

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 in-

dividual 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 into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, any termination of such joint ownership is a disposition of such share, except to the extent that the individual reacquires ownership of the share. For example, if such individual and his joint owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a restricted stock option and a share of stock is transferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share.

(4) *Examples.* The rules of section 421(a) may be illustrated by the following examples:

*Example (1).* On June 1, 1954, the X Corporation grants to E, an employee, a restricted stock option to purchase 100 shares of X Corporation stock at \$95 per share. On that date, the fair market value of X Corporation stock is \$100 per share. On June 1, 1955, while employed by X Corporation, E exercises the option in full and pays X Corporation \$9,500, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of \$12,000. Before June 1, 1956, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1955, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to its transfer to E of the stock. E's basis for such 100 shares is \$9,500.

*Example (2).* Assume, in example (1), that on August 1, 1956, two years and two months after the granting of the option and one year and two months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for \$13,000, which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of \$3,500 (\$13,000 minus E's basis of \$9,500), which is treated as long-term capital gain.

*Example (3).* Assume, in example (2), that on August 1, 1956, E makes a gift of the 100 shares of X Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of \$9,500 becomes the donee's basis for determining gain or loss.

*Example (4).* Assume, in example (1), that on May 1, 1956, one year and 11 months after the granting of the option and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for \$13,000. The special rules of section 421(a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within two years from the date the option was granted. See paragraph (e) of this section for the effect of a disqualifying disposition.

*Example (5).* Assume, in example (1), that E dies on September 1, 1955, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1955, of the restricted stock option. On the date of death, the fair market value of the stock is \$12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If the stock is valued as of the date of E's death for estate tax purposes, the basis of the 100 shares in the hands of the executor is \$12,500.

(b) *Additional rules applicable where the option price is between 85 percent and 95 percent of the value of the stock—(1) In*

*general.* (i) If all the conditions necessary for the application of section 421(a) exist, section 421(b) provides additional rules which are applicable in cases where, at the time the restricted stock option is granted, the option price per share is less than 95 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and 1-year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) an amount determined in the following manner. If the option qualified under section 421(d)(1)(A)(i) (see paragraph (d)(2)(i)(a) of § 1.421-1), such amount shall be the amount, if any, by which the option price is exceeded by the lesser of the fair market value of the share at the time the option was granted or the fair market value of the share at the time of such disposition or death. However, if the option qualified under section 421(d)(1)(A)(ii) (see paragraph (d)(2)(i)(b) of § 1.421-1), such amount shall be whichever of the following amounts is lesser:

(a) The excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(b) The excess of the fair market value of the share at the time the option was granted over the option price, computed as if the option had been exercised at such time.

The amount of such compensation shall be included in the individual's gross income for the taxable year in which the disposition occurs or for the taxable year closing with his death, whichever event results in the application of section 421(b).

(ii) The application of the special rules provided in section 421(b) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the

inclusion of an amount as compensation in the gross income of an individual, as provided in section 421(b), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If the individual exercises a restricted stock option during his lifetime and dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of section 421, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) *Basis.* If the special rules provided in section 421(b) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 421(b). However, in the case of a share of stock acquired by the exercise of a restricted stock option after the death of the employee to whom the option was granted, the basis of such share shall be determined in accordance with the rules of paragraph (d)(4) of this section. If the special rules provided in section 421(b) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 421(b). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) *Examples.* The operation of section 421(b) may be illustrated by the following examples:

*Example (1).* On June 1, 1954, the X Corporation grants to E, an employee, a restricted

stock option to purchase a share of X Corporation's stock for \$85. The fair market value of the X Corporation stock on such date is \$100 per share. On June 1, 1955, E exercises the restricted stock option and on that date the X Corporation transfers the share of stock to E. On January 1, 1957, E sells the share for \$150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) Compensation in the amount of \$15 is includible in E's gross income for 1957, the year of the disposition of the share. The \$15 represents the difference between the option price (\$85) and the fair market value of the share on the date the option was granted (\$100), since such value is less than the fair market value of the share on the date of disposition (\$150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of \$85 is increased by \$15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$100. Since the share was sold for \$150, E realizes a gain of \$50, which is treated as long-term capital gain; (ii) The X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

*Example (2).* Assume, in example (1), that E sells the share of X Corporation stock on January 1, 1958, for \$75, its fair market value on that date. Since \$75 is less than the option price (\$85), no amount in respect of the sale is includible as compensation in E's gross income for 1958. E's basis for determining gain or loss on the sale is \$85. Since E sold the share for \$75, E realized a loss of \$10 on the sale, which loss is treated as a long-term capital loss.

*Example (3).* Assume, in example (1), that the option provides that the option price shall be 90 percent of the fair market value of a share of the stock on the day the option is exercised. On June 1, 1955, when the option is exercised, the fair market value of the stock is \$120 per share so that E pays \$108 for the share of stock. Compensation in the amount of \$10 is includible in E's gross income for 1957, the year of the disposition of the share. This is determined in the following manner. The excess of the fair market value of the stock at the time of the disposition (\$150) over the price paid for the share (\$108) is \$42; and the excess of the fair market value of the stock at the time the option was granted (\$100) over the option price, computed as if the option had been exercised at such time (\$90), is \$10. Accordingly, \$10 the lesser, is includible in gross income. In this situation, E's cost basis of \$108 is increased by \$10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$118. Since the share was sold for \$150, E realizes a gain of \$32, which is treated as long-term capital gain.

*Example (4).* Assume, in example (1), that instead of selling the share on January 1, 1957, E makes a gift of the share on that day. In such case, \$15 is includible as compensation in E's gross income for 1957. E's cost basis of \$85 is increased by \$15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

*Example (5).* Assume, in example (2), that instead of selling the share on January 1, 1958, E makes a gift of the share on that date. Since the fair market value of the share on that day (\$75) is less than the option price (\$85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1958. E's basis for the share is \$85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is \$75 (fair market value of the share at the date of gift).

*Example (6).* Assume, in example (1), that after acquiring the share of stock on June 1, 1955, E dies on August 1, 1956, at which time the share has a fair market value of \$150. Compensation in the amount of \$15 is includible in E's gross income for the taxable year closing with his death, such \$15 being the difference between the option price (\$85) and the fair market value of the share when the option was granted (\$100), since such value is less than the fair market value at date of death (\$150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

*Example (7).* Assume, in example (6), that E dies on August 1, 1955, at which time the share has a fair market value of \$150. Although E's death occurred within two years from the date of the granting of the option and within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

*Example (8).* Assume the same facts as in example (1), except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E and his wife sold the share on June 15, 1956, for \$150, its fair market value on that date. Compensation in the amount of \$15 is includible in E's gross income for 1956, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is \$100, that is, the cost of \$85 increased by the amount of \$15 includible as compensation in E's gross income. The gain of \$50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

*Example (9).* Assume the same facts as in example (1), except that the share of stock

was issued in the names of E and his wife jointly with right of survivorship, and except that E predeceased his wife on August 1, 1956, at which time the share had a fair market value of \$150. Compensation in the amount of \$15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

*Example (10).* Assume, in example (9), that E's wife predeceased him on July 1, 1956. Section 421(b) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1956, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1956 (after the death of his wife), for \$150, its fair market value at that time, the income tax consequences would be the same as in example (1).

(c) *Acquisition of other stock.* (1) Section 421(c) provides that the special rules stated in section 421 (a) and (b), if applicable with respect to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to stock acquired by a distribution or an exchange to which is applicable section 305, 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. Stock so acquired shall, for the purpose of section 421, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such acquisitions. With respect to such acquisitions, section 421(c) does not make inapplicable any of the provisions of section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036). Section 421(c) is applicable only with respect to such acquisitions which occur in any taxable year of the shareholder which begins after December 31, 1953, and ends after August 16, 1954. As to acquisitions occurring in earlier taxable years, see section 130A(c) of the Internal Revenue Code of 1939.

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

*Example.* If, with respect to stock transferred pursuant to the timely exercise of a

restricted stock option, there is a distribution of new stock to which section 305(a) is applicable, and if there is a disposition of such new stock within two years after the option was granted, such disposition makes section 421 inapplicable to the transfer of the original stock pursuant to the exercise of the option to the extent that the disposition effects a reduction of the individual's total interest in the old and new stock. However, if the new stock, as well as the old stock, is not disposed of within two years after the option was granted, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the old stock pursuant to the exercise of the option, section 421 is applicable.

(d) *Exercise after death.* (1) If a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual, and if such exercise occurs in a taxable year of the estate or of such person beginning after December 31, 1953, and ending after August 16, 1954, section 421 applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to such exercise of the option. Nor does section 421 become inapplicable if such executor, administrator, or person disposes of the stock so acquired within two years after the granting of such option or within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the stock pursuant to the exercise of such option. This exception as to the applicability of section 421 does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss. The executor, administrator, or such person need not exercise the option within three months after the death of the individual to whom the option was granted for section 421 to be applicable. However, the exercise of the option must be pursuant to the terms of the option, and any change in the terms of the option is subject to the rules of § 1.421-4, relating to the modification, extension, or renewal of the option. Section 421 is applicable even

though such executor, administrator, or person is not employed by the corporation granting the option, or a parent or subsidiary thereof, either when the option is exercised or at any time. However, section 421 is not applicable to an exercise of the option by the estate or by such person, unless the individual to whom the option was granted met the requirements of paragraph (b) of § 1.421-3, relating to the employment of such individual, either at the time of his death or within three months before such time. If the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual, section 421 is not applicable to the exercise. For example, if the option is sold by the estate, section 421 does not apply to an exercise of the option by such buyer; but if the option is distributed by the administrator to an heir as part of the estate, section 421 is applicable to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets, or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock. Therefore, if section 421(b) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 421(b) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3)(i) If under section 421(b) an amount is required to be included in the gross income of the estate or of such person, the estate or such person shall be allowed a deduction as a result of the inclusion of the value of the restricted stock option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691(c) by treating the restricted stock option as an item of gross income in respect of a decedent

under section 691 and by treating the amount required to be included in gross income under section 421(b) as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an amount includible under section 421(b). For the rules relating to the computation of a deduction under section 691(c), see § 1.691(c)-1.

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

*Example.* On June 1, 1953, E was granted a restricted stock option to purchase for \$85 one share of the stock of his employer. On such day, the fair market value of such stock was \$100 a share. E died on February 1, 1954, without having exercised such option. The option was, however, exercisable by his estate, and for purposes of the estate tax was valued at \$30. On March 1, 1955, the estate exercised the option, and on March 15, 1955, sold for \$150 the share of stock so acquired. For its taxable year including March 15, 1955, the estate is required by section 421(b) to include in its gross income as compensation the amount of \$15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421(d)(6)(B), the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691(a), and no deductions referred to in section 691(b), so that the value for estate tax purposes of the restricted stock option, \$30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the restricted stock option in the estate of E is \$10. Since \$15, the amount includible in gross income by reason of section 421(b), is less than the value for estate tax purposes of the option, only  $\frac{15}{30}$  of the estate tax attributable to the inclusion of the option in the estate is deductible; that is,  $\frac{15}{30}$  of \$10, or \$5. No deduction under section 421(d)(6)(B) is allowable with respect to any capital gain.

(4)(i) In the case of an employee dying before January 1, 1957, the basis of any share of stock acquired by the exercise of the option under this paragraph, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 421(b). The basis of the share shall not be increased by reason of the inclusion

of the value of the restricted stock option in the estate for estate tax purposes.

(ii)(A) In the case of an employee dying after December 31, 1956, the basis of any share of stock acquired by the exercise of the option under this paragraph, determined under section 1011, shall be increased by an amount equal to the portion of the basis of the option attributable to such share. For example, if a restricted stock option to acquire 10 shares of stock has a basis of \$100, the basis of one share acquired by a partial exercise of the option, determined under section 1011, would be increased by  $\frac{1}{10}$  of \$100, or \$10. The option acquires a basis, determined under section 1014(a), only if it is exercised in accordance with section 421. Therefore, to the extent the option is so exercised, in whole or in part, it will acquire a basis equal to its fair market value at the date of the employee's death or, if an election is made under section 2032, its value at its applicable valuation date. In certain cases, the basis of the share is subject to the adjustments provided by (B) and (C) of this subdivision, but such adjustments are only applicable in the case of an option which is subject to section 421(b).

(B) If the amount which would have been includible in gross income under section 421(b) had the employee exercised the option and held the share at the time of his death exceeds the amount which is includible in gross income under section 421(b), the basis of the share, determined under (A) of this subdivision, shall be reduced by such excess. For example, if \$15 would have been includible in the gross income of the employee had he exercised the option and held such share at the time of his death, and only \$10 is includible under section 421(b), the basis of the share, determined under (A) of this subdivision, would be reduced by \$5. For purposes of determining the amount which would have been includible in gross income under section 421(b) if the employee had exercised the option and held such share at the time of his death, the amount which would have been paid for the share shall be computed as if the option had been exercised on the date the employee died.

(C) If the amount includible in gross income under section 421(b) exceeds the portion of the basis of the option attributable to the share, the basis of the share, determined under (A) of this subdivision, shall be increased by such excess. Thus, if \$15 is includible in gross income under section 421(b), and the basis of the option with respect to the share is \$10, the basis of the share, determined under (A) of this subdivision, will be increased by \$5.

(iii) If a restricted stock option is not exercised by the estate of the individual to whom the option was granted, or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual, the option shall be considered to be property which constitutes a right to receive an item of income in respect of a decedent to which the rules of sections 691 and 1014(c) apply.

(iv) The application of this subparagraph may be illustrated by the following examples:

*Example (1).* On June 1, 1954, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for \$85. The fair market value of the X Corporation stock on such date was \$100 per share. On June 1, 1955, E died. The fair market value of X Corporation stock on such date exceeded \$100 per share and the fair market value of the option on the applicable valuation date was \$35. On August 1, 1956, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was \$90. The estate is required by section 421(b) to include \$5 in its gross income as compensation. Since E died before January 1, 1957, the basis of the share is \$90 (the \$85 paid for the stock plus the \$5 includible in gross income as compensation), and the basis of the share is not increased by reason of the inclusion of the value of the option in the estate of E (see section 1014(d)). Thus, no gain or loss is realized on the disposition of the share since the basis of the share is equal to the sale price.

*Example (2).* On June 1, 1956, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation stock for \$85. The fair market value of X Corporation stock on such date was \$100 per share. On June 1, 1957, E died. The fair market value of X Corporation stock on such date exceeded \$100 per share and the fair market value of the option on the applicable valuation date was \$35. On August 1, 1958, the estate of E exercised the option and sold the share of X Corporation stock at a time when

the fair market value of the share was \$120. The basis of the share is \$120 (the \$85 paid for the stock plus the \$35 basis of the option). When the share is sold for \$120, the estate is required to include \$15 in its gross income as compensation. Since \$15 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)(B) of this subparagraph does not apply. Moreover, since the \$15 includible in the gross income of the estate does not exceed the basis of the option (\$35), subdivision (ii)(C) of this subparagraph does not apply. Since the basis of the stock and the sale price are the same, no gain or loss is realized by the estate on the disposition of the share.

*Example (3).* Assume the same facts as in example (2), except that the fair market value of the share of stock at the time of its sale was \$90. The basis of the share, determined under subdivision (ii)(A) of this subparagraph, is \$120 (the \$85 paid for the stock plus the \$35 basis of the option). When the share is sold for \$90, the estate is required to include \$5 in its gross income as compensation. If the employee had exercised the option and held the share at the time of this death, \$15 would have been includible in gross income as compensation for the taxable year ending with his death. Since such amount exceeds by \$10 the amount which the estate is required to include in its gross income, subdivision (ii)(B) of this subparagraph applies, and the basis of the share (\$120), determined under subdivision (ii)(A) of this subparagraph is reduced by \$10. Accordingly, the basis is \$110, and a capital loss of \$20 is realized on the disposition of the share.

*Example (4).* Assume the same facts as in example (2), except that the fair market value of the option on the applicable valuation date was \$5, and that the fair market value of X Corporation stock on the date the employee died did not exceed \$100. The basis of the share, determined under subdivision (ii)(A) of this subparagraph, is \$90 (the \$85 paid for the stock plus the \$5 basis of the option). When the share is sold for \$120, the estate is required to include \$15 in its gross income as compensation. Since such amount exceeds by \$10 the basis of the option, subdivision (ii)(C) of this subparagraph applies, and the basis of the share (\$90), determined under subdivision (ii)(A) of this subparagraph, is increased by \$10. Accordingly, the basis is \$100 and a capital gain of \$20 is realized on the disposition of the share.

*Example (5).* Assume the same facts as in example (2), except that on June 1, 1957, the date the employee died, the fair market value of X Corporation stock was \$98, and that on June 1, 1958, the alternate valuation date, the fair market value of the stock had declined substantially, and the fair market value of the option was \$5. On August 1, 1958, the estate of E exercised the option and sold

the share when its fair market value was \$92. The basis of the share, determined under subdivision (ii)(A) of this subparagraph, is \$90 (the \$85 paid for the stock plus the \$5 basis of the option). When the share is sold for \$92, the estate is required to include \$7 in its gross income as compensation. Since \$13 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)(B) of this subparagraph applies, and the basis of the share (\$90), determined under subdivision (ii)(A) of this subparagraph, is reduced by \$6 to \$84. Furthermore, since the \$7 that the estate is required to include in its gross income when the share is sold for \$92 exceeds by \$2 the basis of the option, subdivision (ii)(C) of this subparagraph applies, and the basis of the share (\$84), determined under subdivision (ii)(A) and (ii)(B) of this subparagraph, is increased by \$2. Accordingly, the basis is \$86 and a capital gain of \$6 is realized on the disposition of the share.

(e) *Disqualifying disposition.* The disposition of a share of stock, acquired by the exercise of a restricted stock option, within two years after the granting of the option or within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the share pursuant to such exercise makes section 421 inapplicable to such transfer of the share. If such disqualifying disposition occurs in a taxable year of the individual which begins after December 31, 1953, and ends after August 16, 1954, 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, if such disposition occurs in a taxable year of the employer which begins after December 31, 1953, and ends after August 16, 1954, the deduction 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. In such cases, no amount shall be treated as income, and no amount shall be allowed as a deduction, for any taxable year other than the taxable year in which occurs the disposition. However, if the stock was transferred pursuant to the exercise of the option in a taxable year other than the taxable year of the disposition, the amount of the deduction shall be determined as if the employee had



been paid compensation at the time provided in paragraph (d) of § 1.421-6.

[T.D. 6500, 25 FR 11696, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

**§ 1.421-6 Options to which section 421 does not apply.**

(a) *Scope of section.* (1) If an employer or other person grants to an employee or other person for any reason connected with the employment of such employee an option to purchase stock of the employer or other property, and if section 421 is not applicable, then this section shall apply. This section will apply, for example, when an option is not a qualified or restricted stock option at the time it is granted or an option granted under an employee stock purchase plan, or when an option is modified so that it no longer qualifies as such an option, or when there is a disqualifying disposition of stock acquired by the exercise of such an option so that section 421 does not apply. When an option is granted for any reason connected with the employment of an employee, this section applies, if section 421 does not apply, irrespective of whether the option is granted by the employer, by a parent or subsidiary of the employer, by a stockholder of any of such corporations, or by any other person, and irrespective of whether the option is granted to the employee, to a member of his family, or to any other person, and irrespective of whether the option is to purchase the stock of the employer, the stock of the parent or subsidiary of the employer, the stock of any other corporation, or to purchase any other property. In addition, § 1.61-15 makes the rules of this section applicable in determining the time when certain other options result in the realization of income and the amount of such income.

(2) This section is applicable to options granted on or after February 26, 1945, and before July 1, 1969 (and thereafter, to the extent that § 1.83-8(b) applies). For rules relating to options granted after June 30, 1969, see § 1.83-7. This section, however, is not applicable to—

(i) Property transferred pursuant to an option exercised before September 25, 1959, if the property is transferred

subject to a restriction which has a significant effect on its value, or

(ii) Property transferred pursuant to an option granted before September 25, 1959, and exercised on or after such date, if, under the terms of the contract granting such option, the property to be transferred upon the exercise of the option is to be subject to a restriction which has a significant effect on its value and if such property is actually transferred subject to such restriction. However, if an option granted before September 25, 1959, and on or after February 26, 1945, is sold or otherwise disposed of before exercise, the provisions of this section shall be fully applicable to such disposition.

(3) If an option to which this section applies has a readily ascertainable fair market value when granted, no amount is includible in gross income under this section as compensation by reason of the transfer or exercise of such option, irrespective of whether such value was included in income for the taxable year in which the option was granted, and any deduction which is allowable as a result of the granting of such option is allowable only for the taxable year in which the option is granted. Thus, if an option having a readily ascertainable fair market value to which this section applies was granted in a taxable year for which an assessment of deficiency was barred at the time of the adoption of paragraph (c) of this section as a Treasury decision, no amount is includible in gross income under this section as compensation by reason of the transfer or exercise of such option. However, if there is a determination to which the rules of sections 1311-1314 apply, there may be an adjustment for the taxable year in which the option was granted.

(b) *Meaning and use of certain terms.*

(1) For the purpose of this section, the term “option” includes the right or privilege of a person to purchase property from any person by virtue of an offer continuing for a stated period of time, whether or not irrevocable, to sell such property at a stated price, such person being under no obligation to purchase.

(2) As used in this section, the terms “employee”, “employment”, and “employer” have reference to the legal and