

Internal Revenue Service, Treasury

§ 1.421-7

January 1, 1964, under section 421(f) and paragraph (e) of § 1.421-5).

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

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§ 1.421-7 Meaning and use of certain terms.

(a) *Option.* (1) For purposes of sections 421 through 425, the term “option” includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (e) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract. See section 423.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1964, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1965, another 1,000 shares on or after June 1, 1966, and a further 1,000 shares on or after June 1, 1967, all shares to be purchased before June 1, 1968, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1964, of three options, each for the purchase of 1,000 shares. However, if a corporation grants to an employee on January 1, 1965, the right to purchase 1,000 shares of its stock at \$65 per share during 1965,

or at \$75 per share during 1966, or at \$85 per share during 1967, such an arrangement will be construed as the grant to the employee on January 1, 1965, of but one option for the purchase of 1,000 shares, which ceases to be outstanding when fully exercised at the price in effect at the time of exercise.

(b) *Statutory options.* (1) The term “statutory option”, used for purposes of convenience hereinafter in this section and in §§ 1.421-8 through 1.425-1, means a qualified stock option, as defined by section 422(b) and § 1.422-2; an option granted under an employee stock purchase plan, as defined by section 423(b) and § 1.423-2; and a restricted stock option, as defined in section 424(b) and § 1.424-2.

(2) An option may qualify as a statutory option only if the option is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime of such individual, only by him. See sections 422(b)(6), 423(b)(9), and 424(b)(2). Accordingly, an option which is transferable by the individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a statutory option. However, in case the option or the plan under which the option was granted contains a provision permitting the individual to whom the option was granted to designate the person who may exercise the option after his death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a statutory option.

(3)(i) The determination of whether an option is a statutory option is made as of the date such option is granted. An option which is a statutory option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a statutory option when granted does not become such an option by reason of subsequent events. See, however, paragraph (e) of § 1.425-1, relating to modification, extension, or renewal of an option. For rules concerning options that are not statutory options, see § 1.83-7.

(ii) The application of this subparagraph 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, 1964, P grants to an employee of P a statutory option to purchase a share of stock of S-1. On January 1, 1965, 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, 1965, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. Section 421 applies to such exercise.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1964, S-1 is not a subsidiary of either S or P. Such option is not a statutory option on June 1, 1964. On January 1, 1965, 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, 1965, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. The employee has not exercised a statutory option.

(c) *Time and date of granting option.*

(1) For purposes of sections 421 through 425, the words “the date of the granting of the option” and “the time such option is granted”, and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in ac-

cordance with the intent of the corporation. However, under section 425(i), if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of, or registration with, some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of a related corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1964, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation's stock, exercisable by X on or after June 1, 1965, provided he is employed by the corporation on June 1, 1965, and provided that A's profits during the fiscal year preceding the year of exercise exceed \$200,000. Such an option is granted to X on June 1, 1964, and will be treated as outstanding as of such date.

(d) *Stock and voting stock.* For purposes of sections 421 through 425, the term “stock” means capital stock of any class, including voting or non-voting common or preferred stock. Except as otherwise provided, the term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term “stock” as used in such sections, provided such stock otherwise possesses the rights and characteristics of capital stock. For purposes of determining what constitutes voting stock in ascertaining whether a plan has been approved by stockholders or whether the limitations pertaining to voting power contained in sections 422(b)(7), 423(b)(3) and 424(b)(3) and the

regulations thereunder have been met, stock which does not have voting rights until the happening of an event, such as the default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Moreover, stock which does not possess a general voting power, and may vote only on particular questions, is not voting stock. However, if such stock is entitled to vote on whether a stock option plan is to be adopted, it is voting stock for the purpose of ascertaining whether the plan has been approved by the shareholders.

(e) *Option price.* (1) For purposes of sections 421 through 425, the term “option price” or “price paid under the option” means the consideration in money or other property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term “option price” does not include amounts paid as interest under a deferred payment arrangement or treated as unstated interest under section 483 and the regulations thereunder. Thus, for example, section 483 is applicable in determining whether the pricing requirements of section 422(b)(4), 423(b)(6), 424(b)(1), or 424(c) are met and is applicable in determining the basis of any stock acquired pursuant to the exercise of a statutory option. However, with respect to statutory options granted prior to January 1, 1965, the determination of whether the applicable pricing requirements are met shall be made without regard to section 483, but section 483 shall be taken into consideration in determining basis for purposes of determining gain or loss.

(2) In the case of a statutory option, any reasonable valuation method may be used for the purpose of determining whether at the time the option is granted the option price satisfies the pricing requirements of section 442(b)(4) (relating to qualified stock options), section 423(b)(6) (relating to employee stock purchase plans), or section 424(b)(1) (relating to restricted stock options), whichever is applicable, with respect to the stock subject to the option. Such methods include the valuation methods described in § 20.2031-2 of this chapter (Estate Tax Regulations).

(f) *Exercise.* For purposes of sections 421 through 425, the term “exercise”, when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. A promise to pay the option price does not constitute an exercise of the option unless the optionee is subject to personal liability on such promise. An agreement or undertaking by the employee to make payments under an employee stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(g) *Transfer.* For purposes of sections 421 through 425, the term “transfer”, when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a statutory option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

(h) *Employment relationship.* (1) Section 421 is applicable to the exercise of a statutory option only if at the time the option is granted, the optionee is an employee of the corporation granting the option, or a related corporation of such corporation, unless the option has been assumed or a new option has been issued in its place under section 425(a). In case of such an assumption or issuance, the optionee must, at the time of such assumption or issuance, be an employee of the corporation so assuming or issuing the option, or a related corporation of such corporation. The determination of whether the optionee is an employee at the time the option is granted (or at the time of the assumption or issuance under section 425(a)) will be made in accordance with the rules contained in section 3401(c) and the regulations thereunder. As to the granting of an option conditioned upon employment, see paragraph (c)(2) of this section. A statutory option must be granted for a reason connected with the individual's employment by the corporation or by its related corporation.

(2) In order to qualify for the special tax treatment of section 421, in addition to meeting the requirements of subparagraph (1) of this paragraph, an individual exercising a qualified stock option or an option granted under an employee stock purchase plan must, at all times during the period beginning with the date of the granting of such option and ending at the time of such exercise or on the day 3 months before the date of such exercise, be an employee of either the corporation granting such option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies. For this purpose, the employment relationship in respect of an option granted in accordance with the requirements of subparagraph (1) of this paragraph will be treated as continuing intact while the individual is on military, sick leave or other bona fide leave of absence (such as temporary employment by the Government) if the period of such leave does not exceed 90 days, or, if longer, so long as the individual's right to reemployment with the corporation granting the option (or a related corporation of such corporation, or a corporation, or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies) is guaranteed either by statute or by contract. Where the period of leave exceeds 90 days and where the individual's right to reemployment is not guaranteed either by statute or by contract, the employment relationship will be deemed to have terminated on the 91st day of such leave.

(3) For purposes of determining whether an individual meets the requirements of this paragraph, the term "employer corporation", as used in section 425 (e) and (f), shall be read as "grantor corporation" or "corporation issuing or assuming a stock option in a transaction to which section 425(a) is applicable", as the case may be. For purposes of the employment requirement, a corporation employing an optionee is considered a related corporation if it was a parent or subsidiary of the corporation granting or assuming the option during the entire

portion of the requisite period of employment during which it was the employer of such optionee.

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, X Corporation granted a statutory option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1965, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises his statutory option on June 1, 1965, section 421 is not applicable to such exercise, because on June 1, 1965, A is not employed by the corporation which granted the option or by a related corporation of such corporation, nor was he employed by any of such corporations within 3 months before June 1, 1965.

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 425(a). If A exercises the option to purchase the share of M stock on June 1, 1965, section 421 is applicable for A is then employed by a corporation which issued an option under section 425(a).

Example (3). E is an employee of P Corporation. On June 1, 1964, P grants E a statutory option to purchase a share of P stock. On June 1, 1965, P acquires 100 percent of the stock of S Corporation; on such date S becomes a subsidiary of P. On July 1, 1965, E ceases to be employed by P and becomes employed by S. On October 10, 1965, while still employed by S, E exercises his option to buy P stock. Since E was at all times during the requisite period of employment an employee of either P, the corporation granting the option, or S, a subsidiary of the grantor during the period in which such corporation was E's employer, section 421 is applicable to the exercise of the option.

Example (4). Assume the same facts as in example (3) except assume that at the time E became an employee of S Corporation, S assumed E's option to purchase P stock under section 425(a). Section 421 is applicable to E's exercise of his option to buy P stock.

Example (5). M Corporation grants a qualified stock option to E, an employee of such corporation. E is an officer in a reserve Air Force unit. E goes on military leave with his unit for 3 weeks. Regardless of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder during such 3-week period, E's employment relationship with M is treated as uninterrupted during the period of E's military leave.

Example (6). Assume the same facts as in example (5) and assume further that E's active duty status is extended indefinitely, but that E has an employment contract with M which provides that upon the termination of any military duty E may be required to serve, E will be entitled to reemployment with M or a parent or subsidiary of M. E exercises his M option while on active military duty. Irrespective of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder at the time of such exercise or within 3 months before such exercise, section 421 can apply to such exercise.

Example (7). X Corporation grants a qualified stock option to A, an employee of X Corporation, whose employment contract provides that in the event of illness, A's right to reemployment with X, or a parent or subsidiary of X, will continue for 1 year after the time A becomes unable to perform his duties for X. A falls ill for 90 days. For purposes of section 422(a)(2), A's employment relationship with X will be treated as uninterrupted during the 90-day period. If A's incapacity extends beyond 90 days, then, for purposes of section 422(a)(2), A's employment relationship with X will be treated as continuing uninterrupted until A's reemployment rights terminate. Under section 422(a)(2), A has 3 months in which to exercise his qualified stock option after his employment relationship with X (and its parent and subsidiary corporation) is terminated.

(i) *Related corporation.* The term "related corporation", used for purposes of convenience in this section and §§ 1.421-8 through 1.425-1, means a corporation which is a parent or subsidiary corporation (as defined by section 425 (e) and (f) and the regulations thereunder).

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

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§ 1.421-8 General rules.

(a) *Effect of qualifying transfer.* (1) If a share of stock is transferred to an individual pursuant to his exercise of a statutory option, and if the requirements of section 422(a) (relating to qualified stock options), section 423(a) (relating to employee stock purchase plans), or section 424(a) (relating to restricted stock option), whichever is applicable, are met, then—

(i) Except as provided in section 422(c)(1) (relating to exercise of option

when price is less than value of stock), and paragraph (e)(2) of § 1.422-2, 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 or the regulations thereunder (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a related corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) and paragraph (a) of § 1.425-1 (relating to corporate reorganizations, liquidations, etc.) applies, with respect to the share so transferred; and

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

(2) For the purpose of this paragraph, each share of stock transferred pursuant to a statutory option is treated separately. For example, if an individual, while employed by a corporation granting him a statutory 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.

(b) *Effect of disqualifying disposition.*

(1) The disposition of a share of stock, acquired by the exercise of a statutory option before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), makes section 421 inapplicable to the transfer of such share. The income attributable to such transfer shall be treated by the individual as income received in the taxable year in which such disposition occurs. Similarly, a deduction under section 162 attributable to the transfer of the share of stock pursuant to the exercise of the option shall be allowable for the taxable year in which such disposition occurs to the employer corporation, its