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 Rvenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 6887, 31 FR 8787, June 24, 1966, as amended by T.D. 6975, 33 FR 14779, Oct. 3, 1968; T.D. 7554, 43 FR 31927, July 24, 1978]

## § 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 parent or subsidiary corporation or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies. 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 the disposition occurs. 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.

(2) Section 421 is not made inapplicable by a transfer before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), if such transfer is not a disposition of the stock as defined in section 425(c) and paragraph (c) of §1.425–1, for example, a transfer from the decendent 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 statutory 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 (c) of this section.

(3) For special rules relating to a disqualifying disposition of a share of stock acquired by the exercise of a qualified stock option, see paragraph (b) of §1.422–1.

(c) *Exercise by estate.* (1) If a statutory 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, section 421(a) applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, except as provided by section 422(c)(1) and paragraph (e)(2) of §1.422–2, 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(a) become inapplicable if such executor, administrator, or person disposes of the stock so acquired before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1). This special rule 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(a) 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 paragraph (e) of §1.425–1, relating to the modification, extension, or renewal of the option. Section 421(a) is applicable even though such executor, administrator, or person is not employed by the corporation granting the option, or a related corporation, either when the option is exercised or at any time. However, section 421(a) 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 employment requirements of section 422(a)(2), 423(a)(2), or 424(a)(2), whichever is applicable, 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(a) is not applicable to the exercise. For example, if the option is sold by the estate, section 421(a) 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(a) 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 423(c), or 424(c)(1) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 423(c) or 424(c)(1) 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 422(c)(1), 423(c), or 424(c)(1), 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 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 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 422(c)(1), 423(c), or 424(c)(1), 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 422(c)(1), 423(c), or 424(c)(1). 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, 1964, E was granted an option under an employee stock purchase plan to purchase for $85 one share of the stock of his employer. On such day, the fair market value of such stock was $100 per share. E died on February 1, 1966, 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, 1966, the estate exercised the option, and on March 15, 1966, sold for $150 the share of stock so acquired. For its taxable year including March 15, 1966, the estate is required by sections 421(c)(1)(B) and 423(c) 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(c)(2), 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 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 option in the estate of E is $10. Since $15, the amount includible in gross income by reason of sections 421(c)(1)(B) and 423(c), 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(c)(2) 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 a restricted stock 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 424(c)(1). 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 an 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 statutory 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 1/10th of $100, or $10. The option acquires a basis, determined under section 1014(a), only if the transfer of the share pursuant to the exercise of such option qualifies for the special tax treatment provided by section 421(a). 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 422(c)(1), 423(c), or 424 (c)(1).

*(b)* If the amount which would have been includible in gross income under section 422(c)(1), 423(c), or 424(c)(1) had the employee exercised the option on the date of his death and held the share at the time of his death exceeds the amount which is includible in gross income under such section, 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 422(c)(1), 423(c), or 424(c)(1), 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 422 (c)(1), 423(c), or 424(c)(1), 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 422(c)(1), 423(c), or 424(c)(1), 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 such section, 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 statutory 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, 1955, 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, 1956, E died. The fair market value of the 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, 1964, 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 424(c)(1) 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) (as in effect with respect to taxable years ending before January 1, 1957)). 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, 1964, the X Corporation granted to E, an employee, an option under its employee stock purchase plan 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, 1966, 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, 1966, 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 his 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, 1966, the date the employee died, the fair market value of X Corporation stock was $98, and that on June 1, 1967, 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, 1967, 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.

(d) *Exercise by deceased employee during lifetime.* If a statutory option is exercised by an individual to whom the option was granted and the individual dies before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), section 421(a) does not become inapplicable if the executor or administrator of the estate of such individual, or any person who acquired such stock by bequest or inheritance or by reason of the death of such individual, disposes of such stock before the expiration of such applicable holding period. This rule does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss.

(e) *Incorporation by reference.* Any requirement that an option expressly contain or state a prescribed limitation or term will be considered met if such limitation or term is set forth in a statutory option plan and is incorporated by reference by the option. Thus, if a statutory option plan expressly provides that no option granted thereunder shall be exercisable after five years from the date of grant, and if an option granted thereunder expressly provides that the option is granted subject to the terms and limitations of such plan, the option will be regarded as being, by its terms, not exercisable after the expiration of 5 years from the date such option is granted.

[T.D. 6887, 31 FR 8789, June 24, 1966]

### § 1.422–4 Qualified stock options (prior law).

Section 422 of the Code, pertaining to qualified stock options, was repealed by section 11801(a)(20) of the Omnibus Budget Reconciliation Act of 1990. In view of the savings provision of section 11821(b) of that act, the regulations under the repealed section 422, which were removed from the Code of Federal Regulations, may be of continuing interest to the public. Those regulations were set forth in 26 CFR 1.422–1 and 1.422–2 as contained in 26 CFR edition revised as of April 1, 1991.

[T.D. 8374, 56 FR 61160, Dec. 2, 1991]

### § 1.422–5 Stockholder approval of incentive stock option plans.

This section addresses the stockholder approval of incentive stock option plans required by section 422(b)(1) of the Internal Revenue Code. (Section 422 was added to the Code as section 422A by section 251 of the Economic Recovery Tax Act of 1981, and was redesignated as section 422 by section 11801 of the Omnibus Budget Reconciliation Act of 1990.) The approval of stockholders must comply with all applicable provisions of the corporate charter, bylaws, and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval in such cases an incentive stock option plan must be approved:

(a) By a majority of the votes cast at a duly held stockholders' meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(b) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (i.e., an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

[T.D. 8374, 56 FR 61160, Dec. 2, 1991]

### § 1.423–1 Applicability of section 421(a).

(a) *General rule.* Subject to the provisions of section 423(c) and paragraph (k) of this section, the special rules of income tax treatment provided in section 421(a) apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted after December 31, 1963, under an employee stock purchase plan provided that the following conditions are satisfied—

(1) The individual must make no disposition of such share within 2 years from the date of the granting of the option, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him; and

(2) At all times during the period beginning with the date of the granting of the option and ending on the day three months before the date of such exercise, the individual must be an employee of either the corporation granting the 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.

(b) *Cross-references.* For rules relating to the employment relationship, see paragraph (h) of §1.421–7. For rules relating to the effect of a disqualifying disposition, see section 421(b) and paragraph (b) of §1.421–8. For definition of the term ''disposition'', see section 425(c) and paragraph (c) of §1.425–1.

[T.D. 6887, 31 FR 8798, June 24, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

### § 1.423–2 Employee stock purchase plan defined.

(a) *In general.* (1) The term ''employee stock purchase plan'' means a plan which meets the requirements of paragraphs (1) through (9) of section 423(b). If the terms of the plan do not satisfy the requirements of paragraphs (3)