

§ 1.424-1 Definitions and special rules applicable to statutory options.

(a) *Substitutions and assumptions of options*—(1) *In general.* (i) This paragraph (a) provides rules under which an *eligible corporation* (as defined in paragraph (a)(2) of this section) may, by reason of a *corporate transaction* (as defined in paragraph (a)(3) of this section), substitute a new statutory option (new option) for an outstanding statutory option (old option) or assume an old option without such substitution or assumption being considered a modification of the old option. For the definition of *modification*, see paragraph (e) of this section.

(ii) For purposes of §§ 1.421-1 through 1.424-1, the phrase “substituting or assuming a stock option in a transaction to which section 424 applies,” “substituting or assuming a stock option in a transaction to which § 1.424-1(a) applies,” and similar phrases means a substitution of a new option for an old option or an assumption of an old option that meets the requirements of this paragraph (a). For a substitution or assumption to qualify under this paragraph (a), the substitution or assumption must meet all of the requirements described in paragraphs (a)(4) and (a)(5) of this section.

(2) *Eligible corporation.* For purposes of this paragraph (a), the term *eligible corporation* means a corporation that is the employer of the optionee or a related corporation of such corporation. For purposes of this paragraph (a), the determination of whether a corporation is the employer of the optionee or a related corporation of such corporation is based upon all of the relevant facts and circumstances existing immediately after the corporate transaction. See § 1.421-1(h) for rules concerning the employment relationship.

(3) *Corporate transaction.* For purposes of this paragraph (a), the term *corporate transaction* includes—

(i) A corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation;

(ii) A distribution (excluding an ordinary dividend or a stock split or stock dividend described in § 1.424-1(e)(4)(v)) or change in the terms or number of outstanding shares of such corporation; and

(iii) Such other corporate events prescribed by the Commissioner in published guidance.

(4) *By reason of.* (i) For a change in an option or issuance of a new option to qualify as a substitution or assumption under this paragraph (a), the change must be made by an *eligible corporation* (as defined in paragraph (a)(2) of this section) and occur by reason of a *corporate transaction* (as defined in paragraph (a)(3) of this section).

(ii) Generally, a change in an option or issuance of a new option is considered to be by reason of a corporate transaction, unless the relevant facts and circumstances demonstrate that such change or issuance is made for reasons unrelated to such corporate transaction. For example, a change in an option or issuance of a new option will be considered to be made for reasons unrelated to a corporate transaction if there is an unreasonable delay between the corporate transaction and such change in the option or issuance of a new option, or if the corporate transaction serves no substantial corporate business purpose independent of the change in options. Similarly, a change in the number or price of shares purchasable under an option merely to reflect market fluctuations in the price of the stock purchasable under an option is not by reason of a corporate transaction.

(iii) A change in an option or issuance of a new option is by reason of a distribution or change in the terms or number of the outstanding shares of a corporation (as described in paragraph (a)(3)(ii) of this section) only if the option as changed, or the new option issued, is an option on the same stock as under the old option (or if such class of stock is eliminated in the change in capital structure, on other stock of the same corporation).

(5) *Other requirements.* For a change in an option or issuance of a new option to qualify as a substitution or assumption under this paragraph (a), all of the requirements described in this paragraph (a)(5) must be met.

(i) In the case of an issuance of a new option (or a portion thereof) in exchange for an old option (or portion thereof), the optionee’s rights under the old option (or portion thereof)

must be canceled, and the optionee must lose all rights under the old option (or portion thereof). There cannot be a substitution of a new option for an old option within the meaning of this paragraph (a) if the optionee may exercise both the old option and the new option. It is not necessary to have a complete substitution of a new option for the old option. However, any portion of such option which is not substituted or assumed in a transaction to which this paragraph (a) applies is an outstanding option to purchase stock or, to the extent paragraph (e) of this section applies, a modified option.

(ii) The excess of the aggregate fair market value of the shares subject to the new or assumed option immediately after the change in the option or issuance of a new option over the aggregate option price of such shares must not exceed the excess of the aggregate fair market value of all shares subject to the old option (or portion thereof) immediately before the change in the option or issuance of a new option over the aggregate option price of such shares.

(iii) On a share by share comparison, the ratio of the option price to the fair market value of the shares subject to the option immediately after the change in the option or issuance of a new option must not be 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 (or portion thereof) immediately before the change in the option or issuance of a new option. The number of shares subject to the new or assumed option 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 shares subject to the option immediately after the change in the option or issuance of the new option as compared to the aggregate spread between the option price and the aggregate fair market value of the shares subject to the option immediately before the change in the option or issuance of the new option.

(iv) The new or assumed option must contain all terms of the old option, except to the extent such terms are ren-

dered inoperative by reason of the corporate transaction.

(v) The new option or assumed option must not give the optionee additional benefits that the optionee did not have under the old option.

(6) *Obligation to substitute or assume not necessary.* For a change in the option or issuance of a new option to meet the requirements of this paragraph (a), it is not necessary to show that the corporation changing an option or issuing a new option is under any obligation to do so. In fact, this paragraph (a) may apply even when the option that is being replaced or assumed expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, this paragraph (a) cannot be applied to revive a statutory option which, for reasons not related to the corporate transaction, expires before it can properly be replaced or assumed under this paragraph (a).

(7) *Issuance of stock without meeting the requirements of this paragraph (a).* A change in the terms of an option resulting in a modification of such option occurs if an optionee's new employer (or a related corporation of the new employer) issues its stock (or stock of a related corporation) upon exercise of such option without satisfying all of the requirements described in paragraphs (a)(4) and (5) of this section.

(8) *Date of grant.* For purposes of applying the rules of this paragraph (a), a substitution or assumption is considered to occur on the date that the optionee would, but for this paragraph (a), be considered to have been granted the option that the eligible corporation is substituting or assuming. A substitution or an assumption that occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(9) 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.

(10) *Examples.* The principles of this paragraph (a) are illustrated by the following examples:

Example 1. Eligible corporation. X Corporation acquires a new subsidiary, Y Corporation, and transfers some of its employees to Y. Y Corporation wishes to grant to its new employees and to the employees of X Corporation new options for Y shares in exchange for old options for X shares that were previously granted by X Corporation. Because Y Corporation is an employer with respect to its own employees and a related corporation of X Corporation, Y Corporation is an eligible corporation under paragraph (a)(2) of this section with respect to both the employees of X and Y Corporations.

Example 2. Corporate transaction. (i) On January 1, 2004, Z Corporation grants E, an employee of Z, an option to acquire 100 shares of Z common stock. At the time of grant, the fair market value of Z common stock is \$200 per share. E's option price is \$200 per share. On July 1, 2005, when the fair market value of Z common stock is \$400, Z declares a stock dividend of preferred stock distributed on common stock that causes the fair market value of Z common stock to decrease to \$200 per share. On the same day, Z grants to E a

new option to acquire 200 shares of Z common stock in exchange for E's old option. The new option has an exercise price of \$100 per share.

(ii) A stock dividend other than that described in §1.424-1(e)(4)(v) is a corporate transaction under paragraph (a)(3)(ii) of this section. Generally, the issuance of a new option is considered to be by reason of a corporate transaction. None of the facts in this *Example 2* indicate that the new option is not issued by reason of the stock dividend. In addition, the new option is issued on the same stock as the old option. Thus, the substitution occurs by reason of the corporate transaction. Assuming the other requirements of this section are met, the issuance of the new option is a substitution that meets the requirements of this paragraph (a) and is not a modification of the option.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*. Assume further that on December 1, 2005, Z declares an ordinary cash dividend. On the same day, Z grants E a new option to acquire Z stock in substitution for E's old option. Under paragraph (a)(3)(ii) of this section, an ordinary cash dividend is not a corporate transaction. Thus, the exchange of the new option for the old option does not meet the requirements of this paragraph (a) and is a modification of the option.

Example 3. Corporate transaction. On March 15, 2004, A Corporation grants E, an employee of A, an option to acquire 100 shares of A stock at \$50 per share, the fair market value of A stock on the date of grant. On May 2, 2005, A Corporation transfers several employees, including E, to B Corporation, a related corporation. B Corporation arranges to purchase some assets from A on the same day as E's transfer to B. Such purchase is without a substantial business purpose independent of making the exchange of E's old options for the new options appear to be by reason of a corporate transaction. The following day, B Corporation grants to E, one of its new employees, an option to acquire shares of B stock in exchange for the old option held by E to acquire A stock. Under paragraph (a)(3)(i) of this section, the purchase of assets is a corporate transaction. Generally, the substitution of an option is considered to occur by reason of a corporate transaction. However, in this case, the relevant facts and circumstances demonstrate that the issuance of the new option in exchange for the old option occurred by reason of the change in E's employer rather than a corporate transaction and that the sale of assets is without a substantial business purpose independent of the change in the options. Thus, the exchange of the new option for the old option is not by reason of a corporate transaction that meets the requirements of this paragraph (a) and is a modification of the old option.

Example 4. Corporate transaction. (i) E, an employee of Corporation A, holds an option to acquire 100 shares of Corporation A stock. On September 1, 2006, Corporation A has one class of stock outstanding and declares a stock dividend of one share of common stock for each outstanding share of common stock. The rights associated with the common stock issued as a dividend are the same as the rights under existing shares of stock. In connection with the stock dividend, E's option is exchanged for an option to acquire 200 shares of Corporation A stock. The per-share exercise price is equal to one half of the per-share exercise price of the original option. The stock dividend merely changes the number of shares of Corporation A outstanding and effects no other change to the stock of Corporation A. The option is proportionally adjusted and the aggregate exercise price remains the same and therefore satisfies the requirements described in § 1.424-1(e)(4)(v).

(ii) The stock dividend is not a corporate transaction under paragraph (a)(3) of this section, and the declaration of the stock dividend is not a modification of the old option under paragraph (a) of this section. Pursuant to § 1.424-1(e)(4)(v), the exercise price of the old option may be adjusted proportionally with the change in the number of outstanding shares of Corporation A such that the ratio of the aggregate exercise price of the option to the number of shares covered by the option is the same both before and after the stock dividend. The adjustment of E's option is not treated as a modification of the option.

Example 5. Additional benefit. On June 1, 2004, P Corporation acquires 100 percent of the shares of S Corporation and issues a new option to purchase P shares in exchange for an old option to purchase S shares that is held by E, an employee of S. On the date of the exchange, E's old option is exercisable for 3 more years, and, after the exchange, E's new option is exercisable for 5 years. Because the new option is exercisable for an additional period of time beyond the time allowed under the old option, the effect of the exchange of the new option for the old option is to give E an additional benefit that E did not enjoy under the old option. Thus, the requirements of paragraph (a)(5) of this section are not met, and this paragraph (a) does not apply to the exchange of the new option for the old option. Therefore, the exchange is a modification of the old options.

Example 6. Spread and ratio tests. E is an employee of S Corporation. E holds an old option that was granted to E by S to purchase 60 shares of S at \$12 per share. On June 1, 2005, S Corporation is merged into P Corporation, and on such date P issues a new option to purchase P shares in exchange for E's old option to purchase S shares. Immediately before the exchange, the fair market value of an S share is \$32; immediately after the ex-

change, the fair market value of a P share is \$24. The new option entitles E to buy P shares at \$9 per share. Because, on a share-by-share comparison, the ratio of the new option price (\$9 per share) to the fair market value of a P share immediately after the exchange (\$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 an S share immediately before the exchange (\$32 per share) ($\frac{9}{24} = \frac{12}{32}$), the requirements of paragraph (a)(5)(iii) of this section are met. The number of shares subject to E's option to purchase P stock is set at 80. Because the excess of the aggregate fair market value over the aggregate option price of the shares 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 shares subject to E's old option to purchase S stock, \$1,200 ($60 \times \32 minus $60 \times \$12$), the requirements of paragraph (a)(5)(ii) of this section are met.

Example 7. Ratio test and partial substitution. Assume the same facts as in *Example 6*, except that the fair market value of an S share immediately before the exchange of the new option for the old option is \$8, that the option price is \$10 per share, and that the fair market value of a P share immediately after the exchange is \$12. P sets the new option price at \$15 per share. Because, on a share-by-share comparison, the ratio of the new option price (\$15 per share) to the fair market value of a P share immediately after the exchange (\$12) is not more favorable to E than the ratio of the old option price (\$10 per share) to the fair market value of an S share immediately before the substitution (\$8 per share) ($\frac{15}{12} = \frac{10}{8}$), the requirements of paragraph (a)(5)(iii) of this section are 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 exchange, 2 shares of P are worth \$24, which is what 3 shares of S were worth immediately before the exchange ($2 \times \$12 = 3 \times \8). Thus, to achieve a complete substitution of a new option for E's old option, E would need to receive a new option to purchase 40 shares of P (i.e., 2 shares of P for each 3 shares of S that E could have purchased under the old option ($\frac{2}{3} = \frac{40}{60}$)). Because E's new option is for only 20 shares of P, P has replaced only $\frac{1}{2}$ of E's old option, and the other $\frac{1}{2}$ is still outstanding.

Example 8. Partial substitution. X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and, in a spin-off, distributes the shares of Y Corporation to the stockholders of X Corporation. E, an employee of X Corporation, is thereafter an employee of Y. Y wishes to substitute a new option to purchase some of its stock for E's old option to purchase 100 shares of X. E's

old option to purchase shares of X, at \$50 a share, was granted when the fair market value of an X share was \$50, and an X share was worth \$100 just before the distribution of the Y shares to X's stockholders. Immediately after the spin-off, which is also the time of the substitution, each share of X and each share of Y is worth \$50. Based on these facts, a new option to purchase 200 shares of Y at an option price of \$25 per share could be granted to E in complete substitution of E's old option. In the alternative, it would also be permissible in connection with the spin off, to grant E a new option to purchase 100 shares of Y, at an option price of \$25 per share, and for E to retain an option to purchase 100 shares of X under the old option, with the option price adjusted to \$25. However, because X is no longer a related corporation with respect to Y, E must exercise the option for 100 shares of X within three months from the date of the spin off for the option to be treated as a statutory option. See § 1.421-1(h). It would also be permissible to grant E a new option to purchase 100 shares of Y, at an option price of \$25 per share, in substitution for E's right to purchase 50 of the shares under the old option.

Example 9. Stockholder approval requirements. (i) X Corporation, a publicly traded corporation, adopts an incentive stock option plan that meets the requirements of § 1.422-2. Under the plan, options to acquire X stock are granted to X employees. X Corporation is acquired by Y Corporation and becomes a subsidiary corporation of Y Corporation. After the acquisition, X employees remain employees of X. In connection with the acquisition, Y Corporation substitutes new options to acquire Y stock for the old options to acquire X stock previously granted to the employees of X. As a result of this substitution, on exercise of the new options, X employees receive Y Corporation stock.

(ii) Because the requirements of § 1.422-2 were met on the date of grant, the substitution of the new Y options for the old X options does not require new stockholder approval. If the other requirements of paragraphs (a)(4) and (5) of this section are met, the issuance of new options for Y stock in exchange for the old options for X stock meets the requirements of this paragraph (a) and is not a modification of the old options.

(iii) Assume the same facts as in paragraphs (i) and (ii) of this *Example 9*. Assume further that as part of the acquisition, X amends its plan to allow future grants under the plan to be grants to acquire Y stock. Because the amendment of the plan to allow options on a different stock is considered the adoption of a new plan under § 1.422-2(b)(2)(iii), the stockholders of X (in this case, Y) must approve the plan within 12 months before or after the date of the amendment of the plan. If the stockholders of X (in this case, Y) timely approve the

plan, the future grants to acquire Y stock will be incentive stock options (assuming the other requirements of § 1.422-2 have been met).

Example 10. Modification. X Corporation merges into Y Corporation. Y Corporation retains employees of X who hold old options to acquire X Corporation stock. When the former employees of X exercise the old options, Y Corporation issues Y stock to the former employees of X. Under paragraph (a)(7) of this section, because Y issues its stock on exercise of the old options for X stock, there is a change in the terms of the old options for X stock. Thus, the issuance of Y stock on exercise of the old options is a modification of the old options.

Example 11. Eligible corporation. (i) D Corporation grants an option to acquire 100 shares of D Corporation stock to E, an employee of D Corporation. S Corporation is a subsidiary of D Corporation. On March 1, 2005, D Corporation spins off S Corporation. E remains an employee of D Corporation. In connection with the spin off, D Corporation substitutes a new option to acquire D Corporation stock and a new option to acquire S Corporation stock for the old option in a manner that meets the requirements of paragraph (a) of this section.

(ii) The substitution of the new option to acquire S and D stock for the old option to acquire D stock is not a modification of the old option. However, because S is no longer a related corporation with respect to D Corporation, E must exercise the option for S stock within three months from March 1, 2005, for the option to be treated as a statutory option. See § 1.421-1(h).

(iii) Assume the same facts as in paragraph (i) of this *Example 11* except that E's employment with D Corporation is terminated on February 20, 2005. The substitution of the new option to acquire S and D stock for the old option to acquire D stock is not a modification of the old option. However, because the employment relationship between E and D Corporation terminated on February 20, 2005, E must exercise the option for the D and S stock within three months from February 20, 2005, for the option to be treated as a statutory option. See § 1.421-1(h).

(b) *Acquisition of new stock.* (1) Section 424(b) provides that the rules provided by sections 421 through 424 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 424, 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 424(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 424, the term "disposition of stock" 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.

(iv) A transfer between spouses or incident to divorce (described in section 1041(a)). The special tax treatment of § 1.421-2(a) with respect to the transferred stock applies to the transferee. However, see § 1.421-1(b)(2) for the

treatment of the transfer of a statutory option incident to divorce.

(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) If an optionee exercises an incentive stock option with statutory option stock and the applicable holding period requirements (under § 1.422-1(a) or § 1.423-1(a)) with respect to such statutory option stock are not met before such transfer, then sections 354, 355, 356, or 1036 (or so much of 1031 as relates to 1036) do not apply to determine whether there is a disposition of those shares. Therefore, there is a disposition of the statutory option stock, and the special tax treatment of § 1.421-2(a) does not apply to such stock.

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

Example 1. On June 1, 2004, the X Corporation grants to E, an employee, a statutory

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, 2005, 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, 2006, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 2005, 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, 2006, 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 capital gain.

Example 3. Assume the same facts as in example (1), except assume that on August 1, 2006, 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, 2006, E sells the 100 shares of X Corporation stock for \$13,000. The special rules of section 421(a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within two years from the date the options were granted and within one year of the date that the shares were transferred to him.

Example 5. Assume the same facts as in example (1), except assume that E dies on September 1, 2005, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 2005, of the statutory 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, 2005, 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, 2005. 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 compensation income at death with respect to the shares even though he held the stock less than 2 years after the transfer of the shares to him pursuant to his exercise of the option. See § 1.421-2(b)(2).

Example 7. On January 1, 2004, X Corporation grants to E, an employee of X Corporation, an incentive stock option to purchase 100 shares of X Corporation stock at \$100 per share (the fair market value of an X Corporation share on that date). On January 1, 2005, when the fair market value of a share of X Corporation stock is \$200, E exercises half of the option, pays X Corporation \$5,000 in cash, and is transferred 50 shares of X Corporation stock with an aggregate fair market value of \$10,000. E makes no disposition of the shares before January 2, 2006. Under § 1.421-2(a), no income is recognized by E on the transfer of shares pursuant to the exercise of the incentive stock option, and X Corporation is not entitled to any deduction at any time with respect to its transfer of the shares to E. E's basis in the shares is \$5,000.

Example 8. Assume the same facts as in Example 7, except that on December 1, 2005, one year and 11 months after the grant of the option and 11 months after the transfer of the 50 shares to E, E uses 25 of those shares, with a fair market value of \$5,000, to pay for the remaining 50 shares purchasable under the option. On that day, X Corporation transfers 50 of its shares, with an aggregate fair market value of \$10,000, to E. Because E disposed of the 25 shares before the expiration of the applicable holding periods, § 1.421-2(a) does not apply to the January 1, 2005, transfer of the 25 shares used by E to exercise the remainder of the option. As a result of the disqualifying disposition of the 25 shares, E recognizes compensation income under the rules of § 1.421-2(b).

Example 9. On January 1, 2005, X Corporation grants an incentive stock option to E, an employee of X Corporation. The exercise price of the option is \$10 per share. On June 1, 2005, when the fair market value of an X Corporation share is \$20, E exercises the option and purchases 5 shares with an aggregate fair market value of \$100. On January 1, 2006, when the fair market value of an X Corporation share is \$50, X Corporation is acquired by Y Corporation in a section 368(a)(1)(A) reorganization. As part of the acquisition, all X Corporation shares are converted into Y Corporation shares. After the conversion, if an optionee holds a fractional share of Y Corporation stock, Y Corporation will purchase the fractional share for cash equal to its fair market value. After applying the conversion formula to the shares held by E, E has 10 ½ Y Corporation shares. Y Corporation purchases E's one-half share for \$25, the fair market value of one-half of a Y Corporation share on the conversion date. Because E sells the one-half share prior

to expiration of the holding periods described in § 1.422-1(a), the sale is a disqualifying disposition of the one-half share. Thus, in 2006, E must recognize compensation income of \$5 (one-half of the fair market value of an X Corporation share on the date of exercise of the option, or \$10, less one-half of the exercise price per share, or \$5). For purposes of computing any additional gain, E's basis in the one-half share increases to \$10 (reflecting the \$5 included in income as compensation). E recognizes an additional gain of \$15 (\$25, the fair market value of the one-half share, less \$10, the basis in such share). The extent to which the additional \$15 of gain is treated as a redemption of Y Corporation stock is determined under section 302.

(d) *Attribution of stock ownership.* To determine the amount of stock owned by an individual for purposes of applying the percentage limitations relating to certain stockholders described in §§ 1.422-2(f) and 1.423-2(d), shares of the employer corporation or of a related corporation that are owned (directly or indirectly) by or for the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, are considered to be owned by the individual. Also, for such purposes, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) shares of the employer corporation or of a related corporation, the shares are considered to be owned proportionately by or for the stockholders, partners, or beneficiaries of the corporation, partnership, estate, or trust. The extent to which stock held by the optionee as a trustee of a voting trust is considered owned by the optionee is determined under all of the facts and circumstances.

(e) *Modification, extension, or renewal of option.* (1) This paragraph (e) provides rules for determining whether a share of stock transferred to an individual upon the individual's exercise of an option after the terms of the option have been changed is transferred pursuant to the exercise of a statutory option.

(2) Any modification, extension, or renewal of the terms of an option to purchase shares is considered the granting of a new option. The new option may or may not be a statutory option. To determine the date of grant of the new option for purposes of section 422 or 423, see § 1.421-1(c).

(3) If section 423(c) applies to an option then, 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)—

(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) For purposes of §§ 1.421-1 through 1.424-1 the term *modification* means any change in the terms of the option (or change in the terms of the plan pursuant to which the option was granted or in the terms of any other agreement governing the arrangement) that gives the optionee additional benefits under the option regardless of whether the optionee in fact benefits from the change in terms. In contrast, for example, a change in the terms of the option shortening the period during which the option is exercisable is not a modification. However, a change providing an extension of the period during which an option may be exercised (such as after termination of employment) or a change providing an alternative to the exercise of the option (such as a stock appreciation right) is a modification regardless of whether the optionee in fact benefits from such extension or alternative right. Similarly, a change providing an additional benefit upon exercise of the option (such as the payment of a cash bonus) or a change providing more favorable terms for payment for the stock purchased under the option (such as the right to tender previously acquired stock) is a modification.

(ii) If an option is not immediately exercisable in full, a change in the terms of the option to accelerate the time at which the option (or any portion thereof) may be exercised is not a modification for purposes of this section. Additionally, no modification occurs if a provision accelerating the time when an option may first be exercised is removed prior to the year in which it would otherwise be triggered.

For example, if an acceleration provision is timely removed to avoid exceeding the \$100,000 limitation described in §1.422-4, a modification of the option does not occur.

(iii) A change to an option which provides, either by its terms or in substance, that the optionee may receive an additional benefit under the option at the future discretion of the grantor, is a modification at the time that the option is changed to provide such discretion. In addition, the exercise of discretion to provide an additional benefit is a modification of the option. However, it is not a modification for the grantor to exercise discretion specifically reserved under an option with respect to the payment of a cash bonus at the time of exercise, the availability of a loan at exercise, the right to tender previously acquired stock for the stock purchasable under the option, or the payment of employment taxes and/or required withholding taxes resulting from the exercise of a statutory option. An option is not modified merely because an optionee is offered a change in the terms of an option if the change to the option is not made. An offer to change the terms of an option that remains open less than 30 days is not a modification of the option. However, if an offer to change the terms of an option remains outstanding for 30 days or more, there is a modification of the option as of the date the offer to change the option is made.

(iv) A change in the terms of the stock purchasable under the option that increases the value of the stock is a modification of such option, except to the extent that a new option is substituted for such option by reason of the change in the terms of the stock in accordance with paragraph (a) of this section.

(v) If an option is amended solely to increase the number of shares subject to the option, the increase is not considered a modification of the option but is treated as the grant of a new option for the additional shares. Notwithstanding the previous sentence, if the exercise price and number of shares subject to an option are proportionally adjusted to reflect a stock split (including a reverse stock split) or stock dividend, and the only effect of the

stock split or stock dividend is to increase (or decrease) on a pro rata basis the number of shares owned by each shareholder of the class of stock subject to the option, then the option is not modified if it is proportionally adjusted to reflect the stock split or stock dividend and the aggregate exercise price of the option is not less than the aggregate exercise price before the stock split or stock dividend.

(vi) Any change in the terms of an option made in an attempt to qualify the option as a statutory option grants additional benefits to the optionee and is, therefore, 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)(5) or 423(b)(9) such change is not a modification.

(vii) 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.

(viii) Any inadvertent change to the terms of an option (or change in the terms of the plan pursuant to which the option was granted or in the terms of any other agreement governing the arrangement) that is treated as a modification under this paragraph (e) is not considered a modification of the option to the extent the change in the terms of the option is removed by the earlier of the date the option is exercised or the last day of the calendar year during which such change occurred. Thus, for example, if the terms of an option are inadvertently changed on March 1 to extend the exercise period and the change is removed on November 1, then if the option is not exercised prior to November 1, the option is not considered modified under this paragraph (e).

(5) 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.

(6) [Reserved]

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

Example 1. On June 1, 2004, 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, 2006. At the time the option is granted, the fair market value of the X Corporation stock is \$100 per share. On February 1, 2005, 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, 2005, the fair market value of the X Corporation stock is \$90 per share. Under section 424(h), the X Corporation is deemed to have granted an option to the employee on February 1, 2005. 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, 2004, or on February 1, 1965. Because the requirements of § 1.424-1(e)(3) and § 1.423-2(g) have not been met, the exercise of such option by the employee after February 1, 2005, is not the exercise of a statutory option.

Example 2. On June 1, 2004, 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, 2005, and on or before June 1, 2006. On June 1, 2004, the fair market value of X Corporation's stock is \$100 per share. On February 1, 2005, X Corporation modifies the option to provide that the option shall be exercisable on or before September 1, 2006. On February 1, 2005, the fair market value of X Corporation stock is \$110 per share. Under section 424(h), X Corporation is deemed to have granted an option to the employee on February 1, 2005, 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, 2004, or on February 1, 2005. Because the requirements of § 1.424-1(e)(3) and § 1.423-2(g) have not been met, 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, 2005, before the date of the modification of the option. Any exercise of the option after February 1, 2005, the date of the modification, is not the exercise of a statutory option. See example (1) in this subpara-

graph. The exercise of the option on January 15, 2005, pursuant to which 50 shares were acquired, is the exercise of a statutory option.

(f) *Definitions.* The following definitions apply for purposes of §§ 1.421-1 through 1.424-1:

(1) *Parent corporation.* The term *parent corporation*, or *parent*, means any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations other than the employer corporation owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(2) *Subsidiary corporation.* The term *subsidiary corporation*, or *subsidiary*, means any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in an unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(g) *Effective/applicability date—(1) In general.* Except for § 1.424-1(a)(10) *Example 9* (iii), the regulations under this section are effective on August 3, 2004. Section 1.424-1(a)(10) *Example 9* (iii) is effective on November 17, 2009. Section 1.424-1(a)(10) *Example 9* (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. 6887, 31 FR 8808, June 24, 1966, as amended by T.D. 9144, 69 FR 46419, Aug. 3, 2004; 69 FR 61310, 61311, Oct. 18, 2004; 69 FR 70551, Dec. 7, 2004; T.D. 9471, 74 FR 59087, Nov. 17, 2009]

EDITORIAL NOTE: By T.D. 9144, 69 FR 46420, Aug. 3, 2004, the Internal Revenue Service published a document in the FEDERAL REGISTER attempting to amend § 1.424-1 (c)(4)(vi) and (viii). However, because of inaccurate language, this amendment could not be incorporated. For the convenience of the user, the language at 69 FR 61311, Oct. 18, 2004, is set forth as follows:

11. Section 1.424-1(c)(4)(vi), the last sentence is removed.

12. Section 1.424-1(c)(4)(viii), second sentence, the language “Thus, for example, if the terms of an option are inadvertently changed on March 1 to extend the exercise period and the change is removed on November, then if the option is not exercised prior to November 1, the option is not considered modified under this paragraph (e).” is removed and the language “Thus for example, if the terms of an option are inadvertently changed on March 1 to extend the exercise period and the change is removed on November 1, then if the option is not exercised prior to November 1, the option is not considered modified under this paragraph (e).” is added in its place.

13. Section 1.424-1(g)(2), third sentence, the language “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 6 months after August 3, 2004, taxpayers may rely on either the REG-122917-02 or this section.” is removed and the language “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 the REG-122917-02 or this section.” is added in its place.

§§ 1.425-1.429 [Reserved]

§ 1.430(d)-1 Determination of target normal cost and funding target.

(a) *In general*—(1) *Overview*. This section sets forth rules for determining a plan’s target normal cost and funding target under sections 430(b) and 430(d),

including guidance relating to the rules regarding actuarial assumptions under sections 430(h)(1), 430(h)(4), and 430(h)(5). Section 430 and this section apply to single employer defined benefit plans (including multiple employer plans as defined in section 413(c)) that are subject to section 412, but do not apply to multiemployer plans (as defined in section 414(f)). For further guidance on actuarial assumptions, see § 1.430(h)(2)-1 (relating to interest rates) and §§ 1.430(h)(3)-1 and 1.430(h)(3)-2 (relating to mortality tables). See also § 1.430(i)-1 for the determination of the funding target and the target normal cost for a plan that is in at-risk status.

(2) *Organization of regulation*. Paragraph (b) of this section sets forth certain definitions that apply for purposes of section 430. Paragraph (c) of this section provides rules regarding which benefits are taken into account in determining a plan’s target normal cost and funding target. Paragraph (d) of this section sets forth the rules regarding the plan provisions that are taken into account in making these determinations, and paragraph (e) of this section provides rules on the plan population that is taken into account for this purpose. Paragraph (f) of this section provides rules relating to the actuarial assumptions and the plan’s funding method that are used to determine present values. Paragraph (g) of this section contains effective/applicability dates and transition rules.

(3) *Special rules for multiple employer plans*. In the case of a multiple employer plan to which section 413(c)(4)(A) applies, the rules of section 430 and this section are applied separately for each employer under the plan, as if each employer maintained a separate plan. Thus, the plan’s funding target and target normal cost are computed separately for each employer under such a multiple employer plan. In the case of a multiple employer plan to which section 413(c)(4)(A) does not apply (that is, a plan described in section 413(c)(4)(B) that has not made the election for section 413(c)(4)(A) to apply), the rules of section 430 and this section are applied as if all participants in the plan were employed by a single employer.