

\$15 is includible as compensation in E's gross income for 1967. 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 the same facts as in example (2) except assume that instead of selling the share on January 1, 1968, 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 1968. 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 the same facts as in example (1), except assume that after acquiring the share of stock on June 1, 1965, E dies on August 1, 1966, 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 the same facts as in example (6), except assume that E dies on August 1, 1965, at which time the share has a fair market value of \$150. Although E's death occurred 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 assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E and his wife sold the share on June 15, 1966, for \$150, its fair market value on that date. Compensation in the amount of \$15 is includible in E's gross income for 1966, 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 assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E predeceased his wife on August 1, 1966,

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 the same facts as in example (9), except assume that E's wife predeceased him on July 1, 1966. Section 423(c) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1966, 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, 1966 (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).

[T.D. 6887, 31 FR 8799, June 24, 1966 as amended by T.D. 7645, 44 FR 55836, Sept. 28, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 8235, 53 FR 48641, Dec. 2, 1988]

#### § 1.425-1 Definitions and special rules applicable to statutory options.

(a) *Corporate reorganizations, liquidations, etc.* (1)(i) The term "issuing or assuming a stock option in a transaction to which section 425(a) applies" means, for purposes of sections 421 through 425, a substitution of a new option for an old option, or an assumption of such old option, by an employer corporation, or a related corporation of such corporation, by reason of a corporate transaction (as defined by subdivision (ii) of this subparagraph), if—

(a) The excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(b) The new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

(ii) For purposes of this section, the term "corporate transaction" means any merger of a corporation into another corporation, any consolidation of two or more corporations into another

corporation, any purchase or acquisition of property or stock by any corporation, any separation of a corporation (including a spin-off or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation, if such action by such corporation results in a significant number of employees being transferred to a new employer or discharged, or in the creation or severance of a parent-sub-sidiary relationship.

(2)(i) A change in the terms of an option attributable to the issuance or assumption of an option by reason of a corporate transaction (as defined under section 425(a) and subparagraph (1)(ii) of this paragraph) is not a modification of such option. See section 425(h)(3) and paragraph (e) of this section. Thus, section 425(a), in effect, provides rules under which a new employer, or a parent or subsidiary of a new employer, may by reason of a corporate transaction assume a statutory option granted by the former employer or parent or subsidiary thereof, or issue a new statutory option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution being considered as a modification of the option. For example, section 425(a) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume statutory options which had been granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Corporation wishes to grant to such employees a statutory option to purchase its stock in place of the statutory option which they had to purchase stock of X Corporation.

(ii) Section 425(a) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a statutory option granted by the employer or parent or

subsidiary thereof, or issue a new statutory option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 425(a) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a statutory option to buy stock of X Corporation in place of a statutory option which they have to purchase the stock of Y Corporation.

(iii) Section 425(a) applies only when the assumption or substitution occurs by reason of a corporate transaction as defined in this paragraph. Thus, section 425(a) may apply where as a result of a corporate transaction a statutory option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 425(a) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph). However, a corporation which has issued an option may not substitute a new option for such option under section 425(a). See, however, paragraph (e) of this section.

(3) For section 425(a) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 425(a) may apply where the option which is being assumed or replaced expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 425(a) cannot be applied to revive a statutory option which, for reasons not related to the corporate transaction, expires before it can properly be assumed or replaced under section 425(a). For section 425(a) to apply, the assumed or substituted option must qualify as a statutory option.

(4)(i) Section 425(a) does not apply if the terms of the assumed or substituted option confer on the employee

more favorable benefits than he had under the old option. Section 425(a) can apply to a corporate transaction only if, on a share by share comparison, the ratio of the option price to the fair market value of the stock subject to the option immediately after the substitution or assumption is no more favorable to the optionee than the ratio of the option price to the fair market value of the stock subject to the old option immediately before such substitution or assumption. The number of shares subject to an option issued or assumed may be adjusted to compensate for any change in the aggregate spread between the aggregate option price and the aggregate fair market value of the stock subject to the option immediately after the substitution or assumption as compared to the aggregate spread between the option price and the aggregate fair market value of the stock subject to the option immediately before such substitution or assumption. Such an adjustment will not prevent section 425(a) from applying to such substitution or assumption.

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

*Example (1).* On June 1, 1965, P Corporation acquires 100 percent of the stock of S Corporation and on such date S becomes a subsidiary of P Corporation. Also on such date, P Corporation substitutes a qualified stock option to purchase P stock for a qualified stock option to purchase S stock held by E, an employee of S. Assume that E's S option had 3 years to run on the date of the substitution. If the P option granted to E in substitution for his S option runs for more than 3 years from the date of the substitution, section 425(a) cannot apply, since the effect of such an option would be to give E an additional benefit which he did not enjoy under his S option.

*Example (2).* E is an employee of S Corporation. E holds a qualified stock option which was granted to him by S to purchase 60 shares of S stock at \$12 per share. On June 1, 1967, S Corporation is merged into P Corporation, and on such date P substitutes a qualified stock option to purchase P stock for E's qualified stock option to purchase S stock. Immediately before the substitution, the fair market value of S stock was \$32 per share; immediately after the substitution, the fair market value of P stock is \$24 per share. The new option entitles E to buy P stock at \$9 per share. Since on a share by

share comparison the ratio of the new option price (\$9 per share) to the fair market value of P stock immediately after the substitution (\$24 per share) is not more favorable to E than the ratio of the old option price (\$12 per share) to the fair market value of S stock immediately before the substitution (\$32 per share) ( $\frac{9}{24} = \frac{12}{32}$ ) the requirement of subparagraph (4)(i) of this paragraph is met. The number of shares subject to E's option to purchase P stock is set at 80. Since the excess of the aggregate fair market value over the aggregate option price of the stock subject to E's new option to purchase P stock, \$1,200 ( $80 \times \$24$  minus  $80 \times \$9$ ), is not greater than the excess of the aggregate fair market value over the aggregate option price of the stock subject to E's old option to purchase S stock, \$1,200 ( $60 \times \$32$  minus  $60 \times \$12$ ), the requirement of subparagraph (1)(i)(a) of this paragraph is met. Thus, section 425(a) may apply to the substitution.

*Example (3).* Assume the same facts as in example (2), except assume that the fair market value of S stock immediately before the substitution was \$8 per share and that the option price was \$10 per share, and that the fair market value of P stock immediately after the substitution is \$12 per share. P sets the new option price at \$15 per share. Since on a share by share comparison the ratio of the new option price (\$15 per share) to the fair market value of P stock immediately after the substitution (\$12 per share) is not more favorable to E than the ratio of the old option price (\$10 per share) to the fair market value of S stock immediately before the substitution (\$8 per share) ( $\frac{15}{12} = \frac{10}{8}$ ), the requirement of subparagraph (4)(i) of this paragraph is met. Assume further that the number of shares subject to E's P option is set at 20 as compared to 60 shares under E's old option to buy S stock. Immediately after the substitution, 2 shares of P stock are worth \$24, which is what 3 shares of S stock were worth immediately before the substitution ( $2 \times \$12 = 3 \times \$8$ ). Thus, to completely replace E's S option, E should have received an option to purchase 40 shares of P stock, *i.e.*, 2 shares of P for each 3 shares of S which E could have purchased under his old option ( $\frac{2}{3} = \frac{40}{60}$ ). Since E's new option covers 20 shares of P stock, it is clear that P has replaced only  $\frac{1}{2}$  of E's stock option. The portion of E's stock option which was not replaced by P is an outstanding stock option to purchase stock of a predecessor corporation of P Corporation for purposes of section 422(b)(5) and (c)(2).

(5) For the purpose of applying section 425(a), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 425(a), be considered to have been granted the option which the

employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 425(a) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 425(a) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. However, if the old option was a qualified or restricted stock option, any portion of such option which is not substituted or assumed in a transaction to which section 425(a) applies will be treated as an outstanding option to purchase stock of a predecessor corporation of the new employer or grantor corporation. See section 422(b)(5) and (c)(2) and paragraph (f) of § 1.422-2. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the statutory option which E has, entitling him to purchase 100 shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at \$50 a share, was granted when the stock had a fair market value of \$50 a share, and the stock was worth \$100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth \$50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of Y Corporation at \$25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Cor-

poration at \$25 a share in substitution for his right to purchase 50 of the shares covered by the old option. However, if the option to purchase X stock was a qualified or restricted stock option, then to the extent the old option is not assumed or a new option issued in substitution therefor in a transaction to which section 425(a) applies, such old option will be treated as an outstanding option under section 422(c)(2) for purposes of section 422(b)(5). See paragraph (f) of § 1.422-2.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in § 20.2031-2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's-length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.

(8) For the purpose of applying section 425(a) and this paragraph, the determination of whether the parent-sub-sidiary relationship exists shall be based upon circumstances existing immediately after the corporate trans-action.

(b) *Acquisition of new stock.* (1) Section 425(b) provides that the rules provided by sections 421 through 425 which are 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 section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies. Stock so acquired shall, for purposes of sections 421 through 425, 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 425(b) 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).

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

*Example.* If, with respect to stock transferred pursuant to the timely exercise of a statutory 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 before the expiration of the applicable holding period required with respect to the stock originally acquired pursuant to the exercise of such option, 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 before the expiration of the holding period required with respect to the original stock acquired pursuant to the exercise of the option, the special tax treatment provided by section 421 is applicable to both the original shares and the shares acquired by virtue of the distribution to which section 305(a) applies.

(c) *Disposition of stock.* (1) For purposes of sections 421 through 425, the term "disposition" includes a sale, exchange, gift, or any transfer of legal title, but does not include—

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

(ii) An exchange to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036); or

(iii) 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.

(2) A share of stock acquired by an individual pursuant to the exercise of a statutory option 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 (other than a termination effected by the death of a joint owner) is a disposition of such share, except to the extent 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 statutory 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. However, a termination of joint ownership resulting from the death of one of the owners is not a disposition of such share. For determination of basis in the hands of the survivor where joint ownership is terminated by the death of one of the owners, see section 1014.

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

*Example (1).* On June 1, 1964, the X Corporation grants to E, an employee, a qualified stock option to purchase 100 shares of X Corporation stock at \$100 per share, the fair

market value of X Corporation stock on that date. On June 1, 1965, while employed by X Corporation, E exercises the option in full and pays X Corporation \$10,000, 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, 1968, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1965, 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 \$10,000.

*Example (2).* Assume the same facts as in example (1), except assume that on August 1, 1968, three years 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 \$3,000 (\$13,000 minus E's basis of \$10,000), which is treated as long-term capital gain.

*Example (3).* Assume the same facts as in example (2), except assume that on August 1, 1968, E makes a gift of the 100 shares of Y 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 \$10,000 becomes the donee's basis for determining gain or loss.

*Example (4).* Assume the same facts as in example (1), except assume that on May 1, 1968, two years 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 three years from the date the shares were transferred to him.

*Example (5).* Assume the same facts as in example (1), except assume that E dies on September 1, 1965, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1965, of the qualified 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.

*Example (6).* Assume the same facts as in example (1), except assume that on June 1, 1965, when the option is exercised by E the 100 shares are transferred by X to E and his wife W, as joint owners with right of survivorship, and that E dies on July 1, 1965. Neither the transfer into joint ownership nor the termination of such joint ownership by E's death is a disposition. Because E has made no disqualifying disposition of the shares, section 421(a) is applicable and E realizes no income at death with respect to the

shares even though he held the stock less than 3 years after the transfer of the shares to him pursuant to his exercise of a qualified stock option. See paragraph (b)(2) of § 1.421-8.

(d) *Attribution of stock ownership.* Section 425(d) provides that in determining the amount of stock owned by an individual for purposes of applying the percentage limitations of section 422(b)(7), 423(b)(3), and 424(b)(3), stock of the employer corporation or of a related corporation which is owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. Also, for such purpose, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

(e) *Modification, extension, or renewal of option.* (1) Section 425(h) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a statutory option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) of an option in any taxable year of the optionee which begins after December 31, 1963, except that section 425(h)(1) and this paragraph shall not apply to any change made before January 1, 1965, in the terms of an option granted after December 31, 1963, to permit such option to meet the requirements of section 422(b) (3), (4), or (5), and the regulations thereunder. See paragraphs (d), (e), and (f), of § 1.422-2, relating to period for exercising options, option price, and prior outstanding options, respectively, in the case of qualified stock options.

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

(3) Except as otherwise provided in subparagraph (4) of this paragraph, in

case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for purposes of applying the rules of sections 423(b)(6), and 424(b)(1)—

- (i) The fair market value on the date of the original granting of the option,
- (ii) The fair market value on the date of the making of such modification, extension, or renewal, or
- (iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(4)(i) In the case of a modification, extension, or renewal of a restricted stock option before January 1, 1964 (or after December 31, 1963, if made pursuant to a binding written contract entered into before January 1, 1964), the rules of subparagraph (3) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

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

*Example.* On June 1, 1962, a restricted stock option was granted to purchase before July 1, 1965, a share of stock for \$85. The fair market value of such stock on June 1, 1962, was \$100. On June 15, 1963, when the fair market value of the stock is \$60, such option is extended so that it is exercisable at any time before July 1, 1966, at \$55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1963, is as follows:

1962	
June .....	\$100
July .....	90
August .....	80
September .....	70
October .....	\$80
November .....	80
December .....	90
1963	
January .....	90
February .....	80
March .....	70
April .....	60
May .....	60

The aggregate of such values is \$950. When this sum is divided by 12, the result is \$79.17, which is an amount less than 80 percent of the fair market value of the stock (\$100) when the option was granted. Accordingly, when the option is extended on June 15, 1963, the option price could have been reduced as low as \$51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to \$960 or more, the rules of subparagraph (3) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(5)(i) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (c) of § 1.421-7. For purposes of sections 421 through 425, the term "modification" means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change which provides more favorable terms for the payment for the stock purchased under the option, is a

modification. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(ii)(a) A change in the number or price of the shares of stock subject to an option merely to reflect a stock dividend, or stock split-up, is not a modification of the option.

(b) A change in the number or price of the shares of stock subject to an option to reflect a corporate transaction (as defined by paragraph (a)(1)(ii) of this section) is not a modification of the option provided that the excess of the aggregate fair market value (determined immediately after such corporate transaction) of the shares subject to the option immediately after such change over the aggregate new option price of such shares is not more than the excess of the aggregate fair market value of the shares subject to the option immediately before the transaction over the aggregate former option price of such shares, and provided that the option after such change does not give the employee additional benefits which he did not have before such change. The ratio of the option price immediately after the change to the fair market value of the stock subject to the option immediately after the corporate transaction must not be more favorable to the optionee on a share by share comparison than the ratio of the old option price to the fair market value of the stock subject to the option immediately before such a transaction. A reduction in the option price of an option, other than as specifically provided for in this section, is a modification of such option.

(c) The application of (b) of this subdivision may be illustrated by the following example:

*Example.* E, an employee of P Corporation, holds a qualified stock option granted to him by P to buy 90 shares of P stock at \$36 per share. P Corporation is a party to a corporate transaction (as defined by paragraph (a)(1)(ii) of this section) which results in a decline in the fair market value of P stock. Immediately before such transaction the fair market value of P stock was \$64 per share. Immediately after such transaction, the fair market value of P stock is \$48 per share. Two

weeks after such transaction, P proposes to amend E's option in order to reflect the decline in the fair market value of P stock attributable to the transaction. At such time, the fair market value of P stock is \$50 per share. However, since the change was not made at the time of the transaction, the fair market value of P stock at the time of the change is irrelevant for purposes of determining whether the change comes under the rule of (b) of this subdivision. P changes the terms of E's option to lower the option price to \$27 per share and to increase the number of shares subject to the option to 120. No other terms of the option are changed. The aggregate fair market value (determined immediately after the corporate transaction) of the shares subject to the option immediately after the change is \$5,760 ( $\$48 \times 120$ ). The aggregate option price of the shares subject to the option immediately after the change is \$3,240 ( $\$27 \times 120$ ). Thus, the excess of such fair market value over such option price is \$2,520 ( $\$5,760 - \$3,240$ ). The aggregate fair market value of the stock subject to the option immediately before the corporate transaction is \$5,760 ( $\$64 \times 90$ ). The aggregate option price for the stock subject to the option immediately before the change is \$3,240 ( $\$36 \times 90$ ). Thus, the excess of such fair market value over such option price is \$2,520 ( $\$5,760 - \$3,240$ ). Accordingly, the excess after the change does not exceed the excess before the corporate transaction. Moreover, the ratio of the option price immediately after the change (\$27 per share) to the fair market value of P stock immediately after the transaction (\$48 per share) is not more favorable to E on a share by share comparison than the ratio of the old option price (\$36 per share) to the fair market value of P stock immediately before the transaction (\$64) ( $\frac{27}{48} = \frac{36}{64}$ ). For purposes of section 425(h), the changes made do not confer additional benefits on E which he did not have before the change. Accordingly, the changes do not constitute a modification of E's option.

(iii) Any change in the terms of an option for the purpose of qualifying the option as a statutory option grants additional benefits and, therefore, is a modification. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution in order to meet the requirements of section 422(b)(6), 423(b)(9), or 424(b)(2), such change is not a modification, provided that in any case where the purpose of the change is to meet the requirements of section 424(b)(2) the option is at the same time changed so that it is not exercisable after the expiration of ten years from



the date the option was granted. Where an option is not immediately exercisable in full, a change in the terms of such option to accelerate the time at which the option (or any portion thereof) may be exercised is not a modification for purposes of section 425(h) and this section. A modification results where an option is revised to insert the language required by section 422(c)(6)(B).

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

(6) A statutory option may, as a result of a modification, extension, or renewal, thereafter cease to be a statutory option, or any option may, by modification, extension, or renewal, thereafter become a statutory option. Moreover, a qualified option after a modification may not be exercisable in accordance with its terms because of the requirements of section 422(b)(5) and section 422(c)(6). See paragraph (f)(3)(i) of § 1.422-2 and examples (8) and (9) of paragraph (f)(4) of § 1.422-2.

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

*Example (1).* On June 1, 1964, the X Corporation grants to an employee an option under X's employee stock purchase plan to purchase 100 shares of the stock of X Corporation at \$90 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is \$100 per share. On February 1, 1965, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be \$80 per share. On February 1, 1965, the fair market value of the X Corporation stock is \$90 per share. Under section 425(h), the X Corporation is deemed to have granted an option to the employee on February 1, 1965. Such option shall be treated as an option to purchase at \$80 per share 100 shares of stock having a fair market value of \$100 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February

1, 1965. The exercise of such option by the employee after February 1, 1965, is not the exercise of a statutory option.

*Example (2).* On June 1, 1964, the X Corporation grants to an employee an option under X's employee stock purchase plan to purchase 100 shares of X Corporation stock at \$90 per share, exercisable after December 31, 1965, and on or before June 1, 1966. On June 1, 1964, the fair market value of X Corporation's stock is \$100 per share. On February 1, 1965, X Corporation modifies the option to provide that the option shall be exercisable on or before September 1, 1966. On February 1, 1965, the fair market value of X Corporation stock is \$110 per share. Under section 425(h), X Corporation is deemed to have granted an option to the employee on February 1, 1965, 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, 1964, or on February 1, 1965. The exercise of such option by the employee is not the exercise of a statutory 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, 1965, before the date of the modification of the option. Any exercise of the option after February 1, 1965, the date of the modification, is not the exercise of a statutory option. See example (1) in this subparagraph. The exercise of the option on January 15, 1965, pursuant to which 50 shares were acquired, is the exercise of a statutory option.

*Example (4).* On June 1, 1964, 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, 1966. At the time the option is granted, the fair market value of the X Corporation stock is \$100 per share. On February 1, 1965, 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, 1965, the fair market value of X Corporation stock is \$80 per share. Under these facts, the X Corporation has granted two options, one option (not a statutory option) with respect to 100 shares having been granted on June 1, 1964, and the other option (a qualified stock option) with respect to the additional 150 shares having been granted on February 1, 1965. 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. 6887, 31 FR 8808, June 24, 1966]