Internal Revenue
bulletin

Bulletin No. 2003–27
July 7, 2003

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. 2003–71, page 1.
Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for July 2003.

REG–122917–02, page 15.
Proposed regulations under sections 421, 422, 424, and 6039 of the Code provide guidance to taxpayers concerning statutory stock options. A public hearing is scheduled for September 2, 2003. EE-86-88 (LR–279–81, 1984–1 C.B. 715) withdrawn.

Notice 2003–38, page 9.
The Service announces a compliance initiative for nonresident aliens and foreign corporations that have not filed U.S. federal income tax returns, and that may consequently be denied deductions and credits pursuant to section 874(a) or 882(c)(2) of the Code.

Notice 2003–40, page 10.
The Service clarifies the answers to six questions concerning tax-exempt qualified New York Liberty Bonds issued under section 1400L(d) of the Code.

EMPLOYEE PLANS

Rev. Rul. 2003–70, page 3.
Small employer plan exception to the COBRA continuation coverage requirements in mergers and acquisitions. Guidance is provided on when a group health plan maintained by an employer that grows to have more than 20 employees through a stock or asset acquisition is required to begin complying with the COBRA continuation coverage requirements.

ESTATE TAX

Notice 2003–39, page 10.
This notice requests suggestions from the public regarding the creation of sample forms for charitable lead trusts.

GIFT TAX

Notice 2003–39, page 10.
This notice requests suggestions from the public regarding the creation of sample forms for charitable lead trusts.

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Finding Lists begin on page ii.
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Department of the Treasury
Internal Revenue Service

EXCISE TAX

Rev. Rul. 2003–70, page 3.
Small employer plan exception to the COBRA continuation coverage requirements in mergers and acquisitions. Guidance is provided on when a group health plan maintained by an employer that grows to have more than 20 employees through a stock or asset acquisition is required to begin complying with the COBRA continuation coverage requirements.

ADMINISTRATIVE

T.D. 9061, page 5.
REG–107618–02, page 13.
Final, temporary, and proposed regulations under section 6081 of the Code provide an automatic extension of time to file certain information returns and exempt organization returns. The temporary regulations remove the requirement for a signature and an explanation to obtain an automatic extension of time to file these returns.

Rev. Proc. 2003–45, page 11.
LIFO; methods of accounting; automatic consent. For certain accounting method changes within the inventory price index computation (IPIC) method of accounting for last-in, first-out (LIFO) inventories, the 5-year prior change scope limitation in section 4.02(6) of Rev. Proc. 2002–9, 2002–1 C.B. 327, is waived. Rev. Proc. 2002–9 modified.

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 consolidated 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 first 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 first Bulletin of the succeeding semiannual period, respectively.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

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 July 2003. See Rev. Rul. 2003–71, page 1.

Section 103.—Interest on State and Local Bonds

The Service clarifies the answers to six questions concerning tax-exempt qualified New York Liberty Bonds issued under section 1400L(d). See Notice 2003–40, page 10.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of July 2003. See Rev. Rul. 2003–71, page 1.

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 July 2003. See Rev. Rul. 2003–71, page 1.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2003. See Rev. Rul. 2003–71, page 1.

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446-1: General rule for methods of accounting.

For certain accounting method changes within the inventory price index computation (IPIC) method of accounting for last-in, first-out (LIFO) inventories, the 5-year prior change scope limitation in section 4.02(6) of Rev. Proc. 2002–9, 2002–1 C.B. 327, is waived. See Rev. Proc. 2003–45, page 11.

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 July 2003. See Rev. Rul. 2003–71, page 1.

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 July 2003. See Rev. Rul. 2003–71, page 1.

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 July 2003. See Rev. Rul. 2003–71, page 1.

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 July 2003. See Rev. Rul. 2003–71, page 1.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of July 2003. See Rev. Rul. 2003–71, page 1.

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 July 2003. See Rev. Rul. 2003–71, page 1.

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 July 2003. See Rev. Rul. 2003–71, page 1.

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, 1274, 1288, and other sections of the Code, tables set forth the rates for July 2003.

Rev. Rul. 2003–71

This revenue ruling provides various prescribed rates for federal income tax purposes for July 2003 (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. 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. Finally, Table 6 contains the blended annual rate for 2003 for purposes of section 7872.

REV. RUL. 2003–71 TABLE 1

Applicable Federal Rates (AFR) for July 2003

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	1.23%	1.23%	1.23%	1.23%
110% AFR	1.35%	1.35%	1.35%	1.35%
120% AFR	1.49%	1.48%	1.48%	1.48%
130% AFR	1.61%	1.60%	1.60%	1.59%
Mid-Term				
AFR	2.55%	2.53%	2.52%	2.52%
110% AFR	2.80%	2.78%	2.77%	2.76%
120% AFR	3.06%	3.04%	3.03%	3.02%
130% AFR	3.32%	3.29%	3.28%	3.27%
150% AFR	3.84%	3.80%	3.78%	3.77%
175% AFR	4.48%	4.43%	4.41%	4.39%
Long-Term				
AFR	4.17%	4.13%	4.11%	4.09%
110% AFR	4.59%	4.54%	4.51%	4.50%
120% AFR	5.02%	4.96%	4.93%	4.91%
130% AFR	5.44%	5.37%	5.33%	5.31%

REV. RUL. 2003–71 TABLE 2

Adjusted AFR for July 2003

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	1.09%	1.09%	1.09%	1.09%
Mid-term adjusted AFR	2.29%	2.28%	2.27%	2.27%
Long-term adjusted AFR	4.05%	4.01%	3.99%	3.98%

REV. RUL. 2003–71 TABLE 3	
Rates Under Section 382 for July 2003	
Adjusted federal long-term rate for the current month	4.05%
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.)	4.45%

REV. RUL. 2003–71 TABLE 4	
Appropriate Percentages Under Section 42(b)(2) for July 2003	
Appropriate percentage for the 70% present value low-income housing credit	7.78%
Appropriate percentage for the 30% present value low-income housing credit	3.33%

REV. RUL. 2003–71 TABLE 5	
Rate Under Section 7520 for July 2003	
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	3.0%

REV. RUL. 2003–71 TABLE 6	
Blended Annual Rate for 2003	
Section 7872(e)(2) blended annual rate for 2003	1.52%

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2003. See Rev. Rul. 2003–71, page 1.

Section 1400L.—Tax Benefits for New York Liberty Zone

The Service clarifies the answers to six questions concerning tax-exempt qualified New York Liberty Bonds issued under section 1400L(d). See Notice 2003–40, page 10.

Section 4980B.—Failure to Satisfy Continuation Coverage Requirements of Group Health Plans

26 CFR 54.4980B–2: Plans that must comply. (Also section 7805; § 54.4980B–9.)

Small employer plan exception to the COBRA continuation coverage requirements in mergers and acquisitions. Guidance is provided on when a group health plan maintained by an employer that grows to have more than 20 employees through a stock or asset acquisition is required to begin complying with the COBRA continuation coverage requirements.

Rev. Rul. 2003–70

ISSUES

1. If, as a result of a transfer of stock, two previously separate employers are treated as a single employer for purposes of the COBRA continuation coverage requirements, how is the number of employees who were employed by the combined entity during the preceding calendar year determined for purposes of applying to the combined entity the exception from the

COBRA continuation coverage requirements for group health plans maintained by employers that normally employed fewer than 20 employees during the preceding calendar year (the small employer plan exception)?

2. If one employer acquires substantial assets (such as a plant or division or substantially all the assets of a trade or business) of another employer, when are the employees associated with the acquired assets taken into account for purposes of applying the small employer plan exception to the acquiring employer?

FACTS

Situation 1. Company *P* maintains a group health plan. *P* normally employed fewer than 20 employees during the previous calendar year. Under section 414(t) of the Internal Revenue Code, no other entity is treated as a single employer with *P*. During the current calendar year, stock in Corporation *O* is transferred so that after the transfer *P* and *O* are considered to be part of a single employer. The combined number of employees normally employed by *P* and *O* during the previous calendar year was at least 20.

Situation 2. Company *R* maintains a group health plan. *R* normally employed fewer than 20 employees during the previous calendar year. No other entity is considered to be part of a single employer with *R*. During the current calendar year, *R* acquires substantially all the assets of a business and continues the business operations associated with those assets without interruption or substantial change. The combined number of employees normally employed by *R* and the acquired business during the previous calendar year was at least 20.

LAW AND ANALYSIS

Section 4980B of the Code requires certain group health plans to make continuation coverage available to certain individuals who would otherwise lose their coverage under the plan as a result of certain occurrences (the "COBRA continuation coverage requirements"). Section 4980B imposes an excise tax if a plan subject to the COBRA continuation coverage requirements fails to comply with those requirements. Section 414(t) provides that all employees who are treated as employed by a single employer under section 414(b), (c), or (m) are treated as employed by a single employer for purposes of section 4980B and that the provisions of section 414(o) apply with respect to the requirements of section 4980B.

Section 4980B(d) of the Code and Q&A–4 of § 54.4980B–2 of the Miscellaneous Excise Tax Regulations provide that small-employer plans are excepted from COBRA. Q&A–5(a) of § 54.4980B–2 provides that, except in the case of a multiemployer plan, a small-employer plan is a plan maintained by an employer that normally employed fewer than 20 employees during the preceding calendar year. Under Q&A–5(b) of § 54.4980B–2, an employer is considered to have normally employed fewer than 20 employees during a particular calendar year if, and only if, it had fewer than 20 employees on at least 50 percent of its typical business days during that year. Under Q&A–4(c) of § 54.4980B–2, a small-employer plan otherwise excepted from COBRA is nonetheless subject to COBRA with respect to qualified beneficiaries who experience a qualifying event during a period when the plan is not a small-employer plan.

Q&A–1 of § 54.4980B–9 defines stock sale for purposes of § 54.4980B–9 as a transfer of stock in a corporation that causes the corporation to become a different employer or a member of a different employer. Under Q&A–2 of § 54.4980B–2, an employer is defined to include any person who is a member of a group described in section 414(b), (c), (m), or (o) that includes a person for whom services are performed.

Q&A–1 of § 54.4980B–9 defines asset sale for purposes of § 54.4980B–9 as a transfer of substantial assets, such as a plant or division or substantially all the assets of a trade or business. Q&A–2 of § 54.4980B–2 provides that the term employer includes a successor to a person for whom services are performed and cross-references the rules in Q&A–8(c) of § 54.4980B–9 for determining when a purchaser of assets is a successor employer to the employer selling the assets. Under Q&A–8(c) of § 54.4980B–9, a buyer of substantial assets is not considered a successor employer to the seller of the assets unless the buyer continues the business operations associated with the purchased assets without interruption or substantial change and the seller ceases to provide any group health plan to any employee in connection with the sale.

In *Situation 1*, as a result of the stock transfer, *P* and *O* are treated as a single employer for purposes of section 4980B. Accordingly, in applying the small employer plan exception of section 4980B(d) to a group health plan maintained by the combined entity following the stock transfer, employees of both *P* and *O* during the previous calendar year must be taken into account. Since *P* and *O* combined normally employed at least 20 employees during the previous calendar year, a group health plan maintained by the combined entity becomes subject to COBRA as of the date of the stock transfer.

In *Situation 2*, Company *R* acquires substantially all the assets of a business and continues the business operations associated with those assets without interruption or substantial change. *R* alone normally employed fewer than 20 employees during the previous calendar year, but together *R* and the acquired business normally employed at least 20 employees during the previous calendar year. However, the acquisition of assets by *R* does not cause *R* to be considered a single employer with any part of the seller of the assets. Thus, the group health plan maintained by *R* continues to be excepted from COBRA until, with the normal application of the rules for determining whether a plan is a small-employer plan, the January 1 following a year in which *R* normally employed at least 20 employees. If, however, under the rules of Q&A–8(c) in § 54.4980B–9, *R* is a successor employer to the seller of the assets, then the group health plan of *R* will have the obligation to make COBRA continuation coverage available to any M&A qualified beneficiaries of the seller in accordance with the rules of Q&A–4(c) in § 54.4980B–2, even though *R* is otherwise excepted from COBRA.

HOLDING

In *Situation 1*, a group health plan maintained by the combined entity ceases to be excepted from COBRA as a small-employer plan as of the date of the stock transfer. In *Situation 2*, a group health plan maintained by the acquiring company continues to be excepted from COBRA as a small-employer plan for at least the remainder of the year of the asset acquisition.

EFFECTIVE DATE

For purposes of the excise tax of section 4980B of the Code, this ruling is effective for stock sales and asset sales that take effect on or after July 7, 2003.

DRAFTING INFORMATION

The principal author of this revenue ruling is Russ Weinheimer of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Mr. Weinheimer at (202) 622–6080 (not a toll-free number).

Section 6081.—Extension of Time for Filing Returns

26 CFR 1.6081–8T: Automatic extension of time to file certain information returns (temporary).

T.D. 9061

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 31, and 602

Automatic Extension of Time to File Certain Information Returns and Exempt Organization Returns

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations providing an automatic extension of time to file certain information returns and exempt organization returns. The temporary regulations remove the requirement for a signature and an explanation to obtain an automatic extension of time to file these returns. The temporary regulations affect taxpayers who are required to file certain information returns and/or exempt organization returns and need an extension of time to file. The text of the temporary regulations also serves as a portion of the text of the proposed regulations set forth in the notice of proposed rulemaking (REG–107618–02) on page 13 of this issue of the Bulletin.

DATES: *Effective Date*: These regulations are effective on June 11, 2003.

Applicability Date: For dates of applicability for these regulations, see §§1.6081–8T, 1.6081–9T, and 31.6081(a)–1T(d).

FOR FURTHER INFORMATION CONTACT: Charles A. Hall, (202) 622–4940 (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 OMB control number 1545–1840. Responses to this collection of information are required by the IRS for taxpayers to obtain a benefit (an automatic extension of time to file certain information or exempt organization returns).

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.

For further information concerning this collection of information, and 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 and 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

This document contains amendments to 26 CFR parts 1, 31, and 602 under section 6081 of the Internal Revenue Code. Section 6081(a) provides that the Secretary may grant a reasonable extension of time for filing any return, declaration, statement, or other document required by Title 26 or by regulations. Except in the case of taxpayers who are abroad, no such extension shall be for more than 6 months. The regulations under section 6081 provide specific rules taxpayers must follow to request an extension of time to file federal tax returns.

Under the generally applicable rule, a taxpayer must submit an application for the extension on or before the due date of the return. The application must be in writing, must be properly signed by the taxpayer or his duly authorized agent, and must clearly set forth the particular tax return for which the extension of the time for filing is desired and a full recital of the reasons for requesting the extension. These rules apply to all returns other than those for which the regulations provide special rules. In addition, the Employment Tax Regulations provide rules for employers to obtain an extension of time to file the Social Security Administration copy of Forms W–2 and W–3. Under those rules, the request must contain a concise statement of the reasons for requesting the extension.

Explanation of Provisions

Information Returns

Filers and transmitters of information returns on Form 1099 (series), 1098 (series), 5498 (series), W–2 (series), W–2G, 1042–S, and 8027 can obtain an extension of time to file these information returns by submitting a signed paper Form 8809, *"Request for Extension of Time to File Information Returns."* The extensions are most often for a period of 30 days. Filers and transmitters may thereafter request an additional 30-day extension. The extensions apply only to the filing with the government. The filer or transmitter is still required to provide statements to the recipients by the date specified in the Code or the regulations.

Currently, in compliance with the regulations, Form 8809 requires a signature and asks for an explanation of the reasons for the request for an extension. In current practice, however, the explanation is not a determining factor for the initial extension. If the filer supplies the name, address, Employer Identification Number, tax year, and type of form(s), the initial extension is routinely granted. An extension beyond the initial 30-day period will not be granted, however, unless the filer provides a detailed explanation.

These temporary regulations allow filers and transmitters to request an automatic 30-day extension of time to file without having to sign Form 8809 and provide an explanation. An explanation and a signature are required if filers and transmitters need additional time to file after receiving the automatic 30-day extension. These regulations also permit employers to obtain an extension of time to file the Social Security Administration copy of Forms W–2 and W–3 without providing a statement of the reasons for requesting the extension.

The new rules will allow the IRS to develop an effective online version of the extension request. Filers and transmitters will benefit from the simplified extension procedure that will provide immediate approval. The IRS will benefit from the efficiencies inherent in such a system and will move closer to achieving electronic filing goals.

Filers and transmitters are eligible for only one automatic extension of time to file. Filers and transmitters filing Forms W–2 on an expedited basis under section 31.6071(a)–1(a)(3)(ii) may receive an automatic extension of time to file Forms W–2 under Rev. Proc. 96–57, 1996–2 C.B. 389. These filers and transmitters are not eligible to obtain the 30-day automatic extension under §1.6081–8T(b). If these filers and transmitters need additional time, they may request an extension under the generally applicable procedures for obtaining additional extensions of time to file Form W–2.

Exempt Organization Returns

These temporary regulations also allow an exempt organization required to file a return on Form 990 (series), 1041–A, 4720, 5227, 6069, or 8870 an automatic three-month extension of time to file if (a) an application is submitted on Form 8868, *"Application for Extension of Time To File an Exempt Organization Return,"* (b) the application is filed on or before the date the return is due, (c) the application shows the full amount properly estimated as tax, and (d) the application is accompanied by full remittance of the amount properly estimated as tax that is unpaid as of the date prescribed for the filing of the return.

A signature and an explanation of the reasons for requesting the extension are not required for an exempt organization to receive the automatic three-month extension of time to file. If an exempt organization needs additional time to file a return after receiving the automatic three-month extension, the exempt organization may file a signed Form 8868 that explains in detail why the additional time is needed. The IRS may grant an additional three months for the exempt organization to file.

Deadwood Provisions

These regulations also remove §1.6081–1T and §§31.6011(a)–5(b)(1) and 31.6081(a)–1(a)(2). Section 1.6081–1T is removed because it relates only to returns for tax years ending before February 1, 1985. Sections 31.6011(a)–5(b)(1) and 31.6081(a)–1(a)(2) are removed because they relate to information returns that are no longer required.

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to the 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 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 the regulations is Charles A. Hall of the Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division).

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Amendments to the Regulations

Accordingly, 26 CFR parts 1, 31, and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.6081–8T also issued under 26 U.S.C. 6081.

Section 1.6081–9T also issued under 26 U.S.C. 6081. * * *

§1.6081–1T [Removed]

Par. 2. Section 1.6081–1T is removed.

Par. 3. Section 1.6081–8T is added to read as follows:

§1.6081–8T Automatic extension of time to file certain information returns (temporary).

(a) *In general*. A person required to file an information return (the filer) on Form W–2 series, W–2G, 1042–S, 1098 series, 1099 series, 5498 series, or 8027 will be allowed an automatic 30-day extension of time to file the return after the date prescribed for filing the return if the filer or the person transmitting the return for the filer (the transmitter) files an application in accordance with paragraph (b) of this section.

(b) *Requirements*. To satisfy this paragraph (b), an application must—

(1) Be submitted on Form 8809, *"Request for Extension of Time To File Information Returns,"* or in any other manner as may be prescribed by the Commissioner; and

(2) Be filed with the Internal Revenue Service office designated in the application's instructions on or before the date prescribed for filing the information return.

(c) *Penalties*. See sections 6652, 6693, 6721, 6722, and 6723 for failure to file an information return.

(d) *Additional 30-day extension of time to file*—(1) *In general*. This paragraph (d) provides procedures for obtaining an additional extension of time for filing an information return on a form listed in paragraph (a) of this section. No extension of time will be granted under this paragraph (d) unless the filer or transmitter has first obtained an automatic extension.

(2) *Procedures*. In the case of an information return on a form listed in paragraph (a) of this section, one additional 30-day extension of time to file the return may be allowed if the filer or transmitter submits a request for the additional extension before the expiration of the automatic 30-day extension. The request must—

(i) Be submitted on Form 8809 or in any other manner as may be prescribed by the Commissioner;

(ii) Explain in detail why the additional time is needed;

(iii) Be signed by the filer or transmitter; and

(iv) Otherwise satisfy the requirements of §1.6081–1.

(e) *No effect on time to provide statement to recipients*. An extension under this section of time to file an information return does not extend the due date for providing a statement to the person with respect to whom the information is required to be reported.

(f) *Effective date*. This section applies to requests for extension of time to file information returns due after June 11, 2003. The applicability of this section expires on June 10, 2006.

Par. 4. Section 1.6081–9T is added to read as follows:

§1.6081–9T Automatic extension of time to file exempt organization returns (temporary).

(a) *In general*. An exempt organization required to file a return on Form 990 (series), 1041–A, 4720, 5227, 6069, or 8870 will be allowed an automatic three-month extension of time to file the return after the date prescribed for filing if the exempt organization files an application in accordance with paragraph (b) of this section. For guidance on extensions of time for an exempt organization to file Form 1120–POL, *U.S. Income Tax Return for Certain Political Organizations*, see §1.6081–3.

(b) *Requirements*. To satisfy this paragraph (b), an application for an automatic extension under this section must—

(1) Be submitted on Form 8868, *"Application for Extension of Time To File an Exempt Organization Return,"* or in any other manner as may be prescribed by the Commissioner;

(2) Be filed with the Internal Revenue Service office designated in the application's instructions on or before the date prescribed for filing the information return;

(3) Show the full amount properly estimated as tentative tax for the exempt organization for the taxable year; and

(4) Be accompanied by the full remittance of the amount properly estimated as tentative tax which is unpaid as of the date prescribed for the filing of the return.

(c) *Termination of automatic extension*. The Commissioner may terminate an automatic extension at any time by mailing to the exempt organization a notice of termination. The notice must be mailed at least 10 days prior to the termination date designated in such notice. The notice of termination must be mailed to the address shown on the application for extension or to the exempt organization's last known address. For further guidance regarding the definition of last known address, see §301.6212–2 of this chapter.

(d) *Penalties*. See sections 6651 and 6652(c) for failure to file an exempt organization return or failure to pay the amount shown as tax on the return.

(e) *Coordination with §1.6081–1*. No extension of time will be granted under §1.6081–1 for filing an exempt organization return listed in paragraph (a) of this section until an automatic extension has been allowed pursuant to this section.

(f) *Effective date*. This section applies to requests for extensions of time to file an exempt organization return due after June 11, 2003. The applicability of this section expires on June 10, 2006.

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 5. The authority citation for part 31 continues to read as follows:

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

Section 31.6081(a)–1T also issued under 26 U.S.C. 6081.* * *

Par. 6. Section 31.6011(a)–5 is amended by revising paragraph (b) to read as follows:

§31.6011(a)–5 Monthly returns.

* * * * *

(b) *Information returns on Form W–3 and Social Security Administration copies of Form W–2.* See §31.6051–2 for requirements with respect to information returns on Form W–3 and Social Security Administration copies of Form W–2.

* * * * *

§31.6051–1 [Amended]

Par. 7. Section 31.6051–1(d)(2)(i)(*c*) is amended by removing the language "§31.6081(a)–1(a)(3)" and adding "§31.6081(a)–1(a)(2)" in its place.

§31.6051–2 [Amended]

Par. 8. Section 31.6051–2(c) is amended by removing the language "31.6081(a)–1(a)(3)" and adding "31.6081(a)–1(a)(2)" in its place.

Par. 9. Section 31.6081(a)–1 is amended by:

1. Removing paragraph (a)(2).

2. Redesignating paragraph (a)(3) as paragraph (a)(2).

3. Revising newly designated paragraph (a)(2)(i).

The revision reads as follows:

§31.6081(a)–1 Extensions of time for filing returns and other documents.

(a) * * *

(2) * * * (i) [Reserved]. For guidance on extensions of time to file the Social Security Administration copy of Forms W–2 and W–3 due after June 11, 2003, see §31.6081(a)–1T.

* * * * *

Par. 10. Section 31.6081(a)–1T is added to read as follows:

§31.6081(a)–1T Extensions of time for filing returns and other documents (temporary).

(a)(1) [Reserved]. For further guidance, see §31.6081(a)–1(a)(1).

(2) *Information returns of employers on Forms W–2 and W–3*—(i) *In general*. The Commissioner may grant an extension of time in which to file the Social Security Administration copy of Forms W–2 and the accompanying transmittal form which constitutes an information return under paragraph §31.6051–2(a). For further guidance regarding extensions of time to file the Social Security Administration copy of Forms W–2 and W–3, see §1.6081–8T of this chapter.

(a)(2)(ii) through (c) [Reserved]. For further guidance, see §31.6081(a)–1(a)(2)(ii) through (c).

(d) *Effective date*. This section applies to requests for extensions of time to file the Social Security Administration copy of Forms W–2 and W–3 due after June 11, 2003. The applicability of this section expires on June 10, 2006.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 12. 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.
* * * * *	
1.6081–8T	1545–1840
1.6081–9T	1545–1840
* * * * *	

David A. Mader,
Assistant Deputy Commissioner of Internal Revenue.

Approved May 21, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 10, 2003, 8:45 a.m., and published in the issue of the Federal Register for June 11, 2003, 68 F.R. 34797)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2003. See Rev. Rul. 2003–71, page 1.

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 July 2003. See Rev. Rul. 2003–71, page 1.

Part III. Administrative, Procedural, and Miscellaneous

Compliance Initiative for Nonresident Aliens and Foreign Corporations

Notice 2003–38

The Internal Revenue Service (IRS) announces a compliance initiative for nonresident aliens and foreign corporations that have not filed U.S. federal income tax returns and that may consequently be denied deductions and credits pursuant to Code section 874(a) or 882(c)(2). Taxpayers that have requests for waivers pending with the IRS under Regs. 1.874–1(b)(2) or 1.882–4(a)(3)(ii) may also participate in this compliance initiative.

This compliance initiative is intended to encourage nonresident aliens and foreign corporations to file income tax returns that were not filed in a timely manner in accordance with the regulations under section 874(a) or 882(c)(2). The IRS will waive the filing deadlines set forth in Regs. 1.874–1(b)(1) and 1.882–4(a)(3)(i) if a taxpayer files on or before September 15, 2003, all required U.S. federal income tax returns for every year for which a waiver is requested. In addition, a taxpayer must pay the reported income tax liability with each such return, must pay statutory interest and penalties as determined by the IRS (except the fraudulent failure to file penalty, as discussed below), and must cooperate with the IRS upon request in determining and satisfying its income tax liability for any taxable year for which a waiver is requested. To qualify for a waiver, a taxpayer must attach a statement to each late income tax return for which a waiver is requested agreeing to cooperate with the IRS upon request in determining and satisfying the taxpayer's income tax liability for that taxable year. The requirements of this compliance initiative may not be satisfied by filing protective returns.

This compliance initiative is not available where the taxpayer has previously filed a U.S. federal income tax return or a protective return for any taxable year prior to a taxable year for which a waiver is requested, or where the IRS has contacted the taxpayer concerning a failure to file U.S. federal income tax returns, initiated an examination or investigation of the taxpayer, or notified the taxpayer that it intends to commence an examination or investigation.

SCOPE OF THE WAIVER

Under this compliance initiative, the IRS will waive the filing deadlines set forth in Regs. 1.874–1(b)(1) and 1.882–4(a)(3)(i) with respect to late-filed U.S. federal income tax returns. With respect to U.S. federal income tax returns filed pursuant to this compliance initiative, the IRS will also waive the fraudulent failure to file penalty under section 6651(f), but not the failure to file penalty under section 6651(a)(1). The IRS will impose other applicable penalties, as appropriate, with respect to U.S. federal income tax returns filed pursuant to this compliance initiative.

If a taxpayer that is eligible under this notice to participate in this compliance initiative files all required U.S. federal income tax returns for taxable years ending in 1996 and all subsequent years for which the applicable deadline set forth in Regs. 1.874–1(b)(1) or 1.882–4(a)(3)(i) has passed, and satisfies all other requirements set forth in this notice, the IRS will not examine any potential U.S. federal income tax liability with respect to taxable years ending prior to 1996. However, effect will be given to a carryover item of deduction or credit only if all required U.S. federal income tax returns are filed on or before September 15, 2003, for the year in which the item arose and for all years through the year in which the item has effect, and the taxpayer cooperates with the IRS upon request in verifying the carryover item of deduction or credit. Protective returns will not satisfy the requirements of this or the preceding paragraph.

SUBMISSION PROCESS

The IRS will waive the timely filing requirement under Regs. 1.874–1(b)(1) and 1.882–4(a)(3)(i) for any taxable year for which a waiver is requested, provided that the nonresident alien or foreign corporation:

(1) files a true and accurate return for such taxable year, not including a protective return, with the Philadelphia Service Center on or before September 15, 2003;

(2) pays the reported tax liability with the filing of the return;

(3) pays statutory interest under section 6601 and penalties as determined by the IRS;

(4) agrees in a statement attached to the return to cooperate with the IRS upon request in determining and satisfying the taxpayer's liability for income tax, interest and penalties, for the taxable year for which a waiver is requested, and does in fact cooperate in accordance with such agreement, and satisfy any liability determined; and

(5) attaches to the return a copy of any power of attorney (Forms 2848) granted by the taxpayer with respect to such taxable year.

Income tax returns that were not timely filed pursuant to Regs. 1.874–1(b)(1) and 1.882–4(a)(3)(i) must be filed with the Philadelphia Service Center via the United States Postal Service to P.O. Box 480, Bensalem, PA 19020; or by private delivery service to 11601 Roosevelt Blvd., Philadelphia, PA 19154.

Each late return filed under this notice must be marked at the top, in red, "RETURN FILED UNDER NOTICE 2003–38."

MISCELLANEOUS

The provisions of this notice relate to qualification for and participation in a compliance initiative with respect to late U.S. federal income tax returns filed on or before September 15, 2003, for prior taxable years by taxpayers subject to section 874(a) or 882(c)(2).

The IRS is committed to assisting all taxpayers to file their required U.S. federal income tax returns. Taxpayers that do not file pursuant to this compliance initiative are not prevented from demonstrating that they satisfy the reasonable cause exception under Regs. 1.874–1(b)(2) or 1.882–4(a)(3)(ii).

PAPERWORK REDUCTION ACT

The collection of information contained in this announcement 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 1545–1845. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collec-

tion of information displays a valid OMB control number. The collection of information in this announcement is in the section titled **SUBMISSION PROCESS**.

This information is required to determine whether a taxpayer is entitled to a waiver under this compliance initiative. The collection of information is required to obtain the benefit described in this notice. The likely respondents are individuals, and businesses or other for-profit organizations.

The estimated total annual reporting burden is 50 hours. The estimated annual burden per respondent is 15 minutes. The number of respondents is uncertain but is estimated at 200. The estimated frequency of responses is one time per respondent. 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.

CONTACT INFORMATION

For further information regarding this notice, contact Jim Carfine at (202) 435–5044 (not a toll-free call).

Charitable Lead Trusts

Notice 2003–39

SECTION 1. PURPOSE

This notice requests suggestions from the public regarding the creation of sample forms for charitable lead trusts.

SECTION 2. BACKGROUND

When interests in the same property are transferred for both charitable and noncharitable purposes, the charitable interest will qualify for the applicable income, gift, and estate tax charitable deductions only if the interest is in a certain prescribed form. If the charitable interest is a lead interest, §§ 170, 2522, and 2055 of the Internal Revenue Code generally require that the charitable interest be in the form of a guaranteed annuity or unitrust interest.

A charitable lead trust is a trust that pays annually a specified annuity or unitrust amount to one or more charitable beneficiaries for a specified term of years or for the life of a named individual or lives of certain named individuals. Upon termination of the annuity or unitrust period, the remainder interest passes to, or for the benefit of, one or more noncharitable beneficiaries.

The Internal Revenue Service has not previously issued sample forms for charitable lead trusts.

SECTION 3. REQUEST FOR PUBLIC COMMENT

The Internal Revenue Service intends to publish sample forms that reflect the statutory and regulatory provisions applicable to charitable lead trusts. The Service requests comments regarding the charitable lead trust sample forms, including comments on the type of format to be used, the substantive provisions to be included, and the various types of charitable lead trusts for which samples would be most helpful.

Taxpayers may submit comments in writing to:

Internal Revenue Service
Attn: CC:PSI:RU (Notice 2003–39)
P.O. Box 7604
Room 5226
Ben Franklin Station
Washington, DC 20044

or have them hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:PSI:RU (Notice 2003–39, Room 5226)
1111 Constitution Ave., NW
Washington, DC 20224

Alternatively, taxpayers may submit comments electronically to the following address: *Notice.Comments@irscounsel.treas.gov*. Please include "Notice 2003–39" in the subject line. Comments and suggestions should be received by October 1, 2003. All comments and suggestions submitted will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Stephanie N. Bland of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Stephanie N. Bland at (202) 622–7830 (not a toll-free call).

Qualified New York Liberty Bond Questions and Answers

Notice 2003–40

PURPOSE

This notice provides guidance concerning qualified New York Liberty Bonds ("Liberty Bonds").

BACKGROUND

Section 301 of the Job Creation and Worker Assistance Act of 2002, Pub.L. No.107–147, created section 1400L of the Internal Revenue Code of 1986, which provides various tax benefits for the area of New York City damaged or affected by the terrorist attack on September 11, 2001. Section 1400L(d) authorizes the issuance of $8 billion of Liberty Bonds, a new type of tax-exempt private activity bond. On July 8, 2002, the Internal Revenue Service issued Notice 2002–42, 2002–27 I.R.B. 36, which provides guidance regarding section 1400L, including section 1400L(d). This notice provides additional guidance with respect to Liberty Bonds.

OVERVIEW OF THE PROVISION

Under section 1400L(d)(1), Liberty Bonds are treated as exempt facility bonds within the meaning of section 142. Section 1400L(d)(2) provides that a Liberty Bond is any bond issued as part of an issue if: (a) 95 percent or more of the net proceeds (as defined in section 150(a)(3)) of the issue are to be used for qualified project costs; (b) the bond is issued by the State of New York or any political subdivision thereof; (c) the Governor of the State of New York or the Mayor of The City of New York designates the bond for purposes of section 1400L(d); and (d) the bond is issued after March 9, 2002, and before January 1, 2005. The maximum aggregate face amount of bonds that may be designated as Liberty Bonds is $8 billion.

Section 1400L(d)(4) defines the term qualified project costs as the cost of acquisition, construction, reconstruction, and renovation of: (a) nonresidential real property and residential rental property (including fixed tenant improvements associated with the property) located in the New York Liberty Zone (as defined in section 1400L(h)), and (b) public utility property (as defined in section 168(i)(10)) located in

the New York Liberty Zone. Qualified project costs also include the cost of acquisition, construction, reconstruction, and renovation of nonresidential real property (including fixed tenant improvements associated with the property) located outside the New York Liberty Zone but within The City of New York, New York, if the property is part of a project that consists of at least 100,000 square feet of usable office or other commercial space located in a single building or multiple adjacent buildings. Liberty Bonds may not be used to finance movable fixtures or equipment.

Section 1400L(d)(5) contains the following modifications to the general rule that Liberty Bonds are treated as exempt facility bonds: (1) Liberty Bonds are not subject to the private activity bond volume cap under section 146; (2) the 15-percent rehabilitation requirement in section 147(d) that applies to the acquisition of certain existing property is increased to 50-percent for Liberty Bonds; (3) Liberty Bonds are eligible for the two-year construction exception to the rebate requirement under section 148(f)(4)(C); (4) repayments of principal on financing provided by Liberty Bonds are subject to certain special rules; and (5) section 57(a)(5), which treats interest on specified private activity bonds as an item of tax preference for purposes of computing the alternative minimum tax, does not apply to Liberty Bonds.

QUESTIONS AND ANSWERS

Set forth below are questions and answers with regard to section 1400L(d).

Q–1. What types of costs are qualified project costs under section 1400L(d)(4)?

A–1. Section 1400L(d)(1) provides that Liberty Bonds are treated as exempt facility bonds. Accordingly, qualified project costs are costs that (a) are chargeable to the capital account of a facility described in section 1400L(d)(4), or (b) would be so chargeable either with a proper election by a taxpayer (for example, under section 266) or but for a proper election by a taxpayer to deduct the costs. Qualified project costs also include costs of functionally related and subordinate property within the meaning of § 1.103–8(a)(3) of the Income Tax Regulations.

Q–2. Does § 1.142–4 apply to Liberty Bonds?

A–2. Yes. Section 1.142–4 applies to exempt facility bonds. Section 1.142–4 contains certain requirements that generally are designed to ensure that exempt facility bonds are not issued to finance working capital expenditures. For example, § 1.142–4(b) provides that, if an expenditure for a facility is paid before the issue date of the bonds to provide that facility, the facility is an exempt facility only if the expenditure meets the requirements of § 1.150–2 (relating to reimbursement allocations).

Q–3. How does § 1.150–2 apply to Liberty Bonds?

A–3. Section 1.150–2 applies to Liberty Bonds in the same manner as exempt facility bonds, except that all issuers of Liberty Bonds are treated as having adopted an official intent (as defined in § 1.150–2(c)) that satisfies the requirements of § 1.150–2(e) with respect to expenditures paid after September 11, 2001, and before June 23, 2003. For expenditures paid on or after June 23, 2003, any official intent must be adopted not later than 60 days after payment of the expenditures. *See* § 1.150–2(d)(1).

Q–4. Do Liberty Bonds issued before January 1, 2005, to currently refund outstanding Liberty Bonds count against the $8 billion volume limitation on Liberty Bonds?

A–4. Liberty Bonds issued before January 1, 2005, to currently refund outstanding Liberty Bonds do not count against the $8 billion volume limitation to the extent that the amount of the refunding bonds does not exceed the outstanding amount of the bonds being refunded.

Q–5. May Liberty Bonds be issued after December 31, 2004, to refund outstanding Liberty Bonds?

A–5. Liberty Bonds may be issued after December 31, 2004, to refund outstanding Liberty Bonds originally issued before January 1, 2005, to the extent (a) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds, and (b) the refunding is not an advance refunding.

Q–6. May Liberty Bonds be issued by entities that are acting on behalf of the State of New York or any political subdivision thereof?

A–6. Liberty Bonds may be issued on behalf of the State of New York or any political subdivision thereof if the issuance satisfies the requirements for determining whether a bond issued on behalf of a State or political subdivision constitutes an obligation of that State or political subdivision for purposes of section 103.

FURTHER INFORMATION

For further information regarding this notice, contact Michael P. Brewer at (202) 622–3980 (not a toll-free call).

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26 CFR 1.472–8: Dollar value method of pricing LIFO inventories.
(Also Part I, §§ 446; 1.446–1.)

Rev. Proc. 2003–45

SECTION 1. PURPOSE

For certain accounting method changes within the inventory price index computation (IPIC) method of accounting for last-in, first-out (LIFO) inventories, this revenue procedure waives the 5-year prior change scope limitation in section 4.02(6) of Rev. Proc. 2002–9, 2002–1 C.B. 327, as modified and clarified by Announcement 2002–17, 2002–1 C.B. 561, modified and amplified by Rev. Proc. 2002–19, 2002–1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002–54, 2002–35 I.R.B. 432.

SECTION 2. BACKGROUND

.01 The regulations under § 472 of the Internal Revenue Code provide special, elective pooling rules for LIFO inventory items accounted for under the IPIC method. *See* §§ 1.472–8(b)(4) (manufacturers and processors) and 1.472–8(c)(2) (wholesalers, retailers, jobbers and distributors) of the Income Tax Regulations. The special IPIC pooling rules provide two optional 5 percent rules for pooling miscellaneous items. Any change in pooling required or permitted as a result of one of these 5 percent rules is a change in method of accounting. The taxpayer must secure the consent of the Commissioner pursuant to § 446(e) and § 1.446–1(e) before combining or separating IPIC pools, and must combine or separate IPIC pools in accordance with the requirements of the applicable regulations. §§ 1.472–8(b)(4), 1.472–8(c)(2).

.02 A taxpayer using the IPIC method of accounting for a trade or business computes the inventory price index (IPI) for a pool using an appropriate price index for an appropriate month. § 1.472–8(e)(3)(iii)(B)(1). A taxpayer not using the

retail method may elect to use a representative appropriate month (representative month). The election to use a representative month is a method of accounting, and the month elected must be used for the taxable year of the election and all subsequent taxable years, unless the electing taxpayer obtains the Commissioner's consent under §§ 446(e) and 1.446–1(e) to change or revoke its election. § 1.472–8(e)(3)(iii)(B)(3).

.03 Rev. Proc. 2002–9 applies to a taxpayer requesting the Commissioner's consent to change to a method of accounting described in the APPENDIX of that revenue procedure. Rev. Proc. 2002–9, section 4.01. Changes in method of accounting to: (1) combine or separate IPIC pools as a result of the application of a 5 percent pooling rule described in § 1.472–8(b)(4) or 1.472–8(c)(2); and (2) change the representative month when the change in representative month is necessitated by a change in taxable year, are described in sections 10.07(1)(d) and 10.07(1)(f), respectively, of the APPENDIX of Rev. Proc. 2002–9.

.04 Rev. Proc. 2002–9 is the exclusive procedure for a taxpayer within its scope to obtain the consent of the Commissioner under §§ 446(e) and 1.446–1(e). Rev. Proc. 2002–9, section 4.01. Section 4.02 of Rev. Proc. 2002–9 sets forth certain scope limitations for the revenue procedure. The 5-year prior change scope limitation set forth in section 4.02(6) of Rev. Proc. 2002–9 provides that the automatic consent procedures of that revenue procedure may not be used if the taxpayer, within the last 5 taxable years (including the year of change) has made a change in the same method of accounting (with or without obtaining the Commissioner's consent) or has applied to change the same method of accounting without effecting the change.

SECTION 3. CHANGES RELATED TO 5 PERCENT RULES FOR IPIC POOLING

Every third year, taxpayers using the IPIC method for LIFO inventories are required to redetermine whether their IPIC pooling complies with the applicable 5 percent rules and to make any pooling changes that are necessary to achieve compliance. §§ 1.472–8(b)(4); 1.472–8(c)(2). As a result, taxpayers using the IPIC pooling method may be required to change their pooling as frequently as every three years. The Service believes that the 5-year prior change scope limitation in section 4.02(6) of Rev. Proc. 2002–9 should not apply to prevent taxpayers from using the automatic consent procedures of Rev. Proc. 2002–9 to obtain the consent of the Commissioner to make the periodic pooling changes required to comply with the 5 percent rules under §§ 1.472–8(b)(4) and 1.472–8(c)(2). Accordingly, the 5-year prior change scope limitation in section 4.02(6) does not apply to a change described in section 10.07(1)(d) of the APPENDIX of Rev. Proc. 2002–9.

SECTION 4. CHANGES OF REPRESENTATIVE MONTH FOR IPI CALCULATIONS

A taxpayer generally is required to change its representative month if the taxpayer changes its taxable year. A taxpayer may change its taxable year voluntarily or, in certain cases, may be required to change its taxable year under the Code or regulations. The Service believes that the 5-year prior change scope limitation in section 4.02(6) of Rev. Proc. 2002–9 should not apply to prevent taxpayers from using the automatic consent procedures of Rev. Proc. 2002–9 to obtain the consent of the Commissioner to change their representative month as necessitated by a change in taxable year. Accordingly, the 5-year prior change scope limitation in section 4.02(6) of Rev. Proc. 2002–9 does not apply to a change described in section 10.07(1)(f) of the APPENDIX of Rev. Proc. 2002–9 if the change in representative month is necessitated by a change in the taxpayer's taxable year.

SECTION 5. EFFECTIVE DATE

.01 Except as otherwise provided in section 5.02 of this revenue procedure, this revenue procedure is effective for taxable years ending on or after December 31, 2002.

.02 If a taxpayer filed an application or ruling request with the national office under Rev. Proc. 97–27, 1997–1 C.B. 680, modified and amplified by Rev. Proc. 2002–19, to make a change in method of accounting described in sections 3 or 4 of this revenue procedure for a year of change for which this revenue procedure is effective (see section 5.01 of this revenue procedure), and the application or ruling request is pending with the national office on June 18, 2003, the national office will process the application or ruling request under the procedures of Rev. Proc. 97–27, unless prior to the later of September 17, 2003, or the issuance of the letter ruling granting or denying consent to the change, the taxpayer notifies the national office that it wants to make the method change under Rev. Proc. 2002–9. If the taxpayer timely notifies the national office that it wants to make the method change under Rev. Proc. 2002–9, the national office may require the taxpayer to make any appropriate modifications to the application or ruling request to comply with the applicable provisions of this revenue procedure and Rev. Proc. 2002–9. The national office will notify the taxpayer if and when such adjustments are required. In addition, any user fee that was submitted with the application or ruling request will be returned to the taxpayer.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–9 is modified to include in section 10.07 of the APPENDIX thereof the scope limitation waivers provided in this revenue procedure.

DRAFTING INFORMATION

The principal author of this revenue procedure is Grant Anderson of the Office of the Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Anderson at (202) 622–4930 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

Automatic Extension of Time to File Certain Information Returns and Exempt Organization Returns

REG–107618–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9061) providing an automatic extension of time to file certain information returns and exempt organization returns. The text of those regulations also serves as the text of these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by September 9, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–107618–02), room 5226, 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:RU (REG–107618–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at: *www.irs.gov/regs.*

FOR FURTHER INFORMATION CONTACT: Concerning submissions, Treena Garret, (202) 622–7180; concerning the regulations, Charles A. Hall, (202) 622–4940 (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, W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by August 11, 2003. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, 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 services to provide information.

The collection of information in this proposed regulation is in §1.6081–8T and §1.6081–9T. This collection of information is required by the IRS for taxpayers to obtain a benefit (an automatic 30-day extension of time to file certain information returns and an automatic three-month extension of time to file exempt organization returns). The respondents are taxpayers required to file certain information returns or exempt organization returns.

Estimates of the reporting burden in §1.6081–8T of these proposed regulations are reflected in the burden estimates of Form 8809, *Request for Extension of Time to File Information Returns*.

Estimated total annual reporting burden for 2001 for Form 8809: 155,000 hours.

Estimated number of responses for 2001 Form 8809: 50,000.

Estimated average annual burden hours per response for 2001 Form 8809: 3 hours and 6 minutes.

Estimates of the reporting burden in §1.6081–9T of these proposed regulations are reflected in the burden estimates of Form 8868, *Application for Extension of Time To File an Exempt Organization Return*.

Estimated total annual reporting burden for 2001 for Form 8868: 1,373,335 hours.

Estimated number of responses for 2001 Form 8868: 248,932.

Estimated average annual burden hours per response for 2001 Form 8809: 5 hours and 31 minutes.

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 and Explanation of Provisions

Temporary regulations (T.D. 9061) on page 5 of this issue of the Bulletin amend 26 CFR parts 1 and 31. The temporary regulations provide that filers and transmitters of certain information returns may obtain an automatic 30-day extension of time to file. The temporary regulations also provide that exempt organizations may obtain an automatic three-month extension of time to file an exempt organization return. The text of those regulations also serves as the text of these regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations. In addition, these regulations also propose other minor changes to conform the regulations under section 6081 to current law and practice.

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 has also been determined that section 553(b) of the

Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to the 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 that the collection of information imposed by this regulation is not significant because the burden in these regulations is more than offset by the reduction of the burden in Forms 8809 and 8868. These regulations reduce the burden in those forms by removing the signature requirement and the requirement to provide an explanation of the need for the extension of time to file. 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 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 business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (preferably a signed original and 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 will be scheduled if requested in writing by any person that timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of the regulations is Charles A. Hall of the Office of the Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division).

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1, 25, 31, 53, 55, and 156 are proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.6081–8 also issued under 26 U.S.C. 6081(a).

Section 1.6081–9 also issued under 26 U.S.C. 6081(a). * * *

Par. 2. Section 1.6081–1 is amended by revising paragraph (a) to read as follows:

§1.6081–1 Extension of time for filing returns.

(a) *In general*. The Commissioner is authorized to grant a reasonable extension of time for filing any return, declaration, statement, or other document which relates to any tax imposed by subtitle A of the Code and which is required under the provisions of subtitle A or F of the Code or the regulations thereunder. However, other than in the case of taxpayers who are abroad, such extensions of time shall not be granted for more than 6 months, and the extension of time for filing the return of a DISC (as defined in section 992(a)), as specified in section 6072(b), shall not be granted. An extension of time for filing an income tax return shall not operate to extend the time for the payment of the tax or any installment thereof unless specified to the contrary in the extension. For rules relating to extensions of time for paying tax, see §1.6161–1.

* * * * *

Par. 3. Section 1.6081–8 is added to read as follows:

§1.6081–8 Automatic extension of time to file certain information returns.

[The text of proposed §1.6081–8 is the same as the text of §1.6081–8T published elsewhere in this issue of the Bulletin].

Par. 4. Section 1.6081–9 is added to read as follows:

§1.6081–9 Automatic extension of time to file exempt organization returns.

[The text of proposed §1.6081–9 is the same as the text of §1.6081–9T published elsewhere in this issue of the Bulletin].

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 5. The authority citation for part 25 continues to read in part as follows:

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

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 6. The authority citation for part 31 continues to read in part as follows:

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

Par. 7. In §31.6081(a)–1, paragraph (a)(2)(i) is revised to read as follows:

§31.6081(a)–1 Extensions of time for filing returns and other documents.

(a) * * *

(2) * * * (i) [The text of proposed §31.6081(a)–1(a)(2)(i) is the same as the text of §31.6081(a)–1T(a)(2)(i) published elsewhere in this issue of the Bulletin].

* * * * *

PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

Par. 8. The authority citation for part 53 continues to read as follows:

Authority: 26 U.S.C. 7805.

PART 55—EXCISE TAX ON REAL ESTATE INVESTMENT TRUSTS AND REGULATED INVESTMENT COMPANIES

Par. 9. The first sentence of the authority citation for part 55 is revised to read as follows:

Authority: 26 U.S.C. 6001, 6011, 6071, 6091, and 7805. * * *

PART 156—EXCISE TAX ON GREENMAIL

Par. 10. The authority citation for part 156 is revised to read as follows:

Authority: 26 U.S.C. 6001, 6011, 6061, 6071, 6091, 6161, and 7805.

Par. 11. 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 in its place:

Section	Remove	Add
1.6081–2(f), first sentence	district director, including the Assistant Commissioner (International), or the director of a service center	Commissioner
1.6081–3(d), first sentence	district director, including the Director of International Operations, or the director of a service center may, in his discretion,	Commissioner may
1.6081–4(c), first sentence	district director, including the Assistant Commissioner (International), or the director of a service center	Commissioner
1.6081–5(a)(1)	1.6031–1(e)(2)	1.6031(a)–1(e)(2)
1.6081–6(d), first sentence	district director, including the Assistant Commissioner (International), or the director of a service center	Commissioner
1.6081–7(d), first sentence	district director, including the Assistant Commissioner (International), or the director of a service center	Commissioner
25.6081–1, second sentence	district director or director of the service center	Commissioner
31.6081(a)–1(b), first sentence	district director or director of a service center	Commissioner
53.6081–1(a), first sentence	District directors and directors of service centers are	The Commissioner is
53.6081–1(b), first sentence	to the district director or director of the service center with whom the return is to be filed	in accordance with the instructions to the extension request form
55.6081–1, first sentence	District directors and directors of service centers are	The Commissioner is
156.6081–1(a), first sentence	District directors and directors of service centers are	The Commissioner is
156.6081–1(b), first sentence	to the district director or director of the service center with whom the return is to be filed	in accordance with the instructions to the extension request form

Judith B. Tomaso,
Acting Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on June 10, 2003, 8:45 a.m., and published in the issue of the Federal Register for June 11, 2003, 68 F.R. 34875)

Notice of Proposed Rulemaking; Withdrawal of Previous Rulemaking; and Notice of Public Hearing

Statutory Options

REG–122917–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; withdrawal of previous rulemaking; and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to statutory options. These proposed 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 proposed regulations provide guidance to assist these taxpayers in complying with the law in addition to clarifying rules regarding statutory options. This document also withdraws a previous notice of proposed rulemaking.

DATES: Written and electronically submitted comments and requests to speak, with outlines of topics to be discussed at the public hearing scheduled for September 2, 2003, must be received by August 12, 2003.

ADDRESSES: Send submissions to CC:PA:RU (REG–122917–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:RU (REG–122917–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically, via the IRS Internet site *www.irs.gov/regs*. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Erinn Madden at (202) 622–6030 (not a toll-free number). To be placed on the attendance list for the hearing, please contact Guy Traynor at (202) 622–7180.

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, W:CAR:MP:T:T:SP; Washington, DC 20224. Comments on the collection of information should be received by August 8, 2003. 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 collection of information in this proposed regulation is in 1.6039–1. Section 6039 of the Code requires all corporations that transfer stock to any person pursuant to the exercise of a statutory option to furnish that person with a written statement describing the transfer. Additionally, the corporation may be required to furnish the person a second written statement when the stock originally transferred pursuant to the exercise of the statutory option is subsequently disposed of by the person. The information on the statements required to be provided by the corporation will be used by recipients to complete their income tax returns in the year of the disposition of the statutory option stock. The likely respondents are for-profit corporations.

Estimated total annual reporting burden: 16,650 hours.

Estimated average annual burden hours per respondent; 20 minutes.

Estimated number of respondents: 50,000.

Estimated annual 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

This document contains proposed 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 1989, 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. 3581), sections 11801 and 11821 of the Omnibus Budget Reconciliation Act of 1989 (OBRA 89), Public Law 101–508 (104 Stat. 1388), 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 104–188 (110 Stat. 1755). Changes concerning section 422 were made by section 251 of the Economic Recovery Tax Act of 1981 (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, section 321(a) of Tax Reform Act of 1986 (96 Stat. 2365), Public Law 99–514 (100 Stat. 2807), section 1003(d) of TAMRA, and sections 11801 and 11821 of OBRA 89, 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 18, 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 23, 1966 (T.D. 6887, 1966–2 C.B. 129), July 24, 1978 (T.D. 7554, 1978–2 C.B. 83), 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, 1999–2 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 (EE–86–88 (LR–279–81, 1984–1 C.B. 715)) on February 7, 1984 (the 1984 proposed regulations). With the exception of certain stockholder approval rules that were published in the **Federal Register** on June 23, 1966 (T.D. 6887) and amended by T.D. 7728 on October 31, 1980, the 1984 proposed regulations provided a comprehensive set of rules under section 422 of the Code. The 1984 proposed regulations are withdrawn.

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 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.

Explanation of Provisions

Overview

These proposed regulations would provide a set of comprehensive rules governing incentive stock options. These proposed regulations incorporate many of the rules contained in the 1984 proposed regulations, although these proposed regulations are re-numbered and re-organized. These proposed regulations would 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

The proposed regulations under section 421 would remove obsolete provisions and update the cross-references to reflect amendments to the applicable statutes and re-organization of the regulations. These proposed regulations also incorporate many provisions of the 1984 proposed regulations. There are two sections of these proposed regulations under section 421: §1.421–1, which would provide rules concerning the meaning and use of terms, and §1.421–2, which would provide general rules regarding the application of section 421.

The terms defined in §1.421–1 of these proposed regulations are the same as those previously defined in §1.421–7, but these proposed regulations make changes to the definitions of certain terms. For example, §1.421–1(a) of these proposed regulations expands the definition of *option* to include warrants.

These proposed regulations would provide that an option must be evidenced in paper or in an electronic form. Under either form, however, the option must be enforceable under applicable law. Similarly, these proposed regulations provide that the plan pursuant to which incentive stock options are granted must be in paper or electronic form, provided that the paper or electronic form establishes an enforceable plan.

In addition, as with any taxpayer record, the form used for the option or plan, whether paper or electronic, must be one that provides adequate substantiation of the applicability of section 421. Thus, for example, the form must be one that provides adequate substantiation of the applicable requirements, such as the date on which the option is granted, the number of shares subject to the option, and the option price. In addition, the taxpayer must retain records relating to the option that are sufficient to comply with section 6001 and the regulations thereunder. If these records are kept electronically, the records must meet the requirements of Rev. Proc. 97–22, 1997–1 C.B. 652, or subsequent guidance, and if the records are kept in an ADP system, the records must meet the requirements of Rev. Proc. 98–25, 1998–11 I.R.B. 7, or subsequent guidance.

The definition of *statutory option* in §1.421–1(b) of these proposed regulations is revised to provide that a statutory option may include an option transferred to a trust if, under section 671 and applicable state law, the individual to whom the option was granted remains the beneficial owner. In contrast, these proposed regulations provide that a transfer of a statutory option incident to divorce will result in the option failing to qualify as a statutory option as of the date of transfer.

Section 1.421–1(i) of these proposed regulations defines *corporation* to have the same meaning prescribed by section 7701(a)(3) and §301.7701–2(b). Thus, for example, a *corporation* includes an S Corporation, a foreign corporation, and a limited liability corporation that is treated as a corporation for all federal tax purposes. In addition, section 1.421–1(d) of these proposed regulations provides that *stock* includes ownership interests other than capital stock. Thus, under these proposed regulations, it would be permissible for any entity that is classified as a corporation for federal tax purposes pursuant to the provisions of §301.7701–2(b) to grant statutory stock options with respect to ownership interests in that entity.

Section 1.421–2 of these proposed regulations incorporates both the provisions of §1.421–8 and many of the related provisions of the 1984 proposed regulations. These proposed regulations also provide further revisions, including specifying that the deduction in connection with a disqualifying disposition is allowed only if other-

wise allowable under sections 83(h) and 162 and if the reporting requirements under §1.83–6(a) are met.

Section 422: Incentive Stock Options

The proposed regulations under section 422 would provide a new set of comprehensive rules, with the exception of the rules regarding stockholder approval described in §1.422–5 of the final regulations (re-numbered as §1.422–3 by these proposed regulations). There are four sections under these proposed regulations: §1.422–1, general rules; §1.422–2, definition of incentive stock option; §1.422–4, the $100,000 limitation; and §1.422–5, permissible provisions.

1. Special rules regarding disqualifying dispositions

The 1984 proposed regulations provided rules concerning the consequences of disqualifying dispositions. The general disqualifying disposition rules for incentive stock options are provided in §§1.421–2(b)(1) and 1.422–1(b)(1) of these proposed regulations. In addition, §1.422–1(b)(2) of these proposed regulations clarifies the operation of the special rules applicable to a disqualifying disposition of an incentive stock option under section 422(c)(2) (section 422A(c)(2), prior to amendment by OBRA 89).

The general rules concerning disqualifying dispositions are described in §1.421–2(b) of these proposed regulations. Under these rules, if there is a disqualifying disposition of a share of stock, the special tax treatment provided by section 421 and §1.421–2(a) does not apply to the transfer of the share. Instead, the exercise of the option is treated as the exercise of a nonstatutory option under §1.83–7. 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 on the date the stock is transferred less the exercise price (determined without reduction for any brokerage fees or other costs paid in connection with the disposition). A deduction attributable to the transfer of the share of stock pursuant to the exercise of the option 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, if otherwise allowable under sections 83(h) and 162 and if the requirements of §1.83–6(a) are met.

Section 422(c)(2), however, provides a special rule that is applicable if an individual makes a disqualifying disposition of stock acquired through the exercise of an incentive stock option and if the disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized by the individual. Under this special rule, the amount includible in gross income on the disqualifying disposition, and the amount deductible, as compensation attributable to the exercise of the option, shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of the share. Under section 422(c)(2), this special rule is not applicable if the disposition is a sale or exchange with respect to which a loss (if sustained) would not be recognized by the individual. Section 1.422A–1(b)(2) of the 1984 proposed regulations described these special rules concerning the disqualifying disposition of an incentive stock option and this description is incorporated into §1.422–1(b)(2) of these proposed regulations.

For example, if the disposition is a sale described in section 1091 (relating to a loss from wash sales of stock or securities), a gift, or a sale described in section 267(a)(1) (relating to sales between related parties), any loss sustained would not be recognized. Because a loss in any of these transactions would not be recognized, under §1.422–1(b)(2)(ii) of these proposed regulations, the special rule provided in §1.422–1(b)(2)(i) of these proposed regulations does not apply. Instead, the general rules for disqualifying dispositions described in §1.421–2(b) of these proposed regulations apply.

For example, assume E, an employee of Corporation X, is granted an incentive stock option to acquire X stock. The option price on the date of grant is $100 (the fair market value of X stock on the date of grant). E exercises the option and is transferred X stock when the fair market value of the stock is $200. E later sells the stock for $150 to M before the applicable holding periods expire. Because the sale is a disqualifying disposition that meets the requirements of §1.422–1(b)(2)(i) of these proposed regulations, in the taxable year of the disqualifying disposition, E is only required to include $50 (the excess of the amount realized on the sale, $150, over the adjusted basis of the share, $100) in gross income as compensation attributable to the exercise of the option. For its taxable year in which the disqualifying disposition occurs, X is allowed a compensation deduction of $50 attributable to E's exercise of the option, if otherwise allowable under sections 83(h) and 162 and if the requirements of §1.83–6(a) are met.

In this example, however, if 10 days after the sale to M, E purchases substantially identical stock, under section 1091, a loss would not be recognized on the sale to M. Thus, under §1.422–1(b)(2)(ii) of these proposed regulations, the special rule in §1.422–1(b)(2)(i) does not apply. Instead of including $50 in gross income in the taxable year of the disqualifying disposition, E must include $100 (the difference between the fair market value of X stock on the date of transfer, $200, and the exercise price, $100) in gross income as compensation attributable to the exercise of the option. In the taxable year in which the disqualifying disposition occurs, X is allowed a compensation deduction of $100 attributable to E's exercise of the option if otherwise allowable under sections 83(h) and 162 and if the requirements of §1.83–6(a) are met.

Since the 1984 proposed regulations were issued, there have been no changes in section 422(c)(2) (other than the redesignation of section 422A(c)(2) as 422(c)(2) by OBRA 89), and these proposed regulations do not make any substantive changes to the 1984 proposed regulations.

2. Stockholder approval of incentive stock option plan

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). These proposed regulations would provide the same basic requirements for stockholder approval as those included in the 1984 proposed regulations.

These proposed regulations, however, would provide additional guidance concerning the circumstances in which stockholder approval is required. As under the 1984 proposed regulations, stockholder approval is required if there is a change in the aggregate number of shares or in the em-

ployees (or class or classes of employees) eligible to be granted options under the plan. In addition, while the standard for determining when stockholder approval is required is the same as under the 1984 proposed regulations, these proposed regulations clarify these requirements and provide a more complete list of situations that require new stockholder approval of the plan by specifically including a change in the shares with respect to which options are issued or a change in the granting corporation. Thus, for example, assume that S, a subsidiary of P, adopts an incentive stock option plan under which incentive stock options for S stock will be granted to S employees, and the plan is approved by the stockholders of S (in this case, P) within the applicable 24-month period. If S later amends the plan to provide for the grant of incentive stock options to acquire P stock (rather than S stock), S must obtain approval from the stockholders of S within 12 months before or after the date of the amendment to the plan because the amendment of the plan to allow the grant of options for P stock is considered the adoption of a new plan.

These proposed regulations also would provide additional guidance regarding the application of the stockholder approval requirements in the context of the substitution or assumption of an option by reason of a corporate transaction. For a discussion of these rules, see the "Substitution, assumption, and modification of options" portion of the preamble.

3. $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 any individual during the calendar year (under all of 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.

The 1984 proposed regulations provided no rules concerning the operation of the $100,000 limitation because these provisions were enacted in 1986. However, Notice 87–49, 1987–2 C.B. 355, provides general guidance about the operation of the $100,000 limitation, including examples illustrating the application of this limitation.

Section 1.422–4 of these proposed regulations provides guidance on the operation of the $100,000 limitation that incorporates and expands on the guidance provided in Notice 87–49. Section 1.422–4(a)(1) of these proposed regulations provides that an option that otherwise qualifies as an incentive stock option nevertheless fails to be an incentive stock option to the extent the $100,000 limitation is exceeded.

To determine whether the $100,000 limitation has been exceeded, the rules provided in §1.422–4(b) of these proposed regulations would apply. Under these proposed regulations, an option that does not qualify as an incentive stock option when granted (including an option which contains terms providing that it will not be treated as an incentive stock option) is disregarded. Additionally, the fair market value of stock is determined on the date of grant of the option. Except as described in the following paragraph, options are taken into account in the order in which they are granted.

An option is considered to be first exercisable during a calendar year if the option will first 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 an optionee is able to exercise the option in a year only if an acceleration provision is satisfied, then the option is exercisable in that year only if the acceleration provision is triggered prior to the end of that year. After an acceleration provision is triggered, for purposes of applying the $100,000 limitation, the options subject to such provision and all other options first exercisable during a calendar year are then taken into account in the order in which granted. 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 an option (or portion thereof) exercised prior to such acceleration. 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 §1.422–4(d), *Example 4* of these proposed regulations.

For example, assume that in 2006, E, an employee of Y Corporation, is granted Option 1 for stock of Y with a fair market value on the date of grant of $75,000. Option 1 is first exercisable in 2008, except that the option provides that it will become immediately exercisable in the event of a change in control. In 2007, E is granted Option 2 for stock of Y with a fair market value on the date of grant of $50,000. Option 2 is immediately exercisable, and E exercises Option 2. A change in control of Y occurs in 2007, after E has exercised Option 2, and Option 1 becomes immediately exercisable. Notwithstanding the fact that Option 1 was granted prior to Option 2, because the acceleration clause is not taken into account until it is triggered and because E exercised Option 2 prior to the change in control, Option 2 is an incentive stock option in its entirety. Option 1 is bifurcated into an incentive stock option to acquire stock with a fair market value of $50,000 on the date of grant and a nonstatutory option to acquire stock with a fair market value of $25,000 on the date of grant.

If the change in control instead occurred prior to E's exercise of Option 2, then Option 1, which was granted first, is treated as an incentive stock option in its entirety, and Option 2 is bifurcated into an incentive stock option to acquire stock with a fair market value of $25,000 on the date of grant and a nonstatutory option to acquire stock with a fair market value of $25,000 on the date of grant.

These proposed regulations also would provide that an option is disregarded for purposes of the $100,000 limitation if, prior to the calendar year during which it would have otherwise become exercisable for the first time, the option is modified and thereafter ceases to be an incentive stock option, is transferred in violation of the nontransferability requirements, or is canceled. In all other situations, a modified, transferred, or canceled option (or portion thereof) is treated as outstanding until the end of the calendar year during which it would otherwise have become exercisable for the first time.

Finally, under these proposed regulations, a disqualifying disposition has no ef-

fect on the determination of whether an option exceeds the $100,000 limitation. Thus, for example, assume Corporation X grants E, an employee of X, Option 1 to acquire X stock with a fair market value on the date of grant of $75,000. Option 1 is exercisable on January 1, 2005. On January 5, 2005, E exercises the option and sells the stock in a disqualifying disposition. On January 15, 2005, X grants E Option 2 to acquire X stock with a fair market value on the date of grant of $50,000. Option 2 is immediately exercisable. Under §1.422–4(b)(6) of the proposed regulations, the disqualifying disposition of Option 1 has no effect on the application of the $100,000 limitation. Thus, Option 2 is bifurcated into an incentive stock option to acquire stock with a fair market value of $25,000 on the date of grant and a nonstatutory option to acquire stock with a fair market value of $25,000 on the date of grant.

4. Permissible provisions

These proposed regulations also provide guidance on additional provisions that may be included in an incentive stock option. Because these provisions are not part of the requirements for an incentive stock option, they are addressed separately in §1.422–5 of these proposed regulations (many of these rules were previously in §1.422A–2(i) of the 1984 proposed regulations). Section 1.422–5 of these proposed regulations addresses provisions permitting cashless exercise, providing the right to receive additional compensation, and providing alternative rights. In each case, these proposed regulations essentially retain the rules described in the 1984 proposed regulations.

Section 424: Definitions and Special Rules

These proposed regulations re-designate the regulations under section 425 as regulations under section 424 and update the regulations. For example, these proposed regulations amend the definition of *disposition* to exclude a transfer of a share of stock acquired pursuant to the exercise of a statutory option if the transfer is described in section 1041(a) (concerning transfers between spouses or former spouses incident to divorce).

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.

These proposed regulations would provide that an *eligible corporation* (as defined in §1.424–1(a)(2) of these proposed regulations) may by reason of a *corporate transaction* (as defined in §1.424–1(a)(3) of these proposed regulations) 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).

An *eligible corporation* is defined as a corporation that is the employer of an optionee or a related corporation of such corporation. The determination of whether a corporation is the employer of the optionee or a related corporation of such corporation is based upon the circumstances existing immediately after the corporate transaction.

Under the 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.

The definitions of *eligible corporation* and *corporate transaction* would be expanded under these proposed regulations. Specifically, these proposed regulations permit corporations with outstanding options to substitute or assume an option under §1.424–1(a) if there is a corporate transaction. Additionally, the definition of *corporate transaction* includes events, such as a stock dividend or stock split, that were previously addressed in §1.425–1(e) of the final regulations, and is otherwise expanded so that events or transactions with similar consequences are treated the same. Because of these changes, the rules in §1.425–1(e)(5)(ii) of the current regulations would be removed.

These proposed regulations also would eliminate the requirement contained in §1.425–1(a)(1)(ii) of the final regulations that the corporate transaction result in a significant number of employees being transferred to a new employer or discharged or in the creation or severance of a parent-subsidiary relationship. However, §1.424–1(a)(4) of these proposed regulations would continue to impose, and provide additional guidance concerning, the requirement that the substitution or assumption be "by reason of" the corporate transaction.

Under these proposed regulations, 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 is considered to be made for reasons unrelated to such 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. A change in an option or issuance of a new option is not by reason of a distribution or change in the terms or number of outstanding shares unless the option as changed, or the new option, is issued on the stock of the same corporation, or if such class of stock is eliminated by the change in capital structure, on other stock of the same corporation. For purposes of a change in name of the corporation, the issuance of a new option is by reason of the change in name of the corporation only if the option issued is on stock of the successor corporation.

These proposed regulations do not otherwise revise the requirements that must be met for a change in an option to qualify as

a substitution or an assumption. For example, no changes are proposed with respect to the requirements that no additional benefits be granted to the optionee in connection with a substitution or assumption or that certain spread and ratio tests must be met.

These proposed regulations also continue to impose the requirement contained in the final regulations that the new or assumed option must otherwise qualify as a statutory option. See §1.424–1(a)(5)(vi) of these proposed regulations. Thus, except as necessary to comply with the specific requirements regarding substitution or assumption, such as the restrictions on ratio and spread, the option must comply with the requirements of §1.422–2 of these proposed regulations or 1.423–2, as applicable. Accordingly, for example, the new option must be granted, or the old option must be assumed, under a plan approved by the stockholders of the corporation substituting or assuming the option.

The proposed regulations do not impose any additional stockholder approval requirement, however, merely because there is a corporate transaction. In Rev. Rul. 71–474, 1971–2 C.B. 215, involving qualified stock options,[1] 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 was approved was sufficient to satisfy the stockholder approval requirements. Similarly, the 1984 proposed regulations provided that the stockholders of the granting corporation must approve the plan within 12 months before or after its adoption without additional requirements.

Section 1.422–2(b)(2) of these proposed regulations would provide that the plan must be approved during the applicable 24-month period by the stockholders of the corporation granting the incentive stock option. There is no requirement that additional stockholder approval be obtained because of post-approval changes in the stockholders. For example, assume S, a subsidiary of P, adopts a plan under which incentive stock options for S stock will be granted to S employees. Under the proposed regulations, the stockholders of S must approve the plan within 12 months before or after the adoption of the plan. If P later completely disposes of its interest in S, outstanding S options and new grants of S options under the plan are treated as options granted under a plan that meets the stockholder approval requirement of §1.422–2(b)(2) of these proposed regulations without regard to whether S seeks approval of the plan from the stockholders of S after the spin-off. Assuming all other applicable requirements are met, the outstanding S options and new options granted by S pursuant to the plan with respect to S stock will be treated as incentive stock options.

These proposed regulations also would provide additional guidance with respect to when a change to an option constitutes a modification. Under these proposed regulations, as under the 1984 proposed regulations, both a provision under an option that provides that the optionee may receive an additional benefit at the future discretion of the granting corporation and the exercise of that discretion are considered modifications of the option. However, under these proposed regulations, it is not a modification for the granting corporation to exercise discretion 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, would be a modification.

In addition, these proposed regulations address more clearly changes related to an option, including changes not only to the option or the option plan, but also changes to any other related agreements. In the case of a change to the stock on which the option is granted that affects the value of the stock, there would be a modification unless a new option is substituted for the old option by reason of the change in the terms of the stock in accordance with the requirements of §1.424–1(a) of these proposed regulations.

Section 6039

These proposed regulations also would provide guidance on the statements required under section 6039 of the Code. Under these proposed regulations, §1.6039–1 of the final regulations would be deleted, and §1.6039–2 would be re-designated as §1.6039–1. These proposed regulations take the same approach toward providing notice as that taken in the 1984 proposed regulations.

Section 1.6039–1(f) of these proposed regulations states that the matter of furnishing statements in electronic form is reserved. Temporary and proposed regulations have been issued under sections 6041 and 6051 (relating to voluntary electronic furnishing of payee statements on Form W–2) and section 6050S (relating to voluntary electronic furnishing of statements to individuals for whom Forms 1098-T, *"Tuition Payments Statement,"* and 1098-E, *"Student Loan Interest Statement"* are filed). See 66 FR 10191 and 10247 (Feb. 14, 2001). The preamble to those temporary and proposed regulations requested comments regarding, among other things, the extent to which the proposed method of electronic filing is appropriate for information statements required under other sections of the Code. In addition, section 401 of the Job Creation and Worker Assistance Act of 2002 authorized all statements required by sections 6041 through 6050T of the Code to be furnished electronically under certain conditions. The issue of electronic statements in general is under review, and comments are requested.

Proposed Effective Date

The regulations under sections 421, 422, and 424 are proposed to apply as of the date that is 180 days after publication of final regulations in the **Federal Register** and apply to any statutory option that is granted on or after that date. The regulations under section 6039 are proposed to apply to transfers on or after the date that is 180 days after publication of final regulations in the **Federal Register** of stock acquired pursuant to a statutory option. The 1984 proposed regulations are withdrawn. Taxpayers may rely on these proposed regulations for the treatment of any statutory option granted after June 9, 2003.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a signifi-

[1]Qualified stock options are no longer permitted under section 422, but the stockholder approval provisions applicable to a plan under which qualified stock options were granted were the same as those that apply to a plan under which incentive stock options are granted.

cant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Section 1.6039–1 of these proposed regulations provides for the collection of information. 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, this notice of proposed rulemaking is being 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 or electronic comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 2, 2003, beginning at 10 a.m. in the IRS Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. All visitors must come to the Constitution Avenue entrance and 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 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 August 12, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of 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 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.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 14a 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 * * *

§§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 "§§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 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 sentence 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
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

Newly Designated Section	Remove	Add
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 qualified domestic relations order (within the meaning of section 414(p)), 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 P on the date of the grant of the option, the option is not a statutory option even though S 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*. * * * 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 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 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 90 days, 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 guaranteed either by statute or by contract. If the period of leave exceeds 90 days and the individual's right to reemployment is not guaranteed either by statute or by contract, the employment relationship is deemed to terminate on the 91st day of such leave. 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*. This section applies to any statutory option granted on or after the date that is 180 days after publication of final regulations in the **Federal Register**. Taxpayers can rely on these regulations for the treatment of any statutory option granted on or after June 9, 2003.

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 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

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

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 at the time of the transfer of such share to the individual upon the exercise of the option with respect to such share (in addition, no income results upon grant of the option, see §1.83–7);

(ii) No deduction under section 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 §1.83–7 for the treatment of nonstatutory options. 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. Similarly, if otherwise allowable under sections 83(h) and 162, a deduction attributable to such transfer is allowable 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, an amount is allowed as a deduction only if the requirements of §1.83–6(a) are satisfied. 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. 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 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. The amount of compensation income A must include in income under §1.83–7 in the year of the disqualifying disposition is $1,000 (($20, the fair market value of X stock on transfer less $10, the exercise price per share) times 100 shares)). If otherwise allowable under sections 83(h) and 162 and if the requirements of §1.83–6(a) are met, 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 expire, 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. Under §1.83–7, the amount of compensation income attributable to E's purchase of the share that E must include in gross income in the year of the disqualifying disposition 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 otherwise allowable under sections 83(h) and 162 and if the requirements of §1.83–6(a) are met, 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 sec-

tion 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*. This section applies to any statutory option granted on or after the date that is 180 days after publication of final regulations in the **Federal Register**. Taxpayers can rely on these regulations for the treatment of any statutory option granted on or after June 9, 2003.

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 transfers 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 in the gross income of such individual, and deductible from the income of the employer corporation (or a related corporation of such corporation, 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 §1.83–7; 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 to 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. 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. Under §1.83–7(a) (relating to options to which section 421 does not apply), 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)). For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under sections 83(h) and 162 and if the requirements of §1.83–6(a) are met, X Corporation is allowed a deduction of $100 for compensation attributable to A's exercise of the incentive stock option.

Example 2. Assume the same facts as in *Example 1*, except that the share of X Corporation stock transferred to A is subject to a substantial risk of forfeiture and not transferable for a period of six months after such transfer. Assume further that the fair market value of X Corporation stock is $225 on February 1, 2005, the date on which the six-month restriction lapses. Under section 83(a) and §1.83–7(a), 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). 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)). For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under sections 83(h) and 162 and if the requirements of §1.83–6(a) are met, X Corporation is allowed a deduction of $125 for the compensation attributable to A's exercise of the option.

Example 3. (i) 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. For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under sections 83(h) and 162 and if the requirements of §1.83–6(a) are met, X Corporation is allowed a deduction of $50 for the compensation attributable to A's exercise of the option.

(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. Under §1.83–7, 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. For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under sections 83(h) and 162 and if the requirements of §1.83–6(a) are met, X Corporation is allowed a $100 deduction for compensation attributable to A's exercise of the option.

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

(ii) A plan that merely provides that the number of shares that may be issued under options and other stock-based awards granted 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 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, that shares purchased under the plan and forfeited back to the plan are available for reissuance under the plan, or that shares surrendered in payment of the exercise price of an option are available for re-issuance under the plan.

(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 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 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, 2004.

(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 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. 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 both statutory and nonstatutory options is not designated in the plan, the requirements of paragraph (b)(3) of this section are not satisfied.

Example 4. 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 under the plan is designated in the plan, the requirements of paragraph (b)(3) of this section are met.

Example 5. 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 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 5*, 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 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 (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. 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 (Estate Tax Regulations) 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). If the stock is non-publicly traded, 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 described 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 owned 7,500 shares of M Corporation stock, and E owned 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 did 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 was granted, F owned 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 were 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]

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 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 of 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 nonstatutory option. In such a case, a corporation can issue a separate certificate for incentive option stock and designate such stock as incentive stock option stock in the corporation's transfer records. In the absence of such a designation, a *pro rata* portion of each share of stock purchased under the option is treated as incentive stock option stock and nonstatutory option stock. 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 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 requirement 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, two-thirds ($100,000 / $150,000) of each share of stock is treated as acquired pursuant to the exercise of an incentive stock option and one-third ($50,000 / $150,000) as stock acquired pursuant to the exercise of 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 the same economic and tax consequences as 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)(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. 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)(1) 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. For its taxable year in which the disqualifying disposition occurs, if other-

wise allowable under sections 83(h) and 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. 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 allowable under sections 83(h) and 162 and if the requirements of §1.83–6(a) are satisfied.

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 that the requirements of §1.83–6 are satisfied.

(f) *Effective date*. This section applies to any statutory option granted on or after the date that is 180 days after publication of final regulations in the **Federal Register**. Taxpayers can rely on these regulations for the treatment of any statutory option granted on or after June 9, 2003.

§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 3*, 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 third 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]

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 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
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*, last 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)" 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 a new paragraph (e)(6).

23. 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:

Section	Remove	Add
1.424–1(e)(7) *Example 1*, first sentence	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
1.424–1(e)(7) *Example 2*, first, second, and fifth sentences	1964	2004

Section	Remove	Add
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.

(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 ordinary dividends) or change in the terms or number of outstanding shares of such corporation (*e.g.*, a stock split or stock dividend);

(iii) A change in the name of the corporation whose stock is purchasable under the old option; and

(iv) 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).

(iv) A change in an option or issuance of a new option is by reason of a change in the name of a corporation (as defined in paragraph (a)(3)(iii) of this section) only if the option as changed or the new option issued is an option on stock of the successor 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 op-

tion 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.

(vi) The new or assumed option must otherwise comply with the requirements of §1.422–2 or §1.423–2. Thus, for example, the old option must be assumed or the new option must be issued under a plan approved by the stockholders of the corporation changing the option or issuing the new option as described in §1.422–2(b)(2) or §1.423–2(c), as applicable.

(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 stock. At the time of grant, the fair market value of Z stock is $200 per share. E's option price is $200 per share. On July 1, 2005, when the fair market value of Z stock is $400, Z declares a stock dividend that causes the fair market value of Z stock to decrease to $200 per share. On the same day, Z grants to E a new option to acquire 200 shares of Z stock in exchange for E's old option. The new option has an exercise price of $100 per share.

(ii) A stock dividend 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. 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 5. 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 6. Ratio test and partial substitution. Assume the same facts as in *Example 5*, 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 ½ of E's old option, and the other ½ is still outstanding.

Example 7. 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. It would also be permissible to grant E a new option to purchase 100 shares of Y, at an option price of $25 per share, in substitution for E's right to purchase 50 of the shares under the old option.

Example 8. 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. Y Corporation maintains an incentive stock option plan that meets the requirements of §1.422–2. Under the plan, options for Y stock may be granted to employees of Y or its related corporations. After the acquisition, X employees remain employees of X. In connection with the acquisition, Y Corporation substitutes new options for Y stock for old options for X stock that were 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 Y Corporation has a plan that meets the requirements of §1.422–2 in existence on the date it acquires X, the new options for Y stock are granted under a plan approved by the stockholders of Y. The stockholders of Y do not need to approve the X plan. 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 paragraph (i) of this *Example 8*, except that Y Corporation does not maintain an incentive stock option plan on the date of the acquisition of X. The Y options will only be incentive stock options if they are granted under a plan that meets the requirements of §1.422–2(b). Therefore, Y must adopt a plan that provides for the grant of incentive stock options, and the plan must be approved by the stockholders of Y in accordance with §1.422–2(b). If the stockholders of Y approve the incentive stock option plan within 12 months before or after the date of the adoption of a plan by Y and the other requirements of §1.422–2 and the requirements of this paragraph (a) are met, the issuance of the new options for Y stock in exchange for the old options for X stock meets the requirements of this paragraph (a) and is not treated as a modification of the old options for X stock. The result is the same if Y Corporation assumes the old options instead of issuing new options.

(iv) Assume the same facts as in paragraph (i) of this *Example 8*, except that there is no exchange of options. Instead, 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 the new plan, the stockholders of X must approve the plan within 12 months before or after the date of the amendment of the plan. If the stockholders of X 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 9. 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.

* * * * *

(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 X 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 10 Y Corporation shares and one-half of a share of X Corporation stock. Y Corporation purchases E's one-half share for $25, the fair market value of one-half of an X 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 X 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 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, or the right to tender previously acquired stock for the stock purchasable under the 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.

(iv) A change in the terms of the stock purchasable under the option that affects 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.

(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 ap-

ply as well to successive modifications, extensions, and renewals.

* * * * *

(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*. This section applies to any statutory option granted on or after the date that is 180 days after publication of final regulations in the **Federal Register**. Taxpayers can rely on these regulations for the treatment of any statutory option granted on or after June 9, 2003.

§1.6039–1 [Removed]

Par. 14. Section 1.6039–1 is removed.

§1.6039–2 [Redesignated]

Par. 15. Section 1.6039–2 is redesignated as 1.6039–1 and revised 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 un-

der 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 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* [Reserved]

(g) *Effective date*. This section applies as of the date that is 180 days after publication of final regulations in the **FEDERAL REGISTER** to transfers of stock acquired pursuant to a statutory option on or after that date. Taxpayers can rely on these regulations with respect to the transfer of stock acquired pursuant to a statutory option on or after June 9, 2003.

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

Part 14a [Removed]

Par. 16. Part 14a is removed.

David A. Mader,
Assistant Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 6, 2003, 8:45 a.m., and published in the issue of the Federal Register for June 9, 2003, 68 F.R. 34344)

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 law 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 the 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.—Statements 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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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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