

(directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

[T.D. 6500, 25 FR 11693, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961]

**§ 1.421-3 Exercise of restricted stock option.**

(a) The special rules of income tax treatment provided in section 421(a) and (b) are applicable only if the following conditions exist with respect to the transfer of a share of stock to an individual:

(1) The share of stock is transferred to the individual pursuant to his exercise after 1949 of a restricted stock option; and

(2) At the time the option is exercised by him, the individual is an employee of the corporation granting such option (or parent or subsidiary thereof), or of a corporation (or parent or subsidiary thereof) which issued or assumed the option under section 421(g) (see paragraph (d) of § 1.421-4), or was an employee of any such corporations within three months before the date the option is exercised.

(b)(1) Section 421 is applicable to the exercise of a restricted stock option only if at the time the individual exercises the option he is a bona fide employee of the corporation granting the option, or of a corporation which is at the time the option is exercised a parent or subsidiary of such corporation, unless the old option has been assumed or a new option has been issued in its place under section 421(g). See paragraph (d) of § 1.421-4. In case of such an assumption of the old option or such issuance of a new option, the individual exercising the option must, at the time he exercises the option, be a bona fide employee of the corporation so assuming or issuing the option, or a parent or subsidiary of such corporation. Section 421 is also applicable if the individual exercising the option was a bona fide employee of any of such corporations within three months before the exercise of the option. For purposes of determining whether an individual meets the requirement of this subparagraph,

the term “employer corporation”, as used in section 421(d) (2) and (3), shall be read as “grantor corporation” or “corporation issuing or assuming a stock option in a transaction to which section 421(g) is applicable”, as the case may be. Therefore, for purposes of the employment requirement, the determination of whether a corporation is a parent corporation or a subsidiary corporation is based upon whether the corporation is a parent or subsidiary of the corporation granting an option or of a corporation which issued or assumed an option under section 421(g).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example (1).* On June 1, 1954, X Corporation granted a restricted stock option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1955, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises this restricted stock option on June 1, 1955, section 421 is not applicable to such exercise, because on June 1, 1955, A is not employed by the corporation which granted the option or by a parent or subsidiary of such corporation. Nor was he employed by any of such corporations within three months before June 1, 1955.

*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 issuing an option under section 421(g). If A exercises the option to purchase the share of M stock on June 1, 1955, section 421 is applicable for A is then employed by a corporation which issued an option under section 421(g).

*Example (3).* Assume that P Corporation which owns all of the stock of S Corporation grants a restricted stock option to E, an employee of S Corporation. If E exercises the option, section 421 is applicable since E is employed by a corporation which is a subsidiary of the corporation which granted the restricted stock option.

(c)(1) The determination whether an option ultimately exercised is a restricted stock option is made as of the date such option is granted. An option which is a restricted stock option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a restricted stock option when granted

does not become such an option by reason of subsequent events. See, however, § 1.421-4, relating to modification, extension, or renewal of an option.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example (1).* S-1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1954, P grants to an employee of P a restricted stock option to purchase a share of stock of S-1. On January 1, 1955, S sells a portion of the S-1 stock which it owns to an unrelated corporation and, as of that date, S-1 ceases to be a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. The employee has exercised a restricted stock option.

*Example (2).* Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1954, S-1 is not a subsidiary of either S or P. Such option is not a restricted stock option on June 1, 1954. On January 1, 1955, S purchases from an unrelated corporation a sufficient number of shares of S-1 stock to make S-1, as of that date, a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. The employee has not exercised a restricted stock option.

(d) For the rules applicable to an exercise of a restricted stock option by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of § 1.421-5.

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**§ 1.421-4 Modification, extension, or renewal.**

(a) *In general.* Section 421(e) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a restricted stock option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) in the case of an exercise of an option in any taxable year of the optionee which begins after

December 31, 1953, and ends after August 16, 1954.

(b) *Effect of a modification, extension, or renewal.* (1) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(2) Except as otherwise provided in subparagraph (3) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for the purpose of applying the rule of section 421(d)(1)(A)—

(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.

(3)(i) The rules of subparagraph (2) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly