NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON PROPOSED REGULATIONS UNDER SECTIONS 421, 422 AND 424 OF THE INTERNAL REVENUE CODE

October 29, 2003

Report No. 1044

New York State Bar Association Tax Section

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of the Internal Revenue Code

Introduction

On June 9, 2003, the Internal Revenue Service (the "Service") issued new proposed regulations (the "New Proposed Regulations") under Sections 421, 422, 423 and 424 of the Internal Revenue Code (the "Code")[1] regarding statutory options (consisting of incentive stock options ("ISOs") and options granted pursuant to employee stock purchase plans).

This report[2] contains the comments of the New York State Bar Association Tax Section[3] with respect to the New Proposed Regulations. The New Proposed Regulations provide welcome consolidation, updating and clarification of previously issued guidance. However, the Committee believes several aspects of the New Proposed Regulations merit reconsideration, in particular the scope of the requirement for shareholder approval of plans under which ISOs may be granted, the need for such approval in certain corporate transactions and the treatment of ISOs in spinoffs.

Background and Summary of Recommendations

The Committee believes that the regulations governing ISOs, unlike certain other tax rules, do not need to be written so as to narrow the opportunity for perceived abuses. Because corporations are not entitled to compensation deductions with respect to ISOs as to which employees enjoy the tax benefits afforded by Section 421 of the Code, and by virtue of the limitations on the amounts of ISO grants imposed by the Code itself, corporations do not typically seek to stretch the boundaries of the ISO rules; rather, they seek to comply with the rules when and to the extent they wish to assure their employees the opportunity to benefit from ISO tax treatment despite the loss of the corporate tax deduction. In addition, in the collective experience of the members of the Committee, a significant percentage of options that are designed to qualify as ISOs do not ultimately obtain those tax benefits, because of the prevalence of disqualifying dispositions and late post-employment exercises. Therefore, the Committee believes that the regulations pertaining to ISOs should be, to the extent possible, drafted to make the requirements under the Code as clear as possible, so that corporations and employees who receive options intended to be ISOs can confidently predict their tax treatment. Examples of the

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[1] Section references herein are to sections of the Code unless otherwise indicated.

[2] This Report was initially prepared by the Committee on Employee Benefits (the "Committee"). The principal authors of this report are Karen G. Krueger and Max J. Schwartz. Significant contributions were made by Brian T. Foley, Gretchen Harders-Chen, George R. Ince, Carl M. Lerner, Andrew L. Oringer, Michael L. Schler and Michael J. Segal.

[3] This Report was considered and approved by the Executive Committee.

clarifications in the New Proposed Regulations that serve this purpose are the provision that all entities that are treated as corporations for tax purposes may grant ISOs, and the provision that an offer to modify an option is not a modification unless it is accepted.

However, the Committee believes that certain other provisions of the New Proposed Regulations confuse or complicate the already complex analysis of whether an option qualifies as an ISO, or add new requirements for which there is no statutory authority, thereby causing unnecessarily burdensome or harsh results. This report addresses several examples of the foregoing and recommends, for the reasons stated in the indicated sections of the report, the following changes:

1. The assumption or substitution of an option in connection with a corporate transaction should not be analyzed as a "new grant" in order to determine whether it has resulted in a modification under Section 424. Specifically, the new shareholder approval requirement added by the New Proposed Regulations should be eliminated, as should any requirement that the assumed or substituted options meet the various grant-date requirements under Section 1.422-2 of the New Proposed Regulations at the time of the assumption or substitution in order to continue to qualify as ISOs. Section I of the report.

2. The regulations regarding assumption or substitution of options in a corporate transaction should be modified so that it is possible, in connection with a spinoff, to preserve ISO status for all options held by current and former employees of both the distributing company and the spun-off company, regardless of which company's stock is subject to the options after the spinoff. Section II of the report.

3. Section 1.425-1(e)(5)(ii)(*a*) of the current final regulations should be preserved so that holders of ISOs are assured of the same anti-dilution protection as shareholders in connection with stock splits, stock dividends and similar events. Section III of the report.

4. In order to satisfy the shareholder approval requirement of Section 422(b)(1), a plan under which ISOs will be granted should need to specify only the maximum number of shares available for awards pursuant to ISOs, with no requirements being imposed as to nonqualified options or other stock awards. Section IV of the report.

5. A change to an option which provides that the optionee may receive an additional benefit at the future discretion of the grantor should not be considered a modification of an option. The modification should occur only if and when the discretion is actually exercised to provide the additional benefit. Section V of the report.

6. It should be sufficient for an ISO plan simply to state that employees in general, or particular classes of employees, are eligible for awards under the

plan. The plan should not be required to state *separately* which employees or classes of employees are eligible to receive ISOs. Section VI of the report.

7. The New Proposed Regulations should clarify that statutory options on ownership interests other than stock are permitted, provided such ownership interests are treated as stock for U.S. tax purposes. Section VII of the report.

8. The New Proposed Regulations should not require that the exercise of a stock appreciation right granted in tandem with an ISO have identical tax and economic consequences as exercise of the related ISO, but only that its tax and economic consequences not be more favorable to the ISO holder. Section VIII of the report.

Section I – Corporate Transactions

Certain provisions of the New Proposed Regulations under Section 424 appear to reflect the view that the assumption or substitution of options in connection with a corporate transaction involves a new grant that must be tested under Section 422 at the time of the assumption or substitution. The Committee believes that this approach is inconsistent with the statutory language and structure of Sections 422 and 424, and that consistently applying this approach would result in unintended disqualifications of ISOs in corporate transactions.

This new grant approach is explicitly reflected in the provisions that would impose both a new shareholder approval requirement (*see* Section 1.424-1(a)(5)(vi) of the New Proposed Regulations) and a new employment requirement (*see* Section 1.424-1(a)(2) of the New Proposed Regulations, defining "eligible corporation") that would have to be met at the time of the assumption or substitution of options in connection with a corporate transaction. The expansion of the shareholder approval requirement for preserving ISO status in corporate transactions is particularly puzzling to the Committee, as the preamble to the New Proposed Regulations states that the "regulations do not impose any additional shareholder approval requirement, however, merely because there is a corporate transaction" and then cites Rev. Rul. 71-474 (1971-2 C.B. 215), which holds that shareholder approval of the assumption of options in a merger is not required to preserve their ISO status. Section 1.424-1(a)(5)(vi) and Examples (8) and (9) in Section 1.424-1(a)(10) of the New Proposed Regulations appear to be inconsistent with the statement in the preamble and the holding of Rev. Rul. 71-474.

Section 1.424-1(a)(5)(vi) of the New Proposed Regulations also states, more generally, that "[t]he new or assumed option must otherwise comply with the requirements of § 1.422-2…." It is not clear whether the quoted language is intended to say that all of these requirements must be met at the time of the substitution or assumption, although the next sentence expressly states that one such requirement – the shareholder approval requirement – must be met at that time. As discussed below and in Section II, reading the quoted language in this manner would have further implications that would make it impossible to preserve options' ISO status in many corporate transactions, but which are not discussed in the New Proposed Regulations or the preamble thereto.

Section 422 contains the requirements for an option to be an ISO. These requirements are tested at the time the option is granted. For example, if an employee is not a 10% shareholder at the time of grant, but subsequently becomes a 10% shareholder, the option qualifies as an ISO despite the fact that the option price is the fair market value of the stock at the time of grant. The only exceptions to this general rule that ISO qualification is tested upon grant are the holding period requirement under Section 422(a)(1) and the continued employment requirement under Section 422(a)(2), the latter of which specifically mentions that it can be satisfied through employment with a corporation "issuing or assuming" the option (such term is defined in Section 424) in a transaction to which Section 424 applies.

Section 424(h) states that an option that is modified, extended or renewed is considered to be newly granted and, therefore, must satisfy all of the Section 422 requirements again at that time. However, Section 424(h)(3) states that an option is *not* modified if the change in the terms of an option is attributable to the "issuance or assumption" of an option under Section 424(a). Section 424(a), in turn, defines "issuing or assuming" and requires that the "issuing or assuming" be "by reason of" the transaction, that the test set forth in Section 1.424-1(a)(5)(ii) and (iii) of the New Proposed Regulations (we refer to this as the "ratio/spread test") be satisfied and that no additional benefits be provided. Neither Section 424(a) nor Section 422 imposes any other requirements for the original ISO to remain an ISO, other than the holding period requirement and the employment requirement (which can be satisfied by employment with the new employer group).

Only if Section 424(a) does *not* apply to a particular issuance of a substitute option or assumption of an option is the option considered re-granted, and thus required to pass all of the other requirements of Section 422 at the time of the issuance or assumption. Yet the New Proposed Regulations appear to take a contrary approach, viewing the issuance or assumption of ISOs in a corporate transaction under Section 424 as a new grant that must satisfy the shareholder approval and employment requirements of Section 422 (and possibly the other requirements of Section 422 as well) at the time of the assumption or substitution. Thus, in order to determine whether there has been a new grant under Section 424(h), the New Proposed Regulations ask whether, if analyzed as a new grant, the option still meets the ISO requirements. This circular approach is inconsistent with the statutory language and unnecessarily creates many difficulties for corporations wishing to preserve ISO status in corporate transactions.

These difficulties can be illustrated by considering a transaction in which corporation X merges into corporation Y, with Y surviving and assuming the outstanding options on X's stock (both nonqualified and ISOs) by converting them into options to acquire Y stock in a manner that complies with the ratio/spread test and with the requirement that optionees receive no additional benefits within the meaning of Section 424(h)(3). (This is the fact pattern addressed in Rev. Rul. 71-474, which as noted above is cited in the preamble to the New Proposed Regulations.)

Such option conversions are typically carried out not by treating the converted X options as being issued under or governed by the terms of Y's plan, but rather by having Y assume the obligations to deliver Y stock upon exercise of the options, and adjusting the number of shares and the exercise price of the options in a manner consistent with the ratio/spread test, and otherwise having the options continue to be subject to the terms and conditions of the X plan under which they were originally granted. To the best of our knowledge, there is no requirement under state corporate law, the federal securities laws or applicable stock exchange rules that Y even have an option plan in effect at the time of the corporate transaction in order to effect the conversion of the X options in this manner. Similarly, in Rev. Rul. 71-474, there is no statement that Y "issued" the assumed options under a Y plan that had been approved by shareholders. Furthermore, if Y does have a pre-existing shareholder-approved stock option plan under which the assumed ISOs can be granted, there is no assurance that the provisions of that plan will match those of X's plan under which the X options were granted or that such plan could accommodate the assumption of the X options. For example, Y's plan may provide for longer post-employment exercise periods or more advantageous exercise techniques, which would violate the requirement that no additional benefits be provided under the converted X options. Thus, in a typical situation, the "new grant" approach in effect would compel Y either to seek shareholder approval of a new or amended plan, or deprive the X optionees of ISO treatment for their options.

Furthermore, the requirement that the recipient of an ISO be an employee of an "eligible corporation" on the date of grant will not be satisfied as to optionees who have left the employment of X and its subsidiaries before the corporate transaction, but who can still exercise their options and obtain ISO treatment because the 90-day or one-year post-employment periods provided for in Section 422 have not yet expired. Thus, even if the ISO status of options held by current employees can be preserved, it appears to be impossible to preserve ISO status for former employees.[4]

Additional difficulties would arise if the New Proposed Regulations are intended to state that converted X ISOs must satisfy all of the other requirements of Section 422 at the time of the conversion in order to preserve ISO status. For example, if the value of the X stock at the time of the corporate transaction exceeds the exercise price of a given X ISO, the converted option (with its number of shares and exercise price adjusted as required by the ratio/spread test) would not satisfy the requirement in Section 422(b)(4) that the option price be no less than fair market value at the time of the conversion. Similarly, for an optionee who was a less-than-10% shareholder of X at the time of the original grant of an ISO, but who has become a 10% shareholder of Y at the time of the conversion, the special rules applicable to 10% shareholders will likely not be satisfied: even if the value of the underlying stock has declined sufficiently to satisfy, at the time of the conversion, the requirement in Section 422(c)(5) that the option price be at least 110% of fair market value, if the option has the typical 10-year term, it would not satisfy the shorter 5-year term requirement for a 10% shareholder.[5]

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[4] See the discussion below in Section II relating to the treatment of individuals who may not be deemed employed by an "eligible corporation" immediately after a corporate transaction.

[5] Additional interpretive questions would arise if all of the requirements of Section 422 were required to be met at the time of the conversion. For example, the New Proposed Regulations do not address how the $100,000 limitation in Section 1.422-4 of the New Proposed Regulations would be applied to a converted A option; however, if the option is considered newly granted at the time of the conversion, it would appear that the $100,000 test would be re-applied at the time of the conversion, likely disqualifying additional options. Furthermore, it is unclear how the ordering rule in Section 1.422-4(b)(3) of the New Proposed Regulations would be applied when multiple years' worth of options held by the same individual were assumed on the same date (i.e., the closing date of the transaction).

The Committee believes that there is no policy reason to treat the substitution or assumption of options in a corporate transaction as a new grant that must meet the shareholder approval, employment and other ISO requirements at the time of that new grant. In a transaction like the one in our example, the decision by the acquiring company to convert options in connection with the merger was not made for the purpose of providing the X employees and former employees with additional compensation; rather, it would typically have been arrived at as the way to treat optionees *pari passu* with shareholders and consistent with their contractual rights. In effect, a contractual obligation of X reflected in the outstanding option agreements has been voluntarily assumed by Y as part of the overall negotiations involved in entering into the merger agreement. In addition, the Committee does not believe that Congress intended the result implied in the New Proposed Regulations, and that in fact the language of Section 424(a) and (h) demonstrates that it intended *not* to test ISOs as if newly granted if the requirements of Section 424(a) are met. By interpreting Section 424(a) itself to require that ISOs be tested as if newly granted, the New Proposed Regulations would make Section 424(a) meaningless as an exception from Section 424(h).

We therefore recommend that Section 1.424-1(a)(5)(vi) and Examples (8) and (9) in Section 1.424-1(a)(10) of the New Proposed Regulations be amended to eliminate the requirements that the substituted or assumed options be re-granted under a shareholder-approved plan of the granting corporation and satisfy, at the time of the substitution or amendment, the employment requirement or any of the other requirements that Section 422 generally imposes only at the time of grant of an ISO.

Section II – Spinoffs

The New Proposed Regulations under Section 424 of the Code raise questions about whether common methods of dealing with options in connection with spinoffs will be viewed as resulting in the modification of such options, and whether all holders of ISOs who are affected by such transactions can be treated equally. In addition to the shareholder approval requirement discussed above, (1) the definition of "eligible corporation" under Section 1.424-1(a)(2) of the New Proposed Regulations by reference to the "employer" of the optionee "immediately after" the corporate transaction, (2) the "same stock" requirement imposed under Section 1.424-1(a)(4)(iii) of the New Proposed Regulations, and (3) the prohibition on exercise of both the "old" and the "new" option under Section 1.424-1(a)(5)(i) of the New Proposed Regulations may be interpreted to severely constrain the types of adjustments that can qualify to preserve ISO tax treatment in a spinoff. The Committee recommends that the New Proposed Regulations be revised to make clear that no modification results in these situations, provided that the ratio/spread test and the prohibition on new benefits are satisfied.

When a corporation ("Distributing") distributes to its shareholders all of its stock of a subsidiary ("Spinco") in a spinoff transaction, there are commonly four categories of optionees whose options to acquire stock of Distributing must be adjusted or replaced in order properly to reflect the spinoff and to ensure fair and appropriate treatment of the optionees:

- current employees who will remain employed by Distributing and its remaining subsidiaries after the spinoff ("Current D Employees");

- current employees who will be employed by Spinco after the spinoff ("Current S Employees");
- former employees who are considered to have been employed in the businesses retained by Distributing ("Former D Employees"); and
- former employees who are considered to have been employed in the businesses of Spinco ("Former S Employees").

There are two typical approaches to dealing with the options of such employees in spinoffs: either each option is converted into two options, one on Distributing stock and one on Spinco stock (we refer to this as a "split"), or each option is converted into either an adjusted option on Distributing Stock or an option on Spinco stock (we refer to this as a "conversion"). Conversion is the method most commonly used for current employees, with Current D Employees retaining their options on Distributing stock, and Current S Employees receiving replacement options on Spinco stock, in each case with the exercise price and number of shares subject to the options being adjusted in a manner complying with the ratio/spread test set forth in Section 1.424-1(a)(5)(ii) and (iii) of the New Proposed Regulations. The split approach is sometimes used only for former employees, and in other cases is used for current employees as well, with the exercise price and number of shares subject to each optionee's options being adjusted so that on an aggregate basis, the requirements of Section 1.424-1(a)(5)(ii) of the New Proposed Regulations are satisfied, and on a share-by-share basis, the requirements of Section 1.424-1(a)(5)(iii) of the New Proposed Regulations are also satisfied. In some cases, Distributing and Spinco each undertake to deliver their own shares upon exercise of options for those shares, whether by their own employees and former employees or those of the other corporation, and in other cases they each undertake to deliver the necessary shares upon exercises by their own employees and former employees.

As a policy matter, the Committee believes that any of these approaches should preserve ISO status for each category of optionee, so long as the requirements of Sections 1.424-1(a)(5)(ii) and (iii) of the New Proposed Regulations are met. However, it appears that this is not the result under the New Proposed Regulations. In the discussion below, we point out those aspects of the New Proposed Regulations that create this undesirable result and suggest changes to correct the problem.

1. <u>Define "spinoff" as a separation, not a distribution.</u> As a preliminary matter, it would be helpful to clarify that, as is made plain under Section 1.425-1(a)(ii) of the current final regulations, a spinoff is a "corporate transaction" within the meaning of Section 424 of the Code. In addition, some confusion relating to spinoffs is created as a result of the New Proposed Regulations' creation of distinct requirements for a substitution or assumption to be considered "by reason of" a corporate transaction, depending upon whether the transaction is a "separation" or a "distribution." Since a spinoff is both, it is not clear at first reading whether the requirement of Section 1.424-1(a)(4)(iii) of the New Proposed Regulations (relating to distributions) applies to spinoffs. Example 7 in Section 1.424-1(a)(10) of the New Proposed Regulations, however, proves that a spinoff must be viewed as a "separation" rather than a "distribution." The example, labeled "partial substitution," states that a new Y option granted to employee E was granted "by reason of" the spinoff. However, if the spinoff were a "distribution," new Y options could not

satisfy the requirements of Section 1.424-1(a)(4)(iii) of the New Proposed Regulations, since the stock of X is not "eliminated" in the spinoff. Both of these points could be clarified by amending Section 1.424-1(a)(3) of the New Proposed Regulations as follows:

> *(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 <u>(such as a spinoff)</u>, reorganization, or liquidation;
>
> (ii) A distribution (excluding ordinary dividends <u>and distributions pursuant to spinoffs or other corporate separations</u>) <u>with respect to,</u> or change in the terms or number of, outstanding shares of such corporation (*e.g.,* a stock split or stock dividend);[6]
>
> (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.

2. <u>Broaden the definition of "eligible corporation</u>." It would also be useful in analyzing spinoffs if the New Proposed Regulations made clear which corporation in the spinoff context is considered to have made the substitution for, or assumed, the options in the fact patterns described above. This is important because of the requirement under Section 1.424-1(a)(4) of the New Proposed Regulations that the "substitution" for or "assumption" of an incentive stock option be made by an "eligible corporation," which, under Section 1.424-1(a)(2), must be the employer of the optionee immediately *after* the transaction. If Current S Employees retain options to acquire Distributing stock (*i.e.*, in a split), it is unclear whether they would be considered "modified" under the New Proposed Regulations and hence whether they would potentially lose their incentive stock option status because the Current S Employees are no longer employed by Distributing or one of its subsidiaries. Similarly, if Current D Employees receive options to acquire Spinco stock, it is unclear whether those options would be considered "modified," because the Current D Employees are not employed by Spinco or its subsidiaries. In sum, under one reading of the New Proposed Regulations, only optionees who are Current D Employees immediately after the spinoff would be able to retain ISO treatment, and perhaps only in respect of their options on D stock. This seems inequitable and not compelled by the statute. This problem could be addressed by treating both Distributing and Spinco as "eligible corporations" with respect to persons who were employed by either of them or their subsidiaries immediately before the spinoff, regardless of which is the employer after the spinoff.

A second problem created by the "eligible corporation" rule is that it does not appear to accommodate former employees at all, even if the spinoff occurs during the period of time when ISO treatment remains available to a former employee (*e.g.,* within three months of termination of employment). We suggest that this result be changed by providing that in the case of a person

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[6] If our recommendations in Sections III and IV are followed, this subsection would have to be further revised.

whose employment has terminated, the "eligible corporation" is the corporation that employed the person immediately before the termination.[7]

3. Clarify that an anti-dilution adjustment is a substitution of a new for an old option. As noted above, a common approach in spinoffs is for Current D Employees to retain their options on stock of Distributing, with an anti-dilution adjustment to reflect the spinoff (a conversion). This appears not to create a modification, assuming that the anti-dilution adjustment is considered a "substitut[ion of] a new statutory option … for an outstanding statutory option" under Section 1.424-1(a)(1)(i) of the New Proposed Regulations, with the new option being "granted" by Distributing. We suggest that this be clarified by a statement that a change to the number of shares and exercise price of an option by reason of a corporate transaction is considered in effect a substitution of a new option.[8]

4. Shareholder approval. In Section I of this report, we commented on the new requirement that means, in the context of a spinoff, Spinco would have to have a shareholder-approved plan under which the new options on stock of Spinco are granted. The preamble to the New Proposed Regulations suggests that this requirement can be satisfied by having Distributing approve the plan before the spinoff. If our recommendation to eliminate the new shareholder approval requirement is not followed, we recommend that it be made clear that approval of a Spinco option plan by Distributing, as sole shareholder, immediately before a spinoff satisfies the shareholder approval requirement.

5. Option terms and conditions. Section 1.424-1(a)(5)(iv) of the New Proposed Regulations does not appear to permit the terms and conditions of the options to be modified for Current S Employees to recognize their new employment arrangement – the only accommodation is that outdated provisions may "be rendered inoperative." Examples of changes that are common and that we submit should not result in a "modification" are (i) changing the requirement of continued employment in order for options to vest and remain exercisable to refer to employment by Spinco and its affiliates, rather than Distributing and its affiliates, (ii) changing vesting provisions triggered by a change of control to refer to a change of control of Spinco rather than Distributing, and (iii) changing noncompetition covenants to cover competition with Spinco rather than Distributing. Accordingly, we recommend that Section 1.424-1(a)(5)(iv) of the New Proposed Regulations be reworded as follows: "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 or changed as necessary to reflect any changes in the corporation employing (or formerly employing) the optionee." This approach would be consistent with the provision in Section 422(a)(2) allowing the employment requirement for ISO tax treatment upon exercise to be satisfied by employment with a corporation that has issued or assumed the option in a transaction satisfying the requirements of Section 424(a).

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[7] The same problem is also presented in other types of transactions, such as mergers, and when an anti-dilution adjustment is made in connection with a stock split (discussed in Section III below) or an extraordinary cash distribution: no corporation can be an "eligible corporation" for persons who are no longer employed at the time of the event in question.

[8] If the Service agrees with our recommendation, the second to last sentence in Section 1.422-2(b)(2)(iii) should be modified to exclude a change in the stock in connection with a spinoff.

Section III – Anti-Dilution Protection for Stock Splits and Similar Events

In Section I above, we noted that Section 424(h) excepts from the term "modification" a change to an option attributable to the "issuance or assumption" of an option under Section 424(a). In other words, the issuance or assumption of an ISO in a manner that meets the requirements of Section 424(a) is not a "modification" of the ISO that would be considered the grant of a new option under Section 424(h). Of course, a change in the terms of an ISO which is not considered a modification for purposes of Section 424(h) because it does not give the employee additional benefits under the option is not considered a new grant, and whether or not such change meets the test of Section 424(a) is irrelevant.

Section 1.425-1(e)(5)(ii)(*a*) of the current final regulations specifies that "[a] change in the number or price of the shares of stock subject to an option merely to reflect a stock dividend, or stock split-up, is not a modification of the option." This rule is entirely separate from the rule in Section 1.425-1(e)(5)(ii)(*b*) of the current final regulations relating to a change in an option to reflect a "corporate transaction." It is this second rule which is explicitly designed to describe the conditions under which the issuance or assumption of an option will meet the requirements of Section 424(a). If the first rule applies, though, the occurrence of a "corporate transaction" is irrelevant, Section 424(a) is irrelevant, and the change in the option is not a modification for purposes of Section 424(h). The New Proposed Regulations fail to carry forward this important distinction because Section 1.424-1(a)(3)(ii) now defines for the first time a stock split or stock dividend as a corporate transaction. This change would mean that a standard anti-dilution adjustment that puts optionees in the same position as shareholders could actually disqualify ISOs.

ISOs generally are adjusted to reflect a stock dividend or stock split in a simple, arithmetic and formulaic manner – the number of shares underlying the ISO is adjusted upward to reflect the number of shares which a stockholder holding the same number of shares would hold after the event, and the per-share exercise price is adjusted downward so that the post-adjustment aggregate exercise price is equal to the pre-adjustment aggregate exercise price. For example, in the case of two-for-one stock split, the number of shares underlying each ISO is doubled, and the per-share exercise price is reduced by half. The intent and result of this adjustment is to put the holders of ISOs in the same position as true stockholders.

It is critical to note that companies (especially public companies) that engage in stock splits or pay stock dividends in their own shares most often do so because of a belief that this will contribute positively to the value of their stock. If the public market views the stock split or stock dividend positively, it will affect the trading value of the stock. Using the 2-for-1 stock split example, it could be expected that the trading price of the stock of a public company would decrease by less than 50%, even though twice as many shares are outstanding after the split than before. All shareholders benefit from this increase in the aggregate value of their shareholdings, which occurs simultaneously with the stock dividend or stock split. ISO holders also would receive the benefit through the simple arithmetic adjustment formula described above. Most importantly, this adjustment mechanism meets the requirements of Section 1.425-1(e)(5)(ii)(*a*) of the current final regulations, and therefore is not a modification of the ISO for purposes of Section 424(h).

The New Proposed Regulations, however, could cause the simple arithmetic adjustment mechanism currently in use to result in a modification of the ISO under Section 424(h), and a resulting loss of ISO treatment. This is because Section 1.424-1(a)(3)(ii) of the New Proposed Regulations defines, for the first time, a stock split or stock dividend as a "corporate transaction." This results in the application of Section 424(a) and, through Section 1.424-1(a)(5)(iii) of the New Proposed Regulations, of the ratio test and the spread test. Those tests require a comparison of the fair market value of the shares underlying the ISO immediately before and immediately following the adjustment (*i.e.*, immediately before and after the actual stock split or stock dividend). In order to comply with those tests, the increase (or lesser decrease) in the value of the shares occurring simultaneously with the stock split or stock dividend which is captured by the true stockholders would be lost by ISO holders if their options were adjusted in the manner prescribed under the New Proposed Regulations. Consider the following example:

- The trading price of A is $10/share. A shareholder holds 100 shares of A, having an aggregate value of $1000. An optionee has an ISO on 100 shares of A, with an exercise price of $5/share for an aggregate spread of $500. A engages in a 2-for-1 stock split. The trading price of A decreases at the time of the split to $6/share.

- Immediately after the split, the shareholder will hold 200 shares of A, with a per-share value of $6 and an aggregate value of $1200. Consequently, the value of the shareholder's shares increased by $200 merely on account of the stock split.

- Using the simple arithmetic ISO adjustment allowed under the current regulations, immediately after the split the optionee would hold options on 200 A shares with a per-share exercise price of $2.50, for an aggregate spread of $700 [($6 - $2.50) x 200]. Just like the stockholder, the optionee sees an increase in value of $200 due to the stock split.

- However, in order to comply with the New Proposed Regulations, the ratio of the option exercise price to the fair market value of the A stock immediately after the stock split would have to equal that ratio immediately prior to the split. The pre-split ratio is 50% ($5:$10). This would require a decrease in the per-share exercise price from $5 to $3, with $3 being 50% of the post-split A stock price of $6. The number of shares subject to the ISO would be adjusted to maintain the pre-split aggregate spread of $500, resulting in an increase in the number of shares to only 166.67. Thus, the $200 value increase accruing to stockholders due to the split would be lost by the ISO holders.

This result cannot have been the intent of the New Proposed Regulations. ISO holders should not have to be treated less favorably than shareholders in order to maintain ISO treatment. This same logic applies to stock dividends, and indeed to any adjustment merely to reflect a change in the number of outstanding shares of a corporation. For that reason, we suggest that Section 1.425-1(e)(5)(ii)(*a*) of the current final regulations be retained.[9]

Section IV – ISO Share Limitations

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[9] This approach would also make clear that an anti-dilution adjustment of an ISO held by a former employee would not disqualify the ISO, merely because it was made at a time when the holder was not an employee of an "eligible corporation" at the time of the adjustment.

Section 1.422-2(b)(3), together with Example 3 of Section 1.422-2(b)(6), of the New Proposed Regulations, state that a plan must provide, and stockholders must approve, a limitation on the amount of *all* shares which may be issued under the plan, including nonqualified options and other stock awards as well as ISOs, rather than only the amount of shares available for issuance under ISOs. We believe that this requirement goes beyond what is required by Section 422(b)(1), does not fulfill any statutory purpose, and will create significant practical difficulties that are described below.

Section 422(b)(1) sets forth a stockholder approval requirement applicable to plans granting ISOs regarding a limitation on the number of shares that may be issued under the plan (the "Limitation Approval Provision"). As relevant thereto, Section 422(b) states in part:

> [T]he term "incentive stock option" means an option granted to an individual, ... but only if (1) the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under *options* . . . , and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted. *[emphasis added]*

Given the predicate references to "an option" and "the option" in Section 422(b), which refer only to ISOs, we believe that the phrase "the aggregate number of shares which may be issued under options" as used in Section 422(b)(1) should be read to refer only to shares issuable under ISOs. We recognize that previous regulatory proposals are not clearly inconsistent with the position now being expressly taken in the New Proposed Regulations with respect to nonqualified options. However, even if the term "options" can or should be read more broadly to include nonqualified options as well, it is not clear on what basis Section 1.422-2(b)(3)(i) of the New Proposed Regulations can extend the Limitation Approval Provision beyond options to "other stock-based awards that may be granted under the plan."[10]

Our view of the statutory language is consistent with the statute's purpose of conferring upon stockholders the right to approve the maximum number of options for which a corporate tax deduction may be unavailable. This statutory purpose is not served by a requirement that plans include, and shareholders approve, overall share limits applicable to nonqualified options and other non-ISO stock awards as well as to ISOs. We are aware of no legislative history indicating that Congress intended, by enacting the Limitation Approval Provision as part of the Code provisions governing ISOs, to regulate the manner in which corporations may use options and other share-based awards that do not benefit from special tax treatment. *See, e.g.*, 1964 U.S. Code Cong. & Ad. News 1313, 1373 (legislative history to a predecessor limitation provision).

We also note that the preamble to the New Proposed Regulations does not identify this new interpretation of the Limitation Approval Provision as involving a significant policy choice, and we are concerned that the Service may not have focused on the extent to which the New Proposed Regulations would require changes in plan structures and stockholder relations for many corporations. How share limitations under equity plans should be structured, and what

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[10] The New Proposed Regulations' interpretation of the Limitation Approval Provision also seems at odds with the statement in Section 1.422-2(b)(1) that "[t]he 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."

limitations should be submitted to stockholders, are important business questions, and a number of corporations, after due consideration, have chosen alternatives that would not meet the requirements of the New Proposed Regulations. For example, many plans contain evergreen limits for non-ISO grants with separate, fixed share limits for ISO grants.[11] On the other hand, if this new requirement were included in the final regulations, a corporation could easily plan around it in the future by adopting one plan providing for ISOs and another plan for nonqualified options and other stock-based compensation. We see no reason for the Service to impose a new requirement that casts doubt on the validity of previously granted ISOs and will serve only as a trap for the unwary in the future.

We would also like to bring to the attention of the Service the extraterritorial impact of the new rule. Non-U.S. companies often do not have share limitations in their plans or have share limitations that would not satisfy the requirements in the present iteration of the New Proposed Regulations. Many of these non-U.S. companies have attempted to qualify for ISO treatment by creating U.S. annexes to, or otherwise by including separate provisions in, their stock plans that contain an ISO limit and are approved by the granting company's shareholders. This is often structured or accomplished in a manner that is dictated by the granting company's own geographic market and local customs and practices. We recognize that these companies need to comply with Section 422 if they wish to grant ISOs. However, the New Proposed Regulations would force them to choose (i) to conform their general policies regarding equity compensation to the ISO rules, even as to nonqualified options and non-option equity grants, (ii) to establish separate ISO plans, even where such a choice is undesirable or not regarded as optimal as a business matter, (iii) to argue that separate ISO provisions constitute a separate plan (a position for which there is no clear authority) or (iv) not to issue ISOs. We believe that it is not necessary, as a matter of statutory interpretation or policy, for the Service to impose these uncertainties and disadvantages on global companies competing to hire and retain U.S. employees.

For all of these reasons, we recommend that the final regulations clarify that, contrary to the approach in the New Proposed Regulations, the Limitation Approval Provision can be satisfied by including a fixed limit on the number of shares that can be issued with respect to ISOs only, with respect to all options (both ISOs and nonqualified options), or with respect to all stock awards. The second and third types of limits should be permitted (though not required) because they have the effect of limiting the number of shares that can be issued pursuant to ISOs.[12]

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[11] Another common provision that appears not to meet the requirement of the New Proposed Regulations calls for adding back to the available shares those shares that are withheld upon exercise of options to cover withholding taxes. Under Section 1.422-2(b)(3)(iii) of the New Proposed Regulations, certain forfeited shares and shares that are surrendered in payment of the option exercise price may be made available for re-issuance without violating the Limitation Approval Provision. Although there is no tax withholding obligation in respect of ISOs, plans that provide for nonqualified options and other awards as well as ISOs also will typically provide that shares that are withheld by the issuing corporation and applied to the satisfaction of the recipient's tax withholding obligation similarly are not counted against the share authorization because they are not issued. Such provisions would appear not to be permissible under the New Proposed Regulations.

[12] If our recommendation is not followed, we suggest at a minimum narrowing the Limitation Approval Provision to apply to options only, and amending Section 1.422-2(b)(3)(iii) of the New Proposed Regulation to

Section V – Modifications

As discussed above, Section 424(h) provides that if an existing ISO is modified, extended or renewed, the modification, extension or renewal will be considered the grant of a new option. Therefore, at the time the option is considered to be newly granted, it must satisfy all of the ISO rules.

The New Proposed Regulations take seemingly inconsistent positions in Section 1.424-1(e)(4)(iii). On the one hand, they provide that changing an option to provide that ". . . the optionee may receive an additional benefit *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 *[emphasis added]*." Thus, the option could be modified twice: once when the discretion is added, even though not exercised, and a second time when the discretion is actually exercised; and at both times, the terms of the option must meet all of the ISO rules. Yet the last sentence of the same paragraph provides that "[a]n 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." These two positions seem inconsistent.

We believe that the approach taken with regard to offers to modify ISOs should be followed with respect to discretionary changes. It is unclear what purpose is served by treating as a modification the addition of discretion to change an option to add a benefit to an optionee at some later date without the actual exercise of such discretion. The mere addition to the option of a provision reciting that the grantor may exercise discretion in the future to add some features conveys nothing additional to the optionee; indeed, it is less beneficial than an offer to modify that the optionee is free to accept, as the optionee cannot compel the grantor to exercise its discretionary authority. It is only at the time when the discretion is actually exercised that a true additional benefit is conveyed and therefore, we submit, only at that time is it appropriate to require that the option meet all of the ISO requirements again.

We also believe that it would be helpful to clarify the interaction between Sections 1.424-1(e)(4)(i) and 1.424-1(e)(4)(iii) of the New Proposed Regulation, as they relate to provisions for payment of cash bonuses upon exercise of ISOs, the availability of loans upon exercise of ISOs, and the right to tender previously acquired stock for the stock purchasable under the ISO. Specifically, we recommend that it be made clear that such a provision results in a "modification" only in two cases. First, if the ISO is amended, after it is granted, so that the optionee is contractually entitled to such a benefit, the ISO should be considered to be modified at the time of the amendment, without regard to whether the optionee ever actually exercises the option so as to receive the benefit, because the addition of the entitlement itself is a benefit to the optionee. Second, if the ISO is amended, after it is granted, to add a provision giving the grantor the discretion to provide such a benefit to the optionee upon exercise, the ISO should be considered to be modified if and when the grantor actually exercises this discretion in connection with an exercise because, as noted above, the mere statement that the grantor has the discretion to provide a benefit does not convey any actual benefit to the optionee. (By contrast, if the

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allow shares tendered in payment of withholding taxes upon the exercise of options (as well as the exercise price) to be made available for grants under the plan.

grantor merely offers to amend the ISO in either of these two ways, and the optionee declines the offer, no modification would occur.)

We therefore suggest that the last sentence of Section 1.424-1(e)(4)(i) of the New Proposed Regulation be altered to read as follows:

> Similarly, a change entitling the optionee to receive an additional benefit upon exercise of the option (such as the payment of a cash bonus) or a change entitling the optionee to more favorable terms for payment for the stock purchased under the option (such as the right to tender previously acquired stock) is a modification.

We further suggest that Section 1.424-1(e)(4)(iii) of the New Proposed Regulation be altered to read as follows:

> (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 not a modification at the time that the option is changed to provide such discretion. [Sentence deleted.] In addition, it is not a modification for the grantor to exercise discretion reserved under an option at the time of its original grant 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. Furthermore, 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. However, any change to the option (other than an exercise of discretion described in the second sentence of this paragraph) that actually provides an additional benefit, whether it occurs either by the unilateral exercise of discretion by the grantor, or as a result of the optionee's acceptance of an offer to make such change, is a modification. Thus, for example, if an option is modified after its original grant to reserve to the grantor discretion 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, the option would be considered modified when and if the grantor actually exercises that discretion.

Section VI – Eligibility

Section 1.421-1(h)(1) of the New Proposed Regulations provides:

> 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…. A statutory option must be granted for a reason connected with the individual's employment by the corporation or by its related corporation.

In specifying the requirements that a plan must satisfy in order for options to qualify as ISOs, the last sentence of Section 1.422-2(b)(4) of the New Proposed Regulations states that:

> 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 class of employees eligible to receive incentive stock options.

The Committee believes that Section 1.422-2(b)(4) of the New Proposed Regulations would create an unfortunate and unnecessary drafting trap for those creating ISO plans that is not required by the language of Section 422 and is unnecessary in light of the provisions of Section 1.421-1(h)(1) quoted above. If the plan in question identifies or describes the employee and non-employee individuals eligible for awards under the plan, we submit that the plan meets, and should be viewed as meeting, the statutory requirements of Section 422. Requiring that the plan recite one of the requirements for ISO qualification serves no purpose; if an option purporting to be an ISO is granted to an individual who is eligible for awards under the plan but does not satisfy the employment requirements of the Code, the option will not qualify for ISO treatment regardless of what the plan says on the subject.

Accordingly, we recommend deleting the last sentence of Section 1.422-2(b)(4) of the New Proposed Regulations. If this change is not made, we recommend alternatively that an otherwise compliant plan should only need to specify either (i) that ISO grants will be made only to eligible individuals who are employees, or (ii) that non-employees will not be eligible for ISO grants (rather than specifically stating which individuals are eligible for ISOs).

Section VII – Definition of Stock

The New Proposed Regulations provide significant and welcome clarification of the types of entities that are permitted to grant statutory stock options and the types of interests that constitute "stock" for purposes of the statutory stock option rules. We are pleased that the New Proposed Regulations clarify that a "corporation" includes all entities that are taxed as corporations for federal tax purposes, including foreign corporations and limited liability companies that elect to be taxed as corporations.

The New Proposed Regulations also clarify that in general "stock" includes ownership interests other than capital stock. However, we recommend that the definition of "stock" under the New Proposed Regulations provide further clarification as it relates to ownership interests other than capital stock, such as partnership interests, limited liability company interests and interests in foreign entities traded in the United States. Under existing regulations, "stock" for purposes of the statutory stock option rules means "capital stock," which is defined to include special classes of stock issued to employees provided that the stock possesses the rights and characteristics of capital stock. For example, the Service has ruled in several instances that foreign depository shares held by a U.S. bank and traded on a U.S. securities exchange (such as American Depository Receipts ("ADRs"), which are a certificated form of American Depository Shares ("ADSs")) are "stock" for purposes of the statutory option rules on the basis that ADRs possess the rights and characteristics of capital stock.

We believe that ownership interests in an entity should be considered stock if those interests are treated as stock for U.S. federal income tax purposes generally. Accordingly, we propose that Section 1.421-1(d)(3) of the New Proposed Regulations be modified to read as follows:

> In general, for purposes of this section and §§ 1.421-2 through 1.424-1, ownership interests <u>in a corporation (as defined under § 1.421-1(i)(1))</u> other than capital stock are

considered stock <u>if those interests are properly treated as equity for U.S. federal income tax purposes.</u>**]**

Section VIII – Tandem Stock Appreciation Rights

Section 1.422-5(d)(3) of the New Proposed Regulations allows a stock appreciation right to be granted in tandem with an ISO if the exercise of the stock appreciation right has the "same economic and tax consequences as the exercise of the option followed by the immediate sale of the stock." The Committee believes that this language requires too much, and is inconsistent with the much more permissive provision of Section 1.422-5(c) of the New Proposed Regulations, which provides that an option does not fail to be an ISO merely because the optionee has the right to receive additional compensation when the option is exercised if such compensation is includible in income under Section 61 or 83.

We therefore recommend that Section 1.422-5(d)(3) of the New Proposed Regulations merely require that the stock appreciation right "may not have tax or economic consequences that are more favorable than the option exercise and sale." For example, an option granted with a stock appreciation right under which the amount due upon exercise of the stock appreciation right is limited to a specified maximum amount should not be unable to qualify as an ISO.