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American Institute of Certified Public Accountants. Committee on Federal Taxation

TAX COMMITTEE COMMENTS AND RECOMMENDATIONS

Comments on Proposed Regulations Relating to the
Treatment of Employee Stock Options and Purchase Plans

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COMMITTEE ON FEDERAL TAXATION

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

<u>Comments on Proposed Regulations</u>
<u>Relating to the Treatment of Employee</u>
<u>Stock Options and Purchase Plans</u>

<u>Section</u>

1.421-7(h)(2)

1

This provision deals with the employment
relationship between the date on which an
option is granted and the date on which the
option is exercised and states in part
"the employment relationship in respect
of an option granted in accordance with
the requirements of subparagraph (1) of
this paragraph will be treated as contin-
uing intact while the individual is on
military or sick leave if the period of
such leave does not exceed 90 days or if
longer, so long as the individual's right
to re-employment with the corporation
granting the option ... is guaranteed either
by statute or by contract."

The limitation on sick or military leave of
90 days unless the individual's right to
re-employment is guaranteed appears to be
without support in the statute or the
Committee Reports and raises further questions
as to what sick leave is for this purpose.
If, for instance, an individual is maintained
on a full-pay basis while he is absent from
work on account of sickness in excess of
90 days, his absence from work should not be
considered a termination of his employment
after 90 days even though he may not return
to active employment.

Proposed Regulations Section 1.421-7(h)(1)
states that the determination of whether
the optionee is an employee at the time the
option is granted is to be made in accordance
with Section 3401(c). It is inconsistent
to use different rules for determining the em-
ployment relationship during the period the
option is outstanding.

The 90-day limitation and the necessity for re-employment guarantee should be deleted.

2

1.421-8(b)(1)   Section 421(b) states that if there is a premature disposition the employer corporation shall be entitled to a deduction for compensation paid. Proposed Regulations Section 1.422(b)(2) also so states. However, Proposed Regulations Section 1.421-8(b)(1) states that the deduction attributable to the transfer of the share of stock pursuant to the exercise of the option, shall be allowable to the grantor of the option. This paragraph should be changed so as to state that the deduction shall be allowable to the employer corporation.

3

1.422-2(e)(2)(ii)   This provision deals with the question of whether or not there was a good faith attempt to set the option price at not less than fair market value. The example given might infer that no other method might be acceptable. It is suggested that language such as that in the first sentence of Proposed Regulations Section 1.421-7(e)(2) be repeated at this point. That sentence provides "in the case of a statutory option, any reasonable valuation method may be used for the purposes of determining whether at the time the option is granted the option price satisfies the pricing requirements of Section 422(b)(4)."

4

1.422-2(h)(1)(ii)   This provision states that, in determining the percentage of the outstanding stock owned by an individual for purposes of Section 422(b)(7),shares authorized for issuance under options held by the employee are not considered as outstanding even though the same shares are considered owned by him (under Proposed Regulations Section 1.422-2(h)(1)(i)) for purposes of the same calculation.

Section 422(c)(3) provides that: "If an individual is granted an option which permits him to purchase stock in excess of the limitations of Section 422(b)(7) .... such option shall be treated as meeting the requirement of that section to the extent that such individual could, if the option were fully exercised at the time of grant, purchase stock under such option without exceeding such limitation." Certainly, for purposes of Section 422(c)(3), the stock that would be acquired by the exercise of options would be considered as both owned by the optionee and outstanding. This result appears to be more clearly intended with respect to the provisions of Section 422(b)(7) since language similar to that quoted above from Section 422(c)(3) is not repeated with respect to the application of stock ownership limitations of Section 423(b)(3) dealing with employee stock purchase plans. The language should be changed to indicate that stock which may be acquired by exercise of options is to be considered as outstanding as well as owned by the optionee.

5

1.423-2(i)(4)   This provision gives examples to illustrate the application of Section 423(b)(8). The second example is not clear. The first sentence of that example assumes that the option granted in 1964 is terminated in 1965 without any part of such option having been exercised. The second part of the example contemplates that in 1966 the optionee exercised the option granted to him in 1964. These statements are inconsistent. Perhaps the example should be stated in two parts.

Typographical Errors

1

1.423-2(k)(3)   There is a typographical error in Example 8. The sales date is shown as 1965 and the year for inclusion in E's income as 1966; the years should be the same.

2

1.424-2(d)(e)(i)   This provision gives several examples to explain the application of Section 424(e)(1). Example 8 includes a typographical error. The year 1956 should be 1966.