

(iv) Assume the same facts as in paragraph (ii) of this *Example 3*, except that A sells the share for \$50. Under paragraph (b)(2)(i) of this section, A is not required to include any amount in gross income as compensation attributable to the exercise of the option. A is allowed a capital loss of \$50 (the difference between the amount realized on the sale, \$50, and the adjusted basis of the share, \$100). X Corporation is not allowed any deduction attributable to A's exercise of the option and disqualifying disposition of the share.

(c) *Failure to satisfy employment requirement.* Section 1.421-2(a) does not apply to the transfer of a share of stock pursuant to the exercise of an incentive stock option if the employment requirement, as determined under paragraph (a)(1)(i)(B) of this section, is not met at the time of the exercise of such option. Consequently, the effects of such a transfer are determined under the rules of § 1.83-7. For rules relating to the employment relationship, see § 1.421-1(h).

Par. 6. Section 1.422-2 is added to read as follows:

§ 1.422-2 Incentive stock options defined.

(a) *Incentive stock option defined*—(1) *In general.* The term *incentive stock option* means an option that meets the requirements of paragraph (a)(2) of this section on the date of grant. An incentive stock option is also subject to the \$100,000 limitation described in § 1.422-4. An incentive stock option may contain a number of permissible provisions that do not affect the status of the option as an incentive stock option. See § 1.422-5 for rules relating to permissible provisions of an incentive stock option.

(2) *Option requirements.* To qualify as an incentive stock option under this section, an option must be granted to an individual in connection with the individual's employment by the corporation granting such option (or by a related corporation), and granted only for stock of any of such corporations. In addition, the option must meet all of the following requirements—

(i) It must be granted pursuant to a plan that meets the requirements described in paragraph (b) of this section;

(ii) It must be granted within 10 years from the date of the adoption of the plan or the date such plan is approved by the stockholders, whichever is earlier (see paragraph (c) of this section);

(iii) It must not be exercisable after the expiration of 10 years from the date of grant (see paragraph (d) of this section);

(iv) It must provide that the option price per share is not less than the fair

market value of the share on the date of grant (see paragraph (e) of this section);

(v) By its terms, it must not be transferable by the individual to whom the option is granted other than by will or the laws of descent and distribution, and must be exercisable, during such individual's lifetime, only by such individual (see §§ 1.421-1(b)(2) and 1.421-2(c)); and

(vi) Except as provided in paragraph (f) of this section, it must be granted to an individual who, 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 of the corporation employing such individual or of any related corporation of such corporation.

(3) *Amendment of option terms.* Except as otherwise provided in § 1.424-1, the amendment of the terms of an incentive stock option may cause it to cease to be an option described in this section. If the terms of an option that has lost its status as an incentive stock option are subsequently changed with the intent to re-qualify the option as an incentive stock option, such change results in the grant of a new option on the date of the change. See § 1.424-1(e).

(4) *Terms provide option not an incentive stock option.* If the terms of an option, when granted, provide that it will not be treated as an incentive stock option, such option is not treated as an incentive stock option.

(b) *Option plan*—(1) *In general.* An incentive stock option must be granted pursuant to a plan that meets the requirements of this paragraph (b). The authority to grant other stock options or other stock-based awards pursuant to the plan, where the exercise of such other options or awards does not affect the exercise of incentive stock options granted pursuant to the plan, does not disqualify such incentive stock options. The plan must be in writing or electronic form, provided that such writing or electronic form is adequate to establish the terms of the plan. See § 1.422-5 for rules relating to permissible provisions of an incentive stock option.

(2) *Stockholder approval.* (i) The plan required by this paragraph (b) must be approved by the stockholders of the corporation granting the incentive stock option within 12 months before or after the date such plan is adopted.

Ordinarily, a plan is adopted when it is approved by the granting corporation's board of directors, and the date of the board's action is the reference point for determining whether stockholder approval occurs within the applicable 24-month period. However, if the

board's action is subject to a condition (such as stockholder approval) or the happening of a particular event, the plan is adopted on the date the condition is met or the event occurs, unless the board's resolution fixes the date of approval as the date of the board's action.

(ii) For purposes of paragraph (b)(2)(i) of this section, the stockholder approval must comply with the rules described in § 1.422-3.

(iii) The provisions relating to the maximum aggregate number of shares to be issued under the plan (described in paragraph (b)(3) of this section) and the employees (or class or classes of employees) eligible to receive options under the plan (described in paragraph (b)(4) of this section) are the only provisions of a stock option plan that must be approved by stockholders for purposes of section 422(b)(1). Any increase in the maximum aggregate number of shares that may be issued under the plan (other than an increase merely reflecting a change in the number of outstanding shares, such as a stock dividend or stock split), or change in the designation of the employees (or class or classes of employees) eligible to receive options under the plan is considered the adoption of a new plan requiring stockholder approval within the prescribed 24-month period. In addition, a change in the granting corporation or the stock available for purchase or award under the plan is considered the adoption of a new plan requiring new stockholder approval within the prescribed 24-month period. Any other changes in the terms of an incentive stock option plan are not considered the adoption of a new plan and, thus, do not require stockholder approval.

(3) *Maximum aggregate number of shares.* (i) The plan required by this paragraph (b) must designate the maximum aggregate number of shares that may be issued under the plan through incentive stock options, nonstatutory options, and all other stock-based awards to be granted thereunder. If nonstatutory options or other stock-based awards may be granted, the plan may separately designate terms for each type of option and other stock-based award and designate the maximum number of shares that may be issued under such option or other stock-based award. Unless otherwise specified, all terms of the plan apply to all options and other stock-based awards that may be granted under the plan.

(ii) A plan that merely provides that the number of shares that may be issued under options and other stock-based