

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)

to determine the amount includible on a disqualifying disposition. The income attributable to such transfer (determined without reduction for any brokerage fees or other costs paid in connection with the disposition) is treated by the individual as compensation income received in the taxable year in which such disqualifying disposition occurs. A deduction attributable to such transfer is allowable, to the extent otherwise allowable under section 162, for the taxable year in which such disqualifying disposition occurs to the employer corporation, or a related corporation of such corporation, or a corporation substituting or assuming an option in a transaction to which § 1.424-1(a) applies. Additionally, the amount allowed as a deduction must be determined as if the requirements of section 83(h) and § 1.83-6(a) apply. No amount is treated as income, and no amount is allowed as a deduction, for any taxable year other than the taxable year in which the disqualifying disposition occurs. If the amount realized on the disposition exceeds (or is less than) the sum of the amount paid for the share and the amount of compensation income recognized as a result of such disposition, the extent to which the difference is treated as gain (or loss) is determined under the rules of section 302 or 1001, as applicable.

(ii) The following examples illustrate the principles of this paragraph (b):

Example 1. On June 1, 2006, X Corporation grants an incentive stock option to A, an employee of X, entitling A to purchase 100 shares of X stock at \$10 per share. On August 1, 2006, A exercises the option when the fair market value of X stock is \$20 per share, and 100 shares of X stock are transferred to A on that date. On December 15, 2007, A sells the stock for \$20 per share. Because A disposed of the stock before June 2, 2008, A did not satisfy the holding period requirements of § 1.422-1(a). Under paragraph (b)(1)(i) of this section, A therefore made a disqualifying disposition of the stock. Thus, paragraph (a) of this section is inapplicable to the transfer of the shares, and A must include the compensation income attributable to the transfer of the shares in gross income in the year of the disqualifying disposition. The amount of compensation income A must include in income is \$1,000 (\$2,000, the fair market value of X stock on transfer less \$1,000, the exercise price per share). If the requirements of § 83(h) and § 1.83-6(a) are satisfied and other-

wise allowable under section 162, X is allowed a deduction of \$1,000 for its taxable year in which the disqualifying disposition occurs.

Example 2. Y Corporation grants an incentive stock option for 100 shares of its stock to E, an employee of Y. The option has an exercise price of \$10 per share. E exercises the option and is transferred the shares when the fair market value of a share of Y stock is \$30. Before the applicable holding periods are met, Y redeems the shares for \$70 per share. Because the holding period requirements of § 1.422-1(a) are not met, the redemption of the shares is a disqualifying disposition of the shares. Under paragraph (b)(1)(i) of this section, A made a disqualifying disposition of the stock. Thus, paragraph (a) of this section is inapplicable to the transfer of the shares, and E must include the compensation income attributable to the transfer of the shares in gross income in the year of the disqualifying disposition. The amount of compensation income that E must include in income is \$2,000 (\$3,000, the fair market value of Y stock on transfer, less \$1,000, the exercise price paid by E). The character of the additional gain that is includible in E's income as a result of the redemption is determined under the rules of section 302. If the requirements of § 83(h) and § 1.83-6(a) are satisfied and otherwise allowable under section 162, Y is allowed a deduction for the taxable year in which the disqualifying disposition occurs for the compensation income of \$2,000. Y is not allowed a deduction for the additional gain includible in E's income as a result of the redemption.

(2) If an optionee transfers stock acquired through the optionee's exercise of a statutory option prior to the expiration of the applicable holding periods, paragraph (a) of this section continues to apply to the transfer of the stock pursuant to the exercise of the option if such transfer is not a disposition of the stock as defined in § 1.424-1(c) (for example, a transfer from a decedent to the decedent's estate or a transfer by bequest or inheritance). Similarly, a subsequent transfer by the executor, administrator, heir, or legatee is not a disqualifying disposition by the decedent. If a statutory option is exercised by the estate of the optionee or by a person who acquired the option by bequest or inheritance or by reason of the death of such optionee, see paragraph (c) of this section. If a statutory option is exercised by the individual to whom the option was granted and the individual dies before the expiration of the holding periods, see paragraph (d) of this section.

(3) For special rules relating to the disqualifying disposition of a share of stock acquired by exercise of an incentive stock option, see §§ 1.422-5(b)(2) and 1.424-1(c)(3).

(c) *Exercise by estate.* (1) If a statutory option is exercised by the estate of the individual to whom the option was granted (or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual), paragraph (a) of this section applies to the transfer of stock pursuant to such exercise in the same manner as if the option had been exercised by the deceased optionee. Consequently, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to the exercise of the option. Paragraph (a) of this section applies even if the executor, administrator, or such person disposes of the stock so acquired before the expiration of the applicable holding periods as determined under § 1.422-1(a) or 1.423-1(a). This special rule does not affect the applicability of section 423(c), relating to the estate's or other qualifying person's recognition of compensation income, or section 1222, relating to what constitutes a short-term and long-term capital gain or loss. Paragraph (a) of this section also applies even if the executor, administrator, or such person does not exercise the option within three months after the death of the individual or is not employed as described in § 1.421-1(h), either when the option is exercised or at any time. However, paragraph (a) of this section does not apply to a transfer of shares pursuant to an exercise of the option by the estate or by such person unless the individual met the employment requirements described in § 1.421-1(h) either at the time of the individual's death or within three months before such time (or, if applicable, within the period described in § 1.422-1(a)(3)). Additionally, paragraph (a) of this section does not apply if the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual. For example, if the option is sold by the estate, paragraph (a) of this

section does not apply to the transfer of stock pursuant to an exercise of the option by the buyer, but if the option is distributed by the administrator to an heir as part of the estate, paragraph (a) of this section applies to the transfer of stock pursuant to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets, or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock for purposes of section 423(c). Therefore, if section 423(c) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 423(c) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3)(i) If, under section 423(c) an amount is required to be included in the gross income of the estate or of such person, the estate or such person shall be allowed a deduction as a result of the inclusion of the value of the option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691(c) by treating the option as an item of gross income in respect of a decedent under section 691 and by treating the amount required to be included in gross income under section 423(c) as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an amount includible under section 423(c). For the rules relating to the computation of a deduction under section 691(c), see § 1.691(c)-1.

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

Example. On June 1, 2004, E was granted an option under an employee stock purchase plan to purchase for \$85 one share of the stock of his employer. On such day, the fair market value of such stock was \$100 per

share. E died on February 1, 2006, without having exercised such option. The option was, however, exercisable by his estate, and for purposes of the estate tax was valued at \$30. On March 1, 2006, the estate exercised the option, and on March 15, 2006, sold for \$150 the share of stock so acquired. For its taxable year including March 15, 2006, the estate is required by sections 421(c)(1)(B) and 423(c) to include in its gross income as compensation the amount of \$15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421(c)(2), the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691(a), and no deductions referred to in section 691(b), so that the value for estate tax purposes of the option, \$30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the option in the estate of E is \$10. Since \$15, the amount includible in gross income by reason of sections 421(c)(1)(B) and 423(c), is less than the value for estate tax purposes of the option, only $\frac{15}{30}$ of the estate tax attributable to the inclusion of the option in the estate is deductible; that is, $\frac{15}{30}$ of \$10, or \$5. No deduction under section 421(c)(2) is allowable with respect to any capital gain.

(4)(i)(a) In the case of the death of an optionee, the basis of any share of stock acquired by the exercise of an option under this paragraph (c), determined under section 1011, shall be increased by an amount equal to the portion of the basis of the option attributable to such share. For example, if a statutory option to acquire 10 shares of stock has a basis of \$100, the basis of one share acquired by a partial exercise of the option, determined under section 1011, would be increased by 1/10th of \$100, or \$10. The option acquires a basis, determined under section 1014(a) or under section 1022, if applicable, only if the transfer of the share pursuant to the exercise of such option qualifies for the special tax treatment provided by section 421(a). To the extent the option is so exercised, in whole or in part, it will acquire a basis equal to its fair market value (or the basis as determined under section 1022, if applicable) at the date of the employee's death or, if an election is made under section 2032, its value at its applicable valuation date. In certain cases, the basis of the share is subject to the adjust-

ments provided by paragraphs (c)(4)(i)(b) and (c) of this section, but such adjustments are only applicable in the case of an option that is subject to section 423(c).

(b) If the amount which would have been includible in gross income under section 423(c) had the employee exercised the option on the date of his death and held the share at the time of his death exceeds the amount which is includible in gross income under such section, the basis of the share, determined under (a) of this subdivision, shall be reduced by such excess. For example, if \$15 would have been includible in the gross income of the employee had he exercised the option and held such share at the time of his death, and only \$10 is includible under section 423(c), the basis of the share, determined under (a) of this subdivision, would be reduced by \$5. For purposes of determining the amount which would have been includible in gross income under section 423(c), if the employee had exercised the option and held such share at the time of his death, the amount which would have been paid for the share shall be computed as if the option had been exercised on the date the employee died.

(c) If the amount includible in gross income under section 423(c) exceeds the portion of the basis of the option attributable to the share, the basis of the share, determined under (a) of this subdivision, shall be increased by such excess. Thus, if \$15 is includible in gross income under such section, and the basis of the option with respect to the share is \$10, the basis of the share, determined under (a) of this subdivision, will be increased by \$5.

(ii) If a statutory option is not exercised by the estate of the individual to whom the option was granted, or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual, the option shall be considered to be property that constitutes a right to receive an item of income in respect of a decedent to which the rules of sections 691 and 1014(c) (or section 1022(f), if applicable) apply.

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

Example 1. On June 1, 2005, the X Corporation granted to E, an employee, an option under its employee stock purchase plan to purchase a share of X Corporation stock for \$85. The fair market value of X Corporation stock on such date was \$100 per share. On June 1, 2006, E died. The fair market value of X Corporation stock on such date exceeded \$100 per share and the fair market value of the option on the applicable valuation date was \$35. On August 1, 2006, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was \$120. The basis of the share is \$120 (the \$85 paid for the stock plus the \$35 basis of the option). When the share is sold for \$120, the estate is required to include \$15 in its gross income as compensation. Since \$15 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, paragraph (c)(4)(i)(b) of this section does not apply. Moreover, since the \$15 includible in the gross income of the estate does not exceed the basis of the option (\$35), paragraph (c)(4)(i)(c) of this section does not apply. Since the basis of the stock and the sale price are the same, no gain or loss is realized by the estate on the disposition of the share.

Example 2. Assume the same facts as in Example 1, except that the fair market value of the share of stock at the time of its sale was \$90. The basis of the share, determined under paragraph (c)(4)(i)(a) of this section, is \$120 (the \$85 paid for the stock plus the \$35 basis of the option). When the share is sold for \$90, the estate is required to include \$5 in its gross income as compensation. If the employee had exercised the option and held the share at the time of his death, \$15 would have been includible in gross income as compensation for the taxable year ending with his death. Since such amount exceeds by \$10 the amount which the estate is required to include in its gross income, paragraph (c)(4)(i)(b) of this section applies, and the basis of the share (\$120), determined under paragraph (c)(4)(i)(a) of this section is reduced by \$10. Accordingly, the basis is \$110, and a capital loss of \$20 is realized on the disposition of the share.

Example 3. Assume the same facts as in Example 1, except that the fair market value of the option on the applicable valuation date was \$5, and that the fair market value of X Corporation stock on the date the employee died did not exceed \$100. The basis of the share, determined under paragraph (c)(4)(i)(a) of this section, is \$90 (the \$85 paid for the stock plus the \$5 basis of the option). When the share is sold for \$120, the estate is required to include \$15 in its gross income as compensation. Since such amount exceeds by \$10 the basis of the option, paragraph (c)(4)(i)(c) of this section applies, and the basis of the share (\$90), determined under

paragraph (c)(4)(i)(b) of this section, is increased by \$10. Accordingly, the basis is \$100 and a capital gain of \$20 is realized on the disposition of the share.

Example 4. Assume the same facts as in Example 1, except that on June 1, 2006, the date the employee died, the fair market value of X Corporation stock was \$98, and that on June 1, 2007, the alternate valuation date, the fair market value of the stock had declined substantially, and the fair market value of the option was \$5. On August 1, 2007, the estate of E exercised the option and sold the share when its fair market value was \$92. The basis of the share, determined under paragraph (c)(4)(i)(a) of this section, is \$90 (the \$85 paid for the stock plus the \$5 basis of the option). When the share is sold for \$92, the estate is required to include \$7 in its gross income as compensation. Since \$13 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, paragraph (c)(4)(i)(b) of this section applies, and the basis of the share (\$90), determined under paragraph (c)(4)(i)(a) of this section, is reduced by \$6 to \$84. Furthermore, since the \$7 that the estate is required to include in its gross income when the share is sold for \$92 exceeds by \$2 the basis of the option, paragraph (c)(4)(i)(c) of this section applies, and the basis of the share (\$84), determined under paragraph (c)(4)(i)(a) of this section and paragraph (c)(4)(i)(b) of this section, is increased by \$2. Accordingly, the basis is \$86 and a capital gain of \$6 is realized on the disposition of the share.

(d) *Option exercised by the individual to whom the option was granted if the individual dies before expiration of the applicable holding periods.* If a statutory option is exercised by the individual to whom the option was granted and such individual dies before the expiration of the applicable holding periods as determined under § 1.422-1(a) or 1.423-1(a), paragraph (a) of this section does not become inapplicable if the executor or administrator of the estate of such individual, or any person who acquired such stock by bequest or inheritance or by reason of the death of such individual, disposes of such stock before the expiration of such applicable holding periods. This rule does not affect the applicability of section 423(c), relating to the individual's recognition of compensation income, or section 1222, relating to what constitutes a short-term and long-term capital gain or loss.

(e) *Incorporation by reference.* Any requirement that an option expressly

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

(f) *Effective/applicability date.*—(1) *In general.* These regulations are effective on August 3, 2004.

(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.

(3) *Application of section 1022.* The provisions of paragraph (c) of this section relating to section 1022 are effective on and after January 19, 2017.

[T.D. 6887, 31 FR 8789, June 24, 1966. 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. 9811, 82 FR 6238, Jan. 19, 2017]

§ 1.422-1 Incentive stock options; general rules.

(a) *Applicability of section 421(a).* (1)(i) Section 1.421-2(a) applies to the transfer of a share of stock to an individual

pursuant to the individual's exercise of an incentive stock option if the following conditions are satisfied—

(A) The individual makes no disposition of such share before the later of the expiration of the 2-year period from the date of grant of the option pursuant to which such share was transferred, or the expiration of the 1-year period from the date of transfer of such share to the individual; and

(B) At all times during the period beginning on the date of grant of the option and ending on the day 3 months before the date of exercise, the individual was an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation (or a related corporation of such corporation) substituting or assuming a stock option in a transaction to which § 1.424-1(a) applies.

(ii) For rules relating to the disposition of shares of stock acquired pursuant to the exercise of a statutory option, see § 1.424-1(c). For rules relating to the requisite employment relationship, see § 1.421-1(h).

(2)(i) The holding period requirement of section 422(a)(1), described in paragraph (a)(1)(i)(A) of this section, does not apply to the transfer of shares by an insolvent individual described in this paragraph (a)(2). If an insolvent individual holds a share of stock acquired pursuant to the individual's exercise of an incentive stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary in any proceeding under the Bankruptcy Act or any other similar insolvency proceeding, neither such transfer, nor any other transfer of such share for the benefit of the individual's creditors in such proceeding is a disposition of such share for purposes of this paragraph (a). For purposes of this paragraph (a)(2), an individual is insolvent only if the individual's liabilities exceed the individual's assets or the individual is unable to satisfy the individual's liabilities as they become due. See section 422(c)(3).

(ii) A transfer by the trustee or other fiduciary that is not treated as a disposition for purposes of this paragraph (a) may be a sale or exchange for purposes of recognizing capital gain or loss with respect to the share transferred.