

its own separate plan, under which an employee of any member of the corporate group may be granted options for stock of any member of the group. On January 1, 2004, X Corporation grants E an incentive stock option (determined without regard to this section) for stock of Y Corporation with a fair market value of \$100,000 on the date of grant. On December 31, 2004, Y Corporation grants E an incentive stock option (determined without regard to this section) for stock of Z Corporation with a fair market value of \$75,000 as of the date of grant. Both of the

options are immediately exercisable. For purposes of this section, options are taken into account in the order in which granted using the fair market value of stock as of the date on the option is granted. During calendar year 2004, the aggregate fair market value of stock with respect to which E's options are exercisable for the first time exceeds \$100,000. Therefore, the option for Y Corporation stock is treated as an incentive stock option, and the option for Z Corporation stock is treated as a nonstatutory option.

Example 3. Acceleration provision. (i) In 2004, X Corporation grants E three incentive stock options (determined without regard to this section) to acquire stock with an aggregate fair market value of \$150,000 on the date of grant. The dates of grant, the fair market value of the stock (as of the applicable date of grant) with respect to which the options are exercisable, and the years in which the options are first exercisable (without regard to acceleration provisions) are as follows:

	Date of grant	Fair market value of stock	First exercisable
Option 1	April 1, 2004	\$60,000	2004
Option 2	May 1, 2004	50,000	2006
Option 3	June 1, 2004	40,000	2004

(ii) In July of 2004, a change in control of X Corporation occurs, and, under the terms of its option plan, all outstanding options become immediately exercisable. Under the rules of this section, Option 1 is treated as an incentive stock option in its entirety; Option 2 exceeds the \$100,000 aggregate fair market value limitation for calendar year 2004 by \$10,000 (Option 1's \$60,000 + Option 2's \$50,000 = \$110,000) and is,

therefore, bifurcated into an incentive stock option for stock with a fair market value of \$40,000 as of the date of grant and a nonstatutory option for stock with a fair market value of \$10,000 as of the date of grant. Option 3 is treated as a nonstatutory option in its entirety.

Example 4. Exercise of option and acceleration provision. (i) In 2004, X Corporation grants E three incentive stock

options (determined without regard to this section) to acquire stock with an aggregate fair market value of \$120,000 on the date of grant. The dates of grant, the fair market value of the stock (as of the applicable date of grant) with respect to which the options are exercisable, and the years in which the options are first exercisable (without regard to acceleration provisions) are as follows:

	Date of grant	Fair market value of stock	First exercisable
Option 1	April 1, 2004	\$60,000	2005
Option 2	May 1, 2004	40,000	2006
Option 3	June 1, 2004	20,000	2005

(ii) On June 1, 2005, E exercises Option 3. At the time of exercise of Option 3, the fair market value of X stock (at the time of grant) with respect to which options held by E are first exercisable in 2005 does not exceed \$100,000. On September 1, 2005, a change of control of X Corporation occurs, and, under the terms of its option plan, Option 2 becomes immediately exercisable. Under the rules of this section, because E's exercise of Option 3 occurs before the change of control and the effects of an acceleration provision are not taken into account until it is triggered, Option 3 is treated as an incentive stock option in its entirety. Option 1 is treated as an incentive stock option in its

entirety. Option 2 is bifurcated into an incentive stock option for stock with a fair market value of \$20,000 on the date of grant and a nonstatutory option for stock with a fair market value of \$20,000 on the date of grant because it exceeds the \$100,000 limitation for 2003 by \$20,000 (Option 1 for \$60,000 + Option 3 for \$20,000 + Option 2 for \$40,000 = \$120,000).

(iii) Assume the same facts as in paragraph (ii) of this *Example 4*, except that the change of control occurs on May 1, 2005. Because options are taken into account in the order in which they are granted, Option 1 and Option 2 are treated as incentive stock options in their entirety. Because the exercise

of Option 3 (on June 1, 2005) takes place after the acceleration provision is triggered, Option 3 is treated as a nonstatutory option in its entirety.

Example 5. Cancellation of option. (i) In 2004, X Corporation grants E three incentive stock options (determined without regard to this section) to acquire stock with an aggregate fair market value of \$140,000 as of the date of grant. The dates of grant, the fair market value of the stock (as of the applicable date of grant) with respect to which the options are exercisable, and the years in which the options are first exercisable (without regard to acceleration provisions) are as follows:

	Date of grant	Fair market value of stock	First exercisable
Option 1	April 1, 2004	\$60,000	2005
Option 2	May 1, 2004	40,000	2005
Option 3	June 1, 2004	40,000	2005

(ii) On December 31, 2004, Option 2 is canceled. Because Option 2 is canceled before the calendar year during which it would have become exercisable for the first time, it is disregarded. As a result, Option 1 and Option 3 are treated as incentive stock options in their entirety.

(iii) Assume the same facts as in paragraph (ii) of this *Example 5*, except that Option 2 is canceled on January 1, 2005. Because Option 2 is not canceled prior to the calendar year during which it would have become exercisable for the first time (2005), it is treated as an outstanding option for purposes of determining whether the \$100,000

requirement for 2005 has been exceeded. Because options are taken into account in the order in which granted, Option 1 is treated as an incentive stock option in its entirety. Because Option 3 exceeds the \$100,000 limitation by \$40,000 (Option 1 for \$60,000 + Option 2 for \$40,000 + Option 3 for