

Newly designated section	Remove	Add
1.421–2(c)(4)(iii), <i>Example 2</i> , second and fifth sentences.	subdivision (ii)(a) of this subparagraph	paragraph (c)(4)(i)(a) of this section.
1.421–2(c)(4)(iii), <i>Example 2</i> , fifth sentence.	subdivision (ii)(b) of this subparagraph	paragraph (c)(4)(i)(b) of this section.
1.421–2(c)(4)(iii), <i>Example 2</i> , first sentence.	<i>example (2)</i>	<i>Example 1.</i>
1.421–2(c)(4)(iii), <i>Example 3</i> , first sentence.	<i>example (2)</i>	<i>Example 1.</i>
1.421–2(c)(4)(iii), <i>Example 3</i> , second and fourth sentences.	subdivision (ii)(a) of this subparagraph	paragraph (c)(4)(i)(a) of this section.
1.421–2(c)(4)(iii), <i>Example 3</i> , fourth sentence.	subdivision (ii)(c) of this subparagraph	paragraph (c)(4)(i)(c) of this section
1.421–2(c)(4)(iii), <i>Example 4</i> , first sentence.	<i>example (2)</i>	<i>Example 1.</i>
1.421–2(c)(4)(iii), <i>Example 4</i> , first sentence.	1966	2006.
1.421–2(c)(4)(iii), <i>Example 4</i> , first and second sentences.	1967	2007.
1.421–2(c)(4)(iii), <i>Example 4</i> , third and fifth sentences.	subdivision (ii)(a) of this subparagraph	paragraph (c)(4)(i)(a) of this section.
1.421–2(c)(4)(iii), <i>Example 4</i> , sixth sentence.	subdivision (ii)(a) of this subparagraph	paragraph (c)(4)(i)(a) of this section.
1.421–2(c)(4)(iii), <i>Example 4</i> , fifth and sixth sentences.	subdivision (ii)(b) of this subparagraph	paragraph (c)(4)(i)(b) of this section.
1.421–2(c)(4)(iii), <i>Example 4</i> , sixth sentence.	subdivision (ii)(c) of this subparagraph	paragraph (c)(4)(i)(c) of this section.

8. Revising paragraph (d).

9. Adding paragraph (f).

The revisions read as follows:

§ 1.421–2 General rules.

(a) *Effect of qualifying transfer.* (1) If a share of stock is transferred to an individual pursuant to the individual's exercise of a statutory option, and if the requirements of § 1.422–1(a) (relating to incentive stock options) or § 1.423–1(a) (relating to employee stock purchase plans) whichever is applicable, are met, then—

(i) No income results at the time of the transfer of such share to the individual upon the exercise of the option with respect to such share (in addition, no income results upon grant of the option, see § 1.83–7);

(ii) No deduction under section 162 or the regulations thereunder (relating to trade or business expenses) is allowable at any time with respect to the share so transferred; and

(iii) No amount other than the price paid under the option is considered as received by the employer corporation, a related corporation of such corporation, or a corporation substituting or assuming a stock option in a transaction to which § 1.424–1(a) (relating to corporate reorganizations, liquidations, etc.) applies, for the share so transferred.

* * * * *

(b) *Effect of disqualifying disposition.*

(1)(i) The disposition (as defined in § 1.424–1(c)) of a share of stock acquired by the exercise of a statutory option before the expiration of the applicable holding periods as determined under

§ 1.422–1(a) or 1.423–1(a) is a disqualifying disposition and makes paragraph (a) of this section inapplicable to the transfer of such share. See § 1.83–7 for the treatment of nonstatutory options. The income attributable to such transfer (determined without reduction for any brokerage fees or other costs paid in connection with the disposition) is treated by the individual as compensation income received in the taxable year in which such disqualifying disposition occurs. Similarly, if otherwise allowable under sections 83(h) and 162, a deduction attributable to such transfer is allowable for the taxable year in which such disqualifying disposition occurs to the employer corporation, or a related corporation of such corporation, or a corporation substituting or assuming an option in a transaction to which § 1.424–1(a) applies. Additionally, an amount is allowed as a deduction only if the requirements of § 1.83–6(a) are satisfied. No amount is treated as income, and no amount is allowed as a deduction, for any taxable year other than the taxable year in which the disqualifying disposition occurs. If the amount realized on the disposition exceeds (or is less than) the sum of the amount paid for the share and the amount of compensation income recognized as a result of such disposition, the extent to which the difference is treated as gain (or loss) is determined under the rules of section 302 or 1001, as applicable.

(ii) The following examples illustrate the principles of this paragraph (b):

Example 1. On June 1, 2006, X Corporation grants an incentive stock option to A, an employee of X, entitling A to purchase 100 shares of X stock at \$10 per share. On August 1, 2006, A exercises the option when the fair market value of X stock is \$20 per share, and 100 shares of X stock are transferred to A on that date. On December 15, 2007, A sells the stock. Because A disposed of the stock before June 2, 2008, A did not satisfy the holding period requirements of § 1.422–1(a). Under paragraph (b)(1)(i) of this section, A made a disqualifying disposition of the stock. Thus, paragraph (a) of this section is inapplicable to the transfer of the shares, and A must include the compensation income attributable to the transfer of the shares in gross income. The amount of compensation income A must include in income under § 1.83–7 in the year of the disqualifying disposition is \$1,000 ((\$20, the fair market value of X stock on transfer less \$10, the exercise price per share) times 100 shares)). If otherwise allowable under sections 83(h) and 162 and if the requirements of § 1.83–6(a) are met, X is allowed a deduction of \$1,000 for its taxable year in which the disqualifying disposition occurs.

Example 2. Y Corporation grants an incentive stock option for 100 shares of its stock to E, an employee of Y. The option has an exercise price of \$10 per share. E exercises the option and is transferred the shares when the fair market value of a share of Y stock is \$30. Before the applicable holding periods expire, Y redeems the shares for \$70 per share. Because the holding period requirements of § 1.422–1(a) are not met, the redemption of the shares is a disqualifying disposition of the shares. Under paragraph (b)(1)(i) of this section, A made a disqualifying disposition of the stock. Thus, paragraph (a) of this section is inapplicable