined in paragraph (a)(3) of this section), substitute a new statutory option (new option) for an outstanding statutory option (old option) or assume an old option without such substitution or assumption being considered a modification of the old option. For the definition of *modification*, see paragraph (e) of this section.

(ii) For purposes of §§1.421–1 through 1.424–1, the phrase "substituting or assuming a stock option in a transaction to which section 424 applies," "substituting or assuming a stock option in a transaction to which §1.424–1(a) applies," and similar phrases means a substitution of a new option for an old option or an assumption of an old option that meets the requirements of this paragraph (a). For a substitution or assumption to qualify under this paragraph (a), the substitution or assumption must meet all of the requirements described in paragraphs (a)(4) and (a)(5) of this section.

(2) *Eligible corporation*. For purposes of this paragraph (a), the term *eligible corporation* means a corporation that is the employer of the optionee or a related corporation of such corporation. For purposes of this paragraph (a), the determination of whether a corporation is the employer of the optionee or a related corporation of such corporation is based upon all of the relevant facts and circumstances existing immediately after the corporate transaction. See §1.421–1(h) for rules concerning the employment relationship.

(3) *Corporate transaction*. For purposes of this paragraph (a), the term *corporate transaction* includes—

(i) A corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation;

(ii) A distribution (excluding an ordinary dividend or a stock split or stock dividend described in §1.424–1(e)(4)(v)) or change in the terms or number of outstanding shares of such corporation; and

(iii) Such other corporate events prescribed by the Commissioner in published guidance.

(4) *By reason of*. (i) For a change in an option or issuance of a new option to qualify as a substitution or assumption under this paragraph (a), the change must be made by an *eligible corporation* (as defined in paragraph (a)(2) of this section) and occur by reason of a *corporate transaction* (as defined in paragraph (a)(3) of this section).

(ii) Generally, a change in an option or issuance of a new option is considered to be by reason of a corporate transaction, unless the relevant facts and circumstances demonstrate that such change or issuance is made for reasons unrelated to such corporate transaction. For example, a change in an option or issuance of a new option will be considered to be made for reasons unrelated to a corporate transaction if there is an unreasonable delay between the corporate transaction and such change in the option or issuance of a new option, or if the corporate transaction serves no substantial corporate business purpose independent of the change in options. Similarly, a change in the number or price of shares purchasable under an option merely to reflect market fluctuations in the price of the stock purchasable under an option is not by reason of a corporate transaction.

(iii) A change in an option or issuance of a new option is by reason of a distribution or change in the terms or number of the outstanding shares of a corporation (as described in paragraph (a)(3)(ii) of this section) only if the option as changed, or the new option issued, is an option on the same stock as under the old option (or if such class of stock is eliminated in the change in capital structure, on other stock of the same corporation).

(5) *Other requirements*. For a change in an option or issuance of a new option to qualify as a substitution or assumption under this paragraph (a), all of the requirements described in this paragraph (a)(5) must be met.

(i) In the case of an issuance of a new option (or a portion thereof) in exchange

for an old option (or portion thereof), the optionee's rights under the old option (or portion thereof) must be canceled, and the optionee must lose all rights under the old option (or portion thereof). There cannot be a substitution of a new option for an old option within the meaning of this paragraph (a) if the optionee may exercise both the old option and the new option. It is not necessary to have a complete substitution of a new option for the old option. However, any portion of such option which is not substituted or assumed in a transaction to which this paragraph (a) applies is an outstanding option to purchase stock or, to the extent paragraph (e) of this section applies, a modified option.

(ii) The excess of the aggregate fair market value of the shares subject to the new or assumed option immediately after the change in the option or issuance of a new option over the aggregate option price of such shares must not exceed the excess of the aggregate fair market value of all shares subject to the old option (or portion thereof) immediately before the change in the option or issuance of a new option over the aggregate option price of such shares.

(iii) On a share by share comparison, the ratio of the option price to the fair market value of the shares subject to the option immediately after the change in the option or issuance of a new option must not be more favorable to the optionee than the ratio of the option price to the fair market value of the stock subject to the old option (or portion thereof) immediately before the change in the option or issuance of a new option. The number of shares subject to the new or assumed option may be adjusted to compensate for any change in the aggregate spread between the aggregate option price and the aggregate fair market value of the shares subject to the option immediately after the change in the option or issuance of the new option as compared to the aggregate spread between the option price and the aggregate fair market value of the shares subject to the option immediately before the change in the option or issuance of the new option.

(iv) The new or assumed option must contain all terms of the old option, except to the extent such terms are rendered inoperative by reason of the corporate transaction.

(v) The new option or assumed option must not give the optionee additional benefits that the optionee did not have under the old option.

(6) *Obligation to substitute or assume not necessary*. For a change in the option or issuance of a new option to meet the requirements of this paragraph (a), it is not necessary to show that the corporation changing an option or issuing a new option is under any obligation to do so. In fact, this paragraph (a) may apply even when the option that is being replaced or assumed expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, this paragraph (a) cannot be applied to revive a statutory option which, for reasons not related to the corporate transaction, expires before it can properly be replaced or assumed under this paragraph (a).

(7) *Issuance of stock without meeting the requirements of this paragraph (a)*. A change in the terms of an option resulting in a modification of such option occurs if an optionee's new employer (or a related corporation of the new employer) issues its stock (or stock of a related corporation) upon exercise of such option without satisfying all of the requirements described in paragraphs (a)(4) and (5) of this section.

(8) *Date of grant*. For purposes of applying the rules of this paragraph (a), a substitution or assumption is considered to occur on the date that the optionee would, but for this paragraph (a), be considered to have been granted the option that the eligible corporation is substituting or assuming. A substitution or an assumption that occurs by reason of a corporate transaction may occur before or after the corporate transaction.

* * * * *

(10) *Examples*. The principles of this paragraph (a) are illustrated by the following examples:

Example 1. Eligible corporation. X Corporation acquires a new subsidiary, Y Corporation, and transfers some of its employees to Y. Y Corporation wishes to grant to its new employees and to the employees of X Corporation new options for Y shares in exchange for old options for X shares that were previously granted by X Corporation. Because Y Corporation is an employer with respect to its own employees and a related corporation of X Corporation, Y Corporation is an eligible corporation under paragraph (a)(2) of this section with respect to both the employees of X and Y Corporations.

Example 2. Corporate transaction. (i) On January 1, 2004, Z Corporation grants E, an employee of Z, an option to acquire 100 shares of Z common stock. At the time of grant, the fair market value of Z common stock is $200 per share. E's option price is $200 per share. On July 1, 2005, when the fair market value of Z common stock is $400, Z declares a stock dividend of preferred stock distributed on common stock that causes the fair market value of Z common stock to decrease to $200 per share. On the same day, Z grants to E a new option to acquire 200 shares of Z common stock in exchange for E's old option. The new option has an exercise price of $100 per share.

(ii) A stock dividend other than that described in §1.424–1(e)(4)(v) is a corporate transaction under paragraph (a)(3)(ii) of this section. Generally, the issuance of a new option is considered to be by reason of a corporate transaction. None of the facts in this *Example 2* indicate that the new option is not issued by reason of the stock dividend. In addition, the new option is issued on the same stock as the old option. Thus, the substitution occurs by reason of the corporate transaction. Assuming the other requirements of this section are met, the issuance of the new option is a substitution that meets the requirements of this paragraph (a) and is not a modification of the option.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*. Assume further that on December 1, 2005, Z declares an ordinary cash dividend. On the same day, Z grants E a new option to acquire Z stock in substitution for E's old option. Under paragraph (a)(3)(ii) of this section, an ordinary cash dividend is not a corporate transaction. Thus, the exchange of the new option for the old option does not meet the requirements of this paragraph (a) and is a modification of the option.

Example 3. Corporate transaction. On March 15, 2004, A Corporation grants E, an employee of A, an option to acquire 100 shares of A stock at $50 per share, the fair market value of A stock on the date of grant. On May 2, 2005, A Corporation transfers several employees, including E, to B Corporation, a related corporation. B Corporation arranges to purchase some assets from A on the same day as E's transfer to B. Such purchase is without a substantial business purpose independent of making the exchange of E's old options for the new options appear to be by reason of a corporate transaction. The following day, B Corporation grants to E, one of its new employees, an option to acquire shares of B stock in exchange for the old option held by E to acquire A stock. Under paragraph (a)(3)(i) of this section, the purchase of assets is a corporate transaction. Generally, the substitution of an option is considered to occur by reason of a corporate transaction. However, in this case, the relevant facts and circumstances demonstrate that the issuance of the new option in exchange for the old option occurred by reason of the change in E's employer rather than a corporate transaction and that the sale of assets is without a substantial corporate business purpose independent of the change in the options. Thus, the exchange of the new option for the old option is not by reason of a corporate transaction that meets the requirements of this paragraph (a) and is a modification of the old option.

Example 4. Corporate transaction. (i) E, an employee of Corporation A, holds an option to acquire 100 shares of Corporation A stock. On September 1, 2006, Corporation A has one class of stock outstanding and declares a stock dividend of one share of common stock for each outstanding share of common stock. The rights associated with the common stock issued as a dividend are the same as the rights

under existing shares of stock. In connection with the stock dividend, E's option is exchanged for an option to acquire 200 shares of Corporation A stock. The per-share exercise price is equal to one half of the per-share exercise price of the original option. The stock dividend merely changes the number of shares of Corporation A outstanding and effects no other change to the stock of Corporation A. The option is proportionally adjusted and the aggregate exercise price remains the same and therefore satisfies the requirements described in §1.424–1(e)(4)(v).

(ii) The stock dividend is not a corporate transaction under paragraph (a)(3) of this section, and the declaration of the stock dividend is not a modification of the old option under paragraph (a) of this section. Pursuant to §1.424–1(e)(4)(v), the exercise price of the old option may be adjusted proportionally with the change in the number of outstanding shares of Corporation A such that the ratio of the aggregate exercise price of the option to the number of shares covered by the option is the same both before and after the stock dividend. The adjustment of E's option is not treated as a modification of the option.

Example 5. Additional benefit. On June 1, 2004, P Corporation acquires 100 percent of the shares of S Corporation and issues a new option to purchase P shares in exchange for an old option to purchase S shares that is held by E, an employee of S. On the date of the exchange, E's old option is exercisable for 3 more years, and, after the exchange, E's new option is exercisable for 5 years. Because the new option is exercisable for an additional period of time beyond the time allowed under the old option, the effect of the exchange of the new option for the old option is to give E an additional benefit that E did not enjoy under the old option. Thus, the requirements of paragraph (a)(5) of this section are not met, and this paragraph (a) does not apply to the exchange of the new option for the old option. Therefore, the exchange is a modification of the old options.

Example 6. Spread and ratio tests. E is an employee of S Corporation. E holds an old option that was granted to E by S to purchase 60 shares of S at $12 per share. On June 1, 2005, S Corporation is merged into P Corporation, and on such date P issues a new option to purchase P shares in exchange for E's old option to purchase S shares. Immediately before the exchange, the fair market value of an S share is $32; immediately after the exchange, the fair market value of a P share is $24. The new option entitles E to buy P shares at $9 per share. Because, on a share-by-share comparison, the ratio of the new option price ($9 per share) to the fair market value of a P share immediately after the exchange ($24 per share) is not more favorable to E than the ratio of the old option price ($12 per share) to the fair market value of an S share immediately before the exchange ($32 per share) (9/24 = 12/32), the requirements of paragraph (a)(5)(iii) of this section are met. The number of shares subject to E's option to purchase P stock is set at 80. Because the excess of the aggregate fair market value over the aggregate option price of the shares subject to E's new option to purchase P stock, $1,200 (80 x $24 minus 80 x $9), is not greater than the excess of the aggregate fair market value over the aggregate option price of the shares subject to E's old option to purchase S stock, $1,200 (60 x $32 minus 60 x $12), the requirements of paragraph (a)(5)(ii) of this section are met.

Example 7. Ratio test and partial substitution. Assume the same facts as in *Example 6*, except that the fair market value of an S share immediately before the exchange of the new option for the old option is $8, that the option price is $10 per share, and that the fair market value of a P share immediately after the exchange is $12. P sets the new option price at $15 per share. Because, on a share-by-share comparison, the ratio of the new option price ($15 per share) to the fair market value of a P share immediately after the exchange ($12) is not more favorable to E than the ratio of the old option price ($10 per share) to the fair market value of an S share immediately before the substitution ($8 per share) (15/12 = 10/8), the requirements of paragraph (a)(5)(iii) of this section are met. Assume further that the number of shares subject to E's P option is set at 20, as compared to 60 shares under E's old option to buy S stock. Immediately after the exchange, 2 shares of P are worth $24, which is what 3 shares of S were worth immediately before the exchange (2 x $12 = 3 x $8). Thus, to achieve a complete substitution of a new option for E's old option, E would need to receive a new option to purchase 40 shares of P (*i.e.*, 2 shares of P for each 3 shares of S that E could have purchased under the old option (2/3 = 40/60)). Because E's new option is for only 20 shares of P, P has replaced only 1/2 of E's old option, and the other 1/2 is still outstanding.

Example 8. Partial substitution. X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and, in a spin-off, distributes the shares of Y Corporation to the stockholders of X Corporation. E, an employee of X Corporation, is thereafter an employee of Y. Y wishes to substitute a new option to purchase some of its stock for E's old option to purchase 100 shares of X. E's old option to purchase shares of X, at $50 a share, was granted when the fair market value of an X share was $50, and an X share was worth $100 just before the distribution of the Y shares to X's stockholders. Immediately after the spin-off, which is also the time of the substitution, each share of X and each share of Y is worth $50. Based on these facts, a new option to purchase 200 shares of Y at an option price of $25 per share could be granted to E in complete substitution of E's old option. In the alternative, it would also be permissible in connection with a spinoff to grant E a new option to purchase 100 shares of Y, at an option price of $25 per share, and for E to retain an option to purchase 100 shares of X under the old option, with the option price adjusted to $25. However, because X is no longer a related corporation with respect to Y, E must exercise the option for 100 shares of X within three months from the date of the spinoff for the option to be treated as a statutory option. See §1.421–1(h).

Example 9. Stockholder approval requirements. (i) X Corporation, a publicly traded corporation, adopts an incentive stock option plan that meets the requirements of §1.422–2. Under the plan, options to acquire X stock are granted to X employees. X Corporation is acquired by Y Corporation and becomes a subsidiary corporation of Y Corporation. After the acquisition, X employees remain employees of X. In connection with the acquisition, Y Corporation substitutes new options to acquire Y stock for the old options to acquire X stock previously granted to the employees of X. As a result of this substitution, on exercise of the new options, X employees receive Y Corporation stock.

(ii) Because the requirements of §1.422–2 were met on the date of grant, the substitution of the new Y options for the old X options does not require new stockholder approval. If the other requirements of paragraphs (a)(4) and (5) of this section are met, the issuance of new options for Y stock in exchange for the old options for X stock meets the requirements of this paragraph (a) and is not a modification of the old options.

(iii) Assume the same facts as in paragraphs (i) and (ii) of this *Example 9*. Assume further that as part of the acquisition, X amends its plan to allow future grants under the plan to be grants to acquire Y stock. Because the amendment of the plan to allow options on a different stock is considered the adoption of a new plan under §1.422–2(b)(2)(iii), the stockholders of Y must approve the plan within 12 months before or after the date of the amendment of the plan. If the stockholders of Y timely approve the plan, the future grants to acquire Y stock will be incentive stock options (assuming the other requirements of §1.422–2 have been met).

Example 10. Modification. X Corporation merges into Y Corporation. Y Corporation retains employees of X who hold old options to acquire X Corporation stock. When the former employees of X exercise the old options, Y Corporation issues Y stock to the former employees of X. Under paragraph (a)(7) of this section, because Y issues its stock on exercise of the old options for X stock, there is a change in the terms of the old options for X stock. Thus, the issuance of Y stock on exercise of the old options is a modification of the old options.

Example 11. Eligible corporation. (i) D Corporation grants an option to acquire 100 shares of D Corporation stock to E, an employee of D Corporation. S Corporation is a subsidiary of D Corporation. On March 1, 2005, D Corporation spins off S Corporation. E remains an employee of D Corporation. In connection with the spin off, D Corporation substitutes a new option to acquire D Corporation stock and a new option to acquire S Corporation stock for the old option in a manner that meets the requirements of paragraph (a) of this section.

(ii) The substitution of the new option to acquire S and D stock for the old option to acquire D stock is not a modification of the old option. However, because S is no longer a related corporation with respect to D Corporation, E must exercise the option for S stock within three months from March 1, 2005, for the option to be treated as a statutory option. See §1.421–1(h).

(iii) Assume the same facts as in paragraph (i) of this *Example 11* except that E's employment with D Corporation is terminated on February 20, 2005. The substitution of the new option to acquire S and D stock for the old option to acquire D stock is not a modification of the old option. However, because the employment relationship between E and D Corporation terminated on February 20, 2005, E must exercise the option for the D and S stock within three months from February 20, 2005, for the option to be treated as a statutory option. See §1.421–1(h).

* * * * *

(c) * * * (1) * * *

(iv) A transfer between spouses or incident to divorce (described in section 1041(a)). The special tax treatment of

§1.421–2(a) with respect to the transferred stock applies to the transferee. However, see §1.421–1(b)(2) for the treatment of the transfer of a statutory option incident to divorce.

* * * * *

(3) If an optionee exercises an incentive stock option with statutory option stock and the applicable holding period requirements (under §1.422–1(a) or §1.423–1(a)) with respect to such statutory option stock are not met before such transfer, then sections 354, 355, 356, or 1036 (or so much of 1031 as relates to 1036) do not apply to determine whether there is a disposition of those shares. Therefore, there is a disposition of the statutory option stock, and the special tax treatment of § 1.421–2(a) does not apply to such stock.

(4) * * *

Example 7. On January 1, 2004, X Corporation grants to E, an employee of X Corporation, an incentive stock option to purchase 100 shares of X Corporation stock at $100 per share (the fair market value of an X Corporation share on that date). On January 1, 2005, when the fair market value of a share of X Corporation stock is $200, E exercises half of the option, pays X Corporation $5,000 in cash, and is transferred 50 shares of X Corporation stock with an aggregate fair market value of $10,000. E makes no disposition of the shares before January 2, 2006. Under §1.421–2(a), no income is recognized by E on the transfer of shares pursuant to the exercise of the incentive stock option, and X Corporation is not entitled to any deduction at any time with respect to its transfer of the shares to E. E's basis in the shares is $5,000.

Example 8. Assume the same facts as in *Example 7*, except that on December 1, 2005, one year and 11 months after the grant of the option and 11 months after the transfer of the 50 shares to E, E uses 25 of those shares, with a fair market value of $5,000, to pay for the remaining 50 shares purchasable under the option. On that day, X Corporation transfers 50 of its shares, with an aggregate fair market value of $10,000, to E. Because E disposed of the 25 shares before the expiration of the applicable holding periods, §1.421–2(a) does not apply to the January 1, 2005, transfer of the 25 shares used by E to exercise the remainder of the option. As a result of the disqualifying disposition of the 25 shares, E recognizes compensation income under the rules of §1.421–2(b).

Example 9. On January 1, 2005, X Corporation grants an incentive stock option to E, an employee of X Corporation. The exercise price of the option is $10 per share. On June 1, 2005, when the fair market value of an X Corporation share is $20, E exercises the option and purchases 5 shares with an aggregate fair market value of $100. On January 1, 2006, when the fair market value of an X Corporation share is $50, X Corporation is acquired by Y Corporation in a section 368(a)(1)(A) reorganization. As part of the acquisition, all X Corporation shares are converted into Y Corporation shares. After the conversion, if an optionee holds a fractional share of Y Corporation stock, Y Corporation will purchase the fractional share for cash equal to its fair market value. After applying the conversion formula to the shares held by E, E has 10½ Y Corporation shares. Y Corporation purchases E's one-half share for $25, the fair market value of one-half of a Y Corporation share on the conversion date. Because E sells the one-half share prior to expiration of the holding periods described in §1.422–1(a), the sale is a disqualifying disposition of the one-half share. Thus, in 2006, E must recognize compensation income of $5 (one-half of the fair market value of an X Corporation share on the date of exercise of the option, or $10, less one-half of the exercise price per share, or $5). For purposes of computing any additional gain, E's basis in the one-half share increases to $10 (reflecting the $5 included in income as compensation). E recognizes an additional gain of $15 ($25, the fair market value of the one-half share, less $10, the basis in such share). The extent to which the additional $15 of gain is treated as a redemption of Y Corporation stock is determined under section 302.

(d) *Attribution of stock ownership*. To determine the amount of stock owned by an individual for purposes of applying the percentage limitations relating to certain stockholders described in §§1.422–2(f) and 1.423–2(d), shares of the employer corporation or of a related corporation that are owned (directly or indirectly) by or for the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, are considered to be owned by the individual. Also, for such purposes, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) shares of the employer corporation or of a related corporation, the shares are considered to be owned proportionately by or for the stockholders, partners, or beneficiaries of the corporation, partnership, estate, or trust. The extent to which stock held by the optionee as a trustee of a voting trust is considered owned by the optionee is determined under all of the facts and circumstances.

(e) *Modification, extension, or renewal of option*. (1) This paragraph (e) provides rules for determining whether a share of stock transferred to an individual upon the individual's exercise of an option after the terms of the option have been changed is transferred pursuant to the exercise of a statutory option.

(2) Any modification, extension, or renewal of the terms of an option to purchase shares is considered the granting of a new option. The new option may or may not be a statutory option. To determine the date of grant of the new option for purposes of section 422 or 423, see §1.421–1(c).

* * * * *

(4)(i) For purposes of §§1.421–1 through 1.424–1 the term *modification* means any change in the terms of the option (or change in the terms of the plan pursuant to which the option was granted or in the terms of any other agreement governing the arrangement) that gives the optionee additional benefits under the option regardless of whether the optionee in fact benefits from the change in terms. In contrast, for example, a change in the terms of the option shortening the period during which the option is exercisable is not a modification. However, a change providing an extension of the period during which an option may be exercised (such as after termination of employment) or a change providing an alternative to the exercise of the option (such as a stock appreciation right) is a modification regardless of whether the optionee in fact benefits from such extension or alternative right. Similarly, a change providing an additional benefit upon exercise of the option (such as the payment of a cash bonus) or a change providing more favorable terms for payment for the stock purchased under the option (such as the right to tender previously acquired stock) is a modification.

(ii) If 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. Additionally, no modification occurs if a provision accelerating the time when an option may first be exercised is removed prior to the year in which it would otherwise be triggered. For example, if an acceleration provision is timely removed to avoid exceeding the $100,000 limitation described in §1.422–4, a modification of the option does not occur.

(iii) A change to an option which provides, either by its terms or in substance, that the optionee may receive an additional benefit under the option at the future discretion of the grantor, is a modification at the time that the option is changed to provide such discretion. In addition, the exercise of discretion to provide an additional benefit is a modification of the option. However, it is not a modification for the grantor to exercise discretion specif-

ically reserved under an option with respect to the payment of a cash bonus at the time of exercise, the availability of a loan at exercise, the right to tender previously acquired stock for the stock purchasable under the option, or the payment of employment taxes and/or required withholding taxes resulting from the exercise of a statutory option. An option is not modified merely because an optionee is offered a change in the terms of an option if the change to the option is not made. An offer to change the terms of an option that remains open less than 30 days is not a modification of the option. However, if an offer to change the terms of an option remains outstanding for 30 days or more, there is a modification of the option as of the date the offer to change the option is made.

(iv) A change in the terms of the stock purchasable under the option that increases the value of the stock is a modification of such option, except to the extent that a new option is substituted for such option by reason of the change in the terms of the stock in accordance with paragraph (a) of this section.

(v) If an option is amended solely to increase the number of shares subject to the option, the increase is not considered a modification of the option but is treated as the grant of a new option for the additional shares. Notwithstanding the previous sentence, if the exercise price and number of shares subject to an option are proportionally adjusted to reflect a stock split (including a reverse stock split) or stock dividend, and the only effect of the stock split or stock dividend is to increase (or decrease) on a *pro rata* basis the number of shares owned by each shareholder of the class of stock subject to the option, then the option is not modified if it is proportionally adjusted to reflect the stock split or stock dividend and the aggregate exercise price of the option is not less than the aggregate exercise price before the stock split or stock dividend.

(vi) Any change in the terms of an option made in an attempt to qualify the option as a statutory option grants additional benefits to the optionee and is, therefore, a modification.

(vii) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(viii) Any inadvertent change to the terms of an option (or change in the terms of the plan pursuant to which the option was granted or in the terms of any other agreement governing the arrangement) that is treated as a modification under this paragraph (e) is not considered a modification of the option to the extent the change in the terms of the option is removed by the earlier of the date the option is exercised or the last day of the calendar year during which such change occurred. Thus, for example, if the terms of an option are inadvertently changed on March 1 to extend the exercise period and the change is removed on November 1, then if the option is not exercised prior to November 1, the option is not considered modified under this paragraph (e).

* * * * *

(6) [Reserved.]

* * * * *

(f) *Definitions*. The following definitions apply for purposes of §§1.421–1 through 1.424–1:

(1) *Parent corporation*. The term *parent corporation*, or *parent*, means any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations other than the employer corporation owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(2) *Subsidiary corporation*. The term *subsidiary corporation*, or *subsidiary*, means any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in an unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(g) *Effective date*— (1) *In general*. These regulations are effective on August 3, 2004.

(2) *Reliance and transition period*. For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR–279–81 (49 FR 4504), the 2003 proposed regulations REG–122917–02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring at least 6 months after August 3, 2004, taxpayers may rely on either the REG–122917–02 or this section. Taxpayers may not rely on LR–279–81 or REG–122917–02 after December 31, 2005. Reliance on LR–279–81, REG–122917–02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

§1.6039–1 and 1.6039–2 [Removed]

Par. 14. Section 1.6039–1 and 1.6039–2 are removed.

Par. 15. A new §1.6039–1 is added to read as follows:

§1.6039–1 Statements to persons with respect to whom information is furnished.

(a) *Requirement of statement with respect to incentive stock options under section 6039(a)(1)*. Every corporation which transfers stock to any person pursuant to such person's exercise of an incentive stock option described in section 422(b) must furnish to such transferee, for each calendar year in which such a transfer occurs, a written statement with respect to the transfer or transfers made during such year. This statement must include the following information—

(1) The name, address, and employer identification number of the corporation transferring the stock;

(2) The name, address, and identifying number of the person to whom the share or shares of stock were transferred;

(3) The name and address of the corporation the stock of which is the subject of the option (if other than the corporation transferring the stock);

(4) The date the option was granted;

(5) The date the shares were transferred to the person exercising the option;

(6) The fair market value of the stock at the time the option was exercised;

(7) The number of shares of stock transferred pursuant to the option;

(8) The type of option under which the transferred shares were acquired; and

(9) The total cost of all the shares.

(b) *Requirement of statement with respect to stock purchased under an employee stock purchase plan under section 6039(a)(2).* (1) Every corporation which records, or has by its agent recorded, a transfer of the title to stock acquired by the transferor pursuant to the transferor's exercise on or after January 1, 1964, of an option granted under an employee stock purchase plan which meets the requirements of section 423(b), and with respect to which the special rule of section 423(c) applied, must furnish to such transferor, for each calendar year in which such a recorded transfer of title to such stock occurs, a written statement with respect to the transfer or transfers containing the information required by paragraph (b)(2) of this section.

(2) The statement required by paragraph (b)(1) of this section must contain the following information—

(i) The name and address of the corporation whose stock is being transferred;

(ii) The name, address, and identifying number of the transferor;

(iii) The date such stock was transferred to the transferor;

(iv) The number of shares to which title is being transferred; and

(v) The type of option under which the transferred shares were acquired.

(3) If the statement required by this paragraph is made by the authorized transfer agent of the corporation, it is deemed to have been made by the corporation. The term *transfer agent*, as used in this section, means any designee authorized to keep the stock ownership records of a corporation and to record a transfer of title of the stock of such corporation on behalf of such corporation.

(4) A statement is required by reason of a transfer described in section 6039(a)(2) of a share only with respect to the first transfer of such share by the person who exercised the option. Thus, for example, if the owner has record title to a share or shares of stock transferred to a recognized broker or financial institution and the stock is subsequently sold by such broker or institution (on behalf of the owner), the corporation is only required to furnish a written statement to the owner relating to the transfer of record title to the broker or financial institution. Similarly, a written statement is required when a share of stock is transferred by the optionee to himself and another person (or persons) as joint tenants, tenants by the entirety or tenants in common. However, when stock is originally issued to the optionee and another person (or persons) as joint tenants, or as tenants by the entirety, the written statement required by this paragraph shall be furnished (at such time and in such manner as is provided by this section) with respect to the first transfer of the title to such stock by the optionee.

(5) Every corporation which transfers any share of stock pursuant to the exercise of an option described in this paragraph shall identify such stock in a manner sufficient to enable the accurate reporting of the transfer of record title to such shares. Such identification may be accomplished by assigning to the certificates of stock issued pursuant to the exercise of such options a special serial number or color.

(c) *Time for furnishing statements* — (1) *In general.* Each statement required by this section to be furnished to any person for a calendar year must be furnished to such person on or before January 31 of the year following the year for which the statement is required.

(2) *Extension of time.* For good cause shown upon written application of the corporation required to furnish statements under this section, the Director, Martinsburg Computing Center, may grant an extension of time not exceeding 30 days in which to furnish such statements. The application must contain a full recital of the reasons for requesting an extension to aid the Director in determining the period of the extension, if any, which will be granted and must be sent to the Martinsburg Computing Center (Attn: Extension of Time Coordinator). Such a request in the form of a letter to the Martinsburg Computing Center, 250 Murall Drive, Kearneysville, West Virginia 25430, signed by the applicant (or its agent) will suffice as an application. The application must be filed on or before the date prescribed in paragraph (c)(1) of this section for furnishing the statements required by this section, and must contain the employer identification number of the corporation required to furnish statements under this section.

(3) *Last day for furnishing statement.* For provisions relating to the time for performance of an act when the last day prescribed for performance falls on Saturday, Sunday, or a legal holiday, see §301.7503–1 of this chapter (Regulations on Procedure and Administration).

(d) *Statements furnished by mail.* For purposes of this section, a statement is considered to be furnished to a person if it is mailed to such person's last known address.

(e) *Penalty.* For provisions relating to the penalty provided for failure to furnish a statement under this section, see section 6722.

(f) *Electronic furnishing of statements.* The statements required to be furnished pursuant to this section may be provided in an electronic format in lieu of a paper format, with the consent of the recipient. See §31.6051–1(j) of the Regulations on Employment Taxes and Collection of Income Tax at the Source for further guidance regarding the manner in which such electronic statements must be furnished.

(g) *Effective date*— (1) *In general.* These regulations are effective on August 3, 2004.

(2) *Reliance and transition period.* For statutory options transferred on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR–279–81 (49 FR 4504), the 2003 proposed regulations REG–122917–02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options transferred after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the

granting corporation occurring at least 6 months after August 3, 2004, taxpayers may rely on either the REG–122917–02 or this section. Taxpayers may not rely on LR–279–81 or REG–122917–02 after December 31, 2005. Reliance on LR–279–81, REG–122917–02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

PART 14a—TEMPORARY INCOME TAX REGULATIONS RELATING TO INCENTIVE STOCK OPTIONS

Part 14a [Removed]

Par. 16. Part 14a is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 17. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.422–1	1545–0820
* * * * *	

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved July 20, 2004.

Gregory Jenner,
Acting Assistant Secretary of Treasury.

(Filed by the Office of the Federal Register on August 2, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 3, 2004, 69 F.R. 46401)

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 861.—Income From Sources Within the United States

26 CFR 1.861–8: Computation of taxable income from sources within the United States and from other sources and activities.

T.D. 9143

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Allocation and Apportionment of Deductions for Charitable Contributions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains temporary regulations relating to the allocation and apportionment of the deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B). These regulations change the method of allocating and apportioning these deductions from ratable apportionment on the basis of gross income to apportionment on the basis of income from sources within the United States. The temporary regulations will affect individuals and corporations that make contributions to

charitable organizations and that have foreign source income and calculate their foreign tax credit limitations under section 904. The text of the temporary regulations also serves as the text of the proposed regulations (REG–208246–90) set forth in this issue of the Bulletin. This document also contains final regulations that remove the existing regulations concerning allocation and apportionment of charitable contribution deductions.

DATES: *Effective Date:* These regulations are effective on July 28, 2004.

Applicability Dates: For dates of applicability, see §§1.861–8(a)(5), 1.861–8T(e)(12)(iv), and 1.861–14T(e)(6)(ii). The regulations are applicable to charitable contributions made on or after July 28, 2004. Taxpayers may elect to apply these regulations to contributions made before July 28, 2004, but during a taxable year ending after July 28, 2004.

FOR FURTHER INFORMATION CONTACT: Teresa Burridge Hughes (202) 622–3850 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the regulations under section 861 relating to the allocation and apportionment of the deduction for charitable contributions allowed under sections 170, 873(b)(2), and 882(c). Currently, regulations under §1.861–8(e)(9)(iv) provide that such deductions generally are not definitely related to any gross income and therefore are ratably apportioned to the statutory and residual groupings on the basis of gross income.

In 1991, the Treasury Department and the IRS issued proposed regulations (the 1991 proposed regulations) that would have changed the ratable apportionment rule of the final regulations to a rule that, assuming certain requirements are met, generally would apportion the deduction for a charitable contribution based on where the contribution would be used. Prop. Treas. Reg. §1.861–8(e)(12), 56 Fed. Reg. 10,395 (1991). More specifically, the 1991 proposed regulations provided that the deduction for a charitable contribution would have been apportioned solely to foreign source gross income if the taxpayer, at the time of the contribution, knows or has reason to know that the contribution will be used solely outside the United States or that the contribution may necessarily be used only outside the United States. The 1991 proposed regulations also provided that the deduction for a charitable contribution would have been apportioned solely to U.S. source gross income if the taxpayer, at the time of the contribution, both designates the contribution for use solely in the United States and reasonably believes that the contribution will be so used. Under the 1991 proposed regulations, a deduction for a charitable contribution that is not apportionable to United States or foreign source gross income under the foregoing rules would have been ratably apportioned on the basis of gross income.

The preamble to the 1991 proposed regulations requested comments on the effects of the proposed rules on U.S. charities with significant international activities. Numerous comments were received on the 1991 proposed regulations, most of which recommended that the proposed rules not be adopted. The principal reason given was that the 1991 proposed regulations would reduce funding for foreign charitable activities generally. In addition, the designation and place of use requirements were seen as generating significant paperwork and accountability burdens for both the contributors and the recipient charities. Many comments suggested that, instead of the bifurcated allocation and apportionment in the proposed regulations, the deduction for a charitable contribution should be allocated solely to income from sources within the United States.

In response to the comments received, and upon further consideration of the issue, the 1991 proposed regulations are being withdrawn. See Notice of Proposed Rulemaking (REG–208246–90) published in this issue of the Bulletin. In addition, the notice of proposed rulemaking includes proposed regulations which cross reference these temporary regulations and proposed regulations with respect to deductions for charitable contributions that are allowed under a U.S. income tax treaty (rather than under sections 170, 873(b)(2), and 882(c)(1)(B)).

Explanation of Provisions

The temporary regulations provide that the deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B) is definitely related and allocable to all of the taxpayer's gross income and is apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources in the United States in each grouping. For example, where a deduction for charitable contributions is allocated and apportioned for purposes of the foreign tax credit limitation, the charitable contribution deduction is allocated to all of the taxpayer's gross income and apportioned solely to the residual grouping consisting of U.S. source gross income. This revision of the regulations is consistent with the policy of the section 170 contribution rules. The revision is intended to ensure that a taxpayer is not discouraged from making a charitable contribution that is deductible under section 170 simply because the allocation and apportionment rules would reduce the taxpayer's foreign source income and, accordingly, the taxpayer's foreign tax credit limitation as a result of the deduction.

The temporary regulations also provide that, where a charitable contribution is made by a member of an affiliated group, the deduction for the charitable contribution is related to and allocated to the income of all of the members of the affiliated group and not to any subset of the group. This rule is consistent with the provisions of Notice 89–91, 1989–2 C.B. 408. Finally, the provisions of the final regulations under §1.861–8(e)(9)(iv) and §1.861–8(g), *Example 18*, which provide for ratable allocation and apportionment of deductions for charitable contributions, are removed.

The regulations are effective for charitable contributions made on or after July 28, 2004. Taxpayers may elect to apply these regulations to contributions made before July 28, 2004, but during a taxable year ending on or after July 28, 2004.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order

12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the Special Analyses section of the preamble to the cross-referenced notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Drafting Information

The principal author of these regulations is Teresa Burridge Hughes, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1 — INCOME TAXES

Paragraph. 1. The authority for part 1 continues to read in part:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section §1.861–8 is amended as follows:

1. Remove the language "paragraphs (c)(2)" from paragraph (a)(2) and add the language "paragraphs (c)(3)" in its place.

2. Add a new second sentence to paragraph (a)(5)(i).

3. Revise paragraph (e)(1).

4. Remove the language "paragraph (c)(2)" from the paragraph (e)(9) introductory text and add the language "paragraph (c)(3)" in its place.

5. Add the word "and" at the end of paragraph (e)(9)(iii).

6. Remove paragraphs (e)(9)(iv) and (g) *Example 18* (iv).

7. Redesignate paragraph (e)(9)(v) as paragraph (e)(9)(iv).

8. Add new paragraph (e)(12).

9. Redesignate paragraph (g) *Example 18* (i) as paragraph (g) *Example 18* (i)(A).

10. Remove the last three entries in the table following the language "Total gross income ....40,000,000" from newly designated paragraph (g) *Example 18* (i)(A).

11. Add new paragraph (g) *Example 18* (i)(B) immediately following the table in newly designated paragraph (g) *Example 18* (i)(A).

12. Designate the undesignated text following new paragraph (g) *Example 18* (i)(B) as paragraph (g) *Example 18* (i)(C).

The revisions and additions read as follows:

§1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.

(a) * * * (1) * * *

(5) * * * (i) * * *Paragraph (g) *Example 18* (i)(B) applies to charitable contributions made on or after July 28, 2004. * * *

* * * * *

(e) *Allocation and apportionment of certain deductions*—(1) *In general*. Paragraphs (e)(2) and (e)(3) of this section contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. Paragraphs (e)(4) through (e)(8) of this section contain rules with respect to the allocation of certain other deductions. Paragraph (e)(9) of this section lists those deductions which are ordinarily considered as not being definitely related to any class of gross income. Paragraph (e)(10) of this section lists special deductions of corporations which must be allocated and apportioned. Paragraph (e)(11) of this section lists personal exemptions which are neither allocated nor apportioned. Paragraph (e)(12) of this section contains rules with respect to the allocation and apportionment of deductions for charitable contributions. Examples of allocation and apportionment are contained in paragraph (g) of this section.

* * * * *

(12) [Reserved]. For further guidance, see §1.861–8T(e)(12).

* * * * *

(g) *General examples*. * * *

Example 18. * * * (i)(A) * * *

(i)(B) In addition, X incurs expenses of its supervision department of $1,600,000.

* * * * *

Par. 3. Section 1.861–8T is amended as follows:

1. Add new paragraph (e)(12).

2. Add a new second sentence to paragraph (h).

The additions read as follows:

§1.861–8T Computation of taxable income from sources within the United States and from other sources and activities (temporary).

* * * * *

(e) * * * (1) * * *

(12) *Deductions for certain charitable contributions*—(i) *In general*. The deduction for charitable contributions that is allowed under sections 170, 873(b)(2), and 882(c)(1)(B) is definitely related and allocable to all of the taxpayer's gross income. The deduction allocated under this paragraph (e)(12)(i) shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources in the United States in each grouping.

(ii) *Coordination with §1.861–14T*. A deduction for a charitable contribution by a member of an affiliated group shall be allocated and apportioned under the rules of this section and §1.861–14T(c)(1).

(iii) *Treaty provisions*. [Reserved].

(iv) *Effective date*. (A) The rules of paragraphs (e)(12)(i) and (ii) shall apply to charitable contributions made on or after July 28, 2004. Taxpayers may apply the provisions of paragraphs (e)(12)(i) and (ii) to charitable contributions made before July 28, 2004, but during the taxable year ending on or after July 28, 2004.

(B) The applicability of this section expires on or before July 27, 2007.

* * * * *

(h) * * * However, see paragraph (e)(12)(iv) of this section and §1.861–14T(e)(6)(ii) for rules concerning the allocation and apportionment of deductions for charitable contributions. * * *

* * * * *

Par. 4. Section 1.861–14T is amended by revising the section heading and adding paragraph (e)(6) to read as follows:

§1.861–14T Special rules for allocating and apportioning certain expenses (other

than interest expense) of an affiliated group of corporations (temporary).

* * * * *

(e) * * * (1) * * * (i) * * *

(6) *Charitable contribution expenses*—(i) *In general*. A deduction for a charitable contribution by a member of an affiliated group shall be allocated and apportioned under the rules of §1.861–8T(e)(12) and paragraph (c)(1) of this section.

(ii) *Effective date*. (A) The rules of this paragraph shall apply to charitable contributions made on or after July 28, 2004, and, for taxpayers applying the second sentence of §1.861–8T(e)(12)(iv)(A), to charitable contributions made during the taxable year ending on or after July 28, 2004.

(B) The applicability of this section expires on or before July 27, 2007.

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved July 20, 2004.

Gregory Jenner,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 27, 2004, 8:45 a.m., and published in the issue of the Federal Register for July 28, 2004, 69 F.R. 44930)

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also, Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for September 2004.

Rev. Rul. 2004–69

This revenue ruling provides various prescribed rates for federal income tax purposes for September 2004 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2004–69 TABLE 1

Applicable Federal Rates (AFR) for September 2004

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	2.34%	2.33%	2.32%	2.32%
110% AFR	2.58%	2.56%	2.55%	2.55%
120% AFR	2.82%	2.80%	2.79%	2.78%
130% AFR	3.05%	3.03%	3.02%	3.01%
Mid-Term				
AFR	3.84%	3.80%	3.78%	3.77%
110% AFR	4.22%	4.18%	4.16%	4.14%
120% AFR	4.61%	4.56%	4.53%	4.52%
130% AFR	5.00%	4.94%	4.91%	4.89%
150% AFR	5.78%	5.70%	5.66%	5.63%
175% AFR	6.76%	6.65%	6.60%	6.56%
Long-Term				
AFR	5.03%	4.97%	4.94%	4.92%
110% AFR	5.54%	5.47%	5.43%	5.41%
120% AFR	6.05%	5.96%	5.92%	5.89%
130% AFR	6.56%	6.46%	6.41%	6.37%

REV. RUL. 2004–69 TABLE 2

Adjusted AFR for September 2004

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	1.65%	1.64%	1.64%	1.63%
Mid-term adjusted AFR	3.16%	3.14%	3.13%	3.12%
Long-term adjusted AFR	4.51%	4.46%	4.44%	4.42%

REV. RUL. 2004–69 TABLE 3

Rates Under Section 382 for September 2004

Adjusted federal long-term rate for the current month	4.51%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.72%

REV. RUL. 2004–69 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for September 2004

Appropriate percentage for the 70% present value low-income housing credit	8.03%
Appropriate percentage for the 30% present value low-income housing credit	3.44%

REV. RUL. 2004–69 TABLE 5

Rate Under Section 7520 for September 2004

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	4.6%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 2004. See Rev. Rul. 2004-69, page 445.

Part III. Administrative, Procedural, and Miscellaneous

Plan Amendments Following Election of Alternative Deficit Reduction Contribution

Notice 2004–59

This notice provides guidance on the restrictions that are placed on plan amendments following an employer's election of the alternative deficit reduction contribution under § 412(l)(12) of the Internal Revenue Code (the "Code") and section 302(d)(12) of the Employee Retirement Income Security Act of 1974 ("ERISA"), as added by section 102 of the Pension Funding Equity Act of 2004, Pub. L. 108–218 ("PFEA '04").

I. Background

Section 102 of PFEA '04, which was enacted on April 10, 2004, added § 412(l)(12) to the Code and section 302(d)(12) to ERISA. Section 412(l)(12) of the Code permits certain employers who are required to make additional contributions under § 412(l) to elect a reduced amount of those contributions ("alternative deficit reduction contributions") for certain plan years. An employer is eligible to make such an election if it is (1) a commercial passenger airline, (2) primarily engaged in the production or manufacture of a steel mill product or the processing of iron ore pellets, or (3) an organization described in § 501(c)(5) that established a plan on June 30, 1955, to which § 412 now applies. On April 12, 2004, the Internal Revenue Service (the "Service") issued Announcement 2004–38, 2004–18 I.R.B. 878, which provides guidance for making the election for an alternative deficit reduction contribution. On May 6, 2004, the Service issued Announcement 2004–43, 2004–21 I.R.B. 955 (corrected by Announcement 2004–51, 2004–23 I.R.B. 1041), which provides further guidance for making the election for the alternative deficit reduction contribution and provides guidance regarding notices that must be provided to participants, beneficiaries, and the Pension Benefit Guaranty Corporation following the making of the election.

Section 412(l)(12)(B) provides that no amendment that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable under the plan shall be adopted during any applicable plan year, unless (1) the plan's enrolled actuary certifies (in such form and manner prescribed by the Secretary) that the amendment provides for an increase in annual contributions that will exceed the increase in annual charges to the funding standard account attributable to such amendment, or (2) the amendment is required by a collective bargaining agreement that is in effect on April 10, 2004. Section 412(l)(12)(B) further provides that, if a plan is amended during any applicable plan year (*i.e.*, a plan year for which the § 412(l)(12) election is made) in violation of the preceding sentence, any election under § 412(l)(12) shall not apply to any applicable plan year ending on or after the date on which the amendment is adopted.

Section 302 of ERISA contains minimum funding standard requirements that are parallel to those under § 412 of the Code, and section 302(d)(12) of ERISA provides an election that is identical to the election under § 412(l)(12) of the Code. Under section 101 of Reorganization Plan No. 4 of 1978, 1979–1 C.B. 480, the Secretary of the Treasury has sole interpretive authority over the interpretation of section 302(d)(12) of ERISA. Accordingly, the guidance set forth in this notice applies as well under section 302(d)(12) of ERISA.

Section 412(c)(12) of the Code provides that, in determining projected benefits, the funding method of a collectively bargained plan (other than a multiemployer plan) shall anticipate benefit increases scheduled to take effect during the term of the collective bargaining agreement applicable to the plan.

Section 1.412(c)(3)–1(d)(1)(i) of the Income Tax Regulations provides that, except as otherwise provided by the Commissioner, a reasonable funding method does not anticipate changes in plan benefits that become effective, whether or not retroactively, in a future plan year or that become effective after the first day of, but during, a current plan year.

Rev. Rul. 77–2, 1977–1 C.B. 120, provides guidance regarding the minimum funding requirements with respect to a change in the benefit structure of a qualified pension plan that becomes effective during a plan year. Section 2.02 of Rev. Rul. 77–2 provides that, in the case of a change in the benefit structure that becomes effective as of a date during a plan year (but subsequent to the first day in such plan year), the charges and credits to the funding standard account shall not reflect the change in such benefit structure for the portion of such plan year prior to the effective date of such change, and shall reflect the change in such benefit structure for the portion of the plan year subsequent to the effective date of the change. Section 3 of Rev. Rul. 77–2 provides that, in determining the charges and credits for the plan year, in lieu of using the rule of section 2.02, a plan is permitted to disregard a change in benefit structure that is adopted after the valuation date for the year.

Section 412(c)(8) provides that any amendment applying to a plan year that is adopted after the close of the plan year but no later than 2½ months after the close of the plan year and that does not reduce the accrued benefit of any participant determined as of the beginning of the first plan year to which the amendment relates shall, at the election of the plan administrator, be deemed to have been made on the first day of such plan year (subject to additional restrictions on plan amendments that reduce benefits). Pursuant to Rev. Proc. 94–42, 1994–1 C.B. 717 and Rev. Rul. 79–325, 1979–2 C.B. 190, § 412(c)(8) also applies to plan amendments adopted during the plan year to which the amendment relates.

II. Questions and Answers Regarding Plan Amendments Following a § 412(l)(12) Election

Q–1. Which plan amendments are subject to the requirements of § 412(l)(12)(B) (regarding plan amendments increasing benefits)?

A–1. Plan amendments that are subject to the requirements of § 412(l)(12)(B) are referred to in this notice as "restricted amendments". A plan amendment is a restricted amendment if it is adopted during a plan year for which an election for an

alternative deficit reduction contribution is in effect, is not required by a collective bargaining agreement in effect on April 10, 2004, and increases benefits (including an increase in an early retirement benefit or retirement-type subsidy), changes the accrual of benefits in a manner that results in increased accruals, or changes the rate at which benefits become nonforfeitable in a manner that results in faster vesting. Thus, for example, with respect to a plan not maintained pursuant to a collective bargaining agreement, a plan amendment adopted February 1, 2004, and providing a benefit increase effective during the 2004 calendar plan year is a restricted amendment if the employer makes an election for an alternative deficit reduction contribution for the 2004 plan year. Furthermore, if that employer makes an election for the alternative deficit reduction contribution for the 2005 plan year, the plan amendment adopted in 2004 will continue to be a restricted amendment for the 2005 plan year. For purposes of determining whether a plan amendment is a restricted amendment, a plan amendment is considered adopted at the later of the time it is adopted or made effective. Thus, a plan amendment with different benefit increases that become effective during different plan years is considered adopted during each plan year in which each benefit increase becomes effective (if no earlier than the date on which the amendment is added to the plan).

A plan amendment adopted during a plan year for which the employer did not make an election for the alternative deficit reduction contribution (or a plan amendment considered adopted during such a plan year) is not a restricted amendment for the plan year adopted or for the subsequent plan year, even if the employer makes an election for an alternative deficit reduction contribution for the subsequent plan year. However, such a plan amendment will be considered adopted during the subsequent plan year for purposes of determining whether the amendment is a restricted amendment unless an election is made under § 412(c)(8) to treat the plan amendment as made on the first day of the plan year in which adopted and unless the amendment is treated as effective as of the beginning of the plan year.

Annual cost-of-living adjustments to statutory limits that are implemented pursuant to plan terms that are adopted and in effect before the beginning of the plan year for which the alternative deficit reduction contribution election is made are not treated as plan amendments that are subject to the requirements of § 412(l)(12)(B). Thus, annual cost-of-living adjustments to the § 401(a)(17) limit and the § 415(b)(1)(A) dollar limit that are automatically put into effect pursuant to plan terms that are adopted and in effect before the beginning of the plan year are not treated as restricted amendments.

Q–2. What plan terms must a restricted amendment include?

A–2. A restricted amendment must include terms that require that contributions to the plan for all plan years in which the alternative deficit reduction contribution election is in effect will exceed the § 412(l)(12)(B) amount described in Q&A–3 of this notice. A restricted amendment may satisfy this requirement by reflecting the formula for the § 412(l)(12)(B) amount set forth in Q&A–3 of this notice. Alternatively, a restricted amendment may satisfy this requirement by providing for a dollar amount of contributions or for some other method of determining contributions if the amount of contributions specified in the plan exceeds the § 412(l)(12)(B) amount. For this purpose, the terms of a collective bargaining agreement pursuant to which a plan is maintained are deemed included in plan terms.

If a restricted amendment is adopted prior to August 31, 2004, the plan complies with this Q&A–2 if, no later than October 31, 2004, the plan is amended to provide for contributions that exceed the § 412(l)(12)(B) amount.

Q–3. How is the § 412(l)(12)(B) amount determined?

A–3. The § 412(l)(12)(B) amount is equal to the sum of the minimum required contribution under § 412 determined as if the restricted amendment had not been made (taking into account the alternative deficit reduction contribution election) plus the incremental amendment amount. The incremental amendment amount is equal to the difference between the required minimum contribution under § 412 that would have been due taking into account the restricted amendment and the required minimum contribution under § 412 that would have been due disregarding the restricted amendment. These two calculations are made as if the alternative deficit reduction contribution had not been elected. The calculation of the required minimum contribution under § 412 that would have been due taking into account the restricted amendment generally is made as if the amendment had been adopted and made effective on the first day of the plan year (*i.e.*, the amendment must be fully reflected in plan costs for this purpose). However, if the amendment does not provide for benefit increases attributable to service prior to the beginning of the plan year, and is not effective as of the first day of the plan year, the amendment may instead be treated in accordance with the rules of section 2.02 of Rev. Rul. 77–2. In addition, the rules of § 412(c)(12) apply to the determination of the § 412(l)(12)(B) amount. For rules regarding the treatment of a credit balance generated as a result of contributions made with respect to the § 412(l)(12)(B) amount for the prior plan year, see Q&A–5.

The § 412(l)(12)(B) amount is computed without regard to any funding waiver for the plan year. Accordingly, the terms of a restricted amendment do not comply with § 412(l)(12)(B) if, under the terms of the plan as amended by the restricted amendment, any portion of the contribution in excess of the incremental amendment need not be made if a funding waiver is granted.

Q–4. How does the § 412(l)(12)(B) amount affect the application of the minimum funding requirements of § 412?

A–4. The § 412(l)(12)(B) amount does not affect the computation of minimum required contributions under § 412. Thus, for example, quarterly contributions under § 412(m) are not required to reflect the minimum contribution required to maintain the applicability of the alternative deficit reduction contribution election. If an amount in excess of minimum required contributions is contributed for a plan year on account of the § 412(l)(12)(B) amount, the plan's funding standard account will reflect a credit balance on account of the excess. In addition, even if an amendment is considered adopted in a later year or years for purposes of determining whether an amendment is a restricted amendment for a plan year for purposes of applying § 412(l)(12)(B), the rules of § 412(c)(12) (requiring the funding method of a collectively bargained plan to take into account

certain anticipated benefit increases) may require the amendment to be taken into account at an earlier time for purposes of computing minimum required contributions under § 412.

Q–5: How does a credit balance generated as a result of contributions made with respect to the § 412(l)(12)(B) amount for the prior plan year affect the computation of the § 412(l)(12)(B) amount for the plan year?

A–5: If a restricted amendment was adopted in a prior plan year for which the alternative deficit reduction contribution election was made, the credit balance resulting from the excess of the § 412(l)(12)(B) amount for the prior plan year over the minimum required contribution for the prior plan year must be disregarded in computing the § 412(l)(12)(B) amount for the current plan year. Thus, for example, assume that an employer elects the alternative deficit reduction contribution for both the 2004 and 2005 calendar plan years, adopts a restricted amendment during the 2004 plan year, and contributes the § 412(l)(12)(B) amount for the 2004 plan year, creating a credit balance as of the end of the 2004 plan year. The determination of the § 412(l)(12)(B) amount for the 2005 plan year (which reflects the restricted amendment adopted in 2004 as well as any restricted amendments adopted in 2005) is made as if there were no credit balance resulting from the excess of the § 412(l)(12)(B) amount for the 2004 plan year over the minimum required contribution for the 2004 plan year. However, if the contributions made for the 2004 plan year exceed the § 412(l)(12)(B) amount for that plan year, the credit balance attributable to that excess can be taken into account in determining the § 412(l)(12)(B) amount for 2005.

Q–6. How does the plan's enrolled actuary certify that a restricted amendment provides for an increase in annual contributions that will exceed the increase in annual charges to the funding standard account attributable to such amendment?

A–6. The plan's enrolled actuary certifies that a restricted amendment provides for an increase in annual contributions that will exceed the increase in annual charges to the funding standard account attributable to such amendment by filing a certification with the Service that, following the adoption of the plan amendment, the plan includes terms to the effect that contributions to the plan while the alternative deficit reduction contribution election is in effect will exceed the § 412(l)(12)(B) amount described in Q&A–3 of this notice. The certification may be based either on plan terms incorporating the formula described in Q&A–3 or on plan terms providing for either an amount of contributions or an alternative formula for contributions under which contributions for the plan year will exceed the § 412(l)(12)(B) amount. The certification must also provide the derivation of the § 412(l)(12)(B) amount as well as the amount of contributions required under the terms of the plan (if determined under an alternative formula).

The certification with respect to a restricted amendment made during a plan year must be filed on or before the due date for the filing of Form 5500 for the plan year at the following address:

Internal Revenue Service
Commissioner, Tax Exempt and
Government Entities Division
Attention: SE:T:EP:RA:T
Alternative DRC Election Amendment
Certification
P.O. Box 27063
McPherson Station
Washington, D.C. 20038

Q–7. What are the consequences of failure to include the plan terms required under § 412(l)(12)(B) as part of a restricted amendment?

A–7. If a restricted amendment does not contain the plan terms required under § 412(l)(12)(B) in a plan year, then the alternative deficit reduction contribution election is no longer valid for the plan year and cannot be made in any succeeding plan year.

Q–8. What are the consequences of failure to contribute the amount required under a restricted amendment that includes plan terms that satisfies the plan language requirements of § 412(l)(12)(B)?

A–8. If the contribution required under the terms of a restricted amendment is not made on or before the due date for contributions for the plan year, then the alternative deficit reduction contribution election is no longer valid for the plan year and cannot be made in any succeeding plan year.

Paperwork Reduction Act

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1889.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this notice is in Q&A–6. This information is required to meet the requirements of section 102 of the Pension Funding Equity Act of 2004 to monitor and make valid determinations with respect to employers that elect an alternative deficit reduction contribution for certain plans and make restricted amendments. As a result of such elections, an employer's deficit reduction contribution for certain plans will be based on amounts specified under § 412(l)(12) of the Code. The likely respondents are businesses or other for-profit institutions, and nonprofit institutions.

The estimated total annual reporting and/or recordkeeping burden is 400 hours.

The estimated annual burden per respondent/recordkeeper varies from 3 to 5 hours, depending on individual circumstances, with an estimated average of 4 hours. The estimated number of respondents and/or recordkeepers is 100.

The estimated frequency of responses is occasional.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. § 6103.

Drafting Information

The principal authors of this notice are James E. Holland of the Employee Plans, Tax Exempt and Government Entities Division and Linda S. F. Marshall of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). Mr. Holland may be reached at 202–283–9699 (not a toll-free number).

Part IV. Items of General Interest

Withdrawal of Notice of Proposed Rulemaking, Notice of Proposed Rulemaking, Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations, and Notice of Public Hearing

Allocation and Apportionment of Deductions for Charitable Contributions

REG–208246–90

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking, notice of proposed rulemaking, notice of proposed rulemaking by cross-reference to temporary regulations, and notice of public hearing.

SUMMARY: This document withdraws the notice of proposed rulemaking published on March 12, 1991 (the 1991 proposed regulations), relating to the allocation and apportionment of charitable deductions. In addition, in this issue of the Bulletin, the Treasury Department and the IRS are issuing temporary regulations (T.D. 9143) providing that the deduction for a charitable contribution (as defined in section 170(c)) is to be allocated to all of the taxpayer's gross income and apportioned on the basis of income from sources within the United States. The text of the temporary regulations also serves as the text of these proposed regulations. Further, regulations are proposed in this document, without cross-reference to temporary regulations, with respect to deductions for charitable contributions that are provided by an income tax treaty rather than by sections 170, 873(b)(2), and 882(c)(1)(B). This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by October 26, 2004. Outlines of topics to be discussed at the public hearing scheduled for December 2, 2004, at 10 a.m. must be received by November 12, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–208246–90), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–208246–90), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC, or sent electronically, via the IRS internet site at *www.irs.gov/regs* or Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–208246–90). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Ave., NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the withdrawal of the 1991 proposed regulations and the proposed regulations, Teresa Burridge Hughes, (202) 622–3850 (not a toll-free number); concerning the submission of comments, the hearing, and/or placement on the building access list to attend the hearing, Treena Garrett, (202) 622–7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Section 1.861–8(e)(9) provides that the deduction for charitable contributions allowed by sections 170, 873(b)(2), and 882(c)(1)(B) is generally considered as not definitely related to any gross income and therefore is ratably apportioned to all of a taxpayer's gross income. On March 12, 1991, Treasury and the IRS published in the **Federal Register** (56 FR 10395) a notice of proposed rulemaking (INTL–116–90, 1991–1 C.B. 949, REG–208246–90) that would have modified the allocation and apportionment of the deduction for charitable contributions. The 1991 proposed regulations generally would have provided for the allocation and apportionment of a deduction for a charitable contribution to sources within or without the United States based on where the contribution was used. Where the deduction for a charitable contribution would not have been allocable to United States or foreign source gross income based on the new test, it would have been ratably apportioned to all gross income. Written comments were received and a public hearing on the 1991 proposed regulations was held on August 1, 1991. In response to comments received, and after further consideration of the issue, the 1991 proposed regulations are withdrawn.

Contemporaneously with the withdrawal of the 1991 proposed regulations, the Treasury Department and the IRS are issuing a Treasury decision containing temporary regulations that are published in this issue of the Bulletin. The temporary regulations provide for the allocation and apportionment of the deduction for charitable contributions to U.S. source income. The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations discusses the comments received on the 1991 proposed regulations, the reasons for the withdrawal of the 1991 proposed regulations, and the approach of the temporary regulations.

This document also proposes a rule for the allocation and apportionment of deductions for charitable contributions that are allowed under a U.S. income tax treaty (rather than under sections 170, 873(b)(2), and 882(c)(1)(B)) that limits the amount of the deduction based on a percentage of income that arises from sources within the treaty partner. In such case, these proposed regulations would provide that the deduction is definitely related and allocable to all of the taxpayer's gross income. The deduction would be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources within the treaty partner within each grouping This rule is proposed to be effective for taxable years beginning on or after the date final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive

Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 2, 2004, beginning at 10 a.m. in the IRS Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For more information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by October 26, 2004, and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 12, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of this document is Teresa Burridge Hughes, Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in its development.

* * * * *

Withdrawal of a Notice of Proposed Rulemaking

Under the authority of 26 U.S.C. 7805, §1.861–8(e) and (g) of the notice of proposed rulemaking (INTL–116–90) published in the **Federal Register** on March 12, 1991, (56 FR 10395) is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.861–8(e)(12) is added to read as follows:

§1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(e) * * * (1) * * *

(e)(12)(i) and (ii) [The text of the proposed addition of §1.861–8(e)(12)(i) and (ii) is the same as §1.861–8T(e)(12)(i) and (ii) published elsewhere in this issue of the Bulletin.]

(e)(12)(iii) *Treaty provisions.* (A) *In general.* If a deduction for charitable contributions not otherwise permitted by sections 170, 873(b)(2), and 882(c)(1)(B) is allowed under a U.S. income tax treaty, and such treaty limits the amount of the deduction based on a percentage of income arising from sources within the treaty partner, the deduction is definitely related and allocable to all of the taxpayer's gross income. The deduction allocated under this paragraph (e)(12)(iii) shall be apportioned between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping on the basis of the relative amounts of gross income from sources within the treaty partner within each grouping.

(B) The rules of this paragraph (e)(12)(iii) are applicable for charitable contributions made on or after the date of publication of this document as a final regulation in the **Federal Register**.

(e)(12)(iv)(A) [The text of the proposed addition of §1.861–8(e)(12)(iv)(A) is the same as §1.861–8T(e)(12)(iv)(A) published elsewhere in this issue of the **Federal Register**.]

(e)(12)(iv)(B) [Reserved].

Par. 4. Section 1.861–14(e)(6) is revised to read as follows:

§1.861–14 Special rules for allocating and apportioning certain expenses (other than interest expense) of an affiliated group of corporations.

* * * * *

(e) * * * (1) * * *

(e)(6) [The text of the proposed revision of §1.861–14(e)(6) is the same as §1.861–14T(e)(6) through (e)(6)(ii)(A) published elsewhere in this issue of the Bulletin.]

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on July 27, 2004, 8:45 a.m., and published in the issue of the Federal Register for July 28, 2004, 69 F.R. 44988)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

Section 179 Elections

REG–152549–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9146) under section 179 of the Internal Revenue Code relating to the election to expense the cost of property subject to section 179. The temporary regulations reflect changes to the law made by the Jobs and Growth Tax Relief Reconciliation Act of 2003. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by November 2, 2004. Requests to speak with outlines of topics to be discussed at the public hearing scheduled for Tuesday, November 30, 2004, at 10 a.m., must be received by November 9, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–152549–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC, 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–152549–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at: *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS - REG–152549–03). The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Winston Douglas, (202) 622–3110; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Robin Jones, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by October 4, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the **Internal Revenue Service**, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collections of information in this proposed regulation are in §§1.179–2T and 1.179–5T. This information is required by §1.179–2T to insure that married individuals filing separate returns properly allocate the cost of section 179 property elected to be expensed in a taxable year and that the dollar limitation is properly allocated among the component members of a controlled group. Also, this information is required by §1.179–5T to insure the specific identification of each piece of acquired section 179 property and reflect how and from whom such property was placed in service. This information will be used for audit and examination purposes. The collection of information is required to obtain a benefit. The likely respondents and/or recordkeepers are individuals, farms, and small businesses.

Estimated total annual reporting and/or recordkeeping burden: 3,015,000 hours.

The estimated annual burden per respondent/recordkeeper varies from .50 to 1 hour, depending on individual circumstances, with an estimated average of .75 hour.

Estimated number of respondents and/or recordkeepers: 4,025,000

Estimated frequency of responses: Annually

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Temporary regulations in this issue of the Bulletin amend 26 CFR part 1 relating to section 179 of the Internal Revenue Code (Code). The temporary regulations provide guidance under section 179 for making and revoking elections to expense the cost of property subject to section 179. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact, as discussed earlier in this preamble, that the amount of time necessary to record and retain the required information will be minimal for those taxpayers electing to expense the cost of section 179 property.

Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 30, 2004, beginning at 10 a.m., in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 9, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Winston H. Douglas, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 reads as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.179–2 is amended by revising paragraphs (b)(1) and (b)(2)(ii) to read as follows:

§1.179–2 Limitations on amount subject to section 179 election.

* * * * *

(b) * * *

(1) [The text of the proposed amendment to §1.179–2(b)(1) is the same as the text of §1.179–2T(b)(1) published elsewhere in this issue of the Bulletin].

(2) * * *

(i) * * *

(ii) [The text of the proposed amendment to §1.179–2(b)(2)(ii) is the same as the text of §1.179–2T(b)(2)(ii) published elsewhere in this issue of the Bulletin].

Par. 3. Section 1.179–4 is amended by revising paragraph (a) to read as follows:

§1.179–4 Definitions.

* * * * *

(a) [The text of the proposed amendment to §1.179–4(a) is the same as the text of §1.179–4T(a) published elsewhere in this issue of the Bulletin].

* * * * *

Par. 4. Section 1.179–5 is amended by adding paragraph (c) to read as follows:

§1.179–5 Time and manner of making election.

* * * * *

(c) [The text of the proposed amendment of §1.179–5(c) is the same as the text of §1.179–5T(c) published elsewhere in this issue of the Bulletin].

Par. 5. Section 1.179–6 is revised to read as follows:

§1.179–6 Effective date.

[The text of the proposed amendment to §1.179–6 is the same as the text of §1.179–6T published elsewhere in this issue of the Bulletin].

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on August 3, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 4, 2004, 69 F.R. 47043)

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Under Section 951 for Determining *Pro Rata* Share

REG–129771–04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 951(a) of the Internal Revenue Code (Code) that provide guidance for determining a United States shareholder's *pro rata* share of a controlled foreign corporation's (CFC's) subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from foreign base company shipping operations, and amounts determined under section 956.

DATES: Written or electronic comments must be received by November 4, 2004. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for November 18, 2004, at 10 a.m. must be received by November 4, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–129771–04), room 5203, Internal Revenue Service, PO Box

7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–129771–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–129771–04). If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jonathan A. Sambur, (202) 622–3840; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse (202) 622–4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 951(a) of the Code relating to the determination of a United States shareholder's *pro rata* share of a CFC's subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from foreign base company shipping operations, and amounts determined under section 956 (collectively, section 951(a)(1) amounts).

In general, section 951(a)(1) requires a United States shareholder that owns stock in a CFC to include its *pro rata* share of such section 951(a)(1) amounts in its gross income. *Pro rata* share is defined in section 951(a)(2) of the Code as the amount:

(A) which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a [CFC] it had distributed *pro rata* to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a [CFC] bears to the entire year, reduced by

(B) the amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation for the taxable year, as (ii) the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire year.

The current regulations provide rules for determining a United States shareholder's *pro rata* share of a CFC's section 951(a)(1) amounts in the case where the CFC has more than one class of stock outstanding. These regulations have remained unchanged since 1965. In the 39 years since the rules were issued, international business arrangements have become much more complex than contemplated in 1965, reflecting in particular more complex structures for determining return on capital. The current regulations do not take into account these developments. The IRS and Treasury, therefore, believe that updated guidance is necessary to ensure results that are more consistent with the economic interests of shareholders in a CFC.

Explanation of Provisions

A. *In General*

Section 1.951–1(e) defines *pro rata share* for purposes of section 951(a) of the Code. These proposed regulations replace existing §1.951–1(e)(2) through (4) and are intended to provide allocations that are more consistent with the economic interests of shareholders in a CFC. The proposed regulations also include a conforming change to §1.951–1(e)(1) to reflect the 1993 legislative amendment to section 956 of the Code.

B. *Pro Rata Share Rules for CFCs with Only One Class of Stock*

Proposed §1.951–1(e)(2) adds an explicit rule to clarify the method by which a United States shareholder's *pro rata* share of a CFC's section 951(a)(1) amounts is determined in the case where the CFC has only one class of stock outstanding. In such a case, each United States shareholder's share of the CFC's section 951(a)(1) amounts shall be determined on a per share basis. *Example 1* of proposed §1.951–1(e)(6) illustrates the application of this rule.

C. *Pro Rata Share Rules for CFCs with More than One Class of Stock*

1. *In General*

Proposed §1.951–1(e)(3) provides rules for determining a United States shareholder's *pro rata* share of a CFC's section 951(a)(1) amounts in the case where the CFC has more than one class of stock outstanding. Proposed §1.951–1(e)(3)(i) retains the general rule in the current regulations, which provides that the amount of subpart F income, withdrawals, or amounts determined under section 956 which shall be taken into account with respect to any one class of stock shall be that amount which bears the same ratio to the total of such subpart F income, withdrawals, or amounts determined under section 956 for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year on which such corporation is a CFC (the hypothetical distribution date) bear to the total earnings and profits of such corporation for such taxable year. *Examples 2* and *8* of proposed §1.951–1(e)(6) illustrate the application of this general rule.

This general rule applies in cases where a CFC has more than one class of stock outstanding and where the allocation of the amount of the CFC's earnings and profits between or among different classes of stock does not depend upon the exercise of discretion by the board of directors or similar governing body of the CFC. The IRS and Treasury Department believe that this general rule, in practice, will apply in most cases in which a CFC has more than one class of stock outstanding.

2. *Discretionary Power to Allocate Earnings to Different Classes of Stock*

In the case where the allocation of the amount of a CFC's earnings and profits for the taxable year between two or more classes of stock depends upon the exer-

cise of discretion by the board of directors or a similar governing body of the CFC, proposed §1.951–1(e)(3)(ii)(A) provides a new general rule that determines the *pro rata* share of the CFC's section 951(a)(1) amounts. This new general rule allocates earnings and profits to classes of shares with discretionary distribution rights by reference to the relative values of such classes of shares on the hypothetical distribution date. Under this new rule, the allocation of earnings and profits to each class of stock with discretionary distribution rights generally will be the amount of earnings and profits that bears the same ratio to the total earnings and profits allocated to all classes of stock with discretionary distribution rights as the value of all shares of such class determined on the hypothetical distribution date bears to the total value of all classes of stock with discretionary distribution rights. This allocation approach is analogous to the approach used for allocating adjustments among classes of stock for consolidated return purposes. See §1.1502–32(c). For guidance with respect to the valuation of stock, see, *e.g.*, *Framatome Connectors USA, Inc. v. Comm'r*, 118 T.C. 32 (2002) (establishing factors to be used to value stock of a CFC for purposes of determining whether the foreign corporation was a CFC pursuant to the value test in section 957(a)(2)); compare Rev. Rul. 59–60, 1959–1 C.B. 237 (valuing privately held stock for estate tax purposes). See §601.601(d)(2)(ii)(*b*). In cases where the value of each share of two or more classes of stock with discretionary distribution rights is substantially the same, the allocation of earnings and profits to each class of stock shall be made as if such classes constituted one class of stock. *Examples 3* and *4* of proposed §1.951–1(e)(6) illustrate the application of these rules.

The general rules of proposed §1.951–1(e)(3)(i) and (ii)(A) both apply in certain cases where a CFC has more than two classes of stock outstanding. Specifically, these rules both apply where a CFC has at least two classes of stock with discretionary distribution rights and at least one class of stock with non-discretionary distribution rights. In general, a United States shareholder's *pro rata* share of a CFC's section 951(a)(1) amounts is determined by allocating earnings and profits to classes of shares with non-discretionary distribution rights (*e.g.*, nonparticipating preferred stock) in accordance with the rules of proposed paragraph (e)(3)(i), and then allocating the remaining earnings and profits, if any, to each remaining class of stock in accordance with the relative value rules of proposed paragraph (e)(3)(ii)(A).

The new rule in proposed §1.951–1(e)(3)(ii)(A) is intended to ensure that the determination of a United States shareholder's *pro rata* share of a CFC's section 951(a)(1) amounts in cases where the United States shareholder's stock has discretionary distribution rights properly reflects the true economics of the shareholder's investment in the CFC. The IRS and Treasury Department believe that in the case of multiple classes of stock with discretionary distribution rights, the relative value of the classes of stock better reflects the economics of the investment in a CFC, and thus provides a better mechanism for determining a United States shareholder's *pro rata* share of a CFC's section 951(a)(1) amounts.

Proposed §1.951–1(e)(3)(ii)(B) provides that the right to redeem stock of a CFC will not be considered a discretionary distribution right for purposes of determining a shareholder's *pro rata* share under proposed §1.951–1(e)(3)(ii)(A), even if the resulting redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d). *Example 7* of proposed §1.951–1(e)(6) illustrates the application of this rule.

3. *Special Allocation Rule for Stock with Mixed Distribution Rights*

Proposed §1.951–1(e)(3)(iii) provides a specific rule that applies the general rules of proposed §1.951–1(e)(3)(i) and (ii)(A) in cases where a class of stock provides for both non-discretionary distribution rights and discretionary distribution rights (*e.g.*, participating preferred stock). In such a case, the proposed regulations require separate allocations of earnings and profits based upon the non-discretionary distribution rights and the relative value of the discretionary distribution rights. *Example 5* of proposed §1.951–1(e)(6) illustrates the application of this rule.

4. *Dividend Arrearages*

Proposed §1.951–1(e)(3)(iv) retains the existing rule with respect to arrearages in dividends with respect to classes of preferred stock of the CFC. The earnings and profits for the taxable year shall be attributable to such arrearage only to the extent the arrearage exceeds the earnings and profits remaining from prior taxable years beginning after December 31, 1962.

D. *Scope of Deemed Distribution.*

Proposed §1.951–1(e)(4) sets forth a special rule that provides that no amount shall be considered to be distributed with respect to a particular class of stock under proposed §1.951–1(e)(3) to the extent that such a distribution would constitute a distribution in redemption of stock, a distribution in liquidation, or a return of capital. This rule would apply notwithstanding the terms of any class of stock of the CFC or any arrangement involving the CFC. Thus, for purposes of determining the allocation of earnings and profits to a class of stock of a CFC based on the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits were distributed *pro rata* to its shareholders on the hypothetical distribution date, taxpayers may not consider any part of the hypothetical distribution as a distribution in redemption of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)), a distribution in liquidation, or a return of capital. The IRS and Treasury Department believe that such characterizations of the hypothetical distribution would not properly reflect a United States shareholder's economic interest in the CFC and thus should not be considered in determining a United States shareholder's *pro rata* share of section 951(a)(1) amounts. *Example 7* of proposed §1.951–1(e)(6) illustrates the application of this rule.

E. *Restrictions or Other Limitations on Distributions of Earnings and Profits by a CFC*

Proposed §1.951–1(e)(5) provides that, except in the case of a governmental restriction described in section 964(b) of the Code, a restriction or other limitation on the distribution of earnings and profits to

a United States shareholder by a CFC will not be taken into account for purposes of determining the amount of earnings and profits allocated to a class of stock of a CFC or the amount of the United States shareholder's *pro rata* share of the CFC's section 951(a)(1) amounts. This rule applies in all cases, including cases where the restriction or limitation is the result of an arrangement between unrelated parties or an arrangement that has a non-tax motivated business purpose and economic substance. The IRS and Treasury Department believe that taking into account such restrictions or limitations in determining a United States shareholder's *pro rata* share is contrary to the purpose of section 951(a) and would not properly reflect a United States shareholder's economic interest in the CFC. *Example 6* of proposed §1.951–1(e)(6) illustrates the application of this rule.

Proposed §1.951–1(e)(5)(ii) provides a broad definition of *restrictions or other limitations on distributions* that are covered by this rule. Under proposed §1.951–1(e)(5)(iii), the right to receive a preferred dividend is not considered a restriction or other limitation on the distribution of earnings and profits with respect to other classes of stock. Proposed §1.951–1(e)(5)(iv) lists some instances where restrictions or other limitations will not be taken into account.

Proposed Effective Date

These regulations are proposed to apply for taxable years of a controlled foreign corporation beginning on or after January 1, 2005.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing has been scheduled for November 18, 2004, at 10 a.m. in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 4, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Comments are requested on all aspects of the proposed regulations, including those aspects for which specific requests for comments are set forth above.

Drafting Information

The principal author of these regulations is Jonathan A. Sambur, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.951–1 is amended by:

1. Removing the language "increase in earnings invested in United States property" in paragraph (e)(1) and adding "amount determined under section 956" in its place.

2. Revising paragraphs (e)(2) through (e)(4) and adding paragraphs (e)(5) through (e)(7) to read as follows:

§1.951–1 Amounts included in gross income of United States shareholders.

* * * * *

(e) * * *

(2) *One class of stock.* If a controlled foreign corporation for a taxable year has only one class of stock outstanding, each United States shareholder's *pro rata* share of such corporation's subpart F income, withdrawal, or amount determined under section 956, for the taxable year under paragraph (e)(1) of this section shall be determined by allocating the controlled foreign corporation's earnings and profits on a per share basis.

(3) *More than one class of stock*—(i) *In general.* Subject to paragraphs (e)(3)(ii) and (e)(3)(iii) of this section, if a controlled foreign corporation for a taxable year has more than one class of stock outstanding, the amount of such corporation's subpart F income, withdrawal, or amount determined under section 956, for the taxable year taken into account with respect to any one class of stock for purposes of paragraph (e)(1) of this section shall be that amount which bears the same ratio to the total of such subpart F income, withdrawal, or amount determined under section 956 for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year were distributed on the last day of such corporation's taxable year on which

such corporation is a controlled foreign corporation (the hypothetical distribution date), bear to the total earnings and profits of such corporation for such taxable year.

(ii) *Discretionary power to allocate earnings to different classes of stock*—(A) *In general.* Subject to paragraph (e)(3)(iii) of this section, the rules of this paragraph apply for purposes of paragraph (e)(1) if the allocation of a controlled foreign corporation's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by that body of persons which exercises with respect to such corporation the powers ordinarily exercised by the board of directors of a domestic corporation (discretionary distribution rights). First, the earnings and profits of the corporation are allocated under paragraph (e)(3)(i) of this section to any class or classes of stock with non-discretionary distribution rights (*e.g.*, preferred stock entitled to a fixed return). Second, the amount of earnings and profits allocated to a class of stock with discretionary distribution rights shall be that amount which bears the same ratio to the remaining earnings and profits of such corporation for such taxable year as the value of all shares of such class of stock, determined on the hypothetical distribution date, bears to the total value of all shares of all classes of stock with discretionary distribution rights of such corporation, determined on the hypothetical distribution date. For purposes of the preceding sentence, in the case where the value of each share of two or more classes of stock with discretionary distribution rights is substantially the same on the hypothetical distribution date, the allocation of earnings and profits to such classes shall be made as if such classes constituted one class of stock in which each share has the same rights to dividends as any other share.

(B) *Special rule for redemption rights.* For purposes of paragraph (e)(3)(ii)(A) of this section, discretionary distribution rights do not include rights to redeem shares of a class of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)).

(iii) *Special allocation rule for stock with mixed distribution rights.* For purposes of paragraphs (e)(3)(i) and (e)(3)(ii) of this section, in the case of a class of stock with both discretionary and non-discretionary distribution rights, earnings and profits shall be allocated to the non-discretionary distribution rights under paragraph (e)(3)(i) of this section and to the discretionary distribution rights under paragraph (e)(3)(ii) of this section. In such a case, paragraph (e)(3)(ii) of this section will be applied such that the value used in the ratio will be the value of such class of stock solely attributable to the discretionary distribution rights of such class of stock.

(iv) *Dividend arrearages.* For purposes of paragraph (e)(3)(i) of this section, if an arrearage in dividends for prior taxable years exists with respect to a class of preferred stock of such corporation, the earnings and profits for the taxable year shall be attributed to such arrearage only to the extent such arrearage exceeds the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962.

(4) *Scope of deemed distribution.* Notwithstanding the terms of any class of stock of the controlled foreign corporation or any agreement or arrangement with respect thereto, no amount shall be considered to be distributed with respect to a particular class of stock for purposes of paragraph (e)(3) of this section to the extent that such distribution would constitute a distribution in redemption of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)), as a distribution in liquidation, or as a return of capital.

(5) *Restrictions or other limitations on distributions*—(i) *In general.* A restriction or other limitation on distributions of earnings and profits by a controlled foreign corporation will not be taken into account, for purposes of this section, in determining the amount of earnings and profits that shall be allocated to a class of stock of the controlled foreign corporation or the amount of the United States shareholder's *pro rata* share of the controlled foreign corporation's subpart F income, withdrawal, or amounts determined under section 956 for the taxable year.

(ii) *Definition.* For purposes of this section, a *restriction or other limitation on distributions* includes any limitation that has the effect of limiting the allocation or distribution of earnings and profits by a controlled foreign corporation to a United States shareholder, other than currency or other restrictions or limitations imposed under the laws of any foreign country as provided in section 964(b).

(iii) *Exception for certain preferred distributions.* The right to receive periodically a fixed amount (whether determined by a percentage of par value, a reference to a floating coupon rate, a stated return expressed in terms of a certain amount of dollars or foreign currency, or otherwise) with respect to a class of stock the distribution of which is a condition precedent to a further distribution of earnings or profits that year with respect to any class of stock (not including a distribution in partial or complete liquidation) is not a restriction or other limitation on the distribution of earnings and profits by a controlled foreign corporation under paragraph (e)(5) of this section.

(iv) *Illustrative list of restrictions and limitations.* Except as provided in paragraph (e)(5)(iii) of this section, restrictions or other limitations on distributions include, but are not limited to—

(A) An arrangement that restricts the ability of the controlled foreign corporation to pay dividends on a class of shares of the corporation owned by United States shareholders until a condition or conditions are satisfied (*e.g.*, until another class of stock is redeemed);

(B) A loan agreement entered into by a controlled foreign corporation that restricts or otherwise affects the ability to make distributions on its stock until certain requirements are satisfied; or

(C) An arrangement that conditions the ability of the controlled foreign corporation to pay dividends to its shareholders on the financial condition of the controlled foreign corporation.

(6) *Examples.* The application of this section may be illustrated by the following examples:

Example 1. (i) *Facts.* FC1, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of one class of stock. Corp E, a domestic corporation and a United States shareholder of FC1, within the meaning of section 951(b), owns 60 shares. Corp H, a domestic corporation and a United States shareholder of FC1, within the meaning of section 951(b), owns 40 shares. FC1, Corp E, and Corp H each use the calendar year as a taxable year. Corp E and Corp H are shareholders of FC1 for its entire 2004 taxable year. For 2004, FC1 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholders under

section 951(a). FC1 makes no distributions during that year.

(ii) *Analysis*. FC1 has one class of stock. Therefore, under paragraph (e)(2) of this section, FC1's earnings and profits are allocated on a per share basis. Accordingly, for the taxable year 2004, Corp E's *pro rata* share of FC1's subpart F income is $60x (60/100 x $100x) and Corp H's *pro rata* share of FC1's subpart F income is $40x (40/100 x $100x).

Example 2. (i) *Facts*. FC2, a controlled foreign corporation within the meaning of section 957(a), has outstanding 70 shares of common stock and 30 shares of 4-percent, nonparticipating, voting, preferred stock with a par value of $10x per share. The common shareholders are entitled to dividends when declared by the board of directors of FC2. Corp A, a domestic corporation and a United States shareholder of FC2, within the meaning of section 951(b), owns all of the common shares. Individual B, a foreign individual, owns all of the preferred shares. FC2 and Corp A each use the calendar year as a taxable year. Corp A and Individual B are shareholders of FC2 for its entire 2004 taxable year. For 2004, FC1 has $50x of earnings and profits, and income of $50x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2004, FC2 distributes as a dividend $12x to Individual B with respect to Individual B's preferred shares. FC2 makes no other distributions during that year.

(ii) *Analysis*. FC2 has two classes of stock, and there are no restrictions or other limitations on distributions within the meaning of paragraph (e)(5) of this section. If the total $50x of earnings were distributed on December 31, 2004, $12x would be distributed with respect to Individual B's preferred shares and the remainder, $38x, would be distributed with respect to Corp A's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp A's *pro rata* share of FC1's subpart F income is $38x for taxable year 2004.

Example 3. (i) *Facts*. The facts are the same as in *Example 2*, except that the shares owned by Individual B are Class B common shares and the shares owned by Corp A are Class A common shares and the board of directors of FC2 may declare dividends with respect to one class of stock without declaring dividends with respect to the other class of stock. The value of the Class A common shares on the last day of FC2's 2004 taxable year is $680x and the value of the Class B common shares on that date is $300x. The board of directors of FC2 determines that FC2 will not make any distributions in 2004 with respect to the Class A and B common shares of FC2.

(ii) *Analysis*. The allocation of FC2's earnings and profits between its Class A and Class B common shares depends solely on the exercise of discretion by the board of directors of FC2. Therefore, under paragraph (e)(3)(ii)(A) of this section, the allocation of earnings and profits between the Class A and Class B common shares will depend on the value of each class of stock on the last day of the controlled foreign corporation's taxable year. On the last day of FC2's taxable year 2004, the Class A common shares had a value of $9.71x/share and the Class B common shares had a value of $10x/share. Because each share of the Class A and Class B common stock of FC2 has substantially the same value on the last day of FC2's taxable year, under paragraph (e)(3)(ii)(A) of this section, for purposes of allocating the earnings and profits of FC2, the Class A and Class B common shares will be treated as one class of stock. Accordingly, for FC2's taxable year 2004, the earnings and profits of FC2 are allocated $35x (70/100 x $50x) to the Class A common shares and $15x (30/100 x $50x) to the Class B common shares. For its taxable year 2004, Corp A's *pro rata* share of FC2's subpart F income will be $35x.

Example 4. (i) *Facts*. FC3, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of Class A common stock, 100 shares of Class B common stock and 10 shares of 5-percent nonparticipating, voting preferred stock with a par value of $50x per share. The value of the Class A shares on the last day of FC3's 2004 taxable year is $800x. The value of the Class B shares on that date is $200x. The Class A and Class B shareholders each are entitled to dividends when declared by the board of directors of FC3, and the board of directors of FC3 may declare dividends with respect to one class of stock without declaring dividends with respect to the other class of stock. Corp D, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the Class A shares. Corp N, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the Class B shares. Corp S, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the preferred shares. FC3, Corp D, Corp N, and Corp S each use the calendar year as a taxable year. Corp D, Corp N, and Corp S are shareholders of FC3 for all of 2004. For 2004, FC3 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2004, FC3 distributes as a dividend $25x to Corp S with respect to the preferred shares. The board of directors of FC3 determines that FC3 will make no other distributions during that year.

(ii) *Analysis*. The distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. Pursuant to paragraph (e)(3)(i) of this section, if the total $100x of earnings were distributed on December 31, 2004, $25x would be distributed with respect to Corp S's preferred shares and the remainder, $75x would be distributed with respect to Corp D's Class A shares and Corp N's Class B shares. The allocation of that $75x between its Class A and Class B shares depends solely on the exercise of discretion by the board of directors of FC3. The value of the Class A shares ($8x/share) and the value of the Class B shares ($2x/share) are not substantially the same on the last day of FC3's taxable year 2004. Therefore for FC3's taxable year 2004, under paragraph (e)(3)(ii)(A) of this section, the earnings and profits of FC3 are allocated $60x ($800/$1,000 x $75x) to the Class A shares and $15x ($200/$1,000 x $75x) to the Class B shares. For the 2004 taxable year, Corp D's *pro rata* share of FC3's subpart F income will be $60x, Corp N's *pro rata* share of FC3's subpart F income will be $15x and Corp S's *pro rata* share of FC3's subpart F income will be $25x.

Example 5. (i) *Facts*. FC4, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of participating, voting, preferred stock and 200 shares of common stock. The owner of a share of preferred stock is entitled to an annual dividend equal to 0.5-percent of FC4's retained earnings for the taxable year and also is entitled to additional dividends when declared by the board of directors of FC4. The common shareholders are entitled to dividends when declared by the board of directors of FC4. The board of directors of FC4 has discretion to pay dividends to the participating portion of the preferred shares (after the payment of the preference) and the common shares. The value of the preferred shares on the last day of FC4's 2004 taxable year is $600x ($100x of this value is attributable to the discretionary distribution rights of these shares) and the value of the common shares on that date is $400x. Corp E, a domestic corporation and United States shareholder of FC4, within the meaning of section 951(b), owns all of the preferred shares. FC5, a foreign corporation that is not a controlled foreign corporation within the meaning of section 957(a), owns all of the common shares. FC4 and Corp E each use the calendar year as a taxable year. Corp E and FC5 are shareholders of FC4 for all of 2004. For 2004, FC4 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2004, FC4's retained earnings are equal to its earnings and profits. FC4 distributes as a dividend $20x to Corp E that year with respect to Corp E's preferred shares. The board of directors of FC4 determines that FC4 will not make any other distributions during that year.

(ii) *Analysis*. The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. The allocation of FC4's earnings and profits between its preferred shares and common shares depends, in part, on the exercise of discretion by the board of directors of FC4 because the preferred shares are shares with both discretionary distribution rights and non-discretionary distribution rights. Paragraph (e)(3)(i) of this section is applied first to determine the allocation of earnings and profits of FC4 to the non-discretionary distribution rights of the preferred shares. If the total $100x of earnings were distributed on December 31, 2004, $20x would be distributed with respect to the non-discretionary distribution rights of Corp E's preferred shares. Accordingly, $20x would be allocated to such shares under paragraphs (e)(3)(i) and (iii) of this section. The remainder, $80x, would be allocated under paragraph (e)(3)(ii)(A) and (e)(3)(iii) of this section between the preferred and common shareholders by reference to the value of the discretionary distribution rights of the preferred shares and the value of the common shares. Therefore, the remaining $80x of earnings and profits of FC4 are allocated $16x ($100x/$500x x $80x) to the preferred shares and $64x ($400x/$500x x $80) to the common shares. For its taxable year 2004, Corp E's *pro rata* share of FC4's subpart F income will be $36x ($20x + $16x) .

Example 6. (i) *Facts*. FC6, a controlled foreign corporation within the meaning of section 957(a), has outstanding 10 shares of common stock and 400 shares of 2-percent nonparticipating, voting, preferred stock with a par value of $1x per share. The common shareholders are entitled to dividends when declared by the board of directors of FC6. Corp M, a domestic corporation and a United States shareholder

of FC6, within the meaning of section 951(b), owns all of the common shares. FC7, a foreign corporation that is not a controlled foreign corporation within the meaning of section 957(a), owns all of the preferred shares. Corp M and FC7 cause the governing documents of FC6 to provide that no dividends may be paid to the common shareholders until FC6 cumulatively earns $100,000x of income. FC6 and Corp M each use the calendar year as a taxable year. Corp M and FC7 are shareholders of FC6 for all of 2004. For 2004, FC6 has $50x of earnings and profits, and income of $50x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2004, FC6 distributes as a dividend $8x to FC7 with respect to FC7's preferred shares. FC6 makes no other distributions during that year.

(ii) *Analysis*. The agreement restricting FC6's ability to pay dividends to common shareholders until FC6 cumulatively earns $100,000x of income is a restriction or other limitation, within the meaning of paragraph (e)(5) of this section, and will be disregarded for purposes of calculating Corp M's *pro rata* share of subpart F income. The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. If the total $50x of earnings were distributed on December 31, 2004, $8x would be distributed with respect to FC7's preferred shares and the remainder, $42x, would be distributed with respect to Corp M's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp M's *pro rata* share of FC6's subpart F income is $42x for taxable year 2004.

Example 7. (i) *Facts*. FC8, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of common stock and 10 shares of 4-percent voting preferred stock with a par value of $50x per share. Pursuant to the terms of the preferred stock, FC8 has the right to redeem at any time, in whole or in part, the preferred stock. FP, a foreign corporation, owns all of the preferred shares. Corp G, a domestic corporation wholly owned by FP and a United States shareholder of FC8, within the meaning of section 951(b), owns all of the common shares. FC8 and Corp G each use the calendar year as a taxable year. FP and Corp G are shareholders of FC8 for all of 2004. For 2004, FC8 has $100x of earnings and profits, and income of $100x with respect to which amounts are required to be included in gross income of United States shareholder under section 951(a). In 2004, FC8 distributes as a dividend $20x to FP with respect to FP's preferred shares. FC8 makes no other distributions during that year.

(ii) *Analysis*. Pursuant to paragraph (e)(3)(ii)(B) of this section, the redemption rights of the preferred shares will not be treated as a discretionary distribution right under paragraph (e)(3)(ii)(A) of this section. Further, if FC8 were treated as having redeemed any preferred shares under paragraph (e)(3)(i) of this section, the redemption would be treated as a distribution to which section 301 applies under section 302(d) due to FP's constructive ownership of the common shares. However, pursuant to paragraph (e)(4) of this section, no amount of earnings and profits would be allocated to the preferred shareholders on the hypothetical distribution date, under paragraph (e)(3)(i) of this section, as a result of FC8's right to redeem, in whole or in part, the preferred shares. FC8's redemption rights with respect to the preferred shares cannot affect the allocation of earnings and profits between FC8's shareholders. Therefore, the redemption rights are not restrictions or other limitations within the meaning of paragraph (e)(5) of this section. Additionally, the non-discretionary distribution rights of the preferred shares are not restrictions or other limitations within the meaning of paragraph (e)(5) of this section. Therefore, if the total $100x of earnings were distributed on December 31, 2004, $20x would be distributed with respect to FP's preferred shares and the remainder, $80x, would be distributed with respect to Corp G's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp G's *pro rata* share of FC8's subpart F income is $80 for taxable year 2004.

Example 8. (i) *Facts*. FC9, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of common stock and 60 shares of 6-percent, nonparticipating, nonvoting, preferred stock with a par value of $100x per share. Individual J, a United States shareholder of FC9, within the meaning of section 951(b), who uses the calendar year as a taxable year, owns 30 shares of the common stock, and 15 shares of the preferred stock during tax year 2004. The remaining 10 common shares and 45 preferred shares of FC9 are owned by Foreign Individual N, a foreign individual. Individual J and Individual N are shareholders of FC9 for all of 2004. For taxable year 2004, FC9 has $1,000x of earnings and profits, and income of $500x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a).

(ii) *Analysis*. The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. If the total $1,000x of earnings and profits were distributed on December 31, 2004, $360x (0.06 x $100x x 60) would be distributed with respect to FC9's preferred stock and $640x ($1,000x minus $360x) would be distributed with respect to its common stock. Accordingly, of the $500x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a), $180x ($360x/$1,000x x $500x) is allocated to the outstanding preferred stock and $320x ($640x/$1,000x x $500x) is allocated to the outstanding common stock. Therefore, under paragraph (e)(3)(i) of this section, Individual J's *pro rata* share of such amounts for 2004 is $285x [($180x x 15/60)+($320x x 30/40)].

(7) *Effective date*. These regulations apply for taxable years of a controlled foreign corporation beginning on or after January 1, 2005.

Nancy Jardini,
Acting Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on August 5, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 6, 2004, 69 F.R. 47822)

Health Savings Accounts (HSAs); Correction

Announcement 2004–67

PURPOSE

This document contains corrections to A–14 in Notice 2004–2, 2004–2 I.R.B. 269, relating to Health Savings Accounts. As published, A–14 of the notice contains errors that may prove to be misleading and are in need of clarification.

CORRECTIONS

The last sentence in A–14 of Notice 2004–2 which currently reads, "After an individual has attained age 65 (the Medicare eligibility age), contributions, including catch-up contributions, cannot be made to an individual's HSA", is corrected to read as follows: "After an individual has attained age 65 and becomes enrolled in Medicare benefits, contributions, including catch-up contributions, cannot be made to an individual's HSA." Additionally, the terms "becomes eligible for" in the first sentence of the Example in A–14 of Notice 2004–2 are replaced by "becomes enrolled in".

FOR FURTHER INFORMATION CONTACT:

Shoshanna Tanner at (202) 622–6080 (not a toll-free number).

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z —Corporation.

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[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2004–1 through 2004–26 is in Internal Revenue Bulletin 2004–26, dated June 28, 2004.