

Employer W amends its health plan to eliminate coverage for 8 more individuals.

(ii) There is no significant reduction in retiree health coverage in either Year 1 or Year 2, because there is no reduction in health coverage as a result of employer action in those years.

(iii) There is no significant reduction in Year 3. The number of individuals whose health coverage ended during Year 3 by reason of employer action (amendment of the plan) is 5. Since the number of individuals receiving coverage for applicable health benefits as of the last day of Year 2 is 99, the employer-initiated reduction percentage for Year 3 is 5.05 percent (5/99), which is less than the 10 percent annual limit.

(iv) There is no significant reduction in Year 4. The number of individuals whose health coverage ended during Year 4 by reason of employer action is 8. Since the number of individuals receiving coverage for applicable health benefits as of the last day of Year 3 is 92, the employer-initiated reduction percentage for Year 4 is 8.70 percent (8/92), which is less than the 10 percent annual limit. The sum of the employer-initiated reduction percentages for Year 3 and Year 4 is 13.75 percent, which is less than the 20 percent cumulative limit.

(v) In Year 5, there is a significant reduction under paragraph (b)(1)(ii) of this section. The number of individuals whose health coverage ended during Year 5 by reason of employer action (amendment of the plan) is 8. Since the number of individuals receiving coverage for applicable health benefits as of the last day of Year 4 is 84, the employer-initiated reduction percentage for Year 5 is 9.52 percent (8/84), which is less than the 10 percent annual limit. However, the sum of the employer-initiated reduction percentages for Year 3, Year 4, and Year 5 is 5.05 percent + 8.70 percent + 9.52 percent = 23.27 percent, which exceeds the 20 percent cumulative limit.

*Example 2.* (i) Employer X, a calendar year taxpayer, maintains a defined benefit pension plan that includes a 401(h) account and permits qualified transfers that satisfy section 420. X also provides lifetime health benefits to employees who retire from Division A as a result of a plant shutdown, no health benefits to employees who retire from Division B, and lifetime health benefits to all employees who retire from Division C. In 2000, X amends its health plan to provide coverage for employees who retire from Division B as a result of a plant shutdown, but only for the 2-year period coinciding with their severance pay. Also in 2000, X amends the health plan to provide that employees who retire from Division A as a result of a plant shutdown receive health coverage only for the 2-year period coinciding with their severance pay. A plant shutdown that affects Division A and Division B employees occurs

in 2000. The number of individuals receiving coverage for applicable health benefits as of the last day of 2001 is 200. In 2002, Employer X makes a qualified transfer under section 420. As of the last day of 2002, applicable health benefits are provided to 170 individuals, because the 2-year period of benefits ends for 10 employees who retired from Division A and 20 employees who retired from Division B as a result of the plant shutdown that occurred in 2000.

(ii) There is no significant reduction in retiree health coverage in 2002. Coverage for the 10 retirees from Division A who lose coverage as a result of the end of the 2-year period is treated as having ended by reason of employer action, because coverage for those Division A retirees ended by reason of a plan amendment made after December 17, 1999. However, the terms of the health plan that limit coverage for employees who retired from Division B as a result of the 2000 plant shutdown (to the 2-year period) were adopted contemporaneously with the provision under which those employees became eligible for retiree coverage under the health plan. Accordingly, under the rule provided in paragraph (b)(4)(ii) of this section, coverage for those 20 retirees from Division B is not treated as having ended by reason of employer action. Thus, the number of individuals whose health benefits ended by reason of employer action in 2002 is 10. Since the number of individuals receiving coverage for applicable health benefits as of the last day of 2001 is 200, the employer-initiated reduction percentage for 2002 is 5 percent (10/200), which is less than the 10 percent annual limit.

(e) *Regulatory effective date.* This section is applicable to transfers of excess pension assets occurring on or after December 18, 1999.

[T.D. 8948, 66 FR 32900, June 19, 2001]

#### CERTAIN STOCK OPTIONS

#### § 1.421-1 Meaning and use of certain terms.

(a) *Option.* (1) For purposes of this section and §§ 1.421-2 through 1.424-1, the term “option” means the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (e) of this section, such individual being under no obligation to purchase. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock

under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the option must express, among other things, an offer to sell at the option price, the maximum number of shares purchasable under the option, and the period of time during which the offer remains open. The term *option* includes a warrant that meets the requirements of this paragraph (a)(1).

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract. See section 423.

(3) An option must be in writing (in paper or electronic form), provided that such writing is adequate to establish an option right or privilege that is enforceable under applicable law.

(b) *Statutory options.* (1) The term *statutory option*, for purposes of this section and §§ 1.421-2 through 1.424-1, means an *incentive stock option*, as defined in § 1.422-2(a), or an option granted under an *employee stock purchase plan*, as defined in § 1.423-2.

(2) An option qualifies as a statutory option only if the option is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom the option was granted, and is exercisable, during the lifetime of such individual, only by such individual. See §§ 1.422-2(a)(2)(v) and 1.423-2(j). Accordingly, an option which is transferable or transferred by the individual to whom the option is granted during such individual's lifetime, or is exercisable during such individual's lifetime by another person, is not a statutory option. However, if the option or the plan under which the option was granted contains a provision permitting the individual to designate the person who may exercise the option after such individual's death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a statutory option. A pledge of the stock purchasable under an option as security for a loan that is used to pay the option price does not cause the option to violate the nontransferability requirements of this paragraph (b). Also, the transfer of an option to a trust does not disqualify the option as a statutory option if, under section 671 and applicable State

law, the individual is considered the sole beneficial owner of the option while it is held in the trust. If an option is transferred incident to divorce (within the meaning of section 1041) or pursuant to a domestic relations order, the option does not qualify as a statutory option as of the day of such transfer. For the treatment of nonstatutory options, see § 1.83-7.

(3)(i) The determination of whether an option is a statutory option is made as of the date such option is granted. An option which is a statutory option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a statutory option when granted does not become such an option by reason of subsequent events. See, however, paragraph (e) of § 1.424-1, relating to modification, extension, or renewal of an option. For rules concerning options that are not statutory options, see § 1.83-7.

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

*Example 1.* X Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 2004, P grants to an employee of P a statutory option to purchase a share of stock of X. On January 1, 2005, S sells a portion of the X stock which it owns to an unrelated corporation and, as of that date, X ceases to be a subsidiary of S. Because X was a subsidiary of P on the date of the grant of the statutory option, the option does not fail to be a statutory option even though X ceases to be a subsidiary of P.

*Example 2.* Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 2004, X is not a subsidiary of either S or P. Such option is not a statutory option on June 1, 2004. On January 1, 2005, S purchases from an unrelated corporation a sufficient number of shares of X stock to make X, as of that date, a subsidiary of S. Because X was not a subsidiary of S or P on the date of the grant of the option, the option is not a statutory option even though X later becomes a subsidiary of P. See §§ 1.422-2(a)(2) and 1.423-2(b).

(c) *Time and date of granting option.* (1) For purposes of this section and §§ 1.421-2 through 1.424-1, the language "the date of the granting of the option" and "the time such option is granted," and similar phrases refer to the date or time when the granting corporation completes the corporate

action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. Except as set forth in §1.423-2(h)(2), a corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. However, under section 424(i), if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of, or registration with, some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of a related corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 2004, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation's stock, exercisable by X on or after June 1, 2005, provided he is employed by the corporation on June 1, 2005, and provided that A's profits during the fiscal year preceding the year of exercise exceed \$200,000. Such an option is granted to X on June 1, 2004, and will be treated as outstanding as of such date.

(d) *Stock and voting stock.* (1) For purposes of this section and §§1.421-2 through 1.424-1, the term *stock* means capital stock of any class, including

voting or nonvoting common or preferred stock. Except as otherwise provided, the term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term *stock* as used in such sections, provided such stock otherwise possesses the rights and characteristics of capital stock.

(2) For purposes of determining what constitutes voting stock in ascertaining whether a plan has been approved by stockholders under §1.422-2(b) or 1.423-2(c) or whether the limitations pertaining to voting power contained in §§1.422-2(f) and 1.423-2(d) have been met, stock which does not have voting rights until the happening of an event, such as the default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Generally, stock which does not possess a general voting power, and may vote only on particular questions, is not voting stock. However, if such stock is entitled to vote on whether a stock option plan may be adopted, it is voting stock.

(3) In general, for purposes of this section and §§1.421-2 through 1.424-1, ownership interests other than capital stock are considered stock.

(e) *Option price.* (1) For purposes of this section and §§1.421-2 through 1.424-1, the term *option price*, *price paid under the option*, or *exercise price* means the consideration in cash or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term *option price* does not include any amounts paid as interest under a deferred payment arrangement or treated as interest.

(2) Any reasonable valuation method may be used to determine whether, at the time the option is granted, the option price satisfies the pricing requirements of sections 422(b)(4), 422(c)(5), 422(c)(7), and 423(b)(6) with respect to the stock subject to the option. Such methods include, for example, the valuation method described in §20.2031-2 of this chapter (Estate Tax Regulations).

(f) *Exercise.* For purposes of this section and §§1.421-2 through 1.424-1, the term "exercise", when used in reference to an option, means the act of

acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. A promise to pay the option price does not constitute an exercise of the option unless the optionee is subject to personal liability on such promise. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option to the extent the payments made remain subject to withdrawal by or refund to the employee.

(g) *Transfer*. For purposes of this section and §§ 1.421-2 through 1.424-1, the term “transfer”, when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a statutory option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation. For purposes of section 422, a transfer may occur even if a share of stock is subject to a substantial risk of forfeiture or is not otherwise transferable immediately after the date of exercise. See § 1.422-1(b)(3) *Example 2*. A transfer does not fail to occur merely because, under the terms of the arrangement, the individual may not dispose of the share for a specified period of time, or the share is subject to a right of first refusal or a right to reacquire the share at the share’s fair market value at the time of sale.

(h) *Employment relationship*. (1) An option is a statutory option only if, at the time the option is granted, the optionee is an employee of the corporation granting the option, or a related corporation of such corporation. If the option has been assumed or a new option has been substituted in its place under § 1.424-1(a), the optionee must, at the time of such substitution or assumption, be an employee (or a former employee within the 3-month period following termination of the employment relationship) of the corporation so substituting or assuming the option, or a related corporation of such corporation. The determination of whether the optionee is an employee at the

time the option is granted (or at the time of the substitution or assumption under § 1.424-1(a)) is made in accordance with section 3401(c) and the regulations thereunder. As to the granting of an option conditioned upon employment, see paragraph (c)(2) of this section. A statutory option must be granted for a reason connected with the individual’s employment by the corporation or by its related corporation.

(2) In addition, § 1.421-2(a) is applicable to the transfer of a share pursuant to the exercise of the statutory option only if the optionee is, at all times during the period beginning with the date of the granting of such option and ending on the day 3 months before the date of such exercise, an employee of either the corporation granting such option, a related corporation of such corporation, or a corporation (or a related corporation of such corporation) substituting or assuming a stock option in a transaction to which § 1.424-1(a) applies. For purposes of the preceding sentence, the employment relationship is treated as continuing intact while the individual is on military leave, sick leave, or other bona fide leave of absence (such as temporary employment by the Government) if the period of such leave does not exceed 3 months, or if longer, so long as the individual’s right to reemployment with the corporation granting the option (or a related corporation of such corporation) or a corporation (or a related corporation of such corporation) substituting or assuming a stock option in a transaction to which § 1.424-1(a) applies, is provided either by statute or by contract. If the period of leave exceeds 3 months and the individual’s right to reemployment is not provided either by statute or by contract, the employment relationship is deemed to terminate on the first day immediately following such three-month period. Thus, if the option is not exercised before such deemed termination of employment, § 1.421-2(a) applies to the transfer of a share pursuant to an exercise of the option only if the exercise occurs within 3 months from the date the employment relationship is deemed terminated.

(3) For purposes of determining whether an individual meets the requirements of this paragraph, the term “employer corporation”, as used in section 424 (e) and (f), shall be read as “grantor corporation” or “corporation issuing or assuming a stock option in a transaction to which section 424(a) is applicable”, as the case may be. For purposes of the employment requirement, a corporation employing an optionee is considered a related corporation if it was a parent or subsidiary of the corporation granting the option or substituting or assuming the option during the entire portion of the requisite period of employment during which it was the employer of such optionee.

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

*Example 1.* On June 1, 2004, X Corporation granted a statutory option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 2005, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises his statutory option on June 1, 2005, section 421 is not applicable to such exercise, because on June 1, 2005, A is not employed by the corporation which granted the option or by a related corporation of such corporation, nor was he employed by any of such corporations within 3 months before June 1, 2005.

*Example 2.* Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation substituting an option under section 424(a). If A exercises the option to purchase the share of M stock on June 1, 2005, section 421 is applicable to the transfer of the M stock because, at all times during the period beginning with the date of grant of the X option and ending with the date of exercise of the M option, A was an employee of the corporation granting the option or substituting or assuming the option under § 1.424-1(a).

*Example 3.* E is an employee of P Corporation. On June 1, 2004, P grants E a statutory option to purchase a share of P stock. On June 1, 2005, P acquires 100 percent of the stock of S Corporation; on such date S becomes a subsidiary of P. On July 1, 2005, E ceases to be employed by P and becomes employed by S. On October 10, 2005, while still employed by S, E exercises his option to buy P stock. Since E was at all times during the

requisite period of employment an employee of either P, the corporation granting the option, or S, a subsidiary of the grantor during the period in which such corporation was E's employer, section 421 is applicable to the exercise of the option.

*Example 4.* Assume the same facts as in example (3) except assume that at the time E became an employee of S Corporation, S assumed E's option to purchase P stock under section 424(a). Section 421 is applicable to E's exercise of his option to buy P stock.

*Example 5.* M Corporation grants a statutory option to E, an employee of such corporation. E is an officer in a reserve Air Force unit. E goes on military leave with his unit for 3 weeks. Regardless of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder during such 3-week period, E's employment relationship with M is treated as uninterrupted during the period of E's military leave.

*Example 6.* Assume the same facts as in example (5) and assume further that E's active duty status is extended indefinitely, but that E has a right to reemployment with M or a related corporation on the termination of any military duty E may be required to serve. E exercises his M option while on active military duty. Irrespective of whether E is an employee of M or a related corporation within the meaning of section 3401(c) and the regulations thereunder at the time of such exercise or within 3 months before such exercise, section 421 applies to such exercise.

*Example 7.* X Corporation grants an incentive option to A, an employee of X Corporation, whose employment contract provides that in the event of illness, A's right to reemployment with X, or a related corporation of X, will continue for 1 year after the time A becomes unable to perform his duties for X. A falls ill for 90 days. For purposes of section 422(a)(2), A's employment relationship with X will be treated as uninterrupted during the 90-day period. If A's incapacity extends beyond 90 days, then, for purposes of section 422(a)(2), A's employment relationship with X will be treated as continuing uninterrupted until A's reemployment rights terminate. Under section 422(a)(2), A has 3 months in which to exercise an incentive option after his employment relationship with X (and related corporations) is deemed terminated.

(i) *Additional definitions.* (1) *Corporation.* For purposes of this section and §§ 1.421-2 through 1.424-1, the term *corporation* has the meaning prescribed by section 7701(a)(3) and § 301.7701-2(b) of this chapter. For example, a *corporation* for purposes of the preceding sentence includes an S corporation (as defined in section 1361), a foreign corporation (as

defined in section 7701(a)(5)), and a limited liability company that is treated as a corporation for all Federal tax purposes.

(2) *Parent corporation and subsidiary corporation.* For the definition of the terms *parent corporation* (and *parent*) and *subsidiary corporation* (and *subsidiary*), for purposes of this section and §§ 1.421-2 through 1.424-1, see § 1.424-1(f)(i) and (ii), respectively. *Related corporation* as used in this section and in §§ 1.421-2 through 1.424-1 means either a parent corporation or subsidiary corporation.

(j) *Effective/applicability date*—(1) *In general.* Except for paragraph (c)(1) of this section, the regulations under this section are effective on August 3, 2004. Paragraph (c)(1) of this section is effective on November 17, 2009. Paragraph (c)(1) of this section 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 8787, June 24, 1966, as amended by T.D. 6975, 33 FR 14779, Oct. 3, 1968; T.D. 7554, 43 FR 31927, July 24, 1978. Redesignated and amended by T.D. 9144, 69 FR 46406, Aug. 3, 2004; 69 FR 61310, Oct. 18, 2004; 69 FR 70551, Dec. 7, 2004; T.D. 9471, 74 FR 59077, Nov. 17, 2009]

**§ 1.421-2 General rules.**

(a) *Effect of qualifying transfer.* (1) If a share of stock is transferred to an individual pursuant to the individual's exercise of a statutory option, and if the requirements of § 1.422-1(a) (relating to incentive stock options) or § 1.423-1(a) (relating to employee stock purchase plans) whichever is applicable, are met, then—

(i) No income results under section 83 at the time of the transfer of such share to the individual upon the exercise of the option with respect to such share;

(ii) No deduction under sections 83(h) or 162 or the regulations thereunder (relating to trade or business expenses) is allowable at any time with respect to the share so transferred; and

(iii) No amount other than the price paid under the option is considered as received by the employer corporation, a related corporation of such corporation, or a corporation substituting or assuming a stock option in a transaction to which § 1.424-1(a) (relating to corporate reorganizations, liquidations, etc.) applies, for the share so transferred.

(2) For the purpose of this paragraph, each share of stock transferred pursuant to a statutory option is treated separately. For example, if an individual, while employed by a corporation granting him a statutory option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(b) *Effect of disqualifying disposition.* (1)(i) The disposition (as defined in § 1.424-1(c)) of a share of stock acquired by the exercise of a statutory option before the expiration of the applicable holding periods as determined under § 1.422-1(a) or 1.423-1(a) is a disqualifying disposition and makes paragraph (a) of this section inapplicable to the transfer of such share. See section 83(a)