

### 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,<sup>1</sup> 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

<sup>1</sup> 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.