

gain. All 100 shares have a holding period beginning on June 1, 2005, for purposes of determining whether the holding period requirements of § 1.422-1(a) are met.

Example 2. Assume the same facts as in *Example 1*. Assume further that, on September 1, 2005, A sells 75 of the shares that A acquired through exercise of the incentive stock option for \$30 per share. Because the holding period requirements were not satisfied, A made a disqualifying disposition of the 75 shares on September 1, 2005. Under the rules of paragraph (b)(3) of this section, A has sold all 60 of the non-section-1036 shares and 15 of the 40 section-1036 shares. Therefore, under paragraph (b)(3) of this section and section 83(a), the amount of compensation attributable to A's exercise of the option and subsequent disqualifying disposition of 75 shares is \$1,500 (the difference between the fair market value of the stock on the date of transfer, \$1,875 (75 shares at \$25 per share), and the amount paid for the stock, \$375 (60 shares at \$0 per share plus 15 shares at \$25 per share)). In addition, A must recognize a capital gain of \$675. Accordingly, A must include in gross income for the taxable year in which the sale occurs \$1,500 as compensation and \$675 as capital gain. For its taxable year in which the disqualifying disposition occurs, if otherwise allowable under section 162 and if the requirements of § 1.83-6(a) are met, X Corporation is allowed a deduction of \$1,500 for the compensation paid to A.

Example 3. Assume the same facts as in *Example 2*, except that, instead of selling the 75 shares of incentive stock option stock on September 1, 2005, A uses those shares to exercise a second incentive stock option. The second option was granted to A by X Corporation on January 1, 2005, entitling A to purchase 100 shares of X Corporation common stock at \$22.50 per share. As in *Example 2*, A has made a disqualifying disposition of the 75 shares of stock pursuant to § 1.424-1(c). Under paragraph (b)(1) of this section, A has disposed of all 60 of the non-section-1036 shares and 15 of the 40 section-1036 shares. Therefore, pursuant to paragraph (b)(3) of this section and section 83(a), the amount of compensation attributable to A's exercise of the first option and subsequent disqualifying disposition of 75 shares is \$1,500 (the difference between the fair market value of the stock on the date of transfer, \$1,875 (75 shares at \$25 per share), and the amount paid for the stock, \$375 (60 shares at \$0 per share plus 15 shares at \$25 per share)). Unlike *Example 2*, A does not recognize any capital gain as a result of exercising the second option because, for all purposes other than the determination of whether the exercise is a disposition pursuant to section 424(c), the exercise is considered an exchange to which section 1036 applies. Accordingly, A must include in gross income for the taxable year in which the disqualifying disposition occurs \$1,500 as compensation. 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 \$1,500 for the compensation

paid to A. After exercising the second option, A owns a total of 125 shares of incentive stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), the 100 "new" shares of incentive stock option stock have the following bases and holding periods: 15 shares have a \$75 carryover basis and a three-year-and-three-month holding period for purposes of determining capital gain, 60 shares have a \$1,500 basis resulting from the inclusion of that amount in income as compensation and a three-month holding period for purposes of determining capital gain, and 25 shares have a zero basis and a holding period beginning on September 1, 2005, for purposes of determining capital gain. All 100 shares have a holding period beginning on September 1, 2005, for purposes of determining whether the holding period requirements of § 1.422-1(a) are met.

Example 4. Assume the same facts as in *Example 2*, except that, instead of selling the 75 shares of incentive stock option stock on September 1, 2005, A uses those shares to exercise a nonstatutory option. The nonstatutory option was granted to A by X Corporation on January 1, 2005, entitling A to purchase 100 shares of X Corporation common stock at \$22.50 per share. Unlike *Example 3*, A has not made a disqualifying disposition of the 75 shares of stock. After exercising the nonstatutory option, A owns a total of 100 shares of incentive stock option stock and 25 shares of nonstatutory stock option stock. Under section 1036 (and so much of section 1031 as relates to section 1036), the 75 new shares of incentive stock option stock have the same basis and holding period as the 75 old shares used to exercise the nonstatutory option. The additional 25 shares of stock received upon exercise of the nonstatutory option are taxed under the rules of section 83(a). Accordingly, A must include in gross income for the taxable year in which the transfer of such shares occurs \$750 (25 shares at \$30 per share) as compensation. A's basis in such shares is the same as the amount included in gross income. For its taxable year in which the transfer occurs, X Corporation is allowed a deduction of \$750 for the compensation paid to A to the extent allowable under sections 83(h) and 162 and if the requirements of § 1.83-6(a) are satisfied.

Example 5. Assume the same facts in *Example 1*, except that the shares transferred pursuant to the exercise of the incentive stock option are subject to a substantial risk of forfeiture and not transferable (substantially nonvested) for a period of six months after such transfer. Assume further that the shares that A uses to exercise the incentive stock option are similarly restricted. Such shares were transferred to A on January 1, 2005, through A's exercise of a nonstatutory stock option which was granted to A on January 1, 2004. A paid \$5 per share for the stock when its fair market value was \$22.50 per share. A did not file a section 83(b) election to include the \$700 spread (the difference between the option price and the fair market value of the stock on date of exercise of the nonstatutory option) in gross income as compensation. After exercising the incentive stock option

with the 40 substantially-nonvested shares, A owns 100 shares of substantially-nonvested incentive stock option stock. Section 1036 (and so much of section 1031 as relates to section 1036) applies to the 40 shares exchanged in exercise of the incentive stock option. However, pursuant to section 83(g), the stock received in such exchange, because it is incentive stock option stock, is not subject to restrictions and conditions substantially similar to those to which the stock given in such exchange was subject. For purposes of section 83(a) and § 1.83-1(b)(1), therefore, A has disposed of the 40 shares of substantially-nonvested stock on June 1, 2005, and must include in gross income as compensation \$800 (the difference between the amount realized upon such disposition, \$1,000, and the amount paid for the stock, \$200). Accordingly, 40 shares of the incentive stock option stock have a \$1,000 basis (the \$200 original basis plus the \$800 included in income as compensation) and 60 shares of the incentive stock option stock have a zero basis. For its taxable year in which the disposition of the substantially-nonvested stock occurs, X Corporation is allowed a deduction of \$800 for the compensation paid to A, provided that the requirements of § 1.83-6 are satisfied.

(f) *Effective date.* This section applies to any statutory option granted on or after the date that is 180 days after publication of final regulations in the **Federal Register**. Taxpayers can rely on these regulations for the treatment of any statutory option granted on or after June 9, 2003.

§ 1.423-1 [Amended]

Par. 11. Section 1.423-1 is amended as follows:

1. In paragraph (a)(2), the language "425(a)" is removed and "424(a)" is added in its place.
2. In paragraph (b), first sentence, the language "§ 1.421-7" is removed and "§ 1.421-1" is added in its place.
3. In paragraph (b), second sentence, the language "§ 1.421-8" is removed and "§ 1.421-2" is added in its place.
4. In paragraph (b), last sentence, the language "425(c)" is removed and "424(c)" is added in its place.
5. In paragraph (b), last sentence, the language "§ 1.425-1" is removed and "§ 1.424-1" is added in its place.

§ 1.423-2 [Amended]

Par. 12. Section 1.423-2 is amended by:

1. In paragraph (b), last sentence, the language "§ 1.421-7" is removed and "§ 1.421-1" is added in its place.
2. In paragraph (d)(1), second sentence, the language "425(d)" is removed and "424(d)" is added in its place.
3. In paragraph (d)(3), *Example 1*, fourth sentence, the language "425(d)" is removed and "424(d)" is added in its place.