

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 employees (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