

(ii)(a) of this subparagraph, 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, subdivision (ii)(c) of this subparagraph applies, and the basis of the share (\$90), determined under subdivision (ii)(a) of this subparagraph, is increased by \$10. Accordingly, the basis is \$100 and a capital gain of \$20 is realized on the disposition of the share.

*Example (5).* Assume the same facts as in example (2), except that on June 1, 1966, the date the employee died, the fair market value of X Corporation stock was \$98, and that on June 1, 1967, 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, 1967, 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 subdivision (ii)(a) of this subparagraph, 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, subdivision (ii)(b) of this subparagraph applies, and the basis of the share (\$90), determined under subdivision (ii)(a) of this subparagraph, 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, subdivision (ii)(c) of this subparagraph applies, and the basis of the share (\$84), determined under subdivision (ii)(a) and (ii)(b) of this subparagraph, is increased by \$2. Accordingly, the basis is \$86 and a capital gain of \$6 is realized on the disposition of the share.

(d) *Exercise by deceased employee during lifetime.* If a statutory option is exercised by an individual to whom the option was granted and the individual dies before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), section 421(a) 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 period. This rule does not affect the applicability of 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.

[T.D. 6887, 31 FR 8789, June 24, 1966]

#### § 1.422-4 Qualified stock options (prior law).

Section 422 of the Code, pertaining to qualified stock options, was repealed by section 11801(a)(20) of the Omnibus Budget Reconciliation Act of 1990. In view of the savings provision of section 11821(b) of that act, the regulations under the repealed section 422, which were removed from the Code of Federal Regulations, may be of continuing interest to the public. Those regulations were set forth in 26 CFR 1.422-1 and 1.422-2 as contained in 26 CFR edition revised as of April 1, 1991.

[T.D. 8374, 56 FR 61160, Dec. 2, 1991]

#### § 1.422-5 Stockholder approval of incentive stock option plans.

This section addresses the stockholder approval of incentive stock option plans required by section 422(b)(1) of the Internal Revenue Code. (Section 422 was added to the Code as section 422A by section 251 of the Economic Recovery Tax Act of 1981, and was redesignated as section 422 by section 11801 of the Omnibus Budget Reconciliation Act of 1990.) The approval of stockholders must comply with all applicable provisions of the corporate charter, bylaws, and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval in such cases an

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incentive stock option plan must be approved:

(a) By a majority of the votes cast at a duly held stockholders' meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(b) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (i.e., an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

[T.D. 8374, 56 FR 61160, Dec. 2, 1991]

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

(a) *General rule.* Subject to the provisions of section 423(c) and paragraph (k) of this section, the special rules of income tax treatment provided in section 421(a) apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted after December 31, 1963, under an employee stock purchase plan provided that the following conditions are satisfied—

(1) The individual must make no disposition of such share within 2 years from the date of the granting of the option, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him; and

(2) At all times during the period beginning with the date of the granting of the option and ending on the day three months before the date of such exercise, the individual must be 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 issuing or assuming a stock option in a transaction to which section 425(a) applies.

(b) *Cross-references.* For rules relating to the employment relationship, see paragraph (h) of § 1.421-7. For rules relating to the effect of a disqualifying disposition, see section 421(b) and paragraph (b) of § 1.421-8. For definition of

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the term “disposition”, see section 425(c) and paragraph (c) of § 1.425-1.

[T.D. 6887, 31 FR 8798, June 24, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

## § 1.423-2 Employee stock purchase plan defined.

(a) *In general.* (1) The term “employee stock purchase plan” means a plan which meets the requirements of paragraphs (1) through (9) of section 423(b). If the terms of the plan do not satisfy the requirements of paragraphs (3) through (9) of section 423(b), such requirements may be satisfied by the terms of an offering made under such plan. However, in such a case, such requirements will be treated as satisfied only with respect to options exercised under such offering.

(2) The determination of whether a particular option is an option granted under an employee stock purchase plan is made at the time such option is granted. If the terms of an option are inconsistent with the terms of the employee stock purchase plan or an offering under such a plan, the option will not be treated as granted under an employee stock purchase plan. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b)(4). If such an option is granted to an individual who is not entitled to the grant of an option under the terms of the plan or offering, such option will not be treated as an option granted under an employee stock purchase plan, and the grant of the option will not disqualify the plan or the options granted under such plan or offering. For example, an option granted to an individual who is ineligible to receive an option under an employee stock purchase plan by reason of his ownership of 5 percent or more of the voting power or value of the stock of the grantor corporation