

Internal Revenue Service, Treasury

§ 1.1504-4

(iii) Transactions increasing likelihood of exercise.

(iv) Measurement date for options issued pursuant to a plan.

(v) Measurement date for related or sequential options.

(vi) Example.

(5) In-the-money.

(d) Options.

(1) Instruments treated as options.

(2) Instruments generally not treated as options.

(i) Options on section 1504(a)(4) stock.

(ii) Certain publicly traded options.

(A) General rule.

(B) Exception.

(iii) Stock purchase agreements.

(iv) Escrow, pledge, or other security agreements.

(v) Compensatory options.

(A) General rule.

(B) Exceptions.

(vi) Options granted in connection with a loan.

(vii) Options created pursuant to a title 11 or similar case.

(viii) Convertible preferred stock.

(ix) Other enumerated instruments.

(e) Elimination of federal income tax liability.

(f) Substantial amount of federal income tax liability.

(g) Reasonable certainty of exercise.

(1) Generally.

(i) Purchase price.

(ii) In-the-money option.

(iii) Not in-the-money option.

(iv) Exercise price.

(v) Time of exercise.

(vi) Related or sequential options.

(vii) Stockholder rights.

(viii) Restrictive covenants.

(ix) Intention to alter value.

(x) Contingencies.

(2) Cash settlement options, phantom stock, stock appreciation rights, or similar interests.

(3) Safe harbors.

(i) Options to acquire stock.

(ii) Options to sell stock.

(iii) Options exercisable at fair market value.

(iv) Exceptions.

(v) Failure to satisfy safe harbor.

(h) Examples.

(i) Effective date.

[T.D. 8462, 57 FR 61800, Dec. 29, 1992]

§ 1.1504-1 Definitions.

The privilege of filing consolidated returns is extended to all includible corporations constituting affiliated groups as defined in section 1504. See the regulations under § 1.1502 for a description of an affiliated group and the

corporations which may be considered as includible corporations.

[T.D. 6500, 25 FR 12106, Nov. 26, 1960]

§§ 1.1504-2—1.1504-3 [Reserved]

§ 1.1504-4 Treatment of warrants, options, convertible obligations, and other similar interests.

(a) *Introduction*—(1) *General rule*. This section provides regulations under section 1504(a)(5) (A) and (B) regarding the circumstances in which warrants, options, obligations convertible into stock, and other similar interests are treated as exercised for purposes of determining whether a corporation is a member of an affiliated group. The fact that an instrument may be treated as an option under these regulations does not prevent such instrument from being treated as stock under general principles of law. Except as provided in paragraph (a)(2) of this section, this section applies to all provisions under the Internal Revenue Code and the regulations to which affiliation within the meaning of section 1504(a) (with or without the exceptions in section 1504(b)) is relevant, including those provisions that refer to section 1504(a)(2) (with or without the exceptions in section 1504(b)) without referring to affiliation, provided that the 80 percent voting power and 80 percent value requirements of section 1504(a)(2) are not modified therein.

(2) *Exceptions*. This section does not apply to sections 163(j), 864(e), or 904(i) or to the regulations thereunder. This section also does not apply to any other provision specified by the Internal Revenue Service in regulations, a revenue ruling, or revenue procedure. See § 601.601(d)(2)(ii)(b) of this chapter.

(b) *Options not treated as stock or as exercised*—(1) *General rule*. Except as provided in paragraph (b)(2) of this section, an option is not considered either as stock or as exercised. Thus, options are disregarded in determining whether a corporation is a member of an affiliated group unless they are described in paragraph (b)(2) of this section.

(2) *Options treated as exercised*—(i) *In general*. Solely for purposes of determining whether a corporation is a member of an affiliated group, an option is treated as exercised if, on a

measurement date with respect to such option—

(A) It could reasonably be anticipated that, if not for this section, the issuance or transfer of the option in lieu of the issuance, redemption, or transfer of the underlying stock would result in the elimination of a substantial amount of federal income tax liability (as described in paragraphs (e) and (f) of this section); and

(B) It is reasonably certain that the option will be exercised (as described in paragraph (g) of this section).

(ii) *Aggregation of options.* All options with the same measurement date are aggregated in determining whether the issuance or transfer of an option in lieu of the issuance, redemption, or transfer of the underlying stock would result in the elimination of a substantial amount of federal income tax liability.

(iii) *Effect of treating option as exercised—(A) In general.* An option that is treated as exercised is treated as exercised for purposes of determining the percentage of the value of stock owned by the holder and other parties, but is not treated as exercised for purposes of determining the percentage of the voting power of stock owned by the holder and other parties.

(B) *Cash settlement options, phantom stock, stock appreciation rights, or similar interests.* If a cash settlement option, phantom stock, stock appreciation right, or similar interest is treated as exercised, the option is treated as having been converted into stock of the issuing corporation. If the amount to be received upon the exercise of such an option is determined by reference to a multiple of the increase in the value of a share of the issuing corporation's stock on the exercise date over the value of a share of the stock on the date the option is issued, the option is treated as converted into a corresponding number of shares of such stock. Appropriate adjustments must be made in any situation in which the amount to be received upon exercise of the option is determined in another manner.

(iv) *Valuation.* For purposes of section 1504(a)(2)(B) and this section, all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority

and blockage discounts within a single class are not taken into account.

(3) *Example.* The provisions of paragraph (b)(2) of this section may be illustrated by the following example:

Example. (i) Corporation P owns all 100 shares of the common stock of Corporation S, the only class of S stock outstanding. Each share of S stock has a fair market value of \$10 and has one vote. On June 30, 1992, P issues to Corporation X an option to acquire 80 shares of the S stock from P.

(ii) If, under the provisions of this section, the option is treated as exercised, then, solely for purposes of determining affiliation, P is treated as owning only 20 percent of the value of the outstanding S stock and X is treated as owning the remaining 80 percent of the value of the S stock. P is still treated as owning all of the voting power of S. Accordingly, because P is treated as owning less than 80 percent of the value of the outstanding S stock, P and S are no longer affiliated. However, because X is not treated as owning any of the voting power of S, X and S are also not affiliated.

(c) *Definitions.* For purposes of this section—

(1) *Issuing corporation.* “Issuing corporation” means the corporation whose stock is subject to an option.

(2) *Related or sequential option.* “Related or sequential option” means an option that is one of a series of options issued to the same or related persons. For purposes of this section, any options issued to the same person or related persons within a two-year period are presumed to be part of a series of options. This presumption may be rebutted if the facts and circumstances clearly establish that the options are not part of a series of options. Any options issued to the same person or related persons more than two years apart are presumed not to be part of a series of options. This presumption may be rebutted if the facts and circumstances clearly establish that the options are part of a series of options.

(3) *Related persons.* Persons are related if they are related within the meaning of section 267(b) (without the application of sections 267(c) and 1563(e)(1)) or 707(b)(1), substituting “10 percent” for “50 percent” wherever it appears.

(4) *Measurement date—(i) General rule.* “Measurement date” means a date on which an option is issued or transferred or on which the terms of an existing

option or the underlying stock are adjusted (including an adjustment pursuant to the terms of the option or the underlying stock).

(ii) *Issuances, transfers, or adjustments not treated as measurement dates.* A measurement date does not include a date on which—

(A) An option is issued or transferred by gift, at death, or between spouses or former spouses under section 1041;

(B) An option is issued or transferred—

(1) Between members of an affiliated group (determined with the exceptions in section 1504(b) and without the application of this section); or

(2) Between persons none of which is a member of the affiliated group (determined without the exceptions in section 1504(b) and without the application of this section), if any, of which the issuing corporation is a member, unless—

(i) Any such person is related to (or acting in concert with) the issuing corporation or any member of its affiliated group; and

(ii) The issuance or transfer is pursuant to a plan a principal purpose of which is to avoid the application of section 1504 and this section;

(C) An adjustment occurs in the terms or pursuant to the terms of an option or the underlying stock that does not materially increase the likelihood that the option will be exercised; or

(D) A change occurs in the exercise price of an option or in the number of shares that may be issued or transferred pursuant to the option as determined by a bona fide, reasonable, adjustment formula that has the effect of preventing dilution of the interests of the holders of the options.

(iii) *Transactions increasing likelihood of exercise.* If a change or alteration referred to in this paragraph (c)(4)(iii) is made for a principal purpose of increasing the likelihood that an option will be exercised, a measurement date also includes any date on which—

(A) The capital structure of the issuing corporation is changed; or

(B) The fair market value of the stock of the issuing corporation is altered through a transfer of assets to or from the issuing corporation (other

than regular, ordinary dividends) or by any other means.

(iv) *Measurement date for options issued pursuant to a plan.* In the case of options issued pursuant to a plan, a measurement date for any of the options constitutes a measurement date for all options issued pursuant to the plan that are outstanding on the measurement date.

(v) *Measurement date for related or sequential options.* In the case of related or sequential options, a measurement date for any of the options constitutes a measurement date for all related or sequential options that are outstanding on the measurement date.

(vi) *Example.* The provisions of paragraph (c)(4)(v) of this section may be illustrated by the following example.

Example. (i) Corporation P owns all 80 shares of the common stock of Corporation S, the only class of S stock outstanding. On January 1, 1992, S issues a warrant, exercisable within 3 years, to U, an unrelated corporation, to acquire 10 newly issued shares of S common stock. On July 1, 1992, S issues a second warrant to U to acquire 10 additional newly issued shares of S common stock. On January 1, 1993, S issues a third warrant to T, a wholly owned subsidiary of U, to acquire 10 newly issued shares of S common stock. Assume that the facts and circumstances do not clearly establish that the options are not part of a series of options.

(ii) January 1, 1992, July 1, 1992, and January 1, 1993, constitute measurement dates for the first warrant, the second warrant, and the third warrant, respectively, because the warrants were issued on those dates.

(iii) Because the first and second warrants were issued within two years of each other, and both warrants were issued to U, the warrants constitute related or sequential options. Accordingly, July 1, 1992, constitutes a measurement date for the first warrant as well as for the second warrant.

(iv) Because the first, second, and third warrants were all issued within two years of each other, and were all issued to the same or related persons, the warrants constitute related or sequential options. Accordingly, January 1, 1993, constitutes a measurement date for the first and second warrants, as well as for the third warrant.

(5) *In-the-money.* “In-the-money” means the exercise price of the option is less than (or in the case of an option to sell stock, greater than) the fair market value of the underlying stock.

(d) *Options*—(1) *Instruments treated as options.* For purposes of this section, except to the extent otherwise provided in this paragraph (d), the following are treated as options:

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

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

(2) *Instruments generally not treated as options.* For purposes of this section, the following will not be treated as options:

(i) *Options on section 1504(a)(4) stock.* Options on stock described in section 1504(a)(4);

(ii) *Certain publicly traded options*—(A) *General rule.* Options which on the measurement date are traded on (or subject to the rules of) a qualified board or exchange as defined in section 1256(g)(7), or on any other exchange, board of trade, or market specified by the Internal Revenue Service in regulations, a revenue ruling, or revenue procedure. See § 601.601(d)(2)(ii)(b) of this chapter;

(B) *Exception.* Paragraph (d)(2)(ii)(A) of this section does not apply to options issued, transferred, or listed with a principal purpose of avoiding the application of section 1504 and this section. For example, a principal purpose of avoiding the application of section 1504 and this section may exist if warrants, convertible or exchangeable debt instruments, or other similar instruments have an exercise price (or, in the case of convertible or exchangeable instruments, a conversion or exchange premium) that is materially less than, or a term that is materially longer than, those that are customary for publicly traded instruments of their type. A principal purpose may also exist if a large percentage of an issuance of an instrument is placed with one investor (or group of investors) and a very small percentage of the issuance is traded on a qualified board or exchange;

(iii) *Stock purchase agreements.* Stock purchase agreements or similar ar-

rangements whose terms are commercially reasonable and in which the parties' obligations to complete the transaction are subject only to reasonable closing conditions;

(iv) *Escrow, pledge, or other security agreements.* Agreements for holding stock in escrow or under a pledge or other security agreement that are part of a typical commercial transaction and that are subject to customary commercial conditions;

(v) *Compensatory options*—(A) *General rule.* Stock appreciation rights, warrants, stock options, phantom stock, or other similar instruments provided to employees, directors, or independent contractors in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) and which—

(1) Are nontransferable within the meaning of § 1.83-3(d); and

(2) Do not have a readily ascertainable fair market value as defined in § 1.83-7(b) on the measurement date;

(B) *Exceptions.* (1) Paragraph (d)(2)(v)(A) of this section does not apply to options issued or transferred with a principal purpose of avoiding the application of section 1504 and this section; and

(2) Paragraph (d)(2)(v)(A) of this section ceases to apply to options that become transferable;

(vi) *Options granted in connection with a loan.* Options granted in connection with a loan if the lender is actively and regularly engaged in the business of lending and the options are issued in connection with a loan to the issuing corporation that is commercially reasonable. This paragraph (d)(2)(vi) continues to apply if the option is transferred with the loan (or if a portion of the option is transferred with a corresponding portion of the loan). However, if the option is transferred without a corresponding portion of the loan, this paragraph (d)(2)(vi) ceases to apply;

(vii) *Options created pursuant to a title 11 or similar case.* Options created by the solicitation or receipt of acceptances to a plan of reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), the option created by the confirmation of the

plan, and any option created under the plan prior to the time the plan becomes effective;

(viii) *Convertible preferred stock.* Convertible preferred stock, provided the terms of the conversion feature do not permit or require the tender of any consideration other than the stock being converted; and

(ix) *Other enumerated instruments.* Any other instruments specified by the Internal Revenue Service in regulations, a revenue ruling, or revenue procedure. See §601.601(d)(2)(ii)(b) of this chapter.

(e) *Elimination of federal income tax liability.* For purposes of this section, the elimination of federal income tax liability includes the elimination or deferral of federal income tax liability. In determining whether there is an elimination of federal income tax liability, the tax consequences to all involved parties are considered. Examples of elimination of federal income tax liability include the use of a loss or deduction that would not otherwise be utilized, the acceleration of a loss or deduction to a year earlier than the year in which the loss or deduction would otherwise be utilized, the deferral of gain or income to a year later than the year in which the gain or income would otherwise be reported, and the acceleration of gain or income to a year earlier than the year in which the gain or income would otherwise be reported, if such gain or income is offset by a net operating loss or net capital loss that would otherwise expire unused. The elimination of federal income tax liability does not include the deferral of gain with respect to the stock subject to the option that would be recognized if such stock were sold on a measurement date.

(f) *Substantial amount of federal income tax liability.* The determination of what constitutes a substantial amount of federal income tax liability is based on all the facts and circumstances, including the absolute amount of the elimination, the amount of the elimination relative to overall tax liability, and the timing of items of income and deductions, taking into account present value concepts.

(g) *Reasonable certainty of exercise—(1) Generally.* The determination of wheth-

er, as of a measurement date, an option is reasonably certain to be exercised is based on all the facts and circumstances, including:

(i) *Purchase price.* The purchase price of the option in absolute terms and in relation to the fair market value of the stock or the exercise price of the option;

(ii) *In-the-money option.* Whether and to what extent the option is in-the-money on the measurement date;

(iii) *Not in-the-money option.* If the option is not in-the-money on the measurement date, the amount or percentage by which the exercise price of the option is greater than (or in the case of an option to sell stock, is less than) the fair market value of the underlying stock;

(iv) *Exercise price.* Whether the exercise price of the option is fixed or fluctuates depending on the earnings, value, or other indication of economic performance of the issuing corporation;

(v) *Time of exercise.* The time at which, or the period of time during which, the option can be exercised;

(vi) *Related or sequential options.* Whether the option is one in a series of related or sequential options;

(vii) *Stockholder rights.* The existence of an arrangement (either within the option agreement or in a related agreement) that, directly or indirectly, affords managerial or economic rights in the issuing corporation that ordinarily would be afforded to owners of the issuing corporation's stock (e.g., voting rights, dividend rights, or rights to proceeds on liquidation) to the person who would acquire the stock upon exercise of the option or a person related to such person. For this purpose, managerial or economic rights in the issuing corporation possessed because of actual stock ownership in the issuing corporation are not taken into account;

(viii) *Restrictive covenants.* The existence of restrictive covenants or similar arrangements (either within the option agreement or in a related agreement) that, directly or indirectly, prevent or limit the ability of the issuing corporation to undertake certain activities while the option is outstanding (e.g., covenants limiting the payment of dividends or borrowing of funds);

(ix) *Intention to alter value.* Whether it was intended that through a change in the capital structure of the issuing corporation or a transfer of assets to or from the issuing corporation (other than regular, ordinary dividends) or by any other means, the fair market value of the stock of the issuing corporation would be altered for a principal purpose of increasing the likelihood that the option would be exercised; and

(x) *Contingencies.* Any contingency (other than the mere passage of time) to which the exercise of the option is subject (e.g., a public offering of the issuing corporation's stock or reaching a certain level of earnings).

(2) *Cash settlement options, phantom stock, stock appreciation rights, or similar interests.* A cash settlement option, phantom stock, stock appreciation right, or similar interest is treated as reasonably certain to be exercised if it is reasonably certain that the option will have value at some time during the period in which the option may be exercised.

(3) *Safe harbors—(i) Options to acquire stock.* Except as provided in paragraph (g)(3)(iv) of this section, an option to acquire stock is not considered reasonably certain, as of a measurement date, to be exercised if—

(A) The option may be exercised no more than 24 months after the measurement date and the exercise price is equal to or greater than 90 percent of the fair market value of the underlying stock on the measurement date; or

(B) The terms of the option provide that the exercise price of the option is equal to or greater than the fair market value of the underlying stock on the exercise date.

(ii) *Options to sell stock.* Except as provided in paragraph (g)(3)(iv) of this section, an option to sell stock is not considered reasonably certain, as of a measurement date, to be exercised if—

(A) The option may be exercised no more than 24 months after the measurement date and the exercise price is equal to or less than 110 percent of the fair market value of the underlying stock on the measurement date; or

(B) The terms of the option provide that the exercise price of the option is equal to or less than the fair market

value of the underlying stock on the exercise date.

(iii) *Options exercisable at fair market value.* For purposes of paragraphs (g)(3)(i)(B) and (g)(3)(ii)(B) of this section, an option whose exercise price is determined by a formula is considered to have an exercise price equal to the fair market value of the underlying stock on the exercise date if the formula is agreed upon by the parties when the option is issued in a bona fide attempt to arrive at fair market value on the exercise date and is to be applied based upon the facts in existence on the exercise date.

(iv) *Exceptions.* The safe harbors of this paragraph (g)(3) do not apply if—

(A) An arrangement exists that provides the holder or a related party with stockholder rights described in paragraph (g)(1)(vii) of this section (except for rights arising upon a default under the option or a related agreement);

(B) It is intended that through a change in the capital structure of the issuing corporation or a transfer of assets to or from the issuing corporation (other than regular, ordinary dividends) or by any other means, the fair market value of the stock of the issuing corporation will be altered for a principal purpose of increasing the likelihood that the option will be exercised; or

(C) The option is one in a series of related or sequential options, unless all such options satisfy paragraph (g)(3) (i) or (ii) of this section.

(v) *Failure to satisfy safe harbor.* Failure of an option to satisfy one of the safe harbors of this paragraph (g)(3) does not affect the determination of whether an option is treated as reasonably certain to be exercised.

(h) *Examples.* The provisions of this section may be illustrated by the following examples. These examples assume that the measurement dates set forth in the examples are the only measurement dates that have taken place or will take place.

Example 1. (i) P is the common parent of a consolidated group, consisting of P, S, and T. P owns all 100 shares of S's only class of stock, which is voting common stock. P also owns all the stock of T. On June 30, 1992, when the fair market value of the S stock is \$40 per share, P sells to U, an unrelated corporation, an option to acquire 40 shares of

the S stock that P owns at an exercise price of \$30 per share, exercisable at any time within 3 years after the granting of the option. P and T have had substantial losses for 5 consecutive years while S has had substantial income during the same period. Because P, S, and T have been filing consolidated returns, P and T have been able to use all of their losses to offset S's income. It is anticipated that P, S, and T will continue their earnings histories for several more years. On July 31, 1992, S declares and pays a dividend of \$1 per share to P.

(ii) If P, S, and T continue to file consolidated returns after June 30, 1992, it could reasonably be anticipated that P, S, and T would eliminate a substantial amount of federal income tax liability by using P's and T's future losses to offset S's income in consolidated returns. Furthermore, based on the difference between the exercise price of the option and the fair market value of the S stock, it is reasonably certain, on June 30, 1992, a measurement date, that the option will be exercised. Therefore, the option held by U is treated as exercised. As a result, for purposes of determining whether P and S are affiliated, P is treated as owning only 60 percent of the value of outstanding shares of S stock and U is treated as owning the remaining 40 percent. P is still treated as owning 100 percent of the voting power. Because members of the P group are no longer treated as owning stock possessing 80 percent of the total value of the S stock as of June 30, 1992, S is no longer a member of the P group. Additionally, P is not entitled to a 100 percent dividends received deduction under section 243(a)(3) because P and S are also treated as not affiliated for purposes of section 243. P is only entitled to an 80 percent dividends received deduction under section 243(c).

Example 2. (i) The facts are the same as in *Example 1* except that rather than P issuing an option to acquire 40 shares of S stock to U on June 30, 1992, P, pursuant to a plan, issues an option to U1 on July 1, 1992, to acquire 20 shares of S stock, and issues an option to U2 on July 2, 1992, to acquire 20 shares of S stock.

(ii) Because the options issued to U1 and U2 were issued pursuant to a plan, July 2, 1992, constitutes a measurement date for both options. Therefore, both options are aggregated in determining whether the issuance of the options, rather than the sale of the S stock, would result in the elimination of a substantial amount of federal income tax liability. Accordingly, as in *Example 1*, because the continued affiliation of P, S, and T could reasonably be anticipated to result in the elimination of a substantial amount of federal income tax liability and the options are reasonably certain to be exercised, the options are treated as exercised for purposes of determining whether P and S

are affiliated, and P and S are no longer affiliated as of July 2, 1992.

Example 3. (i) The facts are the same as in *Example 1* except that the option gives U the right to acquire all 100 shares of the S stock, and U is the common parent of a consolidated group. The U group has had substantial losses for 5 consecutive years and it is anticipated that the U group will continue its earnings history for several more years.

(ii) If P sold the S stock, in lieu of the option, to U, S would become a member of the U group. Because the U group files consolidated returns, if P sold the S stock to U, U would be able to use its future losses to offset future income of S. When viewing the transaction from the effect on all parties, the sale of the option, in lieu of the underlying S stock, does not result in the elimination of federal income tax liability because S's income would be offset by the losses of members of either the P or U group. Accordingly, the option is disregarded and S remains a member of the P group.

Example 4. (i) P is the common parent of a consolidated group, consisting of P and S. P owns 90 of the 100 outstanding shares of S's only class of stock, which is voting common stock, and U, an unrelated corporation, owns the remaining 10 shares. On August 31, 1992, when the fair market value of the S stock is \$100 per share, P sells a call option to U that entitles U to purchase 20 shares of S stock from P, at any time before August 31, 1993, at an exercise price of \$115 per share. The call option does not provide U with any voting rights, dividend rights, or any other managerial or economic rights ordinarily afforded to owners of the S stock. There is no intention on August 31, 1992, to alter the value of S to increase the likelihood of the exercise of the call option.

(ii) Because the exercise price of the call option is equal to or greater than 90 percent of the fair market value of the S stock on August 31, 1992, a measurement date, the option may be exercised no more than 24 months after the measurement date, and none of the items described in paragraph (g)(3)(iv) of this section that preclude application of the safe harbor are present, the safe harbor of paragraph (g)(3)(i) of this section applies and the call option is treated as if it is not reasonably certain to be exercised. Therefore, regardless of whether the continued affiliation of P and S would result in the elimination of a substantial amount of federal income tax liability, the call option is disregarded in determining whether S remains a member of the P group.

Example 5. (i) The facts are the same as in *Example 4* except that the call option gives U the right to vote similar to that of a shareholder.

(ii) Under paragraph (g)(3)(iv) of this section, the safe harbor of paragraph (g)(3)(i) of this section does not apply because the call

option entitles U to voting rights equivalent to that of a shareholder. Accordingly, all of the facts and circumstances surrounding the sale of the call option must be taken into consideration in determining whether it is reasonably certain that the call option will be exercised.

Example 6. (i) In 1992, two unrelated corporations, X and Y, decide to engage jointly in a new business venture. To accomplish this purpose, X organizes a new corporation, S, on September 30, 1992. X acquires 100 shares of the voting common stock of S, which are the only shares of S stock outstanding. Y acquires a debenture of S which is convertible, on September 30, 1995, into 100 shares of S common stock. If the conversion right is not exercised, X will have the right, on September 30, 1995, to put 50 shares of its S stock to Y in exchange for 50 percent of the debenture held by Y. The likelihood of the success of the venture is uncertain. It is anticipated that S will generate substantial losses in its early years of operation. X expects to have substantial taxable income during the three years following the organization of S.

(ii) Under the terms of this arrangement, it is reasonably certain on September 30, 1992, a measurement date, that on September 30, 1995, either through Y's exercise of its conversion right or X's right to put S stock to Y, that Y will own 50 percent of the S stock. Additionally, it could reasonably be anticipated, on September 30, 1992, a measurement date, that the affiliation of X and S would result in the elimination of a substantial amount of federal income tax liability. Accordingly, for purposes of determining whether X and S are affiliated, X is treated as owning only 50 percent of the value of the S stock as of September 30, 1992, a measurement date, and S is not a member of the X affiliated group.

Example 7. (i) The facts are the same as in *Example 6* except that rather than acquiring 100 percent of the S stock and the right to put S stock to Y, X acquires only 80 percent of the S stock, while S, rather than acquiring a convertible debenture, acquires 20 percent of the S stock, and an option to acquire an additional 30 percent of the S stock. The terms of the option are such that the option will only be exercised if the new business venture succeeds.

(ii) In contrast to *Example 6*, because of the true business risks involved in the start-up of S and whether the business venture will ultimately succeed, along with the fact that X does not have an option to put S stock to Y, it is not reasonably certain on September 30, 1992, a measurement date, that the option will be exercised and that X will only own 50 percent of the S stock on September 30, 1995. Accordingly, the option is disregarded in determining whether S is a member of the X group.

(i) *Effective date.* This section applies, generally, to options with a measurement date on or after February 28, 1992. This section does not apply to options issued prior to February 28, 1992, which have a measurement date on or after February 28, 1992, if the measurement date for the option occurs solely because of an adjustment in the terms of the option pursuant to the terms of the option as it existed on February 28, 1992. Paragraph (b)(2)(iv) of this section applies to stock outstanding on or after February 28, 1992.

[T.D. 8462, 57 FR 61801, Dec. 29, 1992; 58 FR 7041, Feb. 3, 1993]

REGULATIONS APPLICABLE FOR TAX YEARS FOR WHICH A RETURN IS DUE ON OR BEFORE AUGUST 11, 1999

§ 1.1502-9A Application of overall foreign loss recapture rules to corporations filing consolidated returns due on or before August 11, 1999.

(a) *Scope—(1) Effective date.* This section applies only to consolidated return years for which the due date of the income tax return (without extensions) is on or before August 11, 1999.

(2) *In general.* Affiliated group of corporations filing a consolidated return sustains an overall foreign loss (a consolidated overall foreign loss) in any taxable year in which its gross income from sources without the United States subject to a separate limitation (as defined in § 1.904(f)-1(c)(2)) is exceeded by the sum of the deductions properly allocated and apportioned thereto. However, for taxable years prior to 1983, affiliated groups may have determined their overall foreign losses for income subject to the passive interest limitation, DISC dividend limitation, and general limitation on a combined basis in accordance with the rules in § 1.904(f)-1(c)(1). The rules contained in §§ 1.904(f)-1 through 1.904(f)-6 are applicable to affiliated groups filing consolidated returns. This section provides special rules for applying those sections to such groups. Paragraph (b) provides rules for additions and subtractions of a portion of overall foreign losses to and from consolidated overall foreign loss accounts. Paragraph (c) requires that separate notional overall