

liabilities exceed the individual's assets or the individual is unable to satisfy the individual's liabilities as they become due. See section 422(c)(3).

(ii) A transfer by the trustee or other fiduciary that is not treated as a disposition for purposes of this paragraph (a) may be a sale or exchange for purposes of recognizing capital gain or loss with respect to the share transferred. For example, if the trustee transfers the share to a creditor in an insolvency proceeding, capital gain or loss must be recognized by the insolvent individual to the extent of the difference between the amount realized from such transfer and the adjusted basis of such share.

(iii) If any transfer by the trustee or other fiduciary (other than a transfer back to the insolvent individual) is not for the exclusive benefit of the creditors in an insolvency proceeding, then whether such transfer is a disposition of the share by the individual for purposes of this paragraph (a) is determined under § 1.424-1(c). Similarly, if the trustee or other fiduciary transfers the share back to the insolvent individual, any subsequent transfer of the share by such individual which is not made in respect of the insolvency proceeding may be a disposition of the share for purposes of this paragraph (a).

(3) If the employee exercising an option ceased employment because of permanent and total disability, within the meaning of section 22(e)(3), 1 year is used instead of 3 months in the employment period requirement of paragraph (a)(1)(i)(B) of this section.

(b) *Failure to satisfy holding period requirements—(1) General rule.* For general rules concerning a disqualifying disposition of a share of stock acquired pursuant to the exercise of an incentive stock option, see § 1.421-2(b)(1).

(2)(i) *Special rule.* If an individual makes a disqualifying disposition of a share of stock acquired by the exercise of an incentive stock option, and if such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to the individual, then, under this paragraph (b)(2)(i), the amount includible in the gross income of such individual, and deductible from the income of the employer corporation (or a related corporation of such corporation, or of a corporation substituting or assuming the option in a transaction to which § 1.424-1(a) applies) as compensation attributable to the exercise of such option, shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of such share. Subject to the special rule provided by this paragraph (b)(2)(i), the amount of

compensation attributable to the exercise of the option is determined under § 1.83-7; see § 1.421-2(b)(1)(i).

(ii) *Limitation to special rule.* The special rule described in paragraph (b)(2)(i) of this section does not apply if the disposition is a sale or exchange with respect to which a loss (if sustained) would not be recognized to the individual. Thus, for example, if a disqualifying disposition is a sale described in section 1091 (relating to loss from wash sales of stock or securities), a gift (or any other transaction which is not at arm's length), or a sale described in section 267(a)(1) (relating to sales between related persons), the special rule described in paragraph (b)(2)(i) of this section does not apply because a loss sustained in any such transaction would not be recognized.

(3) *Examples.* 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 Corporation, entitling A to purchase one share of X Corporation stock. On August 1, 2006, A exercises the option and the share of X Corporation stock is transferred to A on that date. The option price is \$100 (the fair market value of a share of X Corporation stock on June 1, 2006) and the fair market value of a share of X Corporation stock on August 1, 2006 (the date of transfer) is \$200. The share transferred to A is transferable and not subject to a substantial risk of forfeiture. A makes a disqualifying disposition by selling the share on June 1, 2007, for \$250. Under § 1.83-7(a) (relating to options to which section 421 does not apply), the amount of compensation attributable to A's exercise is \$100 (the difference between the fair market value of the share at the date of transfer, \$200, and the amount paid for the share, \$100). Because the amount realized (\$250) is greater than the value of the share at transfer (\$200), paragraph (b)(2)(i) of this section does not apply and thus does not affect the amount includible as compensation in A's gross income and deductible by X. A must include in gross income for the taxable year in which the sale occurred \$100 as compensation and \$50 as capital gain (\$250, the amount realized from the sale, less A's basis of \$200 (the \$100 paid for the share plus the \$100 increase in basis resulting from the inclusion of that amount in A's gross income as compensation attributable to the exercise of the option)). For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under sections 83(h) and 162 and if the requirements of § 1.83-6(a) are met, X Corporation is allowed a deduction of \$100 for compensation attributable to A's exercise of the incentive stock option.

*Example 2.* Assume the same facts as in *Example 1*, except that the share of X Corporation stock transferred to A is subject to a substantial risk of forfeiture and not

transferable for a period of six months after such transfer. Assume further that the fair market value of X Corporation stock is \$225 on February 1, 2005, the date on which the six-month restriction lapses. Under section 83(a) and § 1.83-7(a), the amount of compensation attributable to A's exercise of the option and disqualifying disposition of the share is \$125 (the difference between the fair market value of the share on the date that the restriction lapsed, \$225, and the amount paid for the share, \$100). A must include \$125 of compensation income and \$25 of capital gain in gross income for the taxable year in which the disposition occurs (\$250, the amount realized from the sale, less A's basis of \$225 (the \$100 paid for the share plus the \$125 increase in basis resulting from the inclusion of that amount of compensation in A's gross income)). For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under sections 83(h) and 162 and if the requirements of § 1.83-6(a) are met, X Corporation is allowed a deduction of \$125 for the compensation attributable to A's exercise of the option.

*Example 3.* (i) Assume the same facts as in *Example 1*, except that A sells the share for \$150 to M.

(ii) If the sale to M is a disposition that meets the requirements of paragraph (b)(2)(i) of this section, instead of \$100 which otherwise would have been includible as compensation under § 1.83-7, under paragraph (b)(2)(i) of this section, A must include only \$50 (the excess of the amount realized on such sale, \$150, over the adjusted basis of the share, \$100) in gross income as compensation attributable to the exercise of the incentive stock option. Because A's basis for the share is \$150 (the \$100 which A paid for the share, plus the \$50 increase in basis resulting from the inclusion of that amount in A's gross income as compensation attributable to the exercise of the option), A realizes no capital gain or loss as a result of the sale. For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under sections 83(h) and 162 and if the requirements of § 1.83-6(a) are met, X Corporation is allowed a deduction of \$50 for the compensation attributable to A's exercise of the option.

(iii) Assume the same facts as in paragraph (i) of this *Example 3*, except that 10 days after the sale to M, A purchases substantially identical stock. Because under section 1091(a) a loss (if it were sustained on the sale) would not be recognized on the sale, under paragraph (b)(2)(ii) of this section, the special rule described in paragraph (b)(2)(i) of this section does not apply. Under § 1.83-7, A must include \$100 (the difference between the fair market value of the share on the date of transfer, \$200, and the amount paid for the share, \$100) in gross income as compensation attributable to the exercise of the option for the taxable year in which the disqualifying disposition occurred. A recognizes no capital gain or loss on the transaction. For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under sections 83(h) and 162 and if the requirements of § 1.83-6(a) are met, X Corporation is allowed a \$100 deduction for compensation attributable to A's exercise of the option.