

(ii) An “old member” is any corporation that is a member of an old group.

(5) *Election to choose between membership in more than one controlled group.* If—

(i) An old member has filed an election under paragraph (c)(2) of this section to be treated as a component member of an old group for a December 31 before March 2, 1988, and

(ii) That corporation would (without regard to such paragraph) be a component member of more than one brother-sister controlled group (not including an old group) on the December 31, that corporation may make an election under that paragraph by filing an amended return on or before September 2, 1988. This paragraph (d)(5) does not apply to a corporation that is treated as a member of an old group under paragraph (d)(3) of this section.

(6) *Refunds.* See section 6511(a) for period of limitation on filing claims for credit or refund.

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§ 1.1563-2 Excluded stock.

(a) *Certain stock excluded.* For purposes of sections 1561 through 1563 and the regulations thereunder, the term “stock” does not include:

(1) Nonvoting stock which is limited and preferred as to dividends, and

(2) Treasury stock.

(b) *Stock treated as excluded stock—(1) Parent-subsidiary controlled group.* If a corporation (hereinafter in this paragraph referred to as “parent corporation”) owns 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock in another corporation (hereinafter in this paragraph referred to as “subsidiary corporation”), the provisions of subparagraph (2) of this paragraph shall apply. For purposes of this subparagraph, stock owned by a corporation means stock owned directly plus stock owned with the application of the constructive ownership rules of paragraph (b) (1) and (4) of § 1.1563-3, relating to options and attribution from corpora-

tions. In determining whether the stock owned by a corporation possesses the requisite percentage of the total combined voting power of all classes of stock entitled to vote of another corporation, see paragraph (a)(6) of § 1.1563-1.

(2) *Stock treated as not outstanding.* If the provisions of this subparagraph apply, then for purposes of determining whether the parent corporation or the subsidiary corporation is a member of a parent-subsidiary controlled group of corporations within the meaning of paragraph (a)(2) of § 1.1563-1, the following stock of the subsidiary corporation shall, except as otherwise provided in paragraph (c) of this section, be treated as if it were not outstanding:

(i) *Plan of deferred compensation.* Stock in the subsidiary corporation held by a trust which is part of a plan of deferred compensation for the benefit of the employees of the parent corporation or the subsidiary corporation. The term “plan of deferred compensation” shall have the same meaning such term has in section 406(a)(3) and the regulations thereunder.

(ii) *Principal stockholders and officers.* Stock in the subsidiary corporation owned (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3) by an individual who is a principal stockholder or officer of the parent corporation. A principal stockholder of the parent corporation is an individual who owns (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3) 5 percent or more of the total combined voting power of all classes of stock entitled to vote or 5 percent or more of the total value of shares of all classes of stock of the parent corporation. An officer of the parent corporation includes the president, vice-presidents, general manager, treasurer, secretary, and comptroller of such corporation, and any other person who performs duties corresponding to those normally performed by persons occupying such positions.

(iii) *Employees.* Stock in the subsidiary corporation owned (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3) by

an employee of the subsidiary corporation if such stock is subject to conditions which substantially restrict or limit the employee's right (or if the employee constructively owns such stock, the direct owner's right) to dispose of such stock and which run in favor of the parent or subsidiary corporation. In general, any condition which extends, directly or indirectly, to the parent corporation or the subsidiary corporation preferential rights with respect to the acquisition of the employee's (or direct owner's) stock will be considered to be a condition described in the preceding sentence. It is not necessary, in order for a condition to be considered to be in favor of the parent corporation or the subsidiary corporation, that the parent or subsidiary be extended a discriminatory concession with respect to the price of the stock. For example, a condition whereby the parent corporation is given a right of first refusal with respect to any stock of the subsidiary corporation offered by an employee for sale is a condition which substantially restricts or limits the employee's right to dispose of such stock and runs in favor of the parent corporation. Moreover, any legally enforceable condition which prohibits the employee from disposing of his stock without the consent of the parent (or a subsidiary of the parent) will be considered to be a substantial limitation running in favor of the parent corporation.

(iv) *Controlled exempt organization.* Stock in the subsidiary corporation owned (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3) by an organization (other than the parent corporation):

(a) To which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(b) Which is controlled directly or indirectly by the parent corporation or subsidiary corporation, by an individual, estate, or trust that is a principal stockholder of the parent corporation, by an officer of the parent corporation, or by any combination thereof.

The terms "principal stockholder of the parent corporation" and "officer of

the parent corporation" shall have the same meanings in this subdivision as in subdivision (ii) of this subparagraph. The term "control" as used in this subdivision means control in fact and the determination of whether the control requirement of (b) of this subdivision is met will depend upon all the facts and circumstances of each case, without regard to whether such control is legally enforceable and irrespective of the method by which such control is exercised or exercisable.

(3) *Brother-sister controlled group.* If five or fewer persons (hereinafter referred to as common owners) who are individuals, estates, or trusts own (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3) stock possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock in a corporation, the provisions of subparagraph (4) of this paragraph shall apply. In determining whether the stock owned by such person or persons possesses the requisite percentage of the total combined voting power of all classes of stock entitled to vote of a corporation, see paragraph (a)(6) of § 1.1563-1.

(4) *Stock treated as not outstanding.* If the provisions of this subparagraph apply, then for purposes of determining whether a corporation is a member of a brother-sister controlled group of corporations within the meaning of paragraph (a)(3) of § 1.1563-1, the following stock of such corporation shall, except as otherwise provided in paragraph (c) of this section, be treated as if it were not outstanding:

(i) *Exempt employees' trust.* Stock in such corporation held by an employees' trust described in section 401(a) which is exempt from tax under section 501(a), if such trust is for the benefit of the employees of such corporation.

(ii) *Employees.* Stock in such corporation owned (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3) by an employee of such corporation if such stock is subject to conditions which run in favor of a common owner of such

corporation) and which substantially restrict or limit the employee's right (or if the employee constructively owns such stock, the record owner's right) to dispose of such stock. The principles of subparagraph (2)(iii) of this paragraph shall apply in determining whether a condition satisfies the requirements of the preceding sentence. Thus, in general, a condition which extends, directly or indirectly, to a common owner or such corporation preferential rights with respect to the acquisition of the employee's (or record owner's) stock will be considered to be a condition which satisfies such requirements. For purposes of this subdivision, if a condition which restricts or limits an employee's right (or record owner's right) to dispose of his stock also applies to the stock in such corporation held by such common owner pursuant to a bona fide reciprocal stock purchase arrangement, such condition shall not be treated as one which restricts or limits the employee's (or record owner's) right to dispose of such stock. An example of a reciprocal stock purchase arrangement is an agreement whereby a common owner and the employee are given a right of first refusal with respect to stock of the employer corporation owned by the other party. If, however, the agreement also provides that the common owner has the right to purchase the stock of the employer corporation owned by the employee in the event that the corporation should discharge the employee for reasonable cause, the purchase arrangement would not be reciprocal within the meaning of this subdivision.

(iii) *Controlled exempt organization.* Stock in such corporation owned (directly and with the application of the rules contained in paragraph (b) of § 1.1563-3) by an organization:

(a) To which section 501(c)(3) (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(b) Which is controlled directly or indirectly by such corporation, by an individual, estate, or trust that is a principal stockholder of such corporation, by an officer of such corporation, or by any combination thereof.

The terms "principal stockholder" and "officer" shall have the same meanings in this subdivision as in subparagraph (2)(ii) of this paragraph. The term "control" as used in this subdivision means control in fact and the determination of whether the control requirement of (b) of this subdivision is met will depend upon all the facts and circumstances of each case, without regard to whether such control is legally enforceable and irrespective of the method by which such control is exercised or exercisable.

(5) *Other controlled groups.* The provisions of subparagraphs (1), (2), (3), and (4) of this paragraph shall apply in determining whether a corporation is a member of a combined group (within the meaning of paragraph (a)(4) of § 1.1563-1) or an insurance group (within the meaning of paragraph (a)(5) of § 1.1563-1). For example, under paragraph (a)(4) of § 1.1563-1, in order for a corporation to be a member of a combined group such corporation must be a member of a parent-subsidiary group or a brother-sister group. Accordingly, the excluded stock rules provided by this paragraph are applicable in determining whether the corporation is a member of such group.

(6) *Meaning of employee.* For purposes of this section §§ 1.1563-3 and 1.1563-4, the term "employee" has the same meaning such term is given in section 3306(i) of the Code (relating to definitions for purposes of the Federal Unemployment Tax Act). Accordingly, the term employee as used in such sections includes an officer of a corporation.

(7) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation P owns 70 of the 100 shares of the only class of stock of corporation S. The remaining shares of S are owned as follows: 4 shares by Jones (the general manager of P), and 26 shares by Smith (who also owns 5 percent of the total combined voting power of the stock of P). P satisfies the 50 percent stock ownership requirement of subparagraph (1) of this paragraph with respect to S. Since Jones is an officer of P and Smith is a principal stockholder of P, under subparagraph (2)(ii) of this paragraph the S stock owned by Jones and Smith is treated as not outstanding for purposes of determining whether P and S are members of a parent-subsidiary controlled group of corporations within the meaning of paragraph

(a)(2) of § 1.1563-1. Thus, P is considered to own stock possessing 100 percent (70+70) of the total voting power and value of all the S stock. Accordingly, P and S are members of a parent-subsidary controlled group of corporations.

Example (2). Assume the same facts as in example (1) and further assume that Jones owns 15 shares of the 100 shares of the only class of stock of corporation S-1, and corporation S owns 75 shares of such stock. P satisfies the 50 percent stock ownership requirement of subparagraph (1) of this paragraph with respect to S-1 since P is considered as owning 52.5 percent (70 percent x 75 percent) of the S-1 stock with the application of paragraph (b)(4) of § 1.1563-3. Since Jones is an officer of P, under subparagraph (2)(ii) of this paragraph, the S-1 stock owned by Jones is treated as not outstanding for purposes of determining whether S-1 is a member of the parent-subsidary controlled group of corporations. Thus, S is considered to own stock possessing 88.2 percent (75+85) of the voting power and value of the S-1 stock. Accordingly, P, S, and S-1 are members of a parent-subsidary controlled group of corporations.

Example (3). Corporation X owns 60 percent of the only class of stock of corporation Y. Davis, the president of Y, owns the remaining 40 percent of the stock of Y. Davis has agreed that if he offers his stock in Y for sale he will first offer the stock to X at a price equal to the fair market value of the stock on the first date the stock is offered for sale. Since Davis is an employee of Y within the meaning of section 3306(i) of the Code, and his stock in Y is subject to a condition which substantially restricts or limits his right to dispose of such stock and runs in favor of X, under subparagraph (2)(iii) of this paragraph such stock is treated as if it were not outstanding for purposes of determining whether X and Y are members of a parent-subsidary controlled group of corporations. Thus, X is considered to own stock possessing 100 percent of the voting power and value of the stock of Y. Accordingly, X and Y are members of a parent-subsidary controlled group of corporations. The result would be the same if Davis's wife, instead of Davis, owned directly the 40 percent stock interest in Y and such stock was subject to a right of first refusal running in favor of X.

(c) *Exception—(1) General.* If stock of a corporation is owned by a person directly or with the application of the rules contained in paragraph (b) of § 1.1563-3 and such ownership results in the corporation being a component member of a controlled group of corporations on a December 31, then the stock shall not be treated as excluded stock under the provisions of para-

graph (b) of this section if the result of applying such provisions is that such corporation is not a component member of a controlled group of corporations on such December 31.

(2) *Illustration.* The provisions of this paragraph may be illustrated by the following example:

Example. On each day of 1965, corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. Jones, an officer of P, owns directly 30 shares of S stock and P has an option to acquire such 30 shares from Jones. The remaining shares of S are owned by unrelated persons. If, pursuant to the provisions of paragraph (b)(2)(ii) of this section, the 30 shares of S stock owned directly by Jones is treated as not outstanding, the result is that P would be treated as owning stock possessing only 71 percent (50+70) of the total voting power and value of S stock, and S would not be a component member of a controlled group of corporations on December 31, 1965. However, since P is considered as owning the 30 shares of S stock with the application of paragraph (b)(1) of this section, and such ownership plus the S stock directly owned by P (50 shares) results in S being a component member of a controlled group of corporations on December 31, 1965, the provisions of this paragraph apply. Therefore, the provisions of paragraph (b)(2)(ii) of this section do not apply with respect to the 30 shares of S stock, and on December 31, 1965, S is a component member of a controlled group of corporations consisting of P and S.

[T.D. 6845, 30 FR 9753, Aug. 5, 1965, as amended by T.D. 7181, 37 FR 8070, Apr. 4, 1972]

§ 1.1563-3 Rules for determining stock ownership.

(a) *In general.* In determining stock ownership for purposes of §§ 1.1562-5, 1.1563-1, 1.1563-2, and this section, the constructive ownership rules of paragraph (b) of this section apply to the extent such rules are referred to in such sections. The application of such rules shall be subject to the operating rules and special rules contained in paragraphs (c) and (d) of this section.

(b) *Constructive ownership—(1) Options.* If a person has an option to acquire any outstanding stock of a corporation, such stock shall be considered as owned by such person. For purposes of this subparagraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock. For example, assume Smith