

regarding the application of the stockholder approval requirements in the context of the substitution or assumption of an option by reason of a corporate transaction. For a discussion of these rules, see the "Substitution, assumption, and modification of options" portion of the preamble.

3. \$100,000 Limitation

Section 422(d)(1) provides that to the extent that the aggregate fair market value of stock with respect to which incentive stock options (determined without regard to section 422(d)) are exercisable for the first time by any individual during the calendar year (under all of plans of the employer corporation and any related corporation) exceeds \$100,000, such options are not treated as incentive stock options. Under section 422(d)(2), options are taken into account in the order in which they are granted. Section 422(d)(3) provides that the fair market value of stock is determined at the time the option is granted.

The 1984 proposed regulations provided no rules concerning the operation of the \$100,000 limitation because these provisions were enacted in 1986. However, Notice 87-49 (1987-2 C.B. 355) provides general guidance about the operation of the \$100,000 limitation, including examples illustrating the application of this limitation.

Section 1.422-4 of these proposed regulations provides guidance on the operation of the \$100,000 limitation that incorporates and expands on the guidance provided in Notice 87-49. Section 1.422-4(a)(1) of these proposed regulations provides that an option that otherwise qualifies as an incentive stock option nevertheless fails to be an incentive stock option to the extent the \$100,000 limitation is exceeded.

To determine whether the \$100,000 limitation has been exceeded, the rules provided in § 1.422-4(b) of these proposed regulations would apply. Under these proposed regulations, an option that does not qualify as an incentive stock option when granted (including an option which contains terms providing that it will not be treated as an incentive stock option) is disregarded. Additionally, the fair market value of stock is determined on the date of grant of the option. Except as described in the following paragraph, options are taken into account in the order in which they are granted.

An option is considered to be first exercisable during a calendar year if the option will first become exercisable at any time during the year, assuming that any condition on the optionee's ability

to exercise the option related to the performance of services is satisfied. If an optionee is able to exercise the option in a year only if an acceleration provision is satisfied, then the option is exercisable in that year only if the acceleration provision is triggered prior to the end of that year. After an acceleration provision is triggered, for purposes of applying the \$100,000 limitation, the options subject to such provision and all other options first exercisable during a calendar year are then taken into account in the order in which granted. However, because an acceleration provision is not taken into account prior to its triggering, an incentive stock option that becomes exercisable for the first time during a calendar year by operation of such a provision does not affect the application of the \$100,000 limitation with respect to an option (or portion thereof) exercised prior to such acceleration. An acceleration provision includes, for example, a provision that accelerates the exercisability of an option on a change in ownership or control or a provision that conditions exercisability on the attainment of a performance goal. See § 1.422-4(d), *Example 4* of these proposed regulations.

For example, assume that in 2006, E, an employee of Y Corporation, is granted Option 1 for stock of Y with a fair market value on the date of grant of \$75,000. Option 1 is first exercisable in 2008, except that the option provides that it will become immediately exercisable in the event of a change in control. In 2007, E is granted Option 2 for stock of Y with a fair market value on the date of grant of \$50,000. Option 2 is immediately exercisable, and E exercises Option 2. A change in control of Y occurs in 2007, after E has exercised Option 2, and Option 1 becomes immediately exercisable. Notwithstanding the fact that Option 1 was granted prior to Option 2, because the acceleration clause is not taken into account until it is triggered and because E exercised Option 2 prior to the change in control, Option 2 is an incentive stock option in its entirety. Option 1 is bifurcated into an incentive stock option to acquire stock with a fair market value of \$50,000 on the date of grant and a nonstatutory option to acquire stock with a fair market value of \$25,000 on the date of grant.

If the change in control instead occurred prior to E's exercise of Option 2, then Option 1, which was granted first, is treated as an incentive stock option in its entirety, and Option 2 is bifurcated into an incentive stock option to acquire stock with a fair market value of \$25,000 on the date of grant and a

nonstatutory option to acquire stock with a fair market value of \$25,000 on the date of grant.

These proposed regulations also would provide that an option is disregarded for purposes of the \$100,000 limitation if, prior to the calendar year during which it would have otherwise become exercisable for the first time, the option is modified and thereafter ceases to be an incentive stock option, is transferred in violation of the nontransferability requirements, or is canceled. In all other situations, a modified, transferred, or canceled option (or portion thereof) is treated as outstanding until the end of the calendar year during which it would otherwise have become exercisable for the first time.

Finally, under these proposed regulations, a disqualifying disposition has no effect on the determination of whether an option exceeds the \$100,000 limitation. Thus, for example, assume Corporation X grants E, an employee of X, Option 1 to acquire X stock with a fair market value on the date of grant of \$75,000. Option 1 is exercisable on January 1, 2005. On January 5, 2005, E exercises the option and sells the stock in a disqualifying disposition. On January 15, 2005, X grants E Option 2 to acquire X stock with a fair market value on the date of grant of \$50,000. Option 2 is immediately exercisable. Under § 1.422-4(b)(6) of the proposed regulations, the disqualifying disposition of Option 1 has no effect on the application of the \$100,000 limitation. Thus, Option 2 is bifurcated into an incentive stock option to acquire stock with a fair market value of \$25,000 on the date of grant and a nonstatutory option to acquire stock with a fair market value of \$25,000 on the date of grant.

4. Permissible Provisions

These proposed regulations also provide guidance on additional provisions that may be included in an incentive stock option. Because these provisions are not part of the requirements for an incentive stock option, they are addressed separately in § 1.422-5 of these proposed regulations (many of these rules were previously in § 1.422A-2(i) of the 1984 proposed regulations). Section 1.422-5 of these proposed regulations addresses provisions permitting cashless exercise, providing the right to receive additional compensation, and providing alternative rights. In each case, these proposed regulations essentially retain the rules described in the 1984 proposed regulations.