

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 otherwise 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.