

CERTAIN STOCK OPTIONS

§ 1.421-1 Effective dates and meaning and use of certain terms.

(a) *Option.* (1) For the purpose of section 421, the term “option” includes 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 (d) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. 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 written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

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

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1954, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1955, another 1,000 shares on or after June 1, 1956, and a further 1,000 shares on or after June 1, 1957, all shares to be purchased before June 1, 1958, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1954, of three options, each for the purchase of 1,000 shares. Similarly, if a corporation grants to an employee on January 1, 1955, the right to purchase 1,000 shares of its stock at \$85 per share during 1955, or at \$75 per share during 1956, or at \$65 per share during 1957, such an arrangement will be construed as the grant to the employee on January 1, 1955, of three alternative options, one option for the purchase of 1,000 shares at \$85 per share during 1955, an alternative option for the purchase of 1,000 shares at \$75 per share during 1956, and a third

alternative option for the purchase of 1,000 shares at \$65 per share during 1957.

(b) *Time and date of granting of option.* (1) For the purpose of section 421, the words “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 corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a restricted stock option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(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. A special rule is provided by section 421(d)(5) for options subject to stockholder approval. 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 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 its parent or subsidiary 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, 1954, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation stock, exercisable by X on or after June 1, 1955, provided he is employed by the corporation on June 1, 1955. Such an option is granted to X on June 1, 1954.

(c) *Stock.* For the purpose of section 421, the term "stock" means capital stock of any class, including voting or nonvoting common or preferred stock. 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 section 421, provided such stock otherwise possesses the rights and characteristics of capital stock.

(d) *Option price.* (1) For the purpose of section 421, the term "option price" or "price paid under the option" means the consideration in money or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased.

(2) (i) With respect to its option price, a restricted stock option must, when granted, meet either of the following requirements:

(A) The option price must be fixed or determinable at the time the option is granted; or

(B) In the case of an option exercised during any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954, the option price must be determinable under a variable price option as defined in subdivision (ii) of this subparagraph.

An option which does not meet the requirements of either (A) or (B) of this subdivision when granted will not be treated as a restricted stock option unless it is subsequently changed to meet such requirements. In case of such a change, see paragraph (c)(2) of § 1.421-4.

(ii)(A) The term "variable price option" means an option under which the option price is determined by a formula in which the only variable is the fair market value of the stock at any time during a period of six consecutive

months which includes the day on which such option is exercised. Except as provided in (b) of this subdivision, such formula may provide for determining such price by reference to such value on any particular day in such 6-month period, or by reference to an average value of the stock over either the whole of such 6-month period or over any shorter period included in such 6-month period. Such 6-month period may begin with, end with, or in any other manner span the day on which such option is exercised. Such formula may also depend upon factors other than such value of the stock, but such other factors must not be variable and must be fixed in the option when granted. For example, such formula may provide that the option price shall be 85 percent of the value of the stock on the day the option is exercised, but such price shall not be less than \$85, nor more than \$110. Another example of a formula which meets the requirements of this subdivision is a provision that the option price shall be 95 percent of the fair market value of the stock on the day the option is exercised but not more than \$95. However, the requirements of this subdivision are not met by a formula which provides that if the profits of the employer for the year do not exceed \$100,000, the option price shall be \$15 under the fair market value of the stock at the time the option is exercised, but if such profits exceed \$100,000, the option price shall be \$20 under such value of the stock. For an example of how to determine whether an option which contains a formula meeting the requirements of this subdivision also meets the requirement that the option price must be at least 85 percent of the fair market value of the stock at the time the option is granted, see paragraph (a)(1) of § 1.421-2.

(B) In the case of an option granted after September 30, 1958, the term "variable price option" does not include any option in which the formula provides for determining the option price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is

exercised. Whether an option meets the requirement of this subdivision shall be determined solely by reference to the terms of the option, and the circumstances existing at the time the option is granted or exercised are immaterial. Thus, an option, granted after September 30, 1958, and containing a pricing formula which takes into consideration the value of the stock at any time before the option is exercised, is subject to the new limitation and does not meet the requirement of this subdivision, even though the option price is not actually based upon such prior fair market value either at the time the option is exercised or at the time the option price is computed as if it were exercised for the purpose of applying the 85 percent test of section 421(d)(1)(A). For example, a formula which provides that the option price is to be 45 percent of the fair market value of the stock 30 days before the date on which the option is exercised, but not more than \$85, will not qualify under this subdivision since under this formula the price may be determinable by reference to a higher prior value. On the other hand, a formula which provides that the option price is to be 90 percent of the average value of the stock during the month the option is exercised or the average value of the stock during the preceding month, whichever is lower, will qualify. In the case of an option granted after September 30, 1958, the only way that a formula which provides for determining the option price by reference to the fair market value of the stock at a time before the option is exercised can come within the requirement of this subdivision is to provide that the option price is to be determined by reference to such fair market value only if such fair market value is not greater than the average fair market value of the stock during the month in which the option is exercised. If under the terms of an option the price is to be determined by reference to the fair market value of the stock at a time before the option is exercised, whether such value is higher or lower than the average fair market value of the stock during the month the option is exercised, such option will not be considered a restricted stock option since the option

price may be based upon the prior value of the stock when such value exceeds the average fair market value of the stock during the month the option is exercised. However, if an option provides for determining the option price by reference to a prior fair market value of the stock only when such value is lower than such average value of the stock, such option can qualify as a restricted stock option. The average fair market value of the stock during the month in which the option is exercised means such value during the calendar month the option is exercised and not merely during a 30- or 31-day period including the time the option is exercised. To compute the average fair market value of the stock for the month, it will be necessary to ascertain the fair market value of the stock for each day during the month, including those days which are not business days. In ascertaining the fair market value of the stock for each day, the generally accepted principles for ascertaining such value will be applied.

(e) *Exercise*. For the purpose of section 421, 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. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(f) *Transfer*. For the purpose of section 421, the term "transfer", when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a restricted stock 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.

(g) *Effective dates*. Sections 1.421-1 through 1.421-5 are applicable only to options granted after February 26, 1945, and before January 1, 1964, and all references therein to sections of the Code are to the Internal Revenue Code of

1954, before the amendments made by section 221 of the Revenue Act of 1964 (78 Stat. 63). Section 1.421-6 is applicable only to options granted on or after February 26, 1945, and all references to sections of the Code are to the Internal Revenue Code of 1954, as amended. Sections 1.421-7 and 1.421-8 are applicable only to options granted after December 31, 1963, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, as amended.

[T.D. 6500, 25 FR 11692, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 410, Jan. 19, 1961, T.D. 6887, 31 FR 8786, June 24, 1966]

§ 1.421-2 Restricted stock option.

(a) *In general.* (1) A “restricted stock option” is an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but, except in the case of options described in subparagraph (2) of this paragraph, only if—

(i) At the time such option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option; and

(ii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iii) Such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock either of the employer corporation or of its parent or subsidiary corporation; and

(iv) In the case of options granted after June 21, 1954, such option by its terms is not exercisable after the expiration of ten years from the date on which such option was granted.

For the purpose of applying the rule of subdivision (i) of this subparagraph if the option price is determined by a formula described in paragraph (d)(2)(ii) of § 1.421-1, the option price shall, notwithstanding any provision of the option, be computed as if such option is exercised on the day when it is grant-

ed. For example, if on June 15, 1959, an option is granted providing that the option price shall be \$10 under the average fair market value of the stock during the month in which the option is exercised or the average fair market value of the stock during the preceding month, whichever is lower, and if on June 15, 1959, the value of the stock subject to the option is \$100 a share, to determine if the option meets the requirement of subdivision (i) of this subparagraph, it is necessary to determine the average fair market value of the stock during the months of May and June 1959. If such lower average fair market value is \$95 or more, the option meets the requirement of subdivision (i) of this subparagraph.

(2) Regardless of the extent to which the individual to whom the option is granted owns stock of either the employer corporation, or of its parent or subsidiary corporation, an option is a restricted stock option if—

(i) Such option is granted after February 26, 1945, to such individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations; and

(ii) At the time such option is granted the option price is at least 110 percent of the fair market value at such time of the stock subject to the option; and

(iii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iv) Such option by its terms is not exercisable after the expiration of five years from the date on which such option was granted, or such option is exercised before August 17, 1955.

(3) At the time the option is granted, the relationship between the individual to whom an option is granted and the corporation granting the option (or a corporation which is a parent or subsidiary thereof) must be the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer-