

§ 1.422-5

26 CFR Ch. I (4-1-10 Edition)

(iii) Assume the same facts as in paragraph (ii) of this *Example 4*, except that the change of control occurs on May 1, 2005. Because options are taken into account in the order in which they are granted, Option 1 and Option 2 are treated as incentive stock options in their entirety. Because the exercise of Option 3 (on June 1, 2005) takes place after the acceleration provision is triggered, Option 3 is treated as a nonstatutory option in its entirety.

*Example 5. Cancellation of option.* (i) In 2004, X Corporation grants E three incentive stock options (determined without regard to this section) to acquire stock with an aggregate fair market value of \$140,000 as of the date of grant. The dates of grant, the fair market value of the stock (as of the applicable date of grant) with respect to which the options are exercisable, and the years in which the options are first exercisable (without regard to acceleration provisions) are as follows:

	Date of grant	Fair market value of stock	First exercisable
Option 1 .....	April 1, 2004 .....	\$60,000	2005
Option 2 .....	May 1, 2004 .....	40,000	2005
Option 3 .....	June 1, 2004 .....	40,000	2005

(ii) On December 31, 2004, Option 2 is canceled. Because Option 2 is canceled before the calendar year during which it would have become exercisable for the first time, it is disregarded. As a result, Option 1 and Option 3 are treated as incentive stock options in their entirety.

(iii) Assume the same facts as in paragraph (ii) of this *Example 5*, except that Option 2 is canceled on January 1, 2005. Because Option 2 is not canceled prior to the calendar year during which it would have become exercisable for the first time (2005), it is treated as an outstanding option for purposes of determining whether the \$100,000 limitation for 2005 has been exceeded. Because options are taken into account in the order in which granted, Option 1 is treated as an incentive stock option in its entirety. Because Option 3 exceeds the \$100,000 limitation by \$40,000 (Option 1 for \$60,000 + Option 2 for \$40,000 + Option 3 for \$40,000 = \$140,000), it is treated as a nonstatutory option in its entirety.

(iv) Assume the same facts as in paragraph (i) of this *Example 5*, except that on January 1, 2005, E exercises Option 2 and immediately sells the stock in a disqualifying disposition. A disqualifying disposition has no effect on the determination of whether the underlying option is considered outstanding during the calendar year during which it is first exercisable. Because options are taken into account in the order in which granted, Option 1 is treated as an incentive stock option in its entirety. Because Option 3 exceeds the \$100,000 limitation by \$40,000 (Option 1 for \$60,000 + Option 2 for \$40,000 + Option 3 for \$40,000 = \$140,000), it is treated as a nonstatutory option in its entirety.

*Example 6. Designation of stock.* On January 1, 2004, X grants E an immediately exercisable incentive stock option (determined without regard to this section) to acquire X stock with a fair market value of \$150,000 on that date. Under the rules of this section, the option is bifurcated and treated as an incen-

tive stock option for X stock with a fair market value of \$100,000 and a nonstatutory option for X stock with a fair market value of \$50,000. In these circumstances, X may designate the stock that is treated as stock acquired pursuant to the exercise of an incentive stock option by issuing a separate certificate (or certificates) for \$100,000 of stock and identifying such certificates as Incentive Stock Option Stock in its transfer records. In the absence of such a designation (or a designation in the corporation's transfer records or the plan records) shares with a fair market value of \$100,000 are deemed purchased first under an incentive stock option, and shares with a fair market value of \$50,000 are deemed purchased under a nonstatutory option.

[T.D. 9144, 69 FR 46415, Aug. 3, 2004; 69 FR 70551, Dec. 7, 2004]

§ 1.422-5 Permissible provisions.

(a) *General rule.* An option that otherwise qualifies as an incentive stock option does not fail to be an incentive stock option merely because such option contains one or more of the provisions described in paragraphs (b), (c), and (d) of this section.

(b) *Cashless exercise.* (1) An option does not fail to be an incentive stock option merely because the optionee may exercise the option with previously acquired stock of the corporation that granted the option or stock of the corporation whose stock is being offered for purchase under the option. For special rules relating to the use of statutory option stock to pay the option price of an incentive stock option, see § 1.424-1(c)(3).

(2) All shares acquired through the exercise of an incentive stock option

are individually subject to the holding period requirements described in §1.422-1(a) and the disqualifying disposition rules of §1.422-1(b), regardless of whether the option is exercised with previously acquired stock of the corporation that granted the option or stock of the corporation whose stock is being offered for purchase under the option. If an incentive stock option is exercised with such shares, and the exercise results in the basis allocation described in paragraph (b)(3) of this section, the optionee's disqualifying disposition of any of the stock acquired through such exercise is treated as a disqualifying disposition of the shares with the lowest basis.

(3) If the exercise of an incentive stock option with previously acquired shares is comprised in part of an exchange to which section 1036 (and so much of section 1031 as relates to section 1036) applies, then:

(i) The optionee's basis in the incentive stock option shares received in the section 1036 exchange is the same as the optionee's basis in the shares surrendered in the exchange, increased, if applicable, by any amount included in gross income as compensation pursuant to sections 421 through 424 or section 83. Except for purposes of §1.422-1(a), the holding period of the shares is determined under section 1223. For purposes of §1.422-1 and sections 421(b) and 83 and the regulations thereunder, the amount paid for the shares purchased under the option is the fair market value of the shares surrendered on the date of the exchange.

(ii) The optionee's basis in the incentive stock option shares not received pursuant to the section 1036 exchange is zero. For all purposes, the holding period of such shares begins as of the date that such shares are transferred to the optionee. For purposes of §1.422-1(b) and sections 421(b) and 83 and the regulations thereunder, the amount paid for the shares is considered to be zero.

(c) *Additional compensation.* An option does not fail to be an incentive stock option merely because the optionee has the right to receive additional compensation, in cash or property, when the option is exercised, provided such additional compensation is includible

in income under section 61 or section 83. The amount of such additional compensation may be determined in any manner, including by reference to the fair market value of the stock at the time of exercise or to the option price.

(d) *Option subject to a condition.* (1) An option does not fail to be an incentive stock option merely because the option is subject to a condition, or grants a right, that is not inconsistent with the requirements of §§1.422-2 and 1.422-4.

(2) An option that includes an alternative right is not an incentive stock option if the requirements of §1.422-2 are effectively avoided by the exercise of the alternative right. For example, an alternative right extending the option term beyond ten years, setting an option price below fair market value, or permitting transferability prevents an option from qualifying as an incentive stock option. If either of two options can be exercised, but not both, each such option is a disqualifying alternative right with respect to the other, even though one or both options would individually satisfy the requirements of §§1.422-2, 1.422-4, and this section.

(3) An alternative right to receive a taxable payment of cash and/or property in exchange for the cancellation or surrender of the option does not disqualify the option as an incentive stock option if the right is exercisable only when the then fair market value of the stock exceeds the exercise price of the option and the option is otherwise exercisable, the right is transferable only when the option is otherwise transferable, and the exercise of the right has economic and tax consequences no more favorable than the exercise of the option followed by an immediate sale of the stock. For this purpose, the exercise of the alternative right does not have the same economic and tax consequences if the payment exceeds the difference between the then fair market value of the stock and the exercise price of the option.

(e) *Examples.* The principles of this section are illustrated by the following examples:

*Example 1.* On June 1, 2004, X Corporation grants an incentive stock option to A, an employee of X Corporation, entitling A to

purchase 100 shares of X Corporation common stock at \$10 per share. The option provides that A may exercise the option with previously acquired shares of X Corporation common stock. X Corporation has only one class of common stock outstanding. Under the rules of section 83, the shares transferable to A through the exercise of the option are transferable and not subject to a substantial risk of forfeiture. On June 1, 2005, when the fair market value of an X Corporation share is \$25, A uses 40 shares of X Corporation common stock, which A had purchased on the open market on June 1, 2002, for \$5 per share, to pay the full option price. After exercising the option, A owns 100 shares of incentive stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), 40 of the shares have a \$200 aggregate carryover basis (the \$5 purchase price × 40 shares) and a three-year holding period for purposes of determining capital gain, and 60 of the shares have a zero basis and a holding period beginning on June 1, 2005, for purposes of determining capital gain. All 100 shares have a holding period beginning on June 1, 2005, for purposes of determining whether the holding period requirements of § 1.422-1(a) are met.

*Example 2.* Assume the same facts as in *Example 1*. Assume further that, on September 1, 2005, A sells 75 of the shares that A acquired through exercise of the incentive stock option for \$30 per share. Because the holding period requirements were not satisfied, A made a disqualifying disposition of the 75 shares on September 1, 2005. Under the rules of paragraphs (b)(2) and (b)(3) of this section, A has sold all 60 of the non-section-1036 shares and 15 of the 40 section-1036 shares. Therefore, under paragraph (b)(3) of this section and section 83(a), the amount of compensation attributable to A's exercise of the option and subsequent disqualifying disposition of 75 shares is \$1,500 (the difference between the fair market value of the stock on the date of transfer, \$1,875 (75 shares at \$25 per share), and the amount paid for the stock, \$375 (60 shares at \$0 per share plus 15 shares at \$25 per share)). In addition, A must recognize a capital gain of \$675, which consists of \$375 (\$450, the amount realized from the sale of 15 shares, less A's basis of \$75) plus \$300 (\$1,800, the amount realized from the sale of 60 shares, less A's basis of \$1,500 resulting from the inclusion of that amount in income as compensation). Accordingly, A must include in gross income for the taxable year in which the sale occurs \$1,500 as compensation and \$675 as capital gain. For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under section 162 and if the requirements of § 1.83-6(a) are met, X Corporation is allowed a deduction of \$1,500 for the compensation paid to A.

*Example 3.* Assume the same facts as in *Example 2*, except that, instead of selling the 75 shares of incentive stock option stock on September 1, 2005, A uses those shares to exercise a second incentive stock option. The second option was granted to A by X Corporation on January 1, 2005, entitling A to purchase 100 shares of X Corporation common stock at \$22.50 per share. As in *Example 2*, A has made a disqualifying disposition of the 75 shares of stock pursuant to § 1.424-1(c). Under paragraph (b) of this section, A has disposed of all 60 of the non-section-1036 shares and 15 of the 40 section-1036 shares. Therefore, pursuant to paragraph (b)(3) of this section and section 83(a), the amount of compensation attributable to A's exercise of the first option and subsequent disqualifying disposition of 75 shares is \$1,500 (the difference between the fair market value of the stock on the date of transfer, \$1,875 (75 shares at \$25 per share), and the amount paid for the stock, \$375 (60 shares at \$0 per share plus 15 shares at \$25 per share)). Unlike *Example 2*, A does not recognize any capital gain as a result of exercising the second option because, for all purposes other than the determination of whether the exercise is a disposition pursuant to section 424(c), the exercise is considered an exchange to which section 1036 applies. Accordingly, A must include in gross income for the taxable year in which the disqualifying disposition occurs \$1,500 as compensation. If the requirements of § 83(h) and § 1.83-6(a) are satisfied and the deduction is otherwise allowable under section 162, for its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of \$1,500 for the compensation paid to A. After exercising the second option, A owns a total of 125 shares of incentive stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), the 100 "new" shares of incentive stock option stock have the following bases and holding periods: 15 shares have a \$75 carryover basis and a three-year-and-three-month holding period for purposes of determining capital gain, 60 shares have a \$1,500 basis resulting from the inclusion of that amount in income as compensation and a three-month holding period for purposes of determining capital gain, and 25 shares have a zero basis and a holding period beginning on September 1, 2005, for purposes of determining capital gain. All 100 shares have a holding period beginning on September 1, 2005, for purposes of determining whether the holding period requirements of § 1.422-1(a) are met.

*Example 4.* Assume the same facts as in *Example 2*, except that, instead of selling the 75 shares of incentive stock option stock on September 1, 2005, A uses those shares to exercise a nonstatutory option. The nonstatutory option was granted to A by X Corporation on January 1, 2005, entitling A to purchase 100 shares of X Corporation common

stock at \$22.50 per share. Unlike *Example 3*, A has not made a disqualifying disposition of the 75 shares of stock. After exercising the nonstatutory option, A owns a total of 100 shares of incentive stock option stock and 25 shares of nonstatutory stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), the 75 new shares of incentive stock option stock have the same basis and holding period as the 75 old shares used to exercise the nonstatutory option. The additional 25 shares of stock received upon exercise of the nonstatutory option are taxed under the rules of section 83(a). Accordingly, A must include in gross income for the taxable year in which the transfer of such shares occurs \$750 (25 shares at \$30 per share) as compensation. A's basis in such shares is the same as the amount included in gross income. For its taxable year in which the transfer occurs, X Corporation is allowed a deduction of \$750 for the compensation paid to A to the extent the requirements of section 83(h) and § 1.83-6(a) are satisfied and the deduction is otherwise allowable under section 162.

*Example 5.* Assume the same facts in *Example 1*, except that the shares transferred pursuant to the exercise of the incentive stock option are subject to a substantial risk of forfeiture and not transferable (substantially nonvested) for a period of six months after such transfer. Assume further that the shares that A uses to exercise the incentive stock option are similarly restricted. Such shares were transferred to A on January 1, 2005, through A's exercise of a nonstatutory stock option which was granted to A on January 1, 2004. A paid \$5 per share for the stock when its fair market value was \$22.50 per share. A did not file a section 83(b) election to include the \$700 spread (the difference between the option price and the fair market value of the stock on date of exercise of the nonstatutory option) in gross income as compensation. After exercising the incentive stock option with the 40 substantially-nonvested shares, A owns 100 shares of substantially-nonvested incentive stock option stock. Section 1036 (and so much of section 1031 as relates to section 1036) applies to the 40 shares exchanged in exercise of the incentive stock option. However, pursuant to section 83(g), the stock received in such exchange, because it is incentive stock option stock, is not subject to restrictions and conditions substantially similar to those to which the stock given in such exchange was subject. For purposes of section 83(a) and § 1.83-1(b)(1), therefore, A has disposed of the 40 shares of substantially-nonvested stock on June 1, 2005, and must include in gross income as compensation \$800 (the difference between the amount realized upon such disposition, \$1,000, and the amount paid for the stock, \$200). Accordingly, 40 shares of the incentive stock option stock have a \$1,000 basis

(the \$200 original basis plus the \$800 included in income as compensation) and 60 shares of the incentive stock option stock have a zero basis. For its taxable year in which the disposition of the substantially-nonvested stock occurs, X Corporation is allowed a deduction of \$800 for the compensation paid to A, provided the requirements of section 83(h) and § 1.83-6(a) are satisfied and the deduction is otherwise allowable under section 162.

(f) *Effective/applicability date*—(1) *In general.* Except for § 1.422-2(b)(6) *Example 1* (iii), the regulations under this section are effective on August 3, 2004. Section 1.422-2(b)(6) *Example 1* (iii) is effective on November 17, 2009. Section 1.422-2(b)(6) *Example 1* (iii) applies to statutory options granted on or after January 1, 2010.

(2) *Reliance and transition period.* For statutory options granted on or before June 9, 2003, taxpayers may rely on the 1984 proposed regulations LR-279-81 (49 FR 4504), the 2003 proposed regulations REG-122917-02 (68 FR 34344), or this section until the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring 6 months after August 3, 2004. For statutory options granted after June 9, 2003, and before the earlier of January 1, 2006, or the first regularly scheduled stockholders meeting of the granting corporation occurring at least 6 months after August 3, 2004, taxpayers may rely on either REG-122917-02 or this section. Taxpayers may not rely on LR-279-81 or REG-122917-02 after December 31, 2005. Reliance on LR-279-81, REG-122917-02, or this section must be in its entirety, and all statutory options granted during the reliance period must be treated consistently.

[T.D. 9144, 69 FR 46417, Aug. 3, 2004; 69 FR 61310, Oct. 18, 2004; 69 FR 70551, Dec. 7, 2004; T.D. 9471, 74 FR 59078, Nov. 17, 2009]

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

(a) *General rule.* Subject to the provisions of section 423(c) and § 1.423-2(k), 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 the individual's exercise of an option granted under an employee stock purchase plan, as defined in § 1.423-2, if the following conditions are satisfied—