

an old option to purchase S shares that is held by E, an employee of S. On the date of the exchange, E's old option is exercisable for 3 more years, and, after the exchange, E's new option is exercisable for 5 years. Because the new option is exercisable for an additional period of time beyond the time allowed under the old option, the effect of the exchange of the new option for the old option is to give E an additional benefit that E did not enjoy under the old option. Thus, the requirements of paragraph (a)(5) of this section are not met, and this paragraph (a) does not apply to the exchange of the new option for the old option. Therefore, the exchange is a modification of the old options.

Example 5. Spread and ratio tests. E is an employee of S Corporation. E holds an old option that was granted to E by S to purchase 60 shares of S at \$12 per share. On June 1, 2005, S Corporation is merged into P Corporation, and on such date P issues a new option to purchase P shares in exchange for E's old option to purchase S shares. Immediately before the exchange, the fair market value of an S share is \$32; immediately after the exchange, the fair market value of a P share is \$24. The new option entitles E to buy P shares at \$9 per share. Because, on a share-by-share comparison, the ratio of the new option price (\$9 per share) to the fair market value of a P share immediately after the exchange (\$24 per share) is not more favorable to E than the ratio of the old option price (\$12 per share) to the fair market value of an S share immediately before the exchange (\$32 per share) ($9/24 = 12/32$), the requirements of paragraph (a)(5)(iii) of this section are met. The number of shares subject to E's option to purchase P stock is set at 80. Because the excess of the aggregate fair market value over the aggregate option price of the shares subject to E's new option to purchase P stock, $\$1,200 (80 \times \$24 \text{ minus } 80 \times \$9)$, is not greater than the excess of the aggregate fair market value over the aggregate option price of the shares subject to E's old option to purchase S stock, $\$1,200 (60 \times \$32 \text{ minus } 60 \times \$12)$, the requirements of paragraph (a)(5)(ii) of this section are met.

Example 6. Ratio test and partial substitution. Assume the same facts as in Example 5, except that the fair market value of an S share immediately before the exchange of the new option for the old option is \$8, that the option price is \$10 per share, and that the fair market value of a P share immediately after the exchange is \$12. P sets the new option price at \$15 per share. Because, on a share-by-share comparison, the ratio of the new option price (\$15 per share) to the fair market value of a P share immediately after the exchange (\$12) is not more favorable to E than the ratio of the old option price (\$10 per share) to the fair market value of an S share immediately before the substitution (\$8 per share) ($15/12 = 10/8$), the requirements of paragraph (a)(5)(iii) of this section are met. Assume further that the number of shares subject to E's P option is set at 20, as compared to 60 shares under E's old option to buy S stock. Immediately after the exchange, 2 shares of P are worth \$24, which is what 3 shares of S were worth immediately before the exchange ($2 \times \$12 =$

$3 \times \$8$). Thus, to achieve a complete substitution of a new option for E's old option, E would need to receive a new option to purchase 40 shares of P (i.e., 2 shares of P for each 3 shares of S that E could have purchased under the old option ($2/3 = 40/60$)). Because E's new option is for only 20 shares of P, P has replaced only $1/2$ of E's old option, and the other $1/2$ is still outstanding.

Example 7. Partial substitution. X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and, in a spin-off, distributes the shares of Y Corporation to the stockholders of X Corporation. E, an employee of X Corporation, is thereafter an employee of Y. Y wishes to substitute a new option to purchase some of its stock for E's old option to purchase 100 shares of X. E's old option to purchase shares of X, at \$50 a share, was granted when the fair market value of an X share was \$50, and an X share was worth \$100 just before the distribution of the Y shares to X's stockholders. Immediately after the spin-off, which is also the time of the substitution, each share of X and each share of Y is worth \$50. Based on these facts, a new option to purchase 200 shares of Y at an option price of \$25 per share could be granted to E in complete substitution of E's old option. It would also be permissible to grant E a new option to purchase 100 shares of Y, at an option price of \$25 per share, in substitution for E's right to purchase 50 of the shares under the old option.

Example 8. Stockholder approval requirements. (i) X Corporation, a publicly traded corporation, adopts an incentive stock option plan that meets the requirements of § 1.422-2. Under the plan, options to acquire X stock are granted to X employees. X Corporation is acquired by Y Corporation and becomes a subsidiary corporation of Y Corporation. Y Corporation maintains an incentive stock option plan that meets the requirements of § 1.422-2. Under the plan, options for Y stock may be granted to employees of Y or its related corporations. After the acquisition, X employees remain employees of X. In connection with the acquisition, Y Corporation substitutes new options for Y stock for old options for X stock that were previously granted to the employees of X. As a result of this substitution, on exercise of the new options, X employees receive Y Corporation stock.

(ii) Because Y Corporation has a plan that meets the requirements of § 1.422-2 in existence on the date it acquires X, the new options for Y stock are granted under a plan approved by the stockholders of Y. The stockholders of Y do not need to approve the X plan. If the other requirements of paragraphs (a)(4) and (5) of this section are met, the issuance of new options for Y stock in exchange for the old options for X stock meets the requirements of this paragraph (a) and is not a modification of the old options.

(iii) Assume the same facts as in paragraph (i) of this Example 8, except that Y Corporation does not maintain an incentive stock option plan on the date of the acquisition of X. The Y options will only be incentive stock options if they are granted under a plan that meets the requirements of § 1.422-2(b). Therefore, Y must adopt a plan

that provides for the grant of incentive stock options, and the plan must be approved by the stockholders of Y in accordance with § 1.422-2(b). If the stockholders of Y approve the incentive stock option plan within 12 months before or after the date of the adoption of a plan by Y and the other requirements of § 1.422-2 and the requirements of this paragraph (a) are met, the issuance of the new options for Y stock in exchange for the old options for X stock meets the requirements of this paragraph (a) and is not treated as a modification of the old options for X stock. The result is the same if Y Corporation assumes the old options instead of issuing new options.

(iv) Assume the same facts as in paragraph (i) of this Example 8, except that there is no exchange of options. Instead, as part of the acquisition, X amends its plan to allow future grants under the plan to be grants to acquire Y stock. Because the amendment of the plan to allow options on a different stock is considered the adoption of the new plan, the stockholders of X must approve the plan within 12 months before or after the date of the amendment of the plan. If the stockholders of X timely approve the plan, the future grants to acquire Y stock will be incentive stock options (assuming the other requirements of § 1.422-2 have been met).

Example 9. Modification. X Corporation merges into Y Corporation. Y Corporation retains employees of X who hold old options to acquire X Corporation stock. When the former employees of X exercise the old options, Y Corporation issues Y stock to the former employees of X. Under paragraph (a)(7) of this section, because Y issues its stock on exercise of the old options for X stock, there is a change in the terms of the old options for X stock. Thus, the issuance of Y stock on exercise of the old options is a modification of the old options.

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(c) * * * (1) * * *

(iv) A transfer between spouses or incident to divorce (described in section 1041(a)). The special tax treatment of § 1.421-2(a) with respect to the transferred stock applies to the transferee. However, see § 1.421-1(b)(2) for the treatment of the transfer of a statutory option incident to divorce.

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(3) If an optionee exercises an incentive stock option with statutory option stock and the applicable holding period requirements (under § 1.422-1(a) or 1.423-1(a)) with respect to such statutory option stock are not met before such transfer, then sections 354, 355, 356, or 1036 (or so much of 1031 as relates to 1036) do not apply to determine whether there is a disposition of those shares. Therefore, there is a disposition of the statutory option stock, and the special tax treatment of § 1.421-2(a) does not apply to such stock.

(4) * * *

Example 7. On January 1, 2004, X Corporation grants to E, an employee of X