

specified in paragraph (f)(1) of this section, in any corporation in a group of corporations consisting of the employer corporation and its related corporations, cannot be granted an incentive stock option by any corporation in the group unless such option meets the 110-percent-option-price and 5-year-term requirements of paragraph (f)(1) of this section.

Example 3. (i) F is an employee of R Corporation. R has only one class of stock, of which 100,000 shares are issued and outstanding. F owns no stock in R Corporation or any related corporation of R Corporation. On January 1, 2005, R grants a 10-year incentive stock option to F to purchase 50,000 shares of R stock at \$3 per share, the fair market value of R stock on the date of grant of the option. On April 1, 2005, F exercises half of the January option and receives 25,000 shares of R stock that previously were not outstanding. On July 1, 2005, R grants a second 50,000 share option to F which purports to be an incentive stock option. The terms of the July option are identical to the terms of the January option, except that the option price is \$3.25 per share, which is the fair market value of R stock on the date of grant of the July option.

(ii) Because F did not own more than 10% of the total combined voting power of all classes of stock of R Corporation or any related corporation on the date of the grant of the January option and the pricing requirements of paragraph (e) of this section are satisfied on the date of grant of such option, the unexercised portion of the January option remains an incentive stock option regardless of the changes in F's percentage of stock ownership in R after the date of grant. However, the July option is not an incentive stock option because, on the date that it was granted, F owned 20 percent (25,000 shares owned by F divided by 125,000 shares of R stock issued and outstanding) of the total combined voting power of all classes of R Corporation stock and, thus the pricing requirements of paragraph (f)(1) of this section were not met.

(iii) Assume the same facts as in paragraph (i) of this *Example 3* except that the partial exercise of the January incentive stock option on April 1, 2003, is for only 10,000 shares. Under these circumstances, the July option is an incentive stock option, because, on the date of grant of the July option, F does not own more than 10 percent of the total combined voting power (10,000 shares owned by F divided by 110,000 shares of R issued and outstanding) of all classes of R Corporation stock.

§ 1.422-4 [Removed]

Par. 7. Section 1.422-4 is removed.

§ 1.422-5 [Redesignated]

Par. 8. Section 1.422-5 is redesignated as § 1.422-3.

Par. 9. New § 1.422-4 is added to read as follows:

§ 1.422-4 \$100,000 limitation for incentive stock options.

(a) *\$100,000 per year limitation—(1) General rule.* An option that otherwise

qualifies as an incentive stock option nevertheless fails to be an incentive stock option to the extent that the \$100,000 limitation described in paragraph (a)(2) of this section is exceeded.

(2) *\$100,000 per year limitation.* To the extent that the aggregate fair market value of stock with respect to which an incentive stock option (determined without regard to this section) is exercisable for the first time by any individual during any calendar year (under all plans of the employer corporation and related corporations) exceeds \$100,000, such option is treated as a nonstatutory option. See § 1.83-7 for rules applicable to nonstatutory options.

(b) *Application.* To determine whether the limitation described in paragraph (a)(2) of this section has been exceeded, the following rules apply.

(1) An option that does not meet the requirements of § 1.422-2 when granted (including an option which, when granted, contains terms providing that it will not be treated as incentive stock option) is disregarded. See § 1.422-2(a)(4).

(2) The fair market value of stock is determined as of the date of grant of the option for such stock.

(3) Except as otherwise provided in paragraph (b)(4) of this section, options are taken into account in the order in which they are granted.

(4) For purposes of this section, an option is considered to be first exercisable during a calendar year if the option will 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 the optionee's ability to exercise the option in the year is subject to an acceleration provision, then the option is considered first exercisable in the calendar year in which the acceleration provision is triggered. After an acceleration provision is triggered, the options subject to such provision are then taken into account in accordance with paragraph (b)(3) of this section for purposes of applying the limitation described in paragraph (a)(2) of this section to all options first exercisable during a calendar year. 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 any option (or portion thereof) exercised prior to such acceleration. For purposes of this paragraph (b)(4), 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 paragraph (d), *Example 4* of this section.

(5)(i) An option (or portion thereof) is disregarded if, prior to the calendar year during which it would otherwise have become exercisable for the first time, the option (or portion thereof) is modified and thereafter ceases to be an incentive stock option described in § 1.422-2, is canceled, or is transferred in violation of § 1.421-1(b)(2).

(ii) If an option (or portion thereof) is modified, canceled, or transferred at any other time, such option (or portion thereof) is treated as outstanding according to its original terms until the end of the calendar year during which it would otherwise have become exercisable for the first time.

(6) A disqualifying disposition has no effect on the determination of whether an option exceeds the \$100,000 limitation.

(c) *Bifurcation of options.* The application of the rules described in paragraph (b) of this section may result in an option being treated, in part, as an incentive stock option and, in part, as a nonstatutory option. In such a case, a corporation can issue a separate certificate for incentive option stock and designate such stock as incentive stock option stock in the corporation's transfer records. In the absence of such a designation, a pro rata portion of each share of stock purchased under the option is treated as incentive stock option stock and nonstatutory option stock. See § 1.83-7 for the treatment of nonstatutory options.

(d) *Examples.* The following examples illustrate the principles of this section. In each of the following examples E is an employee of X Corporation. The examples are as follows:

Example 1. General rule. Effective January 1, 2004, X Corporation adopts a plan under which incentive stock options may be granted to its employees. On January 1, 2004, and each succeeding January 1 through January 1, 2013, E is granted immediately exercisable options for X Corporation stock with a fair market value of \$100,000 determined on the date of grant. The options qualify as incentive stock options (determined without regard to this section). On January 1, 2014, E exercises all of the options. Because the \$100,000 limitation has not been exceeded during any calendar year, all of the options are treated as incentive stock options.

Example 2. Order of grant. X Corporation is a parent corporation of Y Corporation, which is a parent corporation of Z Corporation. Each corporation has adopted