

Sec. 421. General Rules.

(a) Effect of Qualifying Transfer.

If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a) or 423(a) are met—

- (1) **no income** shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;
- (2) **no deduction under section 162** (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 424(a) applies, with respect to the share so transferred; and (3) ...

(b) Effect of Disqualifying Disposition.

If the transfer of a share of stock to an individual pursuant to his exercise of an option would otherwise meet the requirements of section 422(a) or 423(a) except that there is a **failure to meet any of the holding period requirements** of section 422(a)(1) or 423(a)(1), then any increase in the income of such individual or deduction from the income of his employer corporation for the taxable year in which such exercise occurred attributable to such disposition, **shall be treated as an increase in income or a deduction from income** in the taxable year of such individual or of such employer corporation in which **such disposition occurred**. No amount shall be required to be deducted and withheld under chapter 24 with respect to any increase in income attributable to a disposition described in the preceding sentence.

(c) Exercise by Estate.

(1) **In general.** If an option to which this part applies is exercised after the death of the employee by the estate of the decedent, or by a person who acquired the right to exercise such option by bequest or inheritance or by reason of the death of the decedent, the provisions of subsection (a) shall apply to the same extent as if the option had been exercised by the decedent, except that—

- (A) the holding period and employment requirements of sections 422(a) and 423(a) shall not apply, and
- (B) any transfer by the estate of stock acquired shall be considered a disposition of such stock for purposes of section 423(c).

(2) **Deduction for estate tax.** If an amount is required to be included under section 423(c) in gross income of the estate of the deceased employee or of a person described in paragraph (1), there shall be allowed to the estate or such person a deduction with respect to the estate tax attributable to the

inclusion in the taxable estate of the deceased employee of the net value for estate tax purposes of the option. ..

(3) Basis of shares acquired. In the case of a share of stock acquired by the exercise of an option to which paragraph (1) applies—

(A) the basis of such share shall include so much of the basis of the option as is attributable to such share; except that the basis of such share shall be reduced by the excess (if any) of (i) the amount which would have been includible in gross income under section 423(c) if the employee had exercised the option on the date of this death and had held the share acquired pursuant to such exercise at the time of his death, over (ii) the amount which is includible in gross income under such section; and

(B) the last sentence of section 423(c) shall apply only to the extent that the amount includible in gross income under such section exceeds so much of the basis of the option as is attributable to such share.

(d) Certain Sales to Comply With Conflict-of-Interest Requirements. If-

(1) a share of stock is transferred to an eligible person (as defined in section 1043(b)(1)) pursuant to such person's exercise of an option to which this part applies, and

(2) such share is disposed of by such person pursuant to a certificate of divestiture (as defined in section 1043(b)(2)),

such disposition shall be treated as meeting the requirements of section 422(a)(1) or 423(a)(1), whichever is applicable.

Sec. 422. Incentive Stock Options

(a) In General.

Section 421(a) shall apply to the transfer of a share of stock to an individual pursuant to his exercise of an incentive stock option if—

(1) **no disposition** of such share is made by him within **2 years from the date of the granting** of the option nor within **1 year after the transfer of such share to him**, and

(2) at all times during the period beginning on the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an **employee** of the corporation, a parent or subsidiary corporation of such corporation,

..

(b) Incentive Stock Option. For purposes of this part, the term “incentive stock option” means an option granted to an individual for any reason connected with **his employment by a corporation**, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

(1) the option is **granted pursuant to a plan** which includes the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders ...

(2) such option is **granted within 10 years** from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier;

(3) such option by its terms is **not exercisable after the expiration of 10 years** from the date such option is granted;

(4) the **option price is not less than the fair market value of the stock at the time such option is granted**;

(5) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(6) **such individual**, at the time the option is granted, **does not own stock** possessing more than **10 percent** of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation.

Such term shall not include any option if (as of the time the option is granted) the terms of such option provide that it will not be treated as an incentive stock option.

(c) Special Rules.

(1) **Good faith efforts to value stock.** ...

(2) **Certain disqualifying dispositions where amount realized is less than value at exercise.**
If—

(A) an individual who has acquired a share of stock by the exercise of an incentive stock option makes a disposition of such share within either of the periods described in subsection (a)(1), and

(B) such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to such individual,

then the amount which is includible in the gross income of such individual, and the amount which is deductible from the income of his employer corporation, as compensation attributable to the exercise of such option shall not exceed the excess (if any) of the amount realized on such

sale or exchange over the adjusted basis of such share.

(3) **Certain transfers by insolvent individuals.** ...

(4) **Permissible provisions.** An option which meets the requirements of subsection (b) shall be treated as an incentive stock option even if—

(A) the employee may pay for the stock with stock of the corporation granting the option,

(B) the employee has a right to receive property at the time of exercise of the option, or

(C) the option is subject to any condition not inconsistent with the provisions of subsection (b).

Subparagraph (B) shall apply to a transfer of property (other than cash) only if section 83 applies to the property so transferred.

(5) **10- percent shareholder rule.** Subsection (b)(6) shall not apply if at the time such option is granted the option price is at least **110%** of the FMV of the stock subject to the option and such option by its terms is not exercisable after the expiration of 5 years from the date such option is granted.

(6) **Special rule when disabled.** .. the 3-month period of subsection (a)(2) shall be 1 year.

(7) Fair market value. For purposes of this section, the fair market value of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse.

(d) \$100,000 Per Year Limitation.

(1) **In general.** To the extent that the aggregate FMV of stock with respect to which incentive stock options (determined without regard to this subsection) are exercisable for the 1st time by any individual during any calendar year (under all plans of the individual's employer corporation and its parent and subsidiary corporations) **exceeds \$100,000**, such options shall be treated as options which are not incentive stock options.

(2) **Ordering rule.** Paragraph (1) shall be applied by taking options into account in the order in which they were granted.

(3) **Determination of fair market value.** For purposes of paragraph (1), the fair market value of any stock shall be determined as of the time the option with respect to such **stock is granted**.

Sec. 423. Employee Stock Purchase Plans

(a) General Rule. Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted after 1963, under an **employee stock purchase plan (as defined in subsection (b))** if—

- (1) no disposition of such share is made by him within 2 years after the date of the granting of the option nor within 1 year after the transfer of such share to him; and
- (2) at all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, he is an employee of the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 424(a) applies.

(b) Employee Stock Purchase Plan.

For purposes of this part, the term **“employee stock purchase plan”** means a plan which meets the following requirements:

- (1) the plan provides that options are to be granted **only to employees** of the employer corporation or of its parent or subsidiary corporation to purchase stock in any such corporation;
- (2) such plan is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;
- (3) under the terms of the plan, **no employee** can be granted an option if such employee, immediately after the option is granted, owns stock possessing **5%** or more of the total combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation. ...;
- (4) under the terms of the plan, options are to be granted to all employees of any corporation whose employees are granted any of such options by reason of their employment by such corporation, except that there may be excluded—
 - (A) employees who have been employed less than 2 years,
 - (B) employees whose customary employment is 20 hours or less per week,
 - (C) employees whose customary employment is for not more than 5 months in any calendar year, and
 - (D) highly compensated employees (within the meaning of section 414(q));

(5) under the terms of the plan, all employees granted such options shall have the same rights and privileges, except that the **amount of stock which may be purchased** by any employee under such option may **bear a uniform relationship** to the total **compensation**, or the basic or regular rate of compensation, of employees, and the plan may provide that no employee may purchase more than a maximum amount of stock fixed under the plan;

(6) under the terms of the plan, the **option price is not less than the lesser of—**

(A) an amount equal to 85% of FMV of the stock at the time such option is granted, or

(B) an amount which under the terms of the option may not be less than 85% of the fair market value of the stock at the time such option is exercised;

(7) under the terms of the plan, such option cannot be exercised after the expiration of—

(A) 5 years from the date such option is granted if, under the terms of such plan, the option price is to be not less than 85 percent of the fair market value of such stock at the time of the exercise of the option, or

(B) 27 months from the date such option is granted, if the option price is not determinable in the manner described in subparagraph (A);

(8) under the terms of the plan, no employee may be granted an option which permits his rights to purchase stock under all such plans of his employer corporation and its parent and subsidiary corporations to accrue at a rate which exceeds **\$25,000** of FMV of such stock (determined at the time such option is granted) for each calendar year in which such option is outstanding at any time. For purposes of this paragraph—

(A) the right to purchase stock under an option accrues when the option (or any portion thereof) first becomes exercisable during the calendar year;

(B) the right to purchase stock under an option accrues at the rate provided in the option, but in no case may such rate exceed \$25,000 of fair market value of such stock (determined at the time such option is granted) for any one calendar year; and

(C) a right to purchase stock which has accrued under one option granted pursuant to the plan may not be carried over to any other option; and

(9) under the terms of the plan, such option is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him.

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(c) Special Rule Where Option Price Is Between 85 Percent and 100 Percent of Value of Stock. ...