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DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 71

[Airspace Docket No. 91-ASO-22]

Revocation of Blairsville, GA Transition Area Before Effective Date

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule.

SUMMARY: This amendment revokes the Blairsville, GA Transition Area. On April 1, 1992 the final rule was published in the **Federal Register** (57 FR 10986) which established the transition area with an effective date of August 20, 1992. The transition area was established for the purpose of providing additional controlled airspace for instrument flight rule (IFR) aeronautical operations. This action was precipitated by the development of a standard instrument approach procedure (SIAP) to serve the Blairsville Airport. Unfortunately, the SIAP could not satisfy flight inspection requirements. In the absence of an instrument approach procedure, justification no longer exists for the transition area.

EFFECTIVE DATE: 0901 UTC, June 15, 1992.

FOR FURTHER INFORMATION CONTACT: James G. Walters, Airspace Section, System Management Branch, Air Traffic Division, Federal Aviation Administration, P.O. Box 20636, Atlanta, Georgia 30320; telephone (404) 763-7646.

SUPPLEMENTARY INFORMATION:

History

On April 1, 1992, the FAA amended part 71 of the Federal Aviation Regulations (14 CFR part 71) to establish the Blairsville, GA Transition Area (57 FR 10986). This action would lower the base of controlled airspace from 1200 feet to 700 feet above the surface in vicinity of the Blairsville Airport effective August 20, 1992. A SIAP had been developed to serve the airport and the additional controlled airspace was needed for IFR aeronautical operations. Subsequent to publication of the Final Rule establishing the transition area, the proposed SIAP failed to pass flight inspection. In the absence of a viable instrument approach procedure, a need no longer exists for the transition area.

The Rule

This amendment to part 71 of the Federal Aviation Regulations revokes the Blairsville, GA Transition Area prior to its effective date. The transition area was established to provide additional controlled airspace for IFR aircraft. A SIAP had been developed to serve the Blairsville Airport. However, subsequent to publication of the final rule which established the transition area, the planned SIAP failed to pass flight inspection. In the absence of the SIAP, a need no longer exists for the transition area. Since this action merely involves the removal of a transition area before it has become effective or charted, this amendment is inconsequential to the public, and notice and public procedure under 5 U.S.C. 553(b) are unnecessary.

The FAA has determined that this regulation only involves an established body of technical regulations for which frequent and routine amendments are necessary to keep them operationally current. It, therefore, (1) is not a "major rule" under Executive Order 12291; (2) is not a "significant rule" under DOT Regulatory Policies and Procedures (44 FR 11034; February 26, 1979); and (3) does not warrant preparation of a regulatory evaluation as the anticipated impact is so minimal. Since this is a routine matter that will only affect air traffic procedures and air navigation, it is certified that this rule will not have a significant economic impact on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

List of Subjects in 14 CFR Part 71

Aviation safety, Transition areas, Incorporation by reference.

Adoption of the Amendment

In consideration of the foregoing, the Federal Aviation Administration amends 14 CFR part 71 as follows:

PART 71—[AMENDED]

1. The authority citation for 14 CFR part 71 continues to read as follows:

Authority: 49 U.S.C. app. 1348(a), 1354(a), 1510; E.O. 10854, 24 FR 9565, 3 CFR, 1959–1963 Comp., p. 389; 49 U.S.C. 106(g); 14 CFR 11.69.

§ 71.1 [Amended]

2. The incorporation by reference in 14 CFR 71.1 of the Federal Aviation Administration Order 7400.7, Compilation of Regulations, published April 30, 1991, and effective November 1, 1991, is amended as follows:

Section 71.181 Transition Areas

Blairsville, GA [Revoked]

Issued in East Point, Georgia, on May 13, 1992.

Don Cass,

Acting Manager, Air Traffic Division, Southern Region.

[FR Doc. 92-12616 Filed 5-28-92; 8:45 am]

BILLING CODE 4910-13-M

Office of the Secretary

14 CFR Part 255

[Docket No. 46494; Amdt. No. 255-8]

RIN 2105-AB47

Computer Reservations System Regulations

AGENCY: Office of the Secretary, DOT.

ACTION: Final rule.

SUMMARY: The Department is extending the expiration date of its existing rules on computer reservations systems (CRSs) to December 11, 1992, to enable the Department to complete its rulemaking on whether those rules should be renewed for a longer period and, if so, with what changes.

EFFECTIVE DATE: May 29, 1992.

FOR FURTHER INFORMATION CONTACT: Thomas Ray or Gwyneth Radloff, Office of the General Counsel, 400 7th Street SW., Washington, DC 20590, (202) 366-4731 or 366-9305, respectively.

SUPPLEMENTARY INFORMATION:

Introduction

When the Department's rules governing computer reservations systems (CRSs) operating in the United States, 14 CFR part 255, were originally adopted by the Civil Aeronautics Board

(the "Board") in 1984, one section (§ 255.10(b)) provided that the rules would expire on December 31, 1990. (When the Board ceased to exist on December 31, 1984, we took over most of its remaining functions, including these rules.) To determine whether we should readopt the rules and, if so, with what changes, we began this proceeding. We issued an Advance Notice of Proposed Rulemaking requesting comments on these issues. Advance Notice of Proposed Rulemaking, Computer Reservations Systems, 54 FR 38670 (September 21, 1989). Because of the large number of comments that were filed, and the complexity of the issues, we could not complete this rulemaking by the rules' original expiration date. We therefore amended § 255.10(b) of the rules to change the termination date from December 31, 1990, to November 30, 1991. 55 FR 53149 (December 27, 1990).

We thereafter issued a notice of proposed rulemaking (NPRM), which proposed to readpot the rules with some changes. 56 FR 12586 (March 26, 1991). In addition to requesting comment on the rules proposed in that notice, we also asked for further information and comment in other areas, such as the need and practicality of rules eliminating architectural bias.

We received a large number of comments and reply comments on the NPRM. The Department of Justice, 16 states and one territory, the European Civil Aviation Conference, the CRS vendors and the carriers controlling the CRSs, six other U.S. airlines, 15 foreign airlines and airline groups, the two major travel agency trade associations, a number of travel agency and agent parties, and other persons and groups filed comments advocating widely-varying positions on the need for CRS rules in general and on specific regulatory proposals. In addition, we decided to grant Northwest's request for additional information on system reliability. Order 91-8-63 (August 30, 1991). The complexity of the issues and our decision to seek additional information on CRS reliability kept us from issuing a final rule by November 30, 1991. We therefore changed the expiration date for the current rules to May 31, 1992. 56 FR 60915 (November 29, 1991).

On January 28, 1992, the President issued an order requiring this Department, as well as other executive branch agencies, to review all existing regulations to see whether they provided benefits outweighing their burdens and directing us to suspend most pending rulemaking for 90 days in order to make resources available for this regulatory review. We determined that the moratorium covered this proceeding. At the end of the moratorium, the President determined that it should be extended for 120 days so that executive agencies could focus their efforts on eliminating rules which were determined in the regulatory review to be unduly burdensome.

In view of the President's regulatory review and the complexity and difficulty of the issues presented in this proceeding, we determined that we could not adopt new rules by May 31, 1992, the rules' current expiration date. We proposed to change the expiration date to December 11, 1992. 57 FR 19821 (May 8, 1992). We tentatively determined that the current rules should be maintained for another six months in order to prevent the disruption that would occur if the rules expired and if we later adopted the same or similar rules.

Comments

We received a comment on our proposal to change the expiration date filed jointly by Alaska Airlines, America West Airlines, Association of Retail Travel Agents, American Society of Travel Agents, Aviation Consumer Action Project, British Airways, Consumer Federation of America, Continental Airlines, Delta Air Lines, KLM Royal Dutch Airlines, Northwest Airlines, System One Corporation, Trans World Airlines, and Worldspan ("the Alaska group"), and individual comments from Worldspan, L.P., Covia Partnership, United Air Lines, American Airlines, and Southwest Airlines.

The Alaska Group complains that our failure to adopt new rules has benefited only American and United, the carriers controlling the two largest CRSs. These parties further assert that virtually every party in this proceeding, except for American and United, agrees that stronger CRS rules are needed and that we have had ample time to adopt new CRS rules, since this proceeding was begun over 2 years ago. They point out that our notice proposing new rules tentatively concluded that the new proposals could substantially promote airline and CRS competition. Finally, as these parties construe the President's statement extending the regulatory review, the final CRS rules should be issued by August 1, 1992, since no further public comment is required for the adoption of new rules. These parties accordingly oppose the proposed extension of the rules' expiration date to any date after August 1.

In its comments, Worldspan regretfully states that our failure to act on the proposals for prohibiting liquidated damages and minimum use clauses in contracts for CRS services between travel agency subscribers and CRS vendors has caused it to end its experiment in offering travel agencies CRS subscription contracts containing neither type of clause, because Worldspan cannot put itself in a disadvantageous position where its subscribers can be converted without penalty by competing systems while Worldspan can obtain subscribers from users of other system only by indemnifying those agencies for liquidated damages.

Southwest Airlines filed a late comment agreeing that the current rules should be extended until new rules are in place but arguing that new rules should be adopted well before December 11. Southwest asserts in particular that we should quickly adopt a rule allowing travel agencies to use third-party equipment as their CRS terminals, as proposed in our NPRM, since such a rule would enable carriers like Southwest to establish direct electronics links between their internal reservations systems and travel agency terminals and thereby promote competition and reduce airline costs. Furthermore, Southwest contends that the President's regulatory review should require the early adoption of new CRS rules; the President's order directs agencies to complete rulemakings that will create jobs and enhance economic growth, and, according to Southwest, our proposed CRS rules will further those goals.

Covia states that we should adopt final rules as soon as possible, since continued delay in the rulemaking creates significant business uncertainties for Covia and its customers, may encourage ill-advised legislative efforts to resolve CRS issues, and aggravates the problems created because the record is assertedly already out of date.

Rather than comment directly on the proposed change in the rules' expiration date, American alleges that we cannot adopt additional rules without a further investigation of the issues, particularly with respect to the various proposals that would require each CRS to offer equal functionality to all participating carriers.

While United (the carrier that controls Covia) does not oppose an extension of the current rules, United agrees with Covia that the record is out-of-date. United also notes that the General Accounting Office's recent report on CRS issues concluded that the rulemaking data's on certain

architectural bias was insufficient to justify adoption of the more radical proposals for eliminating so-called architectural bias. In United's view, we should take the time needed to analyze the relevant issues before adopting any new rules rather than adopt rules because of any deadline established by Department.

Need for Extending the Expiration Date

After reviewing the comments, we have determined to adopt our proposal to amend § 255.10(b) to change the rules' expiration date to December 11, 1992. We cannot complete the rulemaking on whether the current rules should be readopted, with or without changes, by May 31, 1992, and allowing the current rules to expire would be disruptive, as explained in our Notice of Proposed Rulemaking.

We could not adopt new CRS rules by the August 1 deadline proposed by the Alaska group. Because of the regulatory review required by the President, we suspended work on the CRS rules in order to implement the President's directive that we focus our attention on identifying and eliminating burdensome and unnecessary rules already in force. We have identified many such regulations, and carrying out the task of modifying or repealing those regulations will force a delay in our consideration of new CRS rules. In arguing that the President's regulatory review order sets an August 1 deadline for the completion of the CRS rulemaking, the Alaska group has misconstrued the President's instructions. The President stated that agencies should complete rulemakings by August 1 that required no further public comment, if those rulemakings had been identified in the regulatory review process as rulemakings needed for ending unnecessary rules. We did not identify the CRS rulemaking as such a rulemaking in our regulatory review. Instead, our "Report to the President: Review of Regulations" stated that the CRS rules required further review. As a result, the August 1 deadline does not apply to the CRS rulemaking. Finally, the Alaska group's request for a quick completion of this proceeding overlooks the complexity of the issues and the comments on the NPRM that suggested that a number of our proposals should be revised or reconsidered.

We recognize the importance of completing the rulemaking as soon as possible, consistently with the President's instructions on regulatory policy, and we intend to do so.

We recognize that the comments and reply comments on our NPRM were filed almost one year ago and that the CRS and airline businesses may have changed since we issued the NPRM. If, as Covia and United assert, the record should be updated to reflect such changes, Covia and United, as well as other parties, should file supplemental comments advising us of such developments, as American, for example, has done.

Effective Date

We have determined for good cause to make this amendment effective on May 29, 1992, rather than 30 days after publication as required by the Administrative Procedure Act, 5 U.S.C. 553(d), except for good cause shown. In order to maintain the current rules in effect on a continuing basis, we must make this amendment effective by May 29, 1992. Since the amendment preserves the status quo, it will require no changes in the current operations of the CRS vendors, U.S. and foreign airlines, and travel agencies. As a result, making the amendment effective less than 30 days after publication will not burden anyone.

Regulatory Impact Analysis

Executive Order 12291 requires each executive agency to prepare a regulatory impact analysis for every "major rule". The Order defines a major rule as one likely to result in (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers, individual industries, federal, state, or local government agencies, or geographic regions; or (3) significant adverse effects on competition, employment, investment, productivity, innovation, or the ability of the United States-based enterprises to compete with foreign-based enterprises in domestic or export markets. The CRS regulations appear to be a major rule, since they would probably have an annual impact on the economy of $100 million or more.

Our notice proposing to change the rules' expiration date pointed out that the Board had done a regulatory impact analysis in its CRS rulemaking and that our NPRM also contained such an analysis (see 56 FR 12627–12630), although that analysis focused on the effects of the proposed changes to the rules. We stated that the Board's analysis, as modified by our NPRM's analysis, appeared to remain valid for our proposal to extend the rules' expiration date, and that we therefore proposed to rely on those analyses. We noted that we would consider comments from any parties on that analysis before making our proposal final.

No one filed comments on the regulatory impact analysis. We will therefore make final our initial regulatory impact analysis.

Initial Regulatory Flexibility Analysis

The Regulatory Flexibility Act (Pub. L. 96–354) is intended to ensure that agencies consider flexible approaches to the regulation of small businesses and other small entities. It requires regulatory flexibility analyses for rules that, if adopted, would have a significant economic impact on a substantial number of small business entities. In its rulemaking the Board had conducted a regulatory flexibility analysis on the rules' impact, see 49 FR 32560–32561, as noted in our notice proposing to change the May 31, 1992, expiration date. We stated there that the amendment would not change the existing regulation of small businesses and that the Board's analysis appeared applicable to our proposed amendment. We therefore stated that we would adopt that analysis, subject to any comments filed on the proposal.

No party commented on the regulatory flexibility analysis. We have accordingly determined to make final our initial analysis.

Paperwork Reduction Act

This rule will not impose any collection-of-information requirements and so is not subject to the Paperwork Reduction Act, Public Law 96–511, 44 U.S.C. Chapter 35.

Federalism Implications

This rule will not have substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, in accordance with Executive Order 12812, we have determined that the rule does not have sufficient federalism implications to warrant preparation of a Federalism Assessment.

List of Subjects in 14 CFR Part 255

Air carriers, Antitrust, Reporting and recordkeeping requirements.

Accordingly, the Department of Transportation is amending 14 CFR part 255, Carrier-owned Computer Reservation Systems, as follows:

PART 255—CARRIER-OWNED COMPUTER RESERVATION SYSTEMS

1. The authority citation for part 255 continues to read as follows:

Authority: Secs. 102, 204, 404, 411, 419, 1102; Pub. L. 85–726 as amended, 72 Stat. 740, 743, 760, 769, 797; 92 Stat. 1732; 49 U.S.C. 1302, 1324, 1374, 1381, 1389, 1502.

2. Section 255.10 is revised to read as follows:

§ 255.10 Review and termination.

Unless extended, this part shall terminate on December 11, 1992.

Issued in Washington, DC on: May 26, 1992.

Andrew H. Card, Jr.,

Secretary of Transportation.

[FR Doc. 92-12710 Filed 5-27-92; 11:15 am]

BILLING CODE 4910-62-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 8419]

RIN 1545-AC37

One Class of Stock Requirement

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the requirement that a small business corporation have only one class of stock. Changes to the applicable law were made by the Subchapter S Revision Act of 1982. These regulations affect corporations and their shareholders and are necessary to provide them with guidance needed to comply with the applicable tax law.

EFFECTIVE DATE: These regulations are effective for taxable years of the corporation beginning on or after May 28, 1992. However, grandfathering rules are provided for instruments, obligations, or agreements issued or entered into before May 28, 1992. In addition, corporations and their shareholders may apply these regulations to prior taxable years.

FOR FURTHER INFORMATION CONTACT: Scott Carlson (202) 343-8459 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On August 13, 1991, the Internal Revenue Service published in the **Federal Register** a notice of proposed rulemaking (56 FR 38391) amending the Income Tax Regulations (26 CFR part 1) under section 1361 of the Internal Revenue Code (Code) and replacing an earlier notice of proposed rulemaking (55 FR 40870) published in the **Federal Register** of October 5, 1990. These amendments were proposed to implement section 1361 (b)(1)(D) and (c)(4) and (5) as added by the Subchapter S Revision Act of 1982. The notice provided rules relating to the one class of stock requirement for small business corporations electing S status under section 1362 of the Code. Comments responding to the notice were received, and a public hearing was held on October 31, 1991. After considering the comments and the statements made at the hearing, the Service adopts the proposed regulations as revised by this Treasury Decision.

Certain provisions relating to other requirements under section 1361 are reserved in this document. See the notice of proposed rulemaking published in the **Federal Register** (51 FR 35659) on October 7, 1986, with respect to those provisions.

Explanation of Provisions

General Rules

The proposed and final regulations provide that a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock. Under the proposed and final regulations, the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and any binding agreements relating to distribution or liquidation proceeds (collectively, the governing provisions). The proposed and final regulations also provide that although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Under the proposed regulations, a routine commercial contractual arrangement is not a binding agreement relating to distribution and liquidation proceeds, and thus is not a governing provision, unless the arrangement is entered into to circumvent the one class of stock requirement. In response to comments, the final regulations clarify this rule by deleting the word routine, which caused confusion, and by adding a principal purpose standard. The final regulations thus provide that a commercial contractual agreement is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement.

Comments also requested guidance on the appropriate tax effects of distributions that differ in timing or amount. Because the tax effects of such distributions are necessarily based on other provisions of the Code, general tax law principles, and the particular facts and circumstances, the final regulations do not provide additional guidance on this issue.

Shares Taken Into Account

Under the proposed and final regulations, all outstanding shares of stock are taken into account in determining whether a corporation has more than one class of stock. The proposed regulations provide that, for purposes of subchapter S, stock that is issued in connection with the performance of services for the corporation and that is substantially nonvested (within the meaning of § 1.83-3(b)) is not treated as outstanding stock unless the holder makes an election with respect to the stock under section 83(b).

Comments stated that limiting application of these rules to situations in which the services are performed for the corporation is overly restrictive and inconsistent with the regulations under section 83. In response to these comments, the final regulations permit the application of these rules when the services are not performed for the corporation.

Some S corporations have treated substantially nonvested stock for which no section 83(b) election has been made as outstanding stock for purposes of the subchapter S income allocation provisions. Although the final regulations are effective for taxable years of a corporation beginning on or after May 28, 1992, existing stock that has been treated as outstanding by the corporation (even though it is substantially nonvested) is treated as outstanding for purposes of subchapter S, and the fact that it is substantially nonvested and no section 83(b) election has been made with respect to it does not cause the stock to be treated as a second class of stock. The fact that a corporation has been furnished a Schedule K-1 (Form 1120S) with respect to the stock is evidence that the corporation has treated the stock as outstanding.

Some comments requested clarification of certain aspects of the interaction of section 83 and these regulations. The Service is reviewing these issues and plans to issue further guidance addressing them.

The proposed and final regulations also provide that deferred compensation arrangements that do not involve section 83 property are ordinarily not treated as outstanding stock for purposes of subchapter S. Generally, this provision applies to arrangements issued pursuant to a plan under which the employee or independent contractor is not taxed currently on income. However, in response to comments, the final regulations clarify that even in cases in which the deferred compensation plan has a current payment feature (*e.g.*, it provides for the payment of dividend equivalent amounts that are taxed currently as compensation) the plan fits within the deferred compensation exception.

Exceptions to General Rules

State Laws

The proposed and final regulations provide that certain types of state laws are disregarded in determining whether all of a corporation's outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Under the proposed and final regulations, state laws that require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders are disregarded, provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds.

Comments requested that the final regulations address whether the same result would follow if the payments of state income taxes were treated not as constructive distributions but as advances that must be repaid or offset by reductions in distributions. The Service and Treasury believe that the same analysis should apply whether the payments of state income taxes are treated as constructive distributions or as advances that are required to be repaid or offset against distributions. In response to the comments, the final regulations clarify this issue by example.

Redemption and Buy-Sell Agreements and Restrictions on Transferability

The proposed and final regulations provide that agreements to redeem or purchase stock at the time of death, disability, or termination of employment are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights. Some comments suggested that redemption or buy-sell agreements triggered by divorce should also be disregarded. In response to these comments, the final regulations disregard agreements triggered by divorce. In addition, the final regulations provide that the Commissioner, at her discretion, may adopt other exceptions.

Other comments expressed concern about the application of the proposed regulations to forfeiture provisions that cause a share of stock to be substantially nonvested under section 83 of the Code. In response, the final regulations provide that forfeiture provisions that cause a share of stock to be substantially nonvested are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights. Thus, if substantially nonvested stock is treated as outstanding because a section 83 (b) election has been made with respect to it, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded.

The proposed regulations treat general and non-general redemption agreements differently. In response to comments concerning this disparate treatment, the final regulations eliminate the distinction between general and non-general redemption agreements. Under the final regulations, all redemption and buy-sell agreements that are not disregarded under the rules described in the previous two paragraphs are evaluated under a single standard. The final regulations provide that buy-sell agreements, agreements to restrict the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless (i) a principal purpose of the agreement is to circumvent the one class of stock requirement and (ii) the agreement establishes a redemption or purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. As under the proposed regulations, if an agreement provides for the purchase or redemption of stock at book value or at a price between fair market value and book value, it is disregarded.

Some comments expressed uncertainty as to whether put options are subject to this rule. The final regulations do not specifically address this issue. The Service and Treasury believe that an agreement that effectively constitutes a buy-sell or redemption agreement should be treated as such regardless of its designation.

In addition, comments requested clarification of the term book value. In response, the final regulations provide two safe harbors. First, a determination of book value in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments) will be respected. Second, a determination of book value used for any substantial nontax purpose will be respected.

The proposed regulations did not contain any grandfathering provisions applicable to buy-sell or redemption agreements. In response to comments, the final regulations grandfather buy-sell agreements, redemption agreements, and agreements restricting transferability that are entered into before May 28, 1992.

Rules Relating to Debt Obligations, Call Options, and Similar Instruments

In General

The proposed and final regulations provide that instruments, obligations, or arrangements may be treated as a second class of stock in certain circumstances. Like the proposed regulations, the final regulations provide a number of safe harbors or exceptions for certain ordinary business arrangements entered into by S corporations and their shareholders.

Obligations Designated as Debt

The proposed regulations provide that an obligation (whether or not designated as debt) is not treated as a second class of stock unless two conditions are met: (1) The obligation constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law, and (2) the obligation is used to contravene the rights conferred by the corporation's outstanding stock with regard to distribution or liquidation proceeds or to contravene the limitation on eligible shareholders.

In response to comments requesting clarification of the contravention standard and to simplify the regulations, the final regulations substitute for the contravention standard the principal purpose standard that is used elsewhere in the final regulations. Thus, the second condition that must be met for an obligation to be considered a second class of stock under the final regulations is that a principal purpose of the obligation is to circumvent the rights conferred by the corporation's outstanding stock or to circumvent the limitation on eligible shareholders.

Call Options

The proposed regulations provide that a call option (or similar instrument) is not treated as a second class of stock unless, taking into account all the facts and circumstances, the call option is substantially certain to be exercised and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred to a person who is not an eligible shareholder, or materially modified.

Some comments stated that options should never be taken into account in determining whether a corporation has more than one class of stock and cited Rev. Rul. 67–269, 1967–2 C.B. 298, as authority for their position. Rev. Rul. 67–269 does not address deep-in-the-money options. The Service and Treasury believe that deep-in-the-money options effectively confer rights to corporate equity and should be taken into account for purposes of the one class of stock requirement. The final regulations retain the proposed option rules with the modifications discussed below.

Comments also suggested that options should not be retested on transfer from one ineligible shareholder to another or when transfer is by operation of law. In response to these comments, the final regulations adopt a rule that does not retest options on transfer from one ineligible shareholder to another. The Service and Treasury believe that this rule covers most transfers by operation of law that should be excepted. However, the final regulations provide that the Commissioner, in her discretion, may adopt other exceptions.

Guidance was also requested on the treatment of options that vest over time. This type of option could be tested once (when granted) or on several occasions (as vesting occurs). To clarify this question, the comment suggested defining the date of issuance of an option as the date the corporation becomes contractually bound to grant the option and the grant is not subject to contingencies beyond the corporation's control. The Service and Treasury do not believe that it is appropriate to define the date of issuance of an option in the section 1361 regulations. Furthermore, the Service and Treasury believe most options that vest over time will fall within the exception for options issued to employees and independent contractors (discussed below) and, thus will not be tested on date of issuance in any event. However, the Service and Treasury may issue further guidance on this question.

Exceptions for Certain Call Options

The proposed and final regulations set forth two exceptions for call options. First, a call option is not treated as a second class of stock if it is issued to a person that is actively and regularly engaged in the business of lending and is issued in connection with a loan to the corporation that is commercially reasonable. Second, a call option that is issued to an individual who is an employee or an independent contractor in connection with the performance of services (and that is not excessive by reference to the services performed) is not treated as a second class of stock if the call option is nontransferable within the meaning of § 1.83–3(d) and the call option does not have a readily ascertainable fair market value as defined in § 1.83–7(b) at the time the option is issued.

Comments questioned whether a lender could transfer an option and accompanying loan to another lender and remain within the scope of the lender exception. The final regulations specifically provide that the exception continues to apply if a lender transfers an option and the accompanying loan (or a portion of the option and a corresponding portion of the accompanying loan). If a lender transfers the option without a corresponding portion of the loan, the lender exception ceases to apply.

It is not intended that lenders be treated less favorably than other persons to whom options are issued. For this reason, if on the date it is issued to a lender an option is not substantially certain to be exercised or does not have a strike price substantially below the fair market value of the underlying stock, the option is not retested on any subsequent transfer from one ineligible shareholder to another. However, if on the date it is issued to a lender an option is substantially certain to be exercised and has a strike price substantially below the fair market value of the underlying stock, and the lender exception later ceases to apply because the lender transfers the option without the loan, the option is tested on the date of transfer.

Comments also questioned whether the exception for options issued to employees and independent contractors extends beyond termination of employee or independent contractor status. The final regulations clarify by example that this exception is not affected by termination of employee or independent contractor status.

In addition, a comment requested that the exception for options issued to employees and independent contractors specifically apply if the services are performed either for the issuing corporation or for a corporation more than 50 percent of the stock of which is owned by the issuing corporation (by vote and value). The final regulations adopt this rule.

Effective Date

These regulations generally apply to taxable years of a corporation beginning on or after May 28, 1992. However, these regulations do not apply to: an instrument, obligation, or arrangement issued or entered into before May 28, 1992 and not materially modified after that date; a buy-sell agreement, redemption agreement, or agreement restricting transferability entered into before May 28, 1992 and not materially modified after that date; or a call option or similar instrument issued before May 28, 1992 and not materially modified after that date. Corporations and their shareholders may apply these regulations to prior taxable years.

In addition, as noted above, a grandfather rule is provided for existing stock that has been treated as outstanding even though it is substantially nonvested and no section 83(b) election has been made with respect to it.

Special Analyses

It has been determined that these final rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for the regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these final regulations are David R. Haglund and Scott Carlson of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in their development.

List of Subjects in 26 CFR 1.1361–OA Through 1.1378–3

Income taxes, Reporting and recordkeeping requirements, Small businesses.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 * * * Section 1.1361–1(l) also issued under 26 U.S.C. 1361(c)(5)(C).

Par. 2. A new undesignated center heading is added immediately following § 1.1 348–3 to read as follows:

Small Business Corporations and Their Shareholders

§ 1.1361–OA [Redesignated as § 1.1361–O]

Par. 3. Section 1.1361–OA is redesignated as § 1.1361–0.

§ 1.1361–O [Amended]

Par. 4. Newly designated § 1.1361–O is amended by:

1. Removing the language "1.1374–1A" each place it appears and adding "1.1374–1" in its place.

2. Removing the language "1.1375–1A" each place it appears and adding "1.1375–1" in its place.

Par. 5. Section 1.1361–1 is added to read as follows:

§1.1361–1 S corporation defined.

(a) [Reserved]

(b) *Small business corporation defined*—(1) *In general.* For purposes of subchapter S, chapter 1 of the Code and the regulations thereunder, the term small business corporation means a domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2)) and that does not have—

(i) More than 35 shareholders;

(ii) As a shareholder, a person (other than an estate and other than certain trusts described in section 1361(c)(2)) who is not an individual;

(iii) A nonresident alien as a shareholder; or

(iv) More than one class of stock.

(2) *Estate in bankruptcy.* The term *estate*, for purposes of this paragraph, includes the estate of an individual in a case under title 11 of the United States Code.

(3) *Treatment of restricted stock.* For purposes of subchapter S, stock that is issued in connection with the performance of services (within the meaning of § 1.83–3(f)) and that is substantially nonvested (within the meaning of § 1.83–3(b)) is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under section 83(b). In the event of such an election, the stock is treated as outstanding stock of the corporation, and the holder of the stock is treated as a shareholder for purposes of subchapter S. See paragraphs (l) (1) and (3) of this section for rules for determining whether substantially nonvested stock with respect to which an election under section 83(b) has been made is treated as a second class of stock.

(4) *Treatment of deferred compensation plans.* For purposes of subchapter S, an instrument, obligation, or arrangement is not outstanding stock if it—

(i) Does not convey the right to vote;

(ii) Is an unfunded and unsecured promise to pay money or property in the future;

(iii) Is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and

(iv) Is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income.

A deferred compensation plan that has a current payment feature (*e.g.*, payment of dividend equivalent amounts that are taxed currently as compensation) is not for that reason excluded from this paragraph (b)(4).

(5) *Treatment of straight debt.* For purposes of subchapter S, an instrument or obligation that satisfies the definition of straight debt in paragraph (l)(5) of this section is not treated as outstanding stock.

(6) *Effective date provision.* Section 1.1361–1(b) generally applies to taxable years of a corporation beginning on or after May 28, 1992. However, a corporation and its shareholders may apply this § 1.1361–1(b) to prior taxable years. In addition, substantially nonvested stock issued on or before May 28, 1992 that has been treated as outstanding by the corporation is treated as outstanding for purposes of subchapter S, and the fact that it is substantially nonvested and no section 83(b) election has been made with respect to it will not cause the stock to be treated as a second class of stock.

(c) through (k) [Reserved]

(l) *Classes of stock*—(1) *General rule.* A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (l)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

(2) *Determination of whether stock confers identical rights to distribution and liquidation proceeds*—(i) *In general.* The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

(ii) *State law requirements for payment and withholding of income tax.* State laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. Such laws are disregarded

in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, within the meaning of paragraph (l)(1) of this section, provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

(iii) *Buy-sell and redemption agreements*—(A) *In general.* Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless—

(*1*) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l), and

(*2*) The agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights. For purposes of this paragraph (l)(2)(iii)(A), a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence. Although an agreement may be disregarded in determining whether shares of stock confer identical distribution and liquidation rights, payments pursuant to the agreement may have income or transfer tax consequences.

(B) *Exception for certain agreements.* Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of § 1.83-3(b)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Furthermore, the Commissioner may provide by Revenue Ruling or other published guidance that other types of bona fide agreements to redeem or purchase stock are disregarded.

(C) *Safe harbors for determinations of book value.* A determination of book value will be respected if—

(*1*) The book value is determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments); or

(*2*) The book value is used for any substantial nontax purpose.

(iv) *Distributions that take into account varying interests in stock during a taxable year.* A governing provision does not, within the meaning of paragraph (l)(2)(i) of this section, alter the rights to liquidation and distribution proceeds conferred by an S corporation's stock merely because the governing provision provides that, as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current or immediately preceding taxable year. If distributions pursuant to the provision are not made within a reasonable time after the close of the taxable year in which the varying interests occur, the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock.

(v) *Examples.* The application of paragraph (l)(2) of this section may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

Example 1. Determination of whether stock confers identical rights to distribution and liquidation proceeds. (i) The law of State A requires that permission be obtained from the State Commissioner of Corporations before stock may be issued by a corporation. The Commissioner grants permission to S, a corporation, to issue its stock subject to the restriction that any person who is issued stock in exchange for property, and not cash, must waive all rights to receive distributions until the shareholders who contributed cash for stock have received distributions in the amount of their cash contributions.

(ii) The condition imposed by the Commissioner pursuant to state law alters the rights to distribution and liquidation proceeds conferred by the outstanding stock of S so that those rights are not identical. Accordingly, under paragraph (l)(2)(i) of this section, S is treated as having more than one class of stock and does not qualify as a small business corporation.

Example 2. Distributions that differ in timing. (i) S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes $50,000 to A in the current year, but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.

(ii) Under paragraph (l)(2)(i) of this section, the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, section 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

Example 3. Treatment of excessive compensation. (i) S, a corporation, has two equal shareholders, C and D, who are each employed by S and have binding employment agreements with S. The compensation paid by S to C under C's employment agreement is reasonable. The compensation paid by S to D under D's employment agreement, however, is found to be excessive. The facts and circumstances do not reflect that a principal purpose to D's employment agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the employment agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the employment agreements, even though S is not allowed a deduction for the excessive compensation paid to D.

Example 4. Agreement to pay fringe benefits. (i) S, a corporation, is required under binding agreements to pay accident and health insurance premiums on behalf of certain of its employees who are also shareholders. Different premium amounts are paid by S for each employee-shareholder. The facts and circumstances do not reflect that a principal purpose of the agreements is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the agreements. In addition, S is not treated as having more than one class of stock by reason of the payment of fringe benefits.

Example 5. Below-market corporation-shareholder loan. (i) E is a shareholder of S, a corporation. S makes a below-market loan to E that is a corporation-shareholder loan to which section 7872 applies. Under section 7872, E is deemed to receive a distribution with respect to S stock by reason of the loan. The facts and circumstances do not reflect that a principal purpose of the loan is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the loan agreement is not a governing provision. Accordingly, S is not treated as having more than one class of stock by reason of the below-market loan to E.

Example 6. Agreement to adjust distributions for state tax burdens. (i) S, a

corporation, executes a binding agreement with its shareholders to modify its normal distribution policy by making upward adjustments of its distributions to those shareholders who bear heavier state tax burdens. The adjustments are based on a formula that will give the shareholders equal after-tax distributions.

(ii) The binding agreement relates to distribution or liquidation proceeds. The agreement is thus a governing provision that alters the rights conferred by the outstanding stock of S to distribution proceeds so that those rights are not identical. Therefore, under paragraph (l)(2)(i) of this section, S is treated as having more than one class of stock.

Example 7. State law requirements for payment and withholding of income tax. (i) The law of State X requires corporations to pay state income taxes on behalf of nonresident shareholders. The law of State X does not require corporations to pay state income taxes on behalf of resident shareholders. S is incorporated in State X. S's resident shareholders have the right (for example, under the law of State X or pursuant to S's bylaws or a binding agreement) to distributions that take into account the payments S makes on behalf of its nonresident shareholders.

(ii) The payment by S of state income taxes on behalf of its nonresident shareholders are generally treated as constructive distributions to those shareholders. Because S's resident shareholders have the right to equal distributions, taking into account the constructive distributions to the nonresident shareholders, S's shares confer identical rights to distribution proceeds. Accordingly, under paragraph (l)(2)(ii) of this section, the state law requiring S to pay state income taxes on behalf of its nonresident shareholders is disregarded in determining whether S has more than one class of stock.

(iii) The same result would follow if the payments of state income taxes on behalf of nonresident shareholders are instead treated as advances to those shareholders and the governing provisions require the advances to be repaid or offset by reductions in distributions to those shareholders.

Example 8. Redemption agreements. (i) F, G, and H are shareholders of S, a corporation. F is also an employee of S. By agreement, S is to redeem F's shares on the termination of F's employment.

(ii) On these facts, under paragraph (l)(2)(iii)(B) of this section, the agreement is disregarded in determining whether all outstanding shares of S's stock confer identical rights to distribution and liquidation proceeds.

Example 9. Analysis of redemption agreements. (i) J, K, and L are shareholders of S, a corporation. L is also an employee of S. L's shares were not issued to L in connection with the performance of services. By agreement, S is to redeem L's shares for an amount significantly below their fair market value on the termination of L's employment or if S's sales fall below certain levels.

(ii) Under paragraph (l)(2)(iii)(B) of this section, the portion of the agreement providing for redemption of L's stock on termination of employment is disregarded. Under paragraph (l)(2)(iii)(A), the portion of the agreement providing for redemption of L's stock if S's sales fall below certain levels is disregarded unless a principal purpose of that portion of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(3) *Stock taken into account.* Except as provided in paragraphs (b) (3), (4), and (5) of this section (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account. For example, substantially nonvested stock with respect to which an election under section 83(b) has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical, within the meaning of paragraph (l)(1) of this section, to the rights conferred by the other outstanding shares of stock.

(4) *Other instruments, obligations, or arrangements treated as a second class of stock*—(i) *In general.* Instruments, obligations, or arrangements are not treated as a second class of stock for purposes of this paragraph (l) unless they are described in paragraph (l)(5) (ii) or (iii) of this section. However, in no event are instruments, obligations, or arrangements described in paragraph (b)(4) of this section (relating to deferred compensation plans), paragraphs (l)(4)(iii) (B) and (C) of this section (relating to the exceptions and safe harbor for options), paragraph (l)(4)(ii)(B) of this section (relating to the safe harbors for certain short-term unwritten advances and proportionally-held debt), or paragraph (l)(5) of this section (relating to the safe harbor for straight debt), treated as a second class of stock for purposes of this paragraph (l).

(ii) *Instruments, obligations, or arrangements treated as equity under general principles*—(A) *In general.* Except as provided in paragraph (l)(4)(i) of this section, any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock described in paragraph (l)(3) of this section), regardless of whether designated as debt, is treated as a second class of stock of the corporation—

(*1*) If the instrument, obligation, or arrangement constituters equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law; and

(*2*) A principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders contained in paragraph (b)(1) of this section.

(B) *Safe harbor for certain short-term unwritten advances and proportionately held obligations*—(*1*) *Short-term unwritten advances.* Unwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time are not treated as a second class of stock for that taxable year, even if the advances are considered equity under general principles of Federal tax law. The failure of an unwritten advance to meet this safe harbor will not result in a second class of stock unless the advance is considered equity under paragraph (l)(4)(ii)(A)(*1*) of this section and a principal purpose of the advance is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (l)(4)(ii)(A)(*2*) of this section.

(*2*) *Proportionately-held obligations.* Obligations of the same class that are considered equity under general principles of Federal tax law, but are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, are not treated as a second class of stock. Furthermore, an obligation or obligations owned by the sole shareholder of a corporation are always held proportionately to the corporation's outstanding stock. The obligations that are considered equity that do not meet this safe harbor will not result in a second class of stock unless a principal purpose of the obligations is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (l)(4)(ii)(A)(*2*) of this section.

(iii) *Certain call options, warrants or similar instruments*—(A) *In general.* Except as otherwise provided in this paragraph (l)(4)(iii), a call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred

by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified. For purposes of this paragraph (l)(4)(iii), if an option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the terms of the loan, the extension of the time period in which the option may be exercised is not considered a material modification. In addition, a call option does not have a strike price substantially below fair market value if the price at the time of exercise cannot, pursuant to the terms of the instrument, be substantially below the fair market value of the underlying stock at the time of exercise.

(B) *Certain exceptions.* (*1*) A call option is not treated as a second class of stock for purposes of this paragraph (l) if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation. This paragraph (l)(4)(iii)(B)(*1*) continues to apply if the call option is transferred with the loan (or if a portion of the call option is transferred with a corresponding portion of the loan). However, if the call option is transferred without a corresponding portion of the loan, this paragraph (l)(4)(iii)(B)(*1*) ceases to apply. Upon that transfer, the call option is tested under paragraph (l)(4)(iii)(A) (notwithstanding anything in that paragraph to the contrary) if, but for this paragraph, the call option would have been treated as a second class of stock on the date it was issued.

(*2*) A call option that is issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) is not treated as a second class of stock for purposes of this paragraph (l) if—

(*i*) The call option is nontransferable within the meaning of § 1.83–3(d); and

(*ii*) The call option does not have a readily ascertainable fair market value as defined in § 1.83–7(b) at the time the option is issued.

If the call option becomes transferable, this paragraph (l)(4)(iii)(B)(*2*) ceases to apply. Solely for purposes of this paragraph (l)(4)(iii)(B)(*2*), a corporation is related to the issuing corporation if more than 50 percent of the total voting power and total value of its stock is owned by the issuing corporation.

(*3*) The Commissioner may provide other exceptions by Revenue Ruling or other published guidance.

(C) *Safe harbor for certain options.* A call option is not treated as a second class of stock if, on the date the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. For purposes of this paragraph (l)(4)(iii)(C), a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence to obtain a fair value. Failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock.

(iv) *Convertible debt.* A convertible debt instrument is considered a second class of stock if—

(A) It would be treated as a second class of stock under paragraph (l)(4)(ii) of this section (relating to instruments, obligations, or arrangements treated as equity under general principles); or

(B) It embodies rights equivalent to those of a call option that would be treated as a second class of stock under paragraph (l)(4)(iii) of this section (relating to certain call options, warrants, and similar instruments).

(v) *Examples.* The application of this paragraph (l)(4) may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

Example 1. Transfer of call option by eligible shareholder to ineligible shareholder. (i) S, a corporation, has 10 shareholders. S issues call options to A, B, and C, individuals who are U.S. residents. A, B, and C are not shareholders, employees, or independent contractors of S. The options have a strike price of $40 and are issued on a date when the fair market value of S stock is also $40. A year later, P, a partnership, purchases A's option. On the date of transfer, the fair market value of S stock is $80.

(ii) On the date the call option is issued, its strike price is not substantially below the fair market value of the S stock. Under paragraph (l)(4)(iii)(A) of this section, whether a call option is a second class of stock must be redetermined if the call option is transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section. In this case, A is an eligible shareholder of S under paragraph (b)(1) of this section, but P is not. Accordingly, the option is retested on the date it is transferred to D.

(iii) Because on the date the call option is transferred to P its strike price is 50% of the fair market value, the strike price is substantially below the fair market value of the S stock. Accordingly, the call option is treated as a second class of stock as of the date it is transferred to P if, at that time, it is determined that the option is substantially certain to be exercised. The determination of whether the option is substantially certain to be exercised is made on the basis of all the facts and circumstances.

Example 2. Call option issued in connection with the performance of services (i) E is a bona fide employee of S, a corporation. S issues to E a call option in connection with E's performance of services. At the time the call option is issued, it is not transferable and does not have a readily ascertainable fair market value. However, the call option becomes transferable before it is exercised by E.

(ii) While the option is not transferable, under paragraph (l)(4)(iii)(B)(*2*) of this section it is not treated as a second class of stock, regardless of its strike price. When the option becomes transferable, that paragraph ceases to apply, and the general rule of paragraph (l)(4)(iii)(A) of this section applies. Accordingly, if the option is materially modified or is transferred to a person who is not an eligible shareholder under paragraph (b)(1) of this section, and on the date of such modification or transfer, the option is substantially certain to be exercised and has a strike price substantially below the fair market value of the underlying stock, the option is treated as a second class of stock.

(iii) If E left S's employment before the option became transferable, the exception provided by paragraph (l)(4)(iii)(B)(*2*) would continue to apply until the option became transferable.

(5) *Straight debt safe harbor*—(i) *In general.* Notwithstanding paragraph (l)(4) of this section, straight debt is not treated as a second class of stock. For purposes of section 1361(c)(5) and this section, the term straight debt means a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, which—

(A) Does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;

(B) Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and

(C) Is held by an individual (other than a nonresident alien), an estate, or a trust described in section 1361(c)(2).

(ii) *Subordination.* The fact that an obligation is subordinated to other debt of the corporation does not prevent the obligation from qualifying as straight debt.

(iii) *Modification or transfer.* An obligation that originally qualifies as straight debt ceases to so qualify if the obligation—

(A) Is materially modified so that it no longer satisfies the definition of straight debt; or

(B) Is transferred to a third party who is not an eligible shareholder under paragraph (b)(1) of this section.

(iv) *Treatment of straight debt for other purposes.* An obligation of an S corporation that satisfies the definition of straight debt in paragraph (l)(5)(i) of this section is not treated as a second class of stock even if it is considered equity under general principles of Federal tax law. Such an obligation is generally treated as debt and when so treated is subject to the applicable rules governing indebtedness for other purposes of the Code. Accordingly, interest paid or accrued with respect to a straight debt obligation is generally treated as interest by the corporation and the recipient and does not constitute a distribution to which section 1368 applies. However, if a straight debt obligation bears a rate of interest that is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest. Such a recharacterization does not result in a second class of stock.

(v) *Treatment of C corporation debt upon conversion to S status.* If a C corporation has outstanding an obligation that satisfies the definition of straight debt in paragraph (l)(5)(i) of this section, but that is considered equity under general principles of Federal tax law, the obligation is not treated as a second class of stock for purposes of this section if the C corporation converts to S status. In addition, the conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to such an instrument.

(6) *Inadvertent terminations.* See section 1362(f) and the regulations thereunder for rules relating to inadvertent terminations in cases where the one class of stock requirement has been inadvertently breached.

(7) *Effective date.* Section 1.1361–1(l) generally applies to taxable years of a corporation beginning on or after May 28, 1992. However, § 1.1361–1(l) does not apply to: an instrument, obligation, or arrangement issued or entered into before May 28, 1992 and not materially modified after that date; a buy-sell agreement, redemption agreement, or agreement restricting transferability entered into before May 28, 1992 and not materially modified after that date; or a call option or similar instrument issued before May 28, 1992 and not materially modified after that date. In addition, a corporation and its shareholders may apply this § 1.1361–1(l) to prior taxable years.

§§ 1.1374–1A and 1.1375–1A [Redesignated as §§ 1.1374–1 and 1.1375–1]

Par. 6. Sections 1.1374–1A and 1.1375–1A are redesignated §§ 1.1374–1 and 1.1375–1, respectively.

§ 1.1374–1 [Amended]

Par. 7. Newly designated § 1.1374–1 is amended as follows:

1. The concluding text of paragraph(b)(2) is amended by removing the language "1.1375–1A(c)(2)" and adding in its place "1.1375–1(c)(2)".

2. Paragraph (d)(2) is amended by removing the language "1.1375–1A(c)(2)" and "1.1374–1A(b)(2)" and adding in its place "1.1375–1(c)(2)" and "1.1374–1(b)(2)".

§ 1.1375–1 [Amended]

Par. 8. Newly designated § 1.1375–1 is amended as follows:

1. Paragraph (b)(1)(ii) is amended by removing the language "1.1374–1A(d)" and adding in its place "1.1374–1(d)".

2. The concluding text of paragraph (c)(2) is amended by removing the language "1.1374–1A(b)(1)" and adding in its place "1.1374–1(b)(1)".

Shirley D. Peterson,

Commissioner of Internal Revenue.

Approved: May 13, 1992.

Fred T. Goldberg, Jr.,

Assistant Secretary of the Treasury.

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DEPARTMENT OF THE INTERIOR

Office of Surface Mining Reclamation and Enforcement

30 CFR Part 914

Indiana Permanent Regulatory Program; Revegetation—Nonprime Farmland

AGENCY: Office of Surface Mining Reclamation and Enforcement (OSM), Interior.

ACTION: Final rule; approval of amendment.

SUMMARY: OSM is announcing the approval with certain exceptions of proposed amendments to the Indiana permanent regulatory program (hereinafter referred to as the Indiana program) under the Surface Mining Control and Reclamation Act of 1977 (SMCRA). The amendments (Program Amendment No. 91–4 and 91–6) consist of proposed changes to the Indiana Surface Mining Rule provisions concerning revegetation of nonprime farmland. The amendments are intended to establish revegetation success standards for nonprime farmland areas affected by surface mining operations (91–4) and for areas affected by the surface effects of underground mining operations (91–6).

EFFECTIVE DATE: May 29, 1992.

FOR FURTHER INFORMATION CONTACT: Mr. Roger W. Calhoun, Acting Director, Indianapolis Field Office, Office of Surface Mining Reclamation and Enforcement, Minton-Capehart Federal Building, 575 North Pennsylvania Street, room 301, Indianapolis, IN 46204, Telephone (317) 226–6166.

SUPPLEMENTARY INFORMATION:

I. Background on the Indiana Program

On July 29, 1982, the Indiana program was made effective by the conditional approval of the Secretary of the Interior. Information pertinent to the general background on the Indiana program, including the Secretary's findings, the disposition of comments, and a detailed explanation of the conditions of approval of the Indiana program can be found in the July 26, 1982, **Federal Register** (47 FR 32107). Subsequent actions concerning the conditions of approval and program amendments are identified at 30 CFR 914.15 and 914.16.

II. Submission of the Amendment

By letter dated May 22, 1991 (Administrative Record No. IND–0872), the Indiana Department of Natural Resources (IDNR) submitted a proposed amendment to the Indiana program at Indiana Administrative Code (IAC) 310 IAC 12–5. The proposed amendment would repeal 310 IAC 12–5–64 and add sections 310 IAC 12–5–64.1, 64.2, and 64.3. The added sections concern surface mining operations and would establish standards for: Revegetation success for nonprime farmlands; revegetation sampling techniques for nonprime farmland; and statistical methodology to evaluate the success of revegetation.