

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, subdivision (ii) (b) of this subparagraph applies, and the basis of the share (\$120), determined under subdivision (ii) (a) of this subparagraph is reduced by \$10. Accordingly, the basis is \$110, and a capital loss of \$20 is realized on the disposition of the share.

Example (4). Assume the same facts as in example (2), 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 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 \$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 appli-

cable 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