

Corporation, an incentive stock option to purchase 100 shares of X Corporation stock at \$100 per share (the fair market value of an X Corporation share on that date). On January 1, 2005, when the fair market value of a share of X Corporation stock is \$200, E exercises half of the option, pays X Corporation \$5,000 in cash, and is transferred 50 shares of X Corporation stock with an aggregate fair market value of \$10,000. E makes no disposition of the shares before January 2, 2006. Under § 1.421–2(a), no income is recognized by E on the transfer of shares pursuant to the exercise of the incentive stock option, and X Corporation is not entitled to any deduction at any time with respect to its transfer of the shares to E. E's basis in the shares is \$5,000.

Example 8. Assume the same facts as in Example 7, except that on December 1, 2005, one year and 11 months after the grant of the option and 11 months after the transfer of the 50 shares to E, E uses 25 of those shares, with a fair market value of \$5,000, to pay for the remaining 50 shares purchasable under the option. On that day, X Corporation transfers 50 of its shares, with an aggregate fair market value of \$10,000, to E. Because E disposed of the 25 shares before the expiration of the applicable holding periods, § 1.421–2(a) does not apply to the January 1, 2005, transfer of the 25 shares used by E to exercise the remainder of the option. As a result of the disqualifying disposition of the 25 shares, E recognizes compensation income under the rules of § 1.421–2(b).

Example 9. On January 1, 2005, X Corporation grants an incentive stock option to E, an employee of X Corporation. The exercise price of the option is \$10 per share. On June 1, 2005, when the fair market value of an X Corporation share is \$20, E exercises the option and purchases 5 shares with an aggregate fair market value of \$100. On January 1, 2006, when the fair market value of an X Corporation share is \$50, X Corporation is acquired by Y Corporation in a section 368(a)(1)(A) reorganization. As part of the acquisition, all X Corporation shares are converted into Y Corporation shares. After the conversion, if an optionee holds a fractional share of X Corporation stock, Y Corporation will purchase the fractional share for cash equal to its fair market value. After applying the conversion formula to the shares held by E, E has 10 Y Corporation shares and one-half of a share of X Corporation stock. Y Corporation purchases E's one-half share for \$25, the fair market value of one-half of an X Corporation share on the conversion date. Because E sells the one-half share prior to expiration of the holding periods described in § 1.422–1(a), the sale is a disqualifying disposition of the one-half share. Thus, in 2006, E must recognize compensation income of \$5 (one-half of the fair market value of an X Corporation share on the date of exercise of the option, or \$10, less one-half of the exercise price per share, or \$5). For purposes of computing any additional gain, E's basis in the one-half share increases to \$10 (reflecting the \$5 included in income as compensation). E recognizes an additional gain of \$15 (\$25, the fair market value of the one-half share, less \$10, the basis in such share). The extent to

which the additional \$15 of gain is treated as a redemption of X Corporation stock is determined under section 302.

(d) *Attribution of stock ownership.* To determine the amount of stock owned by an individual for purposes of applying the percentage limitations relating to certain stockholders described in §§ 1.422–2(f) and 1.423–2(d), shares of the employer corporation or of a related corporation that are owned (directly or indirectly) by or for the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, are considered to be owned by the individual. Also, for such purposes, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) shares of the employer corporation or of a related corporation, the shares are considered to be owned proportionately by or for the stockholders, partners, or beneficiaries of the corporation, partnership, estate, or trust. The extent to which stock held by the optionee as a trustee of a voting trust is considered owned by the optionee is determined under all of the facts and circumstances.

(e) *Modification, extension, or renewal of option.* (1) This paragraph (e) provides rules for determining whether a share of stock transferred to an individual upon the individual's exercise of an option after the terms of the option have been changed is transferred pursuant to the exercise of a statutory option.

(2) Any modification, extension, or renewal of the terms of an option to purchase shares is considered the granting of a new option. The new option may or may not be a statutory option. To determine the date of grant of the new option for purposes of section 422 or 423, see § 1.421–1(c).

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(4)(i) For purposes of §§ 1.421–1 through 1.424–1 the term *modification* means any change in the terms of the option (or change in the terms of the plan pursuant to which the option was granted or in the terms of any other agreement governing the arrangement) that gives the optionee additional benefits under the option regardless of whether the optionee in fact benefits from the change in terms. In contrast, for example, a change in the terms of the option shortening the period during which the option is exercisable is not a modification. However, a change providing an extension of the period during which an option may be exercised (such as after termination of employment) or a change providing an alternative to the exercise of the option (such as a stock appreciation right) is a

modification regardless of whether the optionee in fact benefits from such extension or alternative right. Similarly, a change providing an additional benefit upon exercise of the option (such as the payment of a cash bonus) or a change providing more favorable terms for payment for the stock purchased under the option (such as the right to tender previously acquired stock) is a modification.

(ii) If an option is not immediately exercisable in full, a change in the terms of the option to accelerate the time at which the option (or any portion thereof) may be exercised is not a modification for purposes of this section. Additionally, no modification occurs if a provision accelerating the time when an option may first be exercised is removed prior to the year in which it would otherwise be triggered. For example, if an acceleration provision is timely removed to avoid exceeding the \$100,000 limitation described in § 1.422–4, a modification of the option does not occur.

(iii) A change to an option which provides, either by its terms or in substance, that the optionee may receive an additional benefit under the option at the future discretion of the grantor, is a modification at the time that the option is changed to provide such discretion. In addition, the exercise of discretion to provide an additional benefit is a modification of the option. However, it is not a modification for the grantor to exercise discretion reserved under an option with respect to the payment of a cash bonus at the time of exercise, the availability of a loan at exercise, or the right to tender previously acquired stock for the stock purchasable under the option. An option is not modified merely because an optionee is offered a change in the terms of an option if the change to the option is not made.

(iv) A change in the terms of the stock purchasable under the option that affects the value of the stock is a modification of such option, except to the extent that a new option is substituted for such option by reason of the change in the terms of the stock in accordance with paragraph (a) of this section.

(v) If an option is amended solely to increase the number of shares subject to the option, the increase is not considered a modification of the option but is treated as the grant of a new option for the additional shares.

(vi) Any change in the terms of an option made in an attempt to qualify the option as a statutory option grants additional benefits to the optionee and is, therefore, a modification.