

corporations within three months before June 1, 1955.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated, and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 421(g). If A exercises the option to purchase the share of M stock on June 1, 1955, section 421 is applicable for A is then employed by a corporation which issued an option under section 421(g).

Example (3). Assume that P Corporation which owns all of the stock of S Corporation grants a restricted stock option to E, an employee of S Corporation. If E exercises the option, section 421 is applicable since E is employed by a corporation which is a subsidiary of the corporation which granted the restricted stock option.

(c)(1) The determination whether an option ultimately exercised is a restricted stock option is made as of the date such option is granted. An option which is a restricted stock option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a restricted stock option when granted does not become such an option by reason of subsequent events. See, however, § 1.421-4, relating to modification, extension, or renewal of an option.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). S-1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1954, P grants to an employee of P a restricted stock option to purchase a share of stock of S-1. On January 1, 1955, S sells a portion of the S-1 stock which it owns to an unrelated corporation and, as of that date, S-1 ceases to be a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. The employee has exercised a restricted stock option.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1954, S-1 is not a subsidiary of either S or P. Such option is not a restricted stock option on June 1, 1954. On January 1, 1955, S purchases from an unrelated corporation a sufficient number of shares of S-1 stock to make S-1, as of that date, a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. The employee has not exercised a restricted stock option.

(d) For the rules applicable to an exercise of a restricted stock option by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of § 1.421-5.

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§ 1.421-4 Modification, extension, or renewal.

(a) *In general.* Section 421(e) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a restricted stock option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) in the case of an exercise of an option in any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954.

(b) *Effect of a modification, extension, or renewal.* (1) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(2) Except as otherwise provided in subparagraph (3) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for the purpose of applying the rule of section 421(d)(1)(A)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(3)(i) The rules of subparagraph (2) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an

amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1954, a restricted stock option was granted to purchase before July 1, 1955, a share of stock for \$85. The fair market value of such stock on June 1, 1954, was \$100. On June 15, 1955, when the fair market value of the stock is \$60, such option is extended so that it is exercisable at any time before July 1, 1956, at \$55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1955, is as follows:

1954	
June	\$100
July	90
August	80
September	70
October	80
November	80
December	90
1955	
January	90
February	80
March	70
April	60
May	60

The aggregate of such values is \$950. When this sum is divided by 12, the result is \$79.17, which is an amount less than 80 percent of the fair market value of the stock (\$100) when the option was granted. Accordingly, when the option is extended on June 15, 1955,

the option price could have been reduced as low as \$51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to \$960 or more, the rules of subparagraph (2) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(c) *Definition of modification, extension, or renewal.* (1) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (b) of § 1.421-1. For the purpose of section 421, the term “modification” means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change, which accelerates the time when the option is first exercisable, or which provides more favorable terms for the payment for the stock purchased under the option, is a modification. A mere change in the terms of the option, with respect to the number or price of the shares of stock subject to the option, to reflect a stock dividend or stock split-up is not a modification of the option. In case there is an assumption or substitution of the option by reason of certain corporate transactions, see paragraph (d) of this section. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(2) Any change in the terms of an option for the purpose of qualifying the option as a restricted stock option grants additional benefits and, therefore, is a modification. For example, if an option was granted to purchase for \$80 a share of stock, the fair market value of which was \$100 at such time, and if later the option price is increased to \$85 in order to meet the requirement of section 421(d)(1)(A), such change is a modification of the option,

although the price is increased. Accordingly, the option, despite the change, is not a restricted stock option if the fair market value of the share is more than \$100 when the price is increased. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution, such change is not a modification, provided the option is at the same time changed so that it is not exercisable after the expiration of ten years from the date the option was granted.

(3) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(d) *Assumption or substitution of restricted stock options in connection with certain corporate transactions.* (1) Where, by reason of a corporate transaction, as defined in this paragraph, an employer corporation, or its parent or subsidiary corporation, assumes an existing option, or issues a new option in place of the old option, such assumption or issuance is not a modification, if—

(i) The excess of the aggregate fair market value of the stock subject to the option immediately after such assumption or issuance over the aggregate option price is not more than the excess of the aggregate fair market value of the stock subject to the option immediately before such assumption or issuance over the aggregate option price, and

(ii) Such assumption of the old option, or issuance of the new option, does not give the optionee additional benefits under the option.

For the purpose of this paragraph, the term “corporate transaction” means a corporate merger, consolidation, purchase or acquisition of property or stock, separation, reorganization, or liquidation. Thus, for this purpose, a “corporate transaction” includes a tax-

able transaction (such as, a purchase of stock or property for cash) and any corporate reorganization (whether or not it comes within the definition of such term in section 368) and any corporate liquidation (whether or not section 332 is applicable).

(2)(i) Section 421(g) provides rules under which a new employer, or parent or subsidiary of a new employer, may by reason of a corporate transaction assume a restricted stock option granted by the former employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. For example, section 421(g) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume restricted stock options which had been granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Corporation wishes to grant to such employees a restricted stock option to purchase its stock in place of the restricted stock option which they had to purchase stock of X Corporation.

(ii) Section 421(g) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a restricted stock option granted by the employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 421(g) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a restricted stock option to buy stock of X Corporation in place of the restricted stock option which they have to purchase the stock of Y Corporation.

(iii) Section 421(g) applies only when the assumption or substitution occurs

by reason of a corporate transaction as defined in this paragraph. Thus, section 421(g) may apply where as a result of a corporate transaction a restricted stock option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 421(g) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph). However, a corporation which has issued an option may not substitute a new option for such option under section 421(g).

(3) For section 421(g) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 421(g) may apply where the option which is being assumed or replaced expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 421(g) cannot be applied to revive a restricted stock option which, for reasons not related to the corporate transaction, expires before it can properly be assumed or replaced under section 421(g). For section 421(g) to apply, the assumed or substituted option must qualify as a restricted stock option.

(4) Section 421(g) does not apply if the terms of the assumed or substituted option confer on the employee more favorable benefits than he had under the old option. Thus, section 421(g) would not apply if the old option had just two years to run but the new option has more than two years to run.

(5) For the purpose of applying section 421(g), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 421(g), be considered to have been granted the option which the employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 421(g) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 421(g) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the restricted stock option which employee E has entitling him to purchase 100 shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at \$42.50 a share, was granted when the stock had a fair market value of \$50 a share, and the stock was worth \$100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth \$50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of Y Corporation at \$21.25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Corporation at \$21.25 a share in substitution for his right to purchase 50 of the shares covered by the old option.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in §20.2031-2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair

market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.

(8) For the purpose of applying section 421(g), the determination of whether the parent-subsidiary relationship exists shall be based upon circumstances existing immediately after the corporate transaction.

(e) *Effect on qualification.* A restricted stock option may, as a result of a modification, extension, or renewal, thereafter cease to be a restricted stock option, or any option may, by modification, extension, or renewal, thereafter become a restricted stock option.

(f) *Examples.* The rule stated in section 421(e) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at \$90 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is \$100 per share. On February 1, 1955, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall

be \$80 per share. On February 1, 1955, the fair market value of the X Corporation stock is \$90 per share. Under section 421(e), the X Corporation is deemed to have granted an option to the employee on February 1, 1955. Unless the value of the stock has substantially declined making paragraph (b)(3) of this section applicable, such option shall be treated as an option to purchase at \$80 per share 100 shares of stock having a fair market value of \$100 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee after February 1, 1955, is not the exercise of a restricted stock option.

Example (2). On June 1, 1954, the X Corporation grants to an employee a restricted stock option to purchase 100 shares of X Corporation stock at \$90 per share, exercisable after December 31, 1955, and on or before June 1, 1956. On June 1, 1954, the fair market value of X Corporation's stock is \$100 per share. On February 1, 1955, X Corporation modifies the option to provide that the option shall be exercisable on or after February 1, 1955, and on or before June 1, 1956. On February 1, 1955, the fair market value of X Corporation stock is \$110 per share. Under section 421(e), X Corporation is deemed to have granted an option to the employee on February 1, 1955, to purchase at \$90 per share 100 shares of stock having a fair market value of \$110 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee is not the exercise of a restricted stock option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1955, before the date of the modification of the option. Any exercise of the option after February 1, 1955, the date of the modification, is not the exercise of a restricted stock option. See example (1) in this paragraph. The exercise of the option on January 15, 1955, pursuant to which 50 shares were acquired, is the exercise of a restricted stock option.

Example (4). On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at \$80 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is \$100 per share. On February 1, 1955, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at \$80 per share will be 250. On February 1, 1955, the fair market value of the X Corporation stock is \$90 per share. Under these facts, the X Corporation has granted two options, one option (not a restricted

stock option) with respect to 100 shares having been granted on June 1, 1954, and the other option (a restricted stock option) with respect to the additional 150 shares having been granted on February 1, 1955. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

[T.D. 6500, 25 FR 11694, Nov. 26, 1960]

§ 1.421-5 Operation of section 421.

(a) *Rules applicable to all restricted stock options*—(1) *In general.* If a share of stock is transferred to an individual pursuant to his timely exercise of a restricted stock option and is not disposed of by him within two years from the date of the granting of the option nor within 1 year (6 months for taxable years before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him, then, under section 421(a)—

(i) No income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(ii) No deduction under section 162 shall be allowable at any time to the employer corporation of such individual or its parent or subsidiary corporation, or to a corporation which assumed or issued the option under section 421(g), with respect to the share so transferred; and

(iii) No amount other than the option price shall be considered as received by any of such corporations for the share so transferred.

For the purpose of subdivisions (i), (ii), and (iii) of this subparagraph, each share of stock transferred pursuant to a restricted stock option is treated separately. For example, if an individual, while employed by a corporation granting him a restricted stock option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(2) *Holding period.* The special rules provided in section 421(a) are not applicable if the individual disposes of the share of stock within two years from the date the option is granted or within six months after the transfer of such share to him. Section 421 is not made inapplicable by a transfer within the 2-year or 1-year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) period if such transfer is not a disposition of the stock as defined in subparagraph (3) of this paragraph, for example, a transfer from the decedent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by the decedent. In case a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of this section.

(3) *Disposition of stock.* (i) For the purpose of section 421, the term “disposition” includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(a) A transfer from a decedent to his estate or a transfer by bequest or inheritance; or

(b) An exchange which occurs in a taxable year of the optionee beginning after December 31, 1953, and ending after August 16, 1954, and to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939; or

(c) A mere pledge or hypothecation. However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(ii) If an individual exercises a restricted stock option, a share of stock acquired pursuant to such exercise is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred