

for Insurance of Accounts is hereby amended to read as follows:

(b) *Semiannual credits.* (1) An insured institution shall not be required to make any credit to its Federal insurance reserve account under this paragraph at any time when its adjusted net worth is at least 10 percent of its specified assets at the close of the semiannual period.

3. Paragraph (b) of § 563.13 of the Rules and Regulations for Insurance of Accounts is hereby amended by revoking subparagraph (5).

4. Paragraph (b) of § 563.13 of the Rules and Regulations for Insurance of Accounts is hereby amended by adding, immediately after subparagraph (4), a new subparagraph, subparagraph (5), to read as follows:

(5) During the three semiannual periods commencing on and after July 1, 1966, the 10 percent of net income semiannual credit requirement in subparagraphs (2) and (3) of this paragraph shall be 5 percent of net income.

5. Paragraph (c) of § 563.13 of the Rules and Regulations for Insurance of Accounts is hereby amended to read as follows:

(c) *Limitations on payment of dividends or interest.* Any insured institution which has failed to meet the requirements of this section shall not declare, pay or advertise dividends or interest for the semiannual period subsequent to the immediately succeeding semiannual period, in excess of the amount approved by the Corporation, unless, in such immediately succeeding semiannual period, the institution has credited to its Federal insurance reserve account an amount equal to the total deficiency in required credits under paragraph (b) of this section plus the required credits thereunder for such period, and is in conformity with paragraph (a) of this section requirements at the end of such period.

(Secs. 402, 403, 48 Stat. 1256, 1257, as amended; 12 U.S.C. 1725, 1726. Reorg. Plan No. 3 of 1947, 12 F.R. 4981, 3 CFR, 1947 Supp.)

Resolved further that the Board hereby finds that it is desirable to have the effective date coincide with the beginning of the semiannual period utilized by the majority in number of insured institutions subject to the regulation and therefore finds that the regulation shall become effective as hereinabove noted.

By the Federal Home Loan Bank Board.

[SEAL] HARRY W. CAULSEN,
Secretary.

[F.R. Doc. 66-6958; Filed, June 23, 1966; 8:51 a.m.]

[No. FSLIC-2,645]

PART 570—BOARD RULINGS

Cash

JUNE 20, 1966.

Whereas, by Federal Home Loan Bank Board Resolution No. FSLIC-2,644 this Board has amended § 561.18 of the Rules and Regulations for Insurance of Ac-

counts (12 CFR 561.18) to eliminate time deposits, other than time deposits in Federal Home Loan Banks and State banks performing similar reserve functions, from the definition of cash; and

Whereas said proposed amendment requires the rescission of § 570.1 of the Rules and Regulations for Insurance of Accounts (12 CFR 570.1);

It is hereby resolved that the Federal Home Loan Bank Board, upon the basis of consideration by it of the advisability of the rescission hereinafter set forth, and for the purpose of effecting such rescission, hereby rescinds § 570.1 of the Rules and Regulations for Insurance of Accounts (12 CFR 570.1), effective July 1, 1966.

(Secs. 402, 403, 48 Stat. 1256, 1257, as amended; 12 U.S.C. 1725, 1726. Reorg. Plan No. 3 of 1947, 12 F.R. 4981, 3 CFR, 1947 Supp.)

By the Federal Home Loan Bank Board.

[SEAL] HARRY W. CAULSEN,
Secretary.

[F.R. Doc. 66-6959; Filed, June 23, 1966; 8:51 a.m.]

[No. FSLIC-2,646]

PART 571—STATEMENTS OF POLICY

Continued Inclusion of Time Deposits As Cash

JUNE 20, 1966.

Resolved that the Federal Home Loan Bank Board, upon the basis of consideration by it of the advisability of revising and codifying its statement of policy relating to the continued inclusion of time deposits as cash adopted by the Board on May 16, 1966, and duly published in the FEDERAL REGISTER on May 20, 1966 (31 F.R. 7362), and for the purpose of effecting such revision and such codification, hereby amends Part 571 of the rules and regulations for the Federal Savings and Loan Insurance Corporation (12 CFR Part 571) by adding, immediately after § 571.1 a new section, § 571.2, to read as follows:

§ 571.2 Continued inclusion of time deposits as cash.

(a) Under § 561.18 of this chapter of the Rules and Regulations for Insurance of Accounts, "cash" is defined as cash on hand, unpledged deposits in a Federal Home Loan Bank or a State bank performing similar reserve functions, and unpledged demand deposits in banks not in the possession of appropriate supervisory authorities.

(b) Insured institutions had, under a former ruling of the Board, been permitted to count time deposits open account and time certificates of deposit as cash within specified limits.

(c) In the circumstances, the Board has determined, as a matter of policy, to allow time deposit open account and time certificates of deposits to be counted as cash according to the following schedule and extent:

(1) Time certificates of deposit made or renewed prior to May 20, 1966, may be

counted as cash until July 1, 1967, or their expiration date (or first alternative maturity after September 30, 1966), whichever is earlier;

(2) Time certificates of deposit renewed between May 20, 1966, and September 30, 1966, for a period not in excess of ninety days may be counted as cash until the expiration of such renewal period;

(3) Time deposits open account subject to a notice period of not more than 30 days may be counted as cash until July 1, 1968; and

(4) No time deposit open account or deposit evidenced by a certificate of deposit shall be considered as cash unless (i) the association itself made the deposit in question, (ii) the deposit, together with all other time deposits of the association in the same bank, does not exceed the greater of one-fourth of one percent of such bank's total deposits as of the bank's last published statement of condition or \$10,000, and (iii) no consideration was received from a third party in connection with the making of the deposit.

(Secs. 402, 403, 48 Stat. 1256, 1257, as amended; 12 U.S.C. 1725, 1726. Reorg. Plan No. 3, of 1947, 12 F.R. 4981, 3 CFR, 1947 Supp.)

By the Federal Home Loan Bank Board.

[SEAL] HARRY W. CAULSEN,
Secretary.

[F.R. Doc. 66-6960; Filed, June 23, 1966; 8:51 a.m.]

[No. FSLIC-2647]

PART 571—STATEMENTS OF POLICY

Procedure and Policy Concerning Institutions Failing To Meet Requirements of Insurance Regulation 563.13

JUNE 20, 1966.

Resolved that, the Federal Home Loan Bank Board, upon the basis of consideration by it of the advisability of revising and codifying its statement of procedure and policy concerning institutions failing to meet requirements of Insurance Regulation 563.13 adopted by the Board on February 23, 1966, and duly published in the FEDERAL REGISTER on March 1, 1966 (31 F.R. 3229), and for the purpose of effecting such revision and such codification, hereby amends Part 571 of the Rules and Regulations for Insurance of Accounts (12 CFR Part 571) by adding, immediately after § 571.2, a new section, § 571.3, to read as follows:

§ 571.3 Procedure and policy concerning institutions failing to meet requirements of Insurance Regulation 563.13.

Insurance Regulation 563.13 provides, among other things, that when an insured institution fails to make the required transfers to its reserves, such institution may not declare, advertise, or pay dividends, in the semiannual period subsequent to the immediately succeeding semiannual period, in

excess of an amount approved by the Federal Savings and Loan Insurance Corporation. This provision of the regulation requires a review of those cases involving a failure to comply with the requirements of the regulation and a determination as to the course of action to be followed in each case. This statement of Board policy establishes the procedure to be followed in such cases and states the guidelines to be used in evaluating such institutions and recommending a specific course of action in each such case.

I. Procedure. The following procedure shall apply in all cases in which an institution has failed to meet the requirements of Insurance Regulation 563.13 for its most recent semiannual period. The appropriate supervisory agent for the Board shall give the board of directors of the institution written notice of the determination of a deficiency and the amount thereof within sixty (60) days after the institution has filed its semiannual report for that period. The written notice shall also contain such supervisory requests and recommendations for corrective action as may be appropriate to the situation and shall contain advice that until such time as the institution receives written notice of the Corporation's determination as to the amount of dividend or interest to be declared, advertised, or paid, the institution should not declare, advertise, or pay any dividends or interest for or during the semiannual period in which it may be subject to limitation by the Corporation.

The institution shall have fifteen (15) days from the date of the written notice from the supervisory agent in which to submit evidence of compliance with supervisory requests or recommendations or to submit any memoranda or other material relevant to the Board's determination as to the amount of dividend or interest to be declared, advertised, or paid.

The supervisory agent, after evaluation of the institution on the basis of the determinative factors set forth in the latter part of this statement and consideration of any corrective action taken and of any material submitted by the institution, shall make his recommendation of action to be taken. This recommendation, together with all relevant supporting data, shall be transmitted to the appropriate regional supervisor of the Board's Office of Examinations and Supervision.

The regional supervisor shall review the supervisory agent's evaluation and recommendation and any material submitted by the institution and shall make an independent evaluation sufficient to support his own recommendation of action to be taken. The evaluation, recommendations, and any supporting data shall be transmitted to the Director, Office of Examinations and Supervision, who will submit to the Board a recommendation for appropriate action.

The Board shall reach a decision as to the appropriate action to be taken, and written notice thereof shall be sent to the institution by the appropriate supervisory agent at least thirty (30) days before the end of the current semiannual period. If additional information is found necessary as to an association's operations or the conditions on which approval of a particular rate or amount of dividends or interest might be warranted, the association shall be so notified in a similar manner.

The institution shall have the right to submit to the Supervisory Agent a written petition for reconsideration, within fifteen (15) days from the date of the written notice of the Board's decision. If the institution decides to petition for reconsideration, it may submit with the petition additional memoranda or other relevant material for consideration by the Board. The Supervisory Agent shall make his recommendation with

respect to the matter and transmit it, together with the petition and any relevant supporting data, to his Regional Supervisor, who will make his own recommendation. The petition, recommendations, and any relevant supporting data shall be transmitted to the Director, Office of Examinations and Supervision, who will submit to the Board his own recommendation for appropriate action. The Supervisory Agent shall promptly notify the institution, in writing, of the action taken by the Board on the petition for reconsideration.

In cases where an institution has completely cured its deficiency, or where it has a relatively minor deficiency, scheduled items of less than 4 percent of specified assets, moderate expense ratios, and a dividend or interest rate not above that paid in the two preceding semiannual periods or not above that paid by a majority (in number) in its standard metropolitan statistical area (or community if not in a standard metropolitan statistical area), and if the Supervisory Agent has recommended that the dividend or interest rate not be adjusted, the appropriate Regional Supervisor, if he concurs in such recommendation, has the authority, delegated by the Board, to determine that rate adjustment is not required.

If the Supervisory Agent so recommends, and the Regional Supervisor concurs in such recommendation, the Regional Supervisor is authorized to determine that rate adjustment is not required in the case of any institution which at any semiannual closing on or after June 30, 1966, fails to meet the semiannual credit requirements of paragraph (b) of Insurance Regulation 563.13, if the total credits made by such institution during that semiannual period would have met the credit requirements of paragraph (b) of Insurance Regulation 563.13 as amended effective July 1, 1966.

II. Evaluation—A. Basic policy. In the evaluation of insured institutions which have failed to meet the requirements of Insurance Regulation 563.13 and in making recommendations for specific courses of action to be employed, all parties will be guided by the principle embodied in section 403(b) of Title IV of the National Housing Act, namely, that the Federal Savings and Loan Insurance Corporation has the right and the duty to require insured institutions to establish and maintain adequate reserves before paying dividends.

The fact that an adjustment in dividend rate might place an institution below the level paid by others does not, in and of itself, constitute adequate grounds for not recommending an adjustment.

No dividend, either cash or stock, on permanent reserve or guarantee stock should be declared by an institution which fails to meet its reserve requirements.

B. Principal determinative factors. It is not possible or feasible to identify or to state categorically or inflexibly all of the criteria or considerations which anyone could or would use in all instances in making a determination as to the need for a specific course of action. Many varied factors must be considered, separately and in context, and in the light of operations of each individual institution. However, the following areas of operation by an insured institution should be of paramount concern, and essential facts and information with respect thereto should in large measure constitute the basis for recommending a specific course of action.

1. Minimum adjustment for institution which could have met requirement. An institution which, after having been advised that it could have met the regulatory requirement by transfer from an existing eligible source, failed to take such action shall be considered for adjustment of its rate to a

point at least 0.10 percent below the rate last paid by the institution.

2. Extent of failure. An institution which failed by only a minor extent to make the required transfer would obviously be a likely candidate for more favorable consideration. However, such a minor failure may not always, of itself, establish valid grounds for a favorable recommendation. In any event, a major effort should be made to secure correction of the cause of minor failures, so as to avoid further deterioration.

3. Soundness of operation. It is the view of the Board that soundly operated institutions will meet changing demand-supply conditions by making timely and necessary adjustments in operating policies and practices. An above-average amount of scheduled items, in many institutions, is a reflection of the failure to adjust lending to more moderate rates of overall growth or demand for housing. Consequently, scheduled items are considered to be an important factor in evaluating the soundness of operations.

An institution's ratio of scheduled items to total assets as compared to national averages must be an important factor in any evaluation. The accumulation of an above-average amount of scheduled items should raise serious doubt as to the advisability of permitting unrestricted competition for additional funds.

It is recognized that there may be special situations peculiar to a few areas, and these should be covered by qualitative comment. However, weak or deteriorating economic conditions are not of themselves a valid reason for recommending against dividend rate adjustment, since such conditions strongly suggest that an institution may not be able to employ funds it receives in a sound, economical manner.

4. Economy of operation. The less economical an institution's operation, the less able it is to comply with the reserve regulation and the more likely it is to accumulate scheduled items by the adoption of unsound policies and practices.

The ratio of expenses to average total assets as compared to a national average, with allowance for size and age, is an important factor in the evaluation of an institution's economy of operation.

It is recognized that during the three-year period following insurance of accounts an institution having less than \$5 million in savings may have special problems with respect to its expense ratio, and these factors should be covered by qualitative comments.

5. Dividend rate practices. Dividend rate practices are considered to be a major factor in an evaluation since a high dividend rate can preclude adequate reserve allocations, thus running counter to the basic principle that an insured institution has an obligation to provide reserves satisfactory to the Insurance Corporation before paying dividends. Furthermore, there is a close association between high dividend rates and higher than average scheduled items.

An institution which fails to make its required reserve allocations in the two semiannual periods following an increase in dividend rate will not be awarded any significant degree of consideration for rate continuance, since the increased rate will be regarded as a substantial contributory factor in the inability to make the required allocations.

If an institution is paying a dividend at a rate above that paid by a majority in its standard metropolitan statistical area, or community (if not in a standard metropolitan statistical area), it is the Board's view that such institution should be considered most seriously for rate adjustment.

6. Other considerations. While the condition and operations of an institution as measured by the factors set out above would

generally be determinative for the purposes of this program, the identification of those matters should not be construed as excluding the consideration of other matters, separately or in context with one or more of the factors stated above, which also may be indicative of the need for limiting an institution's pursuit of additional funds.

Among other considerations to which careful attention should be given are heavy promotional activity, rapid growth, pursuit of high-yield assets, large ratios of construction loans accompanied by high foreclosure rates or scheduled items, and weak or declining reserve positions.

(Secs. 402, 403, 48 Stat. 1256, 1257, as amended; 12 U.S.C. 1725, 1726. Reorg. Plan No. 3 of 1947, 12 F.R. 4981, 3 CFR, 1947 Supp.)

By the Federal Home Loan Bank Board.

[SEAL] HARRY W. CAULSEN,
Secretary.

[F.R. Doc. 66-6961; Filed, June 23, 1966;
8:51 a.m.]

Title 18—CONSERVATION OF POWER AND WATER RESOURCES

Chapter I—Federal Power Commission

SUBCHAPTER B—REGULATIONS UNDER THE FEDERAL POWER ACT

[Docket No. R-303; Order 323]

PART 4—LICENSES, PERMITS, AND DETERMINATION OF PROJECT COSTS

Hydroelectric License Applications; Exhibit Relating to Protection and Enhancement of Fish and Wildlife Resources

JUNE 17, 1966.

On April 19, 1966, the Commission issued a notice of proposed rule making in this proceeding (31 F.R. 6379, Apr. 27, 1966), wherein it proposed to amend Part 4, Regulations Under the Federal Power Act (18 CFR 4.41) to provide that an exhibit setting forth matters related to the conservation and enhancement of fish and wildlife resources affected by the project be filed as part of license applications for proposed projects of more than 2,000 horsepower installed capacity, and constructed projects for which a new license is sought under section 15 of the Federal Power Act.

The exhibit will help expedite the processing of applications by identifying potential problems with respect to fish and wildlife resources and suggesting possible solutions thereto upon the filing of an application. It will also facilitate the Commission's compliance with the requirements of the Fish and Wildlife Coordination Act (16 U.S.C. secs. 661-666c) for consultation with the U.S. Fish and Wildlife Service, Department of the Interior and appropriate State fish and wildlife agencies on the conservation and enhancement of fish and wildlife resources affected by a project.

We received 32 responses to the notice: 23 of these¹ expressed unqualified approval of the proposed rule, and 1 opposed its adoption as unnecessarily duplicative of existing requirements.² The balance,³ while generally supporting the rule, expressed certain reservations and suggested various modifications which we shall deal with below.

The Southern California Edison Co., as well as the Montana Power Co., point to the possible duplication in Exhibit S of materials already required in Exhibit R. Although the subject of recreational facilities may relate to fish and wildlife, the problems relating to fish and wildlife obviously go far beyond those involved in a recreational plan and should be dealt with separately. Moreover, the conservation and enhancement of fish and wildlife is considered separately in legislation on this subject (16 U.S.C. 661-666c). We shall, however, provide that matters covered in Exhibit R need only be included in Exhibit S by reference.

Colorado Wildlife Federation, Inc., indicated its support for the rule so long as it is supplemental to the Fish and Wildlife Coordination Act and not in lieu of it. In this regard, we wish to make clear that the requirement for Exhibit S is not intended to supersede the provisions of the Coordination Act. It will, however, facilitate the Commission's compliance with those provisions. The Colorado Federation also suggested the addition of language to include areas affected by the project as well as those within the project boundary, in the preparation of Exhibit S. It is not our intention to exclude from consideration in the preparation of Exhibit S, fish and wildlife resources affected by the project which are outside of the project bound-

ary, e.g. hatcheries and releases for downstream fish resources. We are modifying the language of the proposed amendment to clarify this point.

The Puget Sound Power & Light Co. objects to the portion of the proposed rule which would require an applicant to consider the enhancement of fish and wildlife resources, in addition to conservation, in the preparation of Exhibit S, asserting that (1) it is contrary to the established policy of providing solely for the conservation of fish and wildlife resources; (2) it shifts the responsibility for enhancement from the public in general to ratepayers of the licensee thereby imposing on them a financial burden for a function not properly chargeable to them; and (3) it would be difficult for a licensee to determine in advance the extent to which it would have to pay for the improvement of fish and wildlife resources. We do not agree that an applicant should limit itself to the consideration of conservation of existing fish and wildlife resources in the preparation of Exhibit S. While our prime objective is, of course, the conservation of fish and wildlife resources which may be affected by a hydroelectric project, it would indeed be shortsighted to overlook opportunities which may present themselves for enhancing such resources or to fail to require potential licensees to give consideration to these matters in the course of preparing their applications. In response to its second contention, where the enhancement of fish and wildlife resources is feasible in connection with the conservation of such resources, the licensee may be required to bear necessary costs therefor as it does all other reasonable costs associated with the project as licensed by the Commission under section 10(a) of the Federal Power Act. As for determining in advance the cost for improving fish and wildlife resources, we are providing in the rule that Applicants furnish cost estimates, as part of the exhibit, with respect to all improvements proposed by the applicant. These estimates would not necessarily include those improvements which may be prescribed during the term of the license.

The State of California-Resources Agency, Department of Fish and Game in its comment on the proposed rule has made several suggestions, one of which also raises the subject of enhancement of fish and wildlife resources. Contrary to the position of Puget Sound Power & Light Co., it urges that the matter of enhancement be emphasized. It cites as an example the Yuba River Project (FPC Project No. 2246) which incorporates features which will rehabilitate a significant salmon run. We believe that the language of the rule adopted will satisfactorily alert applicants to the importance of giving consideration to enhancement of fish and wildlife resources in developing the exhibit. California makes another suggestion similar to that made by the Colorado Wildlife Federation, with respect to the affect of a project upon fish and wildlife resources outside of the project area. As stated above, we have adopted this suggestion.

¹ (1) State of New Hampshire, Fish and Game Department; (2) State of Montana, Department of Fish and Game; (3) State of Minnesota, Department of Conservation; (4) State of Idaho, Fish and Game Department; (5) International Association of Game, Fish and Conservation Commissioners; (6) Wildlife Management Institute; (7) Medical College of South Carolina; (8) Federated Sportsmen's Clubs of New Hampshire, Inc.; (9) City of Seattle, Department of Lighting; (10) Department of the Interior; (11) Arizona Game Protective Association; (12) Oklahoma Resorts, Inc.; (13) Pennsylvania Power & Light Co.; (14) The High Rock Lake Association; (15) Sport Fishing Institute; (16) City of Tacoma, Wash., Department of Public Utilities; (17) Director, Marine Biological Laboratory, Woods Hole, Mass.; (18) State of Alabama, Department of Conservation; (19) Massachusetts Wildlife Federation; (20) Commonwealth of Pennsylvania, Department of Forests and Waters; (21) South Carolina Wildlife Federation; (22) State of North Carolina Wildlife Resources Commission; and (23) The Wilderness Society.

² The Montana Power Co.
³ The Izaak Walton League of America; (2) Colorado Wildlife Federation, Inc.; (3) Puget Sound Power & Light Co.; (4) State of California Resources Agency, Department of Fish and Game; (5) Southern California Edison Co.; (6) Pacific Power & Light Co.; (7) Forest Service, U.S. Department of Agriculture; and (8) State of Colorado Department of Game, Fish and Parks.

The California Department in its comments suggests that the potential applicants be required as part of the Exhibit S report to set forth detailed proposals considered necessary by the Department of the Interior or appropriate state fish and wildlife agencies as well as by the applicant itself. We do not believe it would be appropriate to thus convert the proposed Exhibit S to a joint proposal by the potential applicant and the appropriate Federal and State agencies or to require such applicant to include initially plans to which it does not subscribe. We have provided that the exhibit is to be prepared on the basis of studies made by the applicant after consultation and in cooperation with the appropriate Federal and State authorities and that the report contain a specific statement of the nature of this consultation and cooperation. In addition, the Exhibit S submitted by the applicant will be referred to the appropriate Federal and State agencies for their own comment pursuant to the provisions of the Fish and Wildlife Coordination Act and our rules and regulations (18 CFR 1.37, 4.31) thereby bringing the views of all concerned before the Commission for consideration. We believe that such a procedure rather than one requiring the applicants to speak for the agencies will provide the most appropriate way for achieving best results in this difficult area.

The California Department also contends that the rule as proposed leaves doubt as to whether the applicant is fully responsible for the necessary study costs and suggests a clarifying change of appropriate language to make clear that the applicant is responsible for conducting or having conducted the studies upon which the exhibit must be based. We do not believe that any hard and fast rule should be adopted on this subject. The rule places an obligation upon the applicant to insure that the exhibit is based on adequate studies and an applicant may make equitable arrangements with fish and wildlife agencies to prepare appropriate studies for it, if they are willing to make such studies. In other cases, however, the applicant may retain fish and wildlife staff or consultants to help it develop plans for this aspect of its potential project and the fish and wildlife agencies may see fit to make independent studies. We believe we would not encourage the most comprehensive planning if we attempted to prescribe a single mode of arrangement by rule.

In addition, the California Department urges that the requirement for Exhibit S be made applicable to minor projects. We believe that there may be merit to this suggestion, however, before making any determination thereon we shall solicit additional comments in a supplementary rule making proceeding, while adopting the rule with respect to major license projects at this time.

The Forest Service, in addition to suggesting that the rule not be limited in applicability to the project area, a sug-

gestion with which we have already indicated our concurrence, recommends that consultation with the Forest Service be required where National Forest land is involved and suggests additional language to effect this. We believe that such consultation would serve a useful purpose and we shall amend the proposed rule accordingly.

State of Colorado, Department of Game, Fish and Parks in its comments proposes that the rule be made applicable to projects of 1,000 horsepower or more. As indicated above, we shall consider this matter in a supplementary rule making proceeding. The Colorado Department further proposes that an applicant transmit a complete set of plans, included in the Exhibit S, to the State Fish and Wildlife agency 1 year prior to a hearing upon the application. Such a requirement, in our view, would not be feasible. The rule as proposed requires applicant to consult with State agencies in the preparation of the exhibit. Such consultation, presumably, would take place well in advance of the filing of an application and a considerable period of time before a hearing, if any, would be held upon the application. Moreover, it should be noted that this Commission, upon the filing of the application would submit the Exhibit S to the appropriate State agencies for recommendations pursuant to the Fish and Wildlife Coordination Act and our rules. We have already indicated our agreement with another suggestion by the Colorado Department with respect to the applicability of Exhibit S outside of project areas.

The Izaak Walton League of America suggests that the proposed Rule be broadened to include a requirement for detailed information about project effects on outdoor recreation resources in general. The impact of a project upon the general recreation resources of an area would more appropriately be considered by an applicant in the preparation of Exhibit R which deals with the development of recreational resources. Exhibit S is intended to apply solely to fish and wildlife resources.

In its comment the Pacific Power & Light Co. recommends that it be made clear that Exhibit S contain the specific plan for conservation, including functional designs, if such plan and designs have been prepared. We believe this is made clear by the rule. However, Pacific's primary concern seems to be that a solution of all of the fish and wildlife problems may not be available prior to the filing of an application for license. The rule contemplates a reasonable attempt to solve such problems prior to the filing of the application. As for the company's suggestion that, where a preliminary permit has been issued, Exhibit S include the results of the work required to be done with regard to conservation issues by the preliminary permit, we do not believe that any distinction is required, with respect to Exhibit S, between those applicants holding preliminary permits and those who do not. In both instances the Commission would be equally

concerned with the substance of the exhibit prepared in accordance with the rule.

The Commission finds: The amendment of §§ 4.31, 4.41, and 4.50 is necessary and appropriate for the purposes of carrying out the provisions of the Federal Power Act.

The Commission, acting pursuant to the provisions of the Federal Power Act, as amended, particularly sections 4(e), 9, 10(a), 10(i), and 309 thereof (41 Stat. 1065, 1068; 49 Stat. 858; 16 U.S.C. 797(e), 802, 803, 825h), orders:

(A) Part 4, Subchapter B, Chapter I, Title 18 of the Code of Federal Regulations is amended as follows:

(1) Section 4.41 is amended by adding a new Exhibit S to read as follows:

§ 4.41 Required exhibits.

Exhibit S. A report on the effect, if any, of the project upon the fish and wildlife resources in the project area or in other areas affected by the project and proposals for measures considered necessary to conserve and, if practicable, to enhance fish and wildlife resources affected by the project. The exhibit shall include functional design drawings of any fish ladders proposed to be constructed in compliance with section 18 of the Federal Power Act, such other facilities or developments as may be necessary for the protection, conservation, improvement and mitigation of losses of fish and wildlife resources in accordance with section 10(a) of the Act, and cost estimates for such facilities and developments. The Applicant shall prepare this exhibit on the basis of studies made after consultation and in cooperation with the U.S. Fish and Wildlife Service, Department of the Interior, and appropriate state fish and wildlife agencies and in the case of public lands, advise Federal Agencies having jurisdictional responsibilities therefor of its proposed plans. The exhibit shall include a statement on the nature and extent of applicant's consultation and cooperation with the above agencies. To the extent those aspects of fish and wildlife related to recreation are covered in Exhibit R, a specific reference to Exhibit R will suffice.

(2) In order to provide an exception to the requirement for an Exhibit S with respect to applications for certain constructed projects, § 4.50 is amended by adding the following new paragraph:

§ 4.50 Contents.

Exhibit S. This exhibit shall not be required for license applications on constructed projects, except with respect to applications for licenses under section 15 of the Federal Power Act.

(Secs. 4(e), 9, 10(a), 10(i), 41 Stat. 1065, 1068; sec. 309, 49 Stat. 858; 16 U.S.C. 797(e), 802, 803, 825h)

§ 4.31 [Amended]

(3) In order to conform § 4.31, *Acceptance for Filing or Rejection of Applications*, to the amendment of § 4.41 prescribed in subparagraph (1), and Order 260-A, 28 F.R. 4092, as amended by Order 292, 30 F.R. 523, the third sentence of § 4.31 is amended deleting "and O," and inserting in lieu thereof "O, R, and S."

(B) These amendments shall become effective August 1, 1966.

(C) The Secretary shall cause prompt publication of this order to be made in the FEDERAL REGISTER.

By the Commission.

[SEAL] JOSEPH H. GUTRIDE,
Secretary.
[F.R. Doc. 66-6909; Filed, June 23, 1966;
8:46 a.m.]

Title 24—HOUSING AND HOUSING CREDIT

Subtitle A—Office of the Secretary, Department of Housing and Urban Development

PART 0—STANDARDS OF CONDUCT

Pursuant to and in accordance with sections 201 through 209 of Title 18 of the United States Code, Executive Order 11222 of May 8, 1965 (30 F.R. 6469), and Title 5, Chapter I, Part 735 of the Code of Federal Regulations, Part 0 is added to Subtitle A of Title 24 of the Code of Federal Regulations, reading as follows:

Subpart A—General Provisions

- Sec.
0.735-101 Purpose.
0.735-102 Definitions.
0.735-103 Interpretation and advisory service.
0.735-104 Notification to employees and special Government employees.
0.735-105 Remedial action.
0.735-106 Interest of employee's or special Government employee's relatives.

Subpart B—Conduct and Responsibilities of Employees

- 0.735-201 Basic principle.
0.735-202 Gifts, entertainment, and favors.
0.735-203 Outside activity.
0.735-204 Financial interests.
0.735-205 Personal real estate transactions.
0.735-206 Use of inside information.
0.735-207 Intermediaries and product recommendations.
0.735-208 Membership in organizations.
0.735-209 Use of Government property.
0.735-210 Indebtedness.
0.735-211 Gambling, betting, and lotteries.
0.735-212 General conduct; and conduct prejudicial to the Government.

Subpart C—Conduct and Responsibilities of Special Government Employees

- 0.735-301 Use of Government employment.
0.735-302 Use of inside information.
0.735-303 Coercion.
0.735-304 Gifts, entertainment, and favors.
0.735-305 Applicability of other provisions.

Subpart D—Miscellaneous Statutory Provisions

- 0.735-401 Applicable statutory provisions.

Subpart E—Statements of Employment and Financial Interests

- 0.735-501 Submission of statements.
0.735-502 Supplementary statements.
0.735-503 Information not known by employees.
0.735-504 Information prohibited.
0.735-505 Review of statements.
0.735-506 Confidentiality of statements.
0.735-507 Effect of employee's statements on other requirements.
0.735-508 Specific provisions for special Government employees.

Appendix—List of Positions Subject to Subpart E.

AUTHORITY: The provisions of this Part 0 issued under E.O. 11222 of May 8, 1965, 30 F.R. 6469, 3 CFR, 1965 Supp.; 5 CFR 735.104.

Subpart A—General Provisions

§ 0.735-101 Purpose.

The maintenance of unusually high standards of honesty, integrity, impartiality, and conduct by Government employees and special Government employees is essential to assure the proper performance of the Government business and the maintenance of public confidence. The avoidance of misconduct and conflicts of interest on the part of Government employees and special Government employees through informed judgment is indispensable to the maintenance of these standards. To accord with these concepts, this part sets forth the Department's regulations prescribing standards of conduct and responsibilities, and governing statements of employment and financial interests for employees and special Government employees.

§ 0.735-102 Definitions.

(a) "Department" means the Department of Housing and Urban Development.

(b) "Employee" means an officer or employee of the Department, but does not include a special Government employee.

(c) "Special Government employee" means an officer or employee of the Department appointed to serve with or without compensation, for not more than 130 consecutive days during any period of 365 days, on a full-time, part-time, or intermittent basis, and who is retained, designated, appointed, or employed as a special Government employee under the provisions of section 202 of Title 18 of the United States Code.

(d) "Person" means an individual, a corporation, a company, an association, a firm, a partnership, a society, a joint stock company, or any other organization or institution.

(e) "Outside employment" means all gainful employment other than the performance of official duties. It includes, but is not limited to, working for another employer, the management or operation of a private business for profit (including personally owned businesses, partnerships, corporations, and other business entities), and other self-employment.

§ 0.735-103 Interpretation and advisory service.

(a) *Department counselor.* The General Counsel is designated Counselor for the Department and shall serve as the Department's designee to the Civil Service Commission on matters covered by this part. He shall be responsible for coordinating the Department's counseling services and for assuring that counseling and interpretations on questions of conflicts of interest and other matters covered by this part are available to designated deputy counselors. He may form ad hoc committees to evaluate the effectiveness of the standards, or to consider any new or unusual question arising from their application.

(b) *Deputy counselors.* Such deputy counselors as may be required shall be designated to give authoritative advice and guidance to current and prospective employees and special Government employees on questions of conflicts of interest and on other matters covered by this part.

§ 0.735-104 Notification to employees and special Government employees.

The provisions of this part and all revisions thereof shall be brought to the attention of and made available to:

(a) Each employee and special Government employee at the time of issuance and at least annually thereafter;

(b) Each new employee and special Government employee at the time of employment.

§ 0.735-105 Remedial action.

A violation of this part by an employee or special Government employee may be cause for remedial or disciplinary action. Such action may include, but is not limited to:

- (a) Changes in assigned duties;
(b) Divestment by the employee or special Government employee of his conflicting interest;
(c) Disciplinary action, including separation, which may be in addition to any penalty prescribed by law; or
(d) Disqualification for a particular assignment.

Remedial action, whether disciplinary or otherwise, shall be effected in accordance with any applicable laws, Executive orders, and regulations.

§ 0.735-106 Interests of employee's or special Government employee's relatives.

For the purposes of this part, the interest of a spouse, minor child, or a blood relative who is a full-time resident of an employee's or special Government employee's immediate household is considered to be an interest of the employee or special Government employee.

Subpart B—Conduct and Responsibilities of Employees

§ 0.735-201 Basic principle.

(a) Each employee must realize that the Government's basic and controlling purpose in employing him is the public interest, rather than his private or personal interest, and that he can never have a right of tenure that transcends the public good. He can properly be a Government employee only as long as it remains in the public interest for him to be one. Public trust and confidence in the integrity of the Government are paramount.

(b)(1) This basic principle applies with special force and effect in the Department of Housing and Urban Development, which deals directly with important segments of the public, and whose success depends upon public trust and confidence in its actions. The official actions of the Department often have a direct bearing upon the financial and other interests of individuals, firms, and institutions with which it does business. Furthermore, the effective accomplish-

ment of the Department's mission is significantly dependent upon a public image that engenders confidence in the Department's integrity. Accordingly, the avoidance of any involvement that tends to damage that image is a responsibility of exceptional importance for all employees who participate in or influence official operating determinations that affect the interests of those with whom the Department does business.

(2) If there is knowledge of an employee's involvement in or association with circumstances reasonably construed to reduce public confidence in the acts or determinations of the Department, such knowledge may be sufficient cause for the initiation of action adverse to the employee. Employees, therefore, are alerted to the gravity with which the Department will view any such involvement, especially if it has to do with conflicts of interest or the compromise of integrity—whether real or only apparent.

§ 0.735-202 Gifts, entertainment, and favors.

(a) Except as provided in paragraph (b) of this section, an employee shall not solicit or accept, directly or indirectly, any gift, gratuity, favor, entertainment, loan, or any other thing of monetary value, from a person who:

(1) Has, or is seeking to obtain, contractual or other business or financial relations with the Department;

(2) Conducts operations or activities that are regulated by the Department; or

(3) Has interests that may be substantially affected by the performance or nonperformance of the employee's official duty.

(b) The prohibitions of paragraph (a) of this section do not apply to:

(1) The acceptance of customary business services from banks or other financial institutions if such services are obtained under terms and conditions available to the general public;

(2) Obvious family or personal relationships, such as those between the employee and his parents, children, or spouse, when the circumstances make it clear that it is those relationships rather than the business of the persons concerned which are the motivating factors;

(3) The acceptance of food and refreshments of nominal value on infrequent occasions in the ordinary course of a luncheon or dinner meeting or other meeting or on an inspection tour where an employee may properly be in attendance;

(4) The acceptance of unsolicited advertising or promotional material, such as pens, pencils, note pads, calendars, and other items of nominal intrinsic value.

(c) An employee shall avoid any action, whether or not specifically prohibited by the regulations in this part, which might result in, or create the appearance of:

(1) Using public office for private gain;

(2) Giving preferential treatment to any person;

(3) Impeding Government efficiency or economy;

(4) Losing complete independence or impartiality; or

(5) Making a Government decision outside official channels.

(d) An employee shall not solicit contributions from another employee for a gift, or make a donation as a gift, when such gift is for an employee in a superior official position. An employee in a superior official position shall not accept a gift presented as a contribution from employees receiving less salary than himself.

(e) An employee shall not accept a gift, present, decoration, or other thing from a foreign government unless authorized by law.

§ 0.735-203 Outside activity.

(a) An employee shall not engage in outside employment or other outside activity not compatible with the full and proper discharge of his duties and responsibilities as an employee of the Department. Incompatible activities include but are not limited to:

(1) Acceptance of a fee, compensation, gift, payment of expense, or any other thing of monetary value in circumstances in which acceptance may result in, or create the appearance of, a conflict of interest;

(2) Employment which tends to impair his mental or physical capacity to perform his official duties and responsibilities in an acceptable manner;

(3) Activities that may be construed by the public to be the official acts of the Department;

(4) Activities that establish relationships or property interests that may result in a conflict between his private interests and his official duties; and

(5) Employment that may involve the use of information secured as a result of employment in the Department to the detriment of the Department or the public interest, or that may give preferential treatment to any person, corporation, public agency, or group.

(b) An employee shall not receive any salary or anything of monetary value from a private source as compensation for his services to the Government (18 U.S.C. 209).

(c) Full-time employees and part-time employees with a regularly scheduled tour of duty must obtain the prior approval of a designated personnel officer before engaging in outside employment in the following categories:

(1) Employment related to or similar to the substantive programs conducted by any part of the Department. This includes but is not limited to the broad fields of real estate, mortgage lending, property insurance, construction, construction financing, and land and real estate planning.

(2) Employment in the same professional field as that of the individual's official position.

(3) Employment with any person, firm, or other private organization having business either directly or indirectly with the Department.

(4) Employment by State, local, or other governmental body.

(d) No full-time employee or part-time employee with a regularly scheduled tour of duty shall maintain a publicly listed place of business without the prior approval of a designated personnel officer.

(e) Except for employees subject to the requirements of Subpart E of this part, approvals required by paragraphs (c) and (d) of this section shall be requested on Form HUD-843, Request for Authorization to Engage in Outside Employment and/or Statement of Financial Interests. All pertinent facts regarding the proposed employment, such as the name of the employer, the nature of the work to be performed, and the amount of time involved, shall be set forth.

(f) (1) Employees are encouraged to engage in teaching, lecturing, and writing that is not prohibited by law, Executive order, or this part. However, an employee shall not, either for or without compensation, engage in teaching, lecturing, or writing that is dependent on information obtained as a result of his employment by the Department, except when that information has been made available to the general public or will be made available on request, or when the Secretary or his designee gives written authorization for the use of non-public information on the basis that the use is in the public interest.

(2) An employee may use his name and title in connection with articles for publication which bear upon his work in the Department only if he obtains the approval of a designated personnel officer.

(g) This section does not preclude an employee from:

(1) Accepting bona fide reimbursement, unless prohibited by law, for actual expenses for travel and such other necessary subsistence as is compatible with this part for which no Government payment or reimbursement is made. However, an employee may not be reimbursed, and payment may not be made on his behalf, for excessive personal living expenses, gifts, entertainment or other personal benefits.

(2) Participating in the affairs of or accepting an award for a meritorious public contribution or achievement given by a charitable, religious, professional, social, fraternal, nonprofit educational and recreational, public service, or civic organization.

(3) Participating in the activities of National or State political parties not proscribed by law.

§ 0.735-204 Financial interests.

(a) An employee shall not:

(1) Have a direct or indirect financial interest that conflicts, or appears to conflict, with his official duties and responsibilities.

(2) Engage in, directly or indirectly, a financial transaction as a result of, or primarily relying on, information obtained through his employment by the Department.

(3) Acquire securities issued by the Federal National Mortgage Association.

(4) Acquire ownership of stock or other interest in a rental project financed with an FHA insured mortgage as long as the insurance is in force.

(5) Acquire ownership of FHA debentures or certificates of claim.

(6) Acquire interest in a cooperative or condominium housing project financed under the National Housing Act if the interest is not for obtaining a home for himself or his family.

(7) Be an officer or director of any organization which is an FHA approved mortgagee or lending institution or which services mortgages or other securities for the Department. An employee may hold stock or shares in such organizations provided his official duties are such that the holding will not create or tend to create a conflict of interest. The prohibitions of this paragraph do not apply to Federal Credit Unions that have been approved as Title I lending institutions.

(8) Participate directly or indirectly in any real estate activities for speculative purposes as distinguished from bona fide investment purposes.

(b) This section does not preclude an employee from having a financial interest or engaging in financial transactions to the same extent as a private citizen not employed by the Department so long as it is not prohibited by law, Executive Order 11222, or this part.

§ 0.735-205 Personal real estate transactions.

(a) Because the operations of the Department are directly related to individual real estate transactions, all Department employees must exercise the utmost care in the handling of their personal real estate activities. Employees must therefore report to a designated personnel officer the following types of personal real estate transactions (if the transaction involves FHA mortgage insurance, the report shall be filed at the time the application for such insurance is filed; other types of transactions shall be reported at the time of consummation of the transaction):

(1) Any purchase or sale of real property in which an employee has an interest.

(2) Any Title I property improvement loan obtained by the employee or in which he has a financial interest. In such case the employee must report the name of the lending institution and a description of the improvements being financed.

(3) Any interest in a cooperative or condominium housing project financed under the National Housing Act if it involves a home for himself or his family.

(b) In addition to the reporting requirements of paragraph (a) of this section, employees shall report all real estate holdings other than those held as personal residences.

(c) Except for employees subject to the requirements of Subpart E of this part, reports required by paragraphs (a) and (b) of this section shall be filed on Form HUD-843, Request for Authorization to Engage in Outside Employment and/or Statement of Financial Interests.

§ 0.735-206 Use of inside information.

Except as provided in § 0.735-203(f), no employee shall give or use inside information acquired by means of his position to advance any private interest, particularly the private interests of himself, his family, associates, or friends. For the purpose of this section "inside information" means information obtained under Government authority but which has not become part of the body of public information.

§ 0.735-207 Intermediaries and product recommendations.

No employee shall recommend or suggest the use of any particular or identified nongovernmental intermediary to deal with the Department nor shall he recommend any device or product tested by or for, or used by, the Department, except as required by his official duties.

§ 0.735-208 Membership in organizations.

(a) An employee may not, in his official capacity as an officer or employee of the Department, serve as a member of a non-Federal or private organization except where express statutory authority exists, or statutory language necessarily implies such authority. However, an employee may serve in an individual capacity as a member of a non-Federal or private organization, provided that:

(1) His membership does not violate the restrictions noted in § 0.735-203; and

(2) His official title or organization connection is not shown on any listing or presented in any activity of the organization in such a manner as to imply that he is acting in his official capacity.

(b) An employee may be designated to serve as a liaison representative of the Department to a non-Federal or private organization provided that:

(1) The activity relates to the work of the Department.

(2) The employee does not participate by vote in the policy determinations of the organization.

(3) The Department is in no way bound by any vote or action taken by the organization.

§ 0.735-209 Use of Government property.

An employee shall not directly or indirectly use, or allow the use of Department property of any kind, including property leased to the Department, for other than officially approved activities. An employee has a positive duty to protect and conserve Government property, including equipment, supplies, and other property entrusted or issued to him.

§ 0.735-210 Indebtedness.

An employee shall pay each just financial obligation in a proper and timely manner, especially one imposed by law, such as Federal, State, and local taxes. For the purpose of this section, "just financial obligation" means one acknowledged by the employee or reduced to judgment by a court, and "in a proper and timely manner" means in a manner which the Department determines does not, under the circumstances, reflect adversely

on the Government as his employer. In the event of a dispute between an employee and an alleged creditor, this section does not require the Department to determine the validity or the amount of the disputed debt.

§ 0.735-211 Gambling, betting, and lotteries.

An employee shall not participate, while on Government-owned or leased property or while on duty for the Department, in any gambling activity including the operation of a gambling device, in conducting a lottery or pool, in a game for money or property, or in selling or purchasing a number slip or ticket.

§ 0.735-212 General conduct; and conduct prejudicial to the Government.

(a) Each employee shall conduct himself in a manner that facilitates the effective accomplishment of the work of the Department, observing at all times the requirements of courtesy, consideration, and promptness in dealing with the public and with persons or firms having business with the Department;

(b) An employee shall not engage in criminal, infamous, dishonest, immoral, or notoriously disgraceful conduct, or other conduct prejudicial to the Government.

Subpart C—Conduct and Responsibilities of Special Government Employees

§ 0.735-301 Use of Government employment.

A special Government employee shall not use his Government employment for a purpose that is, or gives the appearance of being, motivated by the desire for private gain for himself or another person, particularly one with whom he has family, business, or financial ties.

§ 0.735-302 Use of inside information.

(a) A special Government employee shall not use inside information obtained as a result of his Government employment for private gain for himself or another person either by direct action on his part or by counsel, recommendation, or suggestion to another person, particularly one with whom he has family, business, or financial ties. For the purpose of this section, "inside information" means information obtained under Government authority which has not become part of the body of public information.

(b) Special Government employees may teach, lecture, or write in a manner consistent with the provisions of § 0.735-203(f).

§ 0.735-303 Coercion.

A special Government employee shall not use his Government employment to coerce, or give the appearance of coercing, a person to provide financial benefit to himself or another person, particularly one with whom he has family, business, or financial ties.

§ 0.735-304 Gifts, entertainment, and favors.

(a) Except as provided in paragraph (b) of this section, a special Government

employee, while so employed or in connection with his employment, shall not receive or solicit from a person having business with the Department anything of monetary value as a gift, gratuity, loan, entertainment, or favor for himself or another person, particularly one with whom he has family, business, or financial ties.

(b) The exceptions of § 0.735-202(b), which are applicable to employees, are also applicable to special Government employees.

§ 0.735-305 Applicability of other provisions.

(a) Each special Government employee is subject to the provisions of §§ 0.735-201, 0.735-208 through 0.735-212, and 0.735-508.

(b) Each special Government employee shall acquaint himself with each statute listed in Subpart D of this part.

Subpart D—Miscellaneous Statutory Provisions

§ 0.735-401 Applicable statutory provisions.

Each employee shall acquaint himself with each statute that relates to his ethical and other conduct as an employee of the Department and of the Government. The attention of each employee is directed to the following statutory provisions:

(a) House Concurrent Resolution 175, 85th Congress, 2d Session, 72 Stat. B12, the "Code of Ethics for Government Service".

(b) Chapter 11 of Title 18, United States Code, relating to bribery, graft, and conflicts of interest, as appropriate to the employees concerned.

(c) The prohibition against lobbying with appropriated funds (18 U.S.C. 1913).

(d) The prohibitions against disloyalty and striking (5 U.S.C. 118p, 118r).

(e) The prohibition against the employment of a member of a Communist organization (50 U.S.C. 784).

(f) The prohibitions against (1) the disclosure of classified information (18 U.S.C. 798, 50 U.S.C. 783); and (2) the disclosure of confidential information (18 U.S.C. 1905).

(g) The provision relating to the habitual use of intoxicants to excess (5 U.S.C. 640).

(h) The prohibition against the misuse of a Government vehicle (5 U.S.C. 78(c)).

(i) The prohibition against the misuse of the franking privilege (18 U.S.C. 1719).

(j) The prohibition against the use of deceit in an examination or personnel action in connection with Government employment (5 U.S.C. 637).

(k) The prohibition against fraud or false statements in a Government matter (18 U.S.C. 1001).

(l) The prohibition against mutilating or destroying a public record (18 U.S.C. 2071).

(m) The prohibition against counterfeiting and forging transportation requests (18 U.S.C. 508).

(n) The prohibitions against (1) embezzlement of Government money or property (18 U.S.C. 641); (2) failing to account for public money (18 U.S.C. 643); and (3) embezzlement of the money or property of another person in the possession of an employee by reason of his employment (18 U.S.C. 654).

(o) The prohibition against unauthorized use of documents relating to claims from or by the Government (18 U.S.C. 285).

(p) The prohibition against proscribed political activities—The Hatch Act (5 U.S.C. 118i), and 18 U.S.C. 602, 603, 607, and 608.

Subpart E—Statements of Employment and Financial Interests

§ 0.735-501 Submission of statements.

(a) Not later than 90 days after the effective date of this part, each employee occupying a position designated in the Appendix shall submit to the reviewing official specified in § 0.735-505, Form HUD-844, Statement of Employment and Financial Interests.

(b) Each employee who enters on duty after the effective date of this part in a position designated in the Appendix shall submit to the reviewing official specified in § 0.735-505 a statement not later than 30 days after his entrance on duty or 90 days after the effective date of this part, whichever is later.

(c) Additions to, deletions from, and other amendments of the list of positions in the Appendix may be made from time to time as necessary to carry out the purpose of the law, Executive Order 11222, and Part 735 of the Civil Service Commission Regulations (5 CFR Part 735). Such amendments are effective upon actual notification to the incumbents. The amended list shall be submitted at least annually for publication in the FEDERAL REGISTER.

§ 0.735-502 Supplementary statements.

(a) Changes in, or additions to, the information contained in an employee's statement shall be reported to the appropriate reviewing official in a supplementary statement at the end of the quarter in which the change occurs. Interim memoranda reports shall be filed if required to meet the prior approval provisions of § 0.735-203 (c) and (d), or the requirements of § 0.735-205(a) concerning the timely reporting of real estate transactions. Financial interests or employment acquired during a quarter, but disposed of or terminated before the end of such quarter, shall constitute changes or additions to be reported at the end of such quarter. Quarters end March 31, June 30, September 30, and December 31. If there are no changes or additions in a quarter, a negative report is not required. However, for the purpose of annual review, a supplementary statement, negative or otherwise, is required as of June 30 of each year.

(b) A supplementary statement shall be submitted on Form HUD-844, and

shall be designated "Supplementary". A supplementary statement shall furnish all information required by an initial statement and by appropriate notation, shall indicate any changes in, or additions to the information set out in the employee's initial statement or last supplementary statement.

§ 0.735-503 Information not known by employees.

If any information required to be included on a statement or supplementary statement, including holdings placed in trust, is not known to the employee but is known to another person, the employee shall request that other person to submit information in his behalf.

§ 0.735-504 Information prohibited.

This subpart does not require an employee to report information relating to his connection with, or interest in, a professional society or a charitable, religious, social, fraternal, recreational, public service, civic, or political organization or a similar organization not conducted as a business enterprise. For the purpose of this section, educational and other institutions doing research and development or related work involving grants of money from or contracts with the Government are deemed "business enterprises" and are required to be included in an employee's statement.

§ 0.735-505 Review of statements.

(a) Employees reporting directly to the Secretary shall submit their statements directly to the Secretary for review; employees reporting directly to the Under Secretary shall submit their statements directly to the Under Secretary for review.

(b) Employees reporting directly to Assistant Secretaries shall submit their statements directly to the appropriate Assistant Secretary for review; employees reporting directly to the General Counsel shall submit their statements directly to the General Counsel for review.

(c) Employees not included in paragraph (a) or (b) of this section shall submit their statements directly to the appropriate Deputy Counselor.

(d) When a statement submitted under paragraph (b) or (c) of this section, or information from other sources, indicates a conflict between the interest of an employee and the performance of his official duties, and when the conflict or appearance of conflict cannot be resolved by the reviewing official, he shall report the information concerning the conflict or appearance of conflict to the Secretary through the Counselor. The employee concerned shall be given an opportunity to explain the conflict or appearance of conflict before any required remedial action is initiated.

§ 0.735-506 Confidentiality of statements.

After the review process has been completed, the statements submitted under § 0.735-505 shall be promptly forwarded to the personnel office having custody of the employee's official personnel file. The statements shall be held in con-

fidence and retained in limited access files. Information from a statement may not be disclosed except as the Secretary or his designee, or the Civil Service Commission may determine for good cause shown.

§ 0.735-507 Effect of employee's statements on other requirements.

The statements and supplementary statements required of employees are in addition to, and not in substitution for, or in derogation of, any similar requirement imposed by law, order, or regulation. The submission of a statement or supplementary statement by an employee does not permit him or any other person to participate in a matter in which his or the other person's participation is prohibited by law, order or regulation.

§ 0.735-508 Specific provisions for special Government employees.

(a) Except as provided in paragraph (c) of this section, each special Government employee shall submit to the reviewing official specified in § 0.735-505, Form HUD-844-A, Statement of Employment and Financial Interests, not later than the time of his employment. He shall keep his statement current throughout his employment with the Department by the submission of supplementary statements.

(b) The provisions of §§ 0.735-503, 0.735-504, 0.735-506, and 0.735-507 are applicable to a special Government employee who is required to file a statement.

(c) The Secretary or his designee may waive the provisions of this section in the case of a special Government employee who is not a consultant or an expert when it is determined that the duties of the position held by the special Government employee are of a nature and at such level of responsibility that the submission of a statement is not necessary to protect the integrity of the Government. For the purpose of this paragraph, "consultant" and "expert" have the meanings given those terms by Chapter 304 of the Federal Personnel Manual.

This part was approved by the Civil Service Commission on May 17, 1966.

Effective date. This part shall be effective as of June 24, 1966.

ROBERT C. WEAVER,
Secretary of Housing and
Urban Development.

APPENDIX—LIST OF POSITIONS SUBJECT TO SUBPART E

Officers and employees in the following positions are subject to the provisions of Subpart E of this part:

(a) Employees paid at a level of the Federal Executive Salary Schedule established by the Federal Executive Salary Act of 1964, as amended, except the Secretary, who is subject to separate reporting requirements under section 401 of Executive Order 11222;

(b) Employees in grade GS-16 or above of the General Schedule established by the Classification Act of 1949, as amended, or in comparable or higher positions not subject to that Act; and

(c) Employees in the following positions:

OFFICE OF THE SECRETARY

Departmental:
Administrative Assistant to the Secretary.

Director, Low-Income Housing Demonstration Staff, Office of Program Policy.

Director, Division of Research Development, Office of Program Policy.

Director, Equal Opportunity Standards and Regulations Staff.

Deputy Director, Compliance Division.

Field Supervisory Investigators, Compliance Division.

Director, Audit Division, Office of Administration.

Deputy Director, Audit Division, Office of Administration.

Field Supervisory Auditors, Audit Division, Office of Administration.

Director, Division of Finance and Accounts, Office of Administration.

Deputy Director, Division of Finance and Accounts, Office of Administration.

Director, Division of General Services, Office of Administration.

Director, Property Management and Procurement Branch, Division of General Services, Office of Administration.

Field:
Deputy Regional Administrator.

Regional Director of Administration.

Director, Division of Community Facilities.

Deputy Director, Division of Community Facilities.

Director, Division of Urban Renewal.

Deputy Director, Division of Urban Renewal.

Director, Northwest Operations.

Deputy Director, Northwest Operations.

Regional Counsel.

Chief, Real Estate Disposition, Division of Urban Renewal.

Chief, Real Estate Acquisition, Division of Urban Renewal.

ASSISTANT SECRETARY FOR MORTGAGE CREDIT AND FEDERAL HOUSING COMMISSIONER

Federal Housing Administration

Departmental:
Director of Compliance Coordination.

Director of Examination and Audit.

Director, Audit Division.

Director, Division of General Services.

Deputy Director, Division of General Services.

Chief, Procurement and Property Section, Division of General Services.

Director, Community Disposition Staff.

Deputy Director, Community Disposition Staff.

Field Office Director, Community Disposition Staff.

Field:
Multifamily Housing Representative.

Director, Insuring Office.

Deputy Director, Insuring Office.

Assistant Director (Chief of Operations).

Chief Underwriter.

State Director (New York).

Assistant State Director.

Federal National Mortgage Association

Departmental:
Vice President.

Loan Manager.

Secretary-Treasurer.

Controller.

Director of Examination and Audit.

Field:
Agency Manager.

Assistant Agency Manager.

ASSISTANT SECRETARY FOR METROPOLITAN DEVELOPMENT

Departmental:
Director, Urban Planning Assistance

Branch, Office of Planning Standards and Coordination.

Director, Division of Academic Facilities, Office of Technical Services.

Land and Facilities Development Administration:

Director, Division of Senior Citizens Housing.

Director, Division of Public Facilities Grants.

Director, Division of Public Facilities Loans.

Director, Division of Land Development.

Director, Division of College Housing.

Director, Finance Standards Staff.

Deputy Director, Finance Standards Staff.

Urban Transportation Administration:

Positions at GS-15.

URBAN RENEWAL ADMINISTRATION

Departmental:
Director, Demonstration Program Branch.

Deputy Assistant Commissioner, Rehabilitation and Codes.

PUBLIC HOUSING ADMINISTRATION

Departmental:
Director, Office Services Branch.

Financing Officer.

Field:
Regional Director.

[F.R. Doc. 66-6930; Filed, June 23, 1966; 8:48 a.m.]

Title 26—INTERNAL REVENUE

Chapter I—Internal Revenue Service, Department of the Treasury

[T.D. 6837]

SUBCHAPTER A—INCOME TAX

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

SUBCHAPTER F—PROCEDURE AND ADMINISTRATION

PART 301—PROCEDURE AND ADMINISTRATION

Treatment of Employee Stock Options and Purchase Plans

On December 19, 1964, notice of proposed rule making with respect to the amendment of the Income Tax Regulations (26 CFR Part 1) under sections 402, 421 through 425, 691, 1012, 1014, 6039, 6071, and 6091 of the Internal Revenue Code of 1954, and the Procedure and Administration Regulations (26 CFR Part 301) under sections 6652 and 6678 of the Internal Revenue Code of 1954, in order to conform to section 221 of the Revenue Act of 1964 (78 Stat. 63), was published in the FEDERAL REGISTER (29 F.R. 18063). Paragraphs (e)(1) and (f)(3) of § 1.423-2, as set forth in paragraph 7 of the appendix to the notice of proposed rule making, are hereby withdrawn. After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the amendment of the regulations as proposed (except pars. (e)(1) and (f)(3) of § 1.423-2) is hereby adopted, subject to the changes set forth below:

PARAGRAPH 1. Section 1.421-1(g) as set forth in paragraph 5 of the notice of proposed rule making is revised.

PAR. 2. Section 1.421-7, as set forth in paragraph 7 of the notice of proposed rule making, is changed by revising paragraphs (c)(2), (d), (e)(1), and (h)(2), (3), and (4).

PAR. 3. Section 1.421-8, as set forth in paragraph 7 of the notice of proposed rule making, is changed by revising para-

graph (b) (1) and by adding new paragraphs (d) and (e).

PAR. 4. Section 1.422-1 as set forth in paragraph 7 of the notice of proposed rule making, is changed by revising paragraph (b) (2) and example (2) of paragraph (b) (3).

PAR. 5. Section 1.422-2, as set forth in paragraph 7 of the notice of proposed rule making, is changed by revising paragraphs (a) (1) (i) and (ii), (b) (1), (2), and (3), (e) (2) (ii), (f) (1) (iii), and (f) (3) (i), by adding examples (8) and (9) to paragraph (f) (4) and by revising paragraph (h) (1) (i).

PAR. 6. Section 1.423-2, as set forth in paragraph 7 of the notice of proposed rule making, is changed by revising paragraphs (c) (1), (3), and (4), (e) (1) and (f) (3).

PAR. 7. Section 1.424-2, as set forth in paragraph 7 of the notice of proposed rule making, is changed by revising paragraphs (a) (2) (iv), (a) (4), (b) (1) (iii), and paragraph (d) (3) (i) and (ii).

PAR. 8. Section 1.425-1, as set forth in paragraph 7 of the notice of proposed rule making, is changed by revising paragraph (c) (2), by adding a new example (6) to paragraph (c) (3) and by revising paragraphs (e) (5) (iii) and (e) (6).

PAR. 9. Section 1.691(c)-1, as set forth in paragraph 8 in the notice of proposed rule making, is changed by revising paragraph (c) (1).

PAR. 10. Section 1.6039-1, as set forth in paragraph 12 of the notice of proposed rule making, is changed by revising paragraphs (a), (b) (1), (b) (2), (b) (5), (c) (1), and (d).

PAR. 11. Section 1.6039-2, as set forth in paragraph 12 of the notice of proposed rule making, is changed by revising paragraph (a).

PAR. 12. Paragraph (c) of § 1.6071-1, as set forth in paragraph 13 of the notice of proposed rule making, is changed by adding new subparagraph (14).

PAR. 13. Paragraph (b) of § 1.6091-1, as set forth in paragraph 14 of the notice of proposed rule making, is changed by adding new subparagraph (14).

[SEAL] SHELDON S. COHEN,
Commissioner of Internal Revenue.

Approved: June 20, 1966.

STANLEY S. SURREY,
Assistant Secretary of
the Treasury.

In order to conform the Income Tax Regulations (26 CFR Part 1) under sections 402, 421 through 425, 691, 1012, 1014, 6039, 6071, and 6091 of the Internal Revenue Code of 1954, and the Procedure and Administration Regulations (26 CFR Part 301) under sections 6652, and 6678 of the Internal Revenue Code of 1954, to section 221 of the Revenue Act of 1964 (78 Stat. 63), such regulations are amended as follows:

PARAGRAPH 1. Section 1.402(a) is amended by revising section 402(a) (3) (B) and by adding a historical note. These amended and added provisions read as follows:

§ 1.402(a) Statutory provisions; taxability of beneficiary of employees' trust; exempt trust.

Sec. 402. Taxability of beneficiary of employees' trust—(a) Taxability of beneficiary of exempt trust. * * *

(3) Definitions. * * *

(B) The term "securities of the employer or subsidiary corporation (as defined in subsections (e) and (f) of section 425) of the corporation" include securities of a parent employer corporation.

[Sec. 402(a) as amended by sec. 4(c), Self-Employed Individuals Tax Retirement, Act 1962 (76 Stat. 825); sec. 221(c) (1), Rev. Act 1964 (78 Stat. 75)]

PAR. 2. Paragraph (b) (1) (ii) of § 1.402(a)-1 is amended to read as follows:

§ 1.402(a)-1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(b) Distributions including securities of the employer corporation—(1) In general. * * *

(ii) For purposes of section 402(a) and of this section, the term "securities" means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form, and the term "securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in subsections (e) and (f) of section 425) of the employer corporation.

PAR. 3. The center heading "Miscellaneous Provisions" which immediately precedes § 1.421 is revised to read as follows:

CERTAIN STOCK OPTIONS

PAR. 4. Section 1.421 is amended by revising the heading thereof, by revising section 421 (including the heading), and by revising the historical note at the end thereof. These amended provisions and historical note read as follows:

§ 1.421 Statutory provisions; general rules.

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), 423(a), or 424(a) are met—

(1) Except as provided in section 422(c) (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 425(a) applies, with respect to the share so transferred; and

(3) No amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

(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), 423(a), or 424(a) except that there is a failure to meet any of the holding

period requirements of section 422(a) (1), 423(a) (1), or 424(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.

(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), 423(a), and 424(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 sections 423(c) and 424(c) (1).

(2) Deduction for estate tax. If an amount is required to be included under section 422(c) (1), 423(c), or 424(c) (1) 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. For this purpose, the deduction shall be determined under section 691(c) as if the option acquired from the deceased employee were an item of gross income in respect of the decedent under section 691 and as if the amount includible in gross income under section 422(c) (1), 423(c), or 424(c) (1) were an amount included in gross income under section 691 in respect of such item of gross income.

(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 422(c) (1), 423(c), or 424(c) (1) if the employee had exercised the option on the date of his 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 sections 422(c) (1), 423(c), and 424(c) (1) shall apply only to the extent that the amount includible in gross income under such sections exceeds so much of the basis of the option as is attributable to such share.

[Sec. 421 as amended by sec. 1, Act of February 11, 1958 (Pub. Law 85-320, 72 Stat. 4); sections 25 and 26, Technical Amendments Act 1958 (72 Stat. 1623, 1624); sec. 221(a), Rev. Act 1964 (78 Stat. 63)]

PAR. 5. Section 1.421-1 is amended by revising the heading thereof, and by adding a new paragraph (g) at the end thereof. These revised and added provisions read as follows:

§ 1.421-1 Effective dates and meaning and use of certain terms.

(g) Effective dates. Sections 1.421-1 through 1.421-5 are applicable only to options granted after February 26, 1945,

and before January 1, 1964, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, before the amendments made by section 221 of the Revenue Act of 1964 (78 Stat. 63). Section 1.421-6 is applicable only to options granted on or after February 26, 1945, and all references to sections of the Code are to the Internal Revenue Code of 1954, as amended. Sections 1.421-7 and 1.421-8 are applicable only to options granted after December 31, 1963, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, as amended.

PAR. 6. Section 1.421-6 is amended by revising paragraphs (a) (1), (d) (7), and (f) thereof. These amended provisions read as follows:

§ 1.421-6. Options to which section 421 does not apply.

(a) *Scope of section.* (1) If an employer or other person grants to an employee or other person for any reason connected with the employment of such employee an option to purchase stock of the employer or other property, and if section 421 is not applicable, then this section shall apply. This section will apply, for example, when an option is not a qualified or restricted stock option at the time it is granted or an option granted under an employee stock purchase plan, or when an option is modified so that it no longer qualifies as such an option, or when there is a disqualifying disposition of stock acquired by the exercise of such an option so that section 421 does not apply. When an option is granted for any reason connected with the employment of an employee, this section applies, if section 421 does not apply, irrespective of whether the option is granted by the employer, by a parent or subsidiary of the employer, by a stockholder of any of such corporations, or by any other person, and irrespective of whether the option is granted to the employee, to a member of his family, or to any other person, and irrespective of whether the option is to purchase the stock of the employer, the stock of the parent or subsidiary of the employer, the stock of any other corporation, or to purchase any other property. In addition, § 1.61-15 makes the rules of this section applicable in determining the time when certain other options result in the realization of income and the amount of such income.

(d) Options without a readily ascertainable fair market value.

(7) Notwithstanding the other provisions of this paragraph, if this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a qualified or restricted stock option, or acquired by the exercise of an option granted under an employee stock purchase plan, the taxable year of the employee for which he is required to include in his gross income the compensation resulting from such option is determined under section 421(b) and paragraph (b) of § 1.421-8 (or, in the case of taxable years ending before January 1, 1964, under section 421(f) and paragraph (e)

of § 1.421-5) and, in the case of a disqualifying disposition of a share of stock acquired by the exercise of a qualified stock option, the amount of such compensation shall be subject to the limitation provided by section 422(c)(4) and paragraph (b) of § 1.422-1.

(f) *Deductions.* If the employer grants an option to which this section applies, the employer of the employee in connection with whose employment the option is granted is considered to have paid compensation to such employee at the same time and in the same amount as such employee is considered under paragraph (c) or (d) of this section to have realized compensation. The deductibility of the amount considered so paid is determined under section 162 or other provision of the Code which is applicable to such a payment. Whether such amount may be deducted in the taxable year considered so paid, or whether such amount is a capital expenditure which is not deductible or which may be amortized, depends upon the nature of the transaction involved and the facts and circumstances of each case. If this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a qualified or restricted stock option, or acquired by the exercise of an option granted under an employee stock purchase plan, the employer's taxable year for which such compensation is deductible is determined under section 421(b) and paragraph (b) of § 1.421-8 (or, in the case of taxable years ending before January 1, 1964, under section 421(f) and paragraph (e) of § 1.421-5).

PAR. 7. There are inserted immediately after § 1.421-6 the following new sections:

§ 1.421-7. Meaning and use of certain terms.

(a) *Option.* (1) For purposes of sections 421 through 425, the term "option" includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (e) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract. See section 423.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1964, grants to

an employee the right to purchase 1,000 shares of its stock on or after June 1, 1965, another 1,000 shares on or after June 1, 1966, and a further 1,000 shares on or after June 1, 1967, all shares to be purchased before June 1, 1968, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1964, of three options, each for the purchase of 1,000 shares. However, if a corporation grants to an employee on January 1, 1965, the right to purchase 1,000 shares of its stock at \$65 per share during 1965, or at \$75 per share during 1966, or at \$85 per share during 1967, such an arrangement will be construed as the grant to the employee on January 1, 1965, of but one option for the purchase of 1,000 shares, which ceases to be outstanding when fully exercised at the price in effect at the time of exercise.

(b) *Statutory options.* (1) The term "statutory option", used for purposes of convenience hereinafter in this section and in §§ 1.421-8 through 1.425-1, means a qualified stock option, as defined by section 422(b) and § 1.422-2; an option granted under an employee stock purchase plan, as defined by section 423(b) and § 1.423-2; and a restricted stock option, as defined in section 424(b) and § 1.424-2.

(2) An option may qualify as a statutory option only if the option is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime of such individual, only by him. See sections 422(b)(6), 423(b)(9), and 424(b)(2). Accordingly, an option which is transferable by the individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a statutory option. However, in case the option or the plan under which the option was granted contains a provision permitting the individual to whom the option was granted to designate the person who may exercise the option after his death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a statutory option.

(3) (i) The determination of whether an option is a statutory option is made as of the date such option is granted. An option which is a statutory option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a statutory option when granted does not become such an option by reason of subsequent events. See, however, paragraph (e) of § 1.425-1, relating to modification, extension, or renewal of an option.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). S-1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1964, P grants to an employee of P a statutory option to purchase a share of stock of S-1. On January 1, 1965, S sells a portion of the S-1 stock which it owns to an unre-

lated corporation and, as of that date, S-1 ceases to be a subsidiary of S. On May 1, 1965, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. Section 421 applies to such exercise.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1964, S-1 is not a subsidiary of either S or P. Such option is not a statutory option on June 1, 1964. On January 1, 1965, S purchases from an unrelated corporation a sufficient number of shares of S-1 stock to make S-1, as of that date, a subsidiary of S. On May 1, 1965, while still employed by P, the employee exercises his option to purchase a share of S-1 stock. The employee has not exercised a statutory option.

(c) Time and date of granting option.

(1) For purposes of sections 421 through 425, the words "the date of the granting of the option" and "the time such option is granted", and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. However, under section 425(1), if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of, or registration with, some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of a related corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1964, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation's stock, exer-

cisable by X on or after June 1, 1965, provided he is employed by the corporation on June 1, 1965, and provided that A's profits during the fiscal year preceding the year of exercise exceed \$200,000. Such an option is granted to X on June 1, 1964, and will be treated as outstanding as of such date.

(d) Stock and voting stock. For purposes of sections 421 through 425, the term "stock" means capital stock of any class, including voting or nonvoting common or preferred stock. Except as otherwise provided, the term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term "stock" as used in such sections, provided such stock otherwise possesses the rights and characteristics of capital stock. For purposes of determining what constitutes voting stock in ascertaining whether a plan has been approved by stockholders or whether the limitations pertaining to voting power contained in sections 422(b)(7), 423(b)(3) and 424(b)(3) and the regulations thereunder have been met, stock which does not have voting rights until the happening of an event, such as the default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Moreover, stock which does not possess a general voting power, and may vote only on particular questions, is not voting stock. However, if such stock is entitled to vote on whether a stock option plan is to be adopted, it is voting stock for the purpose of ascertaining whether the plan has been approved by the shareholders.

(e) Option price. (1) For purposes of sections 421 through 425, the term "option price" or "price paid under the option" means the consideration in money or other property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term "option price" does not include amounts paid as interest under a deferred payment arrangement or treated as unstated interest under section 483 and the regulations thereunder. Thus, for example, section 483 is applicable in determining whether the pricing requirements of section 422(b)(4), 423(b)(6), 424(b)(1), or 424(c) are met and is applicable in determining the basis of any stock acquired pursuant to the exercise of a statutory option. However, with respect to statutory options granted prior to January 1, 1965, the determination of whether the applicable pricing requirements are met shall be made without regard to section 483, but section 483 shall be taken into consideration in determining basis for purposes of determining gain or loss.

(2) In the case of a statutory option, any reasonable valuation method may be used for the purpose of determining whether at the time the option is granted the option price satisfies the pricing requirements of section 422(b)(4) (relating to qualified stock options), section 423(b)(6) (relating to employee stock purchase plans), or section 424(b)(1) (relating to restricted stock options),

whichever is applicable, with respect to the stock subject to the option. Such methods include the valuation methods described in § 20.2031-2 of this chapter (Estate Tax Regulations).

(f) Exercise. For purposes of sections 421 through 425, the term "exercise", when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. A promise to pay the option price does not constitute an exercise of the option unless the optionee is subject to personal liability on such promise. An agreement or undertaking by the employee to make payments under an employee stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(g) Transfer. For purposes of sections 421 through 425, the term "transfer", when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a statutory option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

(h) Employment relationship. (1) Section 421 is applicable to the exercise of a statutory option only if at the time the option is granted, the optionee is an employee of the corporation granting the option, or a related corporation of such corporation, unless the option has been assumed or a new option has been issued in its place under section 425(a). In case of such an assumption or issuance, the optionee must, at the time of such assumption or issuance, be an employee of the corporation so assuming or issuing the option, or a related corporation of such corporation. The determination of whether the optionee is an employee at the time the option is granted (or at the time of the assumption or issuance under section 425(a)) will be made in accordance with the rules contained in section 3401(c) and the regulations thereunder. As to the granting of an option conditioned upon employment, see paragraph (c)(2) of this section. A statutory option must be granted for a reason connected with the individual's employment by the corporation or by its related corporation.

(2) In order to qualify for the special tax treatment of section 421, in addition to meeting the requirements of subparagraph (1) of this paragraph, an individual exercising a qualified stock option or an option granted under an employee stock purchase plan must, at all times during the period beginning with the date of the granting of such option and ending at the time of such exercise or on the day 3 months before the date of such exercise, be an employee of either the corporation granting such option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a

stock option in a transaction to which section 425(a) applies. For this purpose, the employment relationship in respect of an option granted in accordance with the requirements of subparagraph (1) of this paragraph will be treated as continuing intact while the individual is on military or sick leave if the period of such leave does not exceed 90 days, or, if longer, so long as the individual's right to reemployment with the corporation granting the option (or a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which sec. 425(a) applies) is guaranteed either by statute or by contract. Where the period of military or sick leave exceeds 90 days and where the individual's right to reemployment is not guaranteed either by statute or by contract, the employment relationship will be deemed to have terminated on the 91st day of such leave.

(3) For purposes of determining whether an individual meets the requirements of this paragraph, the term "employer corporation", as used in section 425 (e) and (f), shall be read as "grantor corporation" or "corporation issuing or assuming a stock option in a transaction to which section 425(a) is applicable", as the case may be. For purposes of the employment requirement, a corporation employing an optionee is considered a related corporation if it was a parent or subsidiary of the corporation granting or assuming the option during the entire portion of the requisite period of employment during which it was the employer of such optionee.

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, X Corporation granted a statutory option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1965, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises his statutory option on June 1, 1965, section 421 is not applicable to such exercise, because on June 1, 1965, A is not employed by the corporation which granted the option or by a related corporation of such corporation, nor was he employed by any of such corporations within 3 months before June 1, 1965.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 425(a). If A exercises the option to purchase the share of M stock on June 1, 1965, section 421 is applicable for A is then employed by a corporation which issued an option under section 425(a).

Example (3). E is an employee of P Corporation. On June 1, 1964, P grants E a statutory option to purchase a share of P stock. On June 1, 1965, P acquires 100 percent of the stock of S Corporation; on such date S becomes a subsidiary of P. On July 1, 1965, E ceases to be employed by P and becomes employed by S. On October 10, 1965, while still employed by S, E exercises his option to buy P stock. Since E was at all times during the requisite period of employment an employee of either P, the corporation granting the option, or S, a subsidiary of the grantor during the period in which such corporation was E's employer, section 421 is applicable to the exercise of the option.

Example (4). Assume the same facts as in example (3) except assume that at the time E became an employee of S Corporation, S assumed E's option to purchase P stock under section 425(a). Section 421 is applicable to E's exercise of his option to buy P stock.

Example (5). M Corporation grants a qualified stock option to E, an employee of such corporation. E is an officer in a reserve Air Force unit. E goes on military leave with his unit for 3 weeks. Regardless of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder during such 3-week period, E's employment relationship with M is treated as uninterrupted during the period of E's military leave.

Example (6). Assume the same facts as in example (5) and assume further that E's active duty status is extended indefinitely, but that E has an employment contract with M which provides that upon the termination of any military duty E may be required to serve. E will be entitled to reemployment with M or a parent or subsidiary of M. E exercises his M option while on active military duty. Irrespective of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder at the time of such exercise or within 3 months before such exercise, section 421 can apply to such exercise.

Example (7). X Corporation grants a qualified stock option to A, an employee of X Corporation, whose employment contract provides that in the event of illness, A's right to reemployment with X, or a parent or subsidiary of X, will continue for 1 year after the time A becomes unable to perform his duties for X. A falls ill for 90 days. For purposes of section 422(a)(2), A's employment relationship with X will be treated as uninterrupted during the 90-day period. If A's incapacity extends beyond 90 days, then, for purposes of section 422(a)(2), A's employment relationship with X will be treated as continuing uninterrupted until A's reemployment rights terminate. Under section 422(a)(2), A has 3 months in which to exercise his qualified stock option after his employment relationship with X (and its parent and subsidiary corporation) is terminated.

(1) **Related corporation.** The term "related corporation", used for purposes of convenience in this section and §§ 1.421-8 through 1.425-1, means a corporation which is a parent or subsidiary corporation (as defined by section 425 (e) and (f) and the regulations thereunder).

§ 1.421-8 General rules.

(a) **Effect of qualifying transfer.** (1) If a share of stock is transferred to an individual pursuant to his exercise of a statutory option, and if the requirements of section 422(a) (relating to qualified stock options), section 423(a) (relating to employee stock purchase plans), or section 424(a) (relating to restricted stock options), whichever is applicable, are met, then—

(i) Except as provided in section 422 (c)(1) (relating to exercise of option when price is less than value of stock), and paragraph (e)(2) of § 1.422-2, 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;

(ii) No deduction under section 162 or the regulations thereunder (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a related corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) and paragraph (a) of § 1.425-1 (relating to corporate reorganizations, liquidations, etc.) applies, with respect to the share so transferred; and

(iii) No amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

(2) For the purpose of this paragraph, each share of stock transferred pursuant to a statutory option is treated separately. For example, if an individual, while employed by a corporation granting him a statutory option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(b) **Effect of disqualifying disposition.** (1) The disposition of a share of stock, acquired by the exercise of a statutory option before the expiration of the applicable holding period as determined under section 422(a)(1), 423 (a)(1), or 424(a)(1), makes section 421 inapplicable to the transfer of such share. The income attributable to such transfer shall be treated by the individual as income received in the taxable year in which such disposition occurs. Similarly, a deduction under section 162 attributable to the transfer of the share of stock pursuant to the exercise of the option shall be allowable for the taxable year in which such disposition occurs to the employer corporation, its parent or subsidiary corporation or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies. In such cases, no amount shall be treated as income, and no amount shall be allowed as a deduction, for any taxable year other than the taxable year in which the disposition occurs. If the stock was transferred pursuant to the exercise of the option in a taxable year other than the taxable year of the disposition, the amount of the deduction shall be determined as if the employee had been paid compensation at the time provided in paragraph (d) of § 1.421-6.

(2) Section 421 is not made inapplicable by a transfer before the expiration of the applicable holding period as determined under section 422(a)(1), 423 (a)(1), or 424(a)(1), if such transfer is not a disposition of the stock as defined in section 425(c) and paragraph (c) of § 1.425-1, for example, a transfer from the decedent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by

the decedent. In case a statutory option is exercised by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (c) of this section.

(3) For special rules relating to a disqualifying disposition of a share of stock acquired by the exercise of a qualified stock option, see paragraph (b) of § 1.422-1.

(c) *Exercise by estate.* (1) If a statutory option is exercised by the estate of the individual to whom the option was granted, or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual, section 421(a) applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, except as provided by section 422(c)(1) and paragraph (e)(2) of § 1.422-2, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to such exercise of the option. Nor does section 421(a) become inapplicable if such executor, administrator, or person disposes of the stock so acquired before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1). This special rule does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss. The executor, administrator, or such person need not exercise the option within three months after the death of the individual to whom the option was granted for section 421(a) to be applicable. However, the exercise of the option must be pursuant to the terms of the option, and any change in the terms of the option is subject to the rules of paragraph (e) of § 1.425-1, relating to the modification, extension, or renewal of the option. Section 421(a) is applicable even though such executor, administrator, or person is not employed by the corporation granting the option, or a related corporation, either when the option is exercised or at any time. However, section 421(a) is not applicable to an exercise of the option by the estate or by such person, unless the individual to whom the option was granted met the employment requirements of section 422(a)(2), 423(a)(2), or 424(a)(2), whichever is applicable, either at the time of his death or within three months before such time. If the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual, section 421(a) is not applicable to the exercise. For example, if the option is sold by the estate, section 421(a) does not apply to an exercise of the option by such buyer; but if the option is distributed by the administrator to an heir as part of the estate, section 421(a) is applicable to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets,

or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock. Therefore, if section 423(c), or 424(c)(1) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 423(c) or 424(c)(1) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3) (i) If, under section 422(c)(1), 423(c), or 424(c)(1), an amount is required to be included in the gross income of the estate or of such person, the estate or such person shall be allowed a deduction as a result of the inclusion of the value of the option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691(c) by treating the option as an item of gross income in respect of a decedent under section 691 and by treating the amount required to be included in gross income under section 422(c)(1), 423(c), or 424(c)(1), as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an amount includible under section 422(c)(1), 423(c), or 424(c)(1). For the rules relating to the computation of a deduction under section 691(c), see § 1.691(c)-1.

(ii) The application of subdivision (i) may be illustrated by the following example:

Example. On June 1, 1964, E was granted an option under an employee stock purchase plan to purchase for \$85 one share of the stock of his employer. On such day, the fair market value of such stock was \$100 per share. E died on February 1, 1966, without having exercised such option. The option was, however, exercisable by his estate, and for purposes of the estate tax was valued at \$30. On March 1, 1966, the estate exercised the option, and on March 15, 1966, sold for \$150 the share of stock so acquired. For its taxable year including March 15, 1966, the estate is required by sections 421(c)(1)(B) and 423(c) to include in its gross income as compensation the amount of \$15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421(c)(2), the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691(a), and no deductions referred to in section 691(b), so that the value for estate tax purposes of the option, \$30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the option in the estate of E is \$10. Since \$15, the amount includible in gross income by reason of sections 421(c)(1)(B) and 423(c), is less than the value for estate tax purposes of the option, only 15% of the estate tax attributable to the inclusion of the option in the estate is deductible; that is, 15% of \$10, or \$5. No deduction under section 421(c)(2) is allowable with respect to any capital gain.

(4) (i) In the case of an employee dying before January 1, 1957, the basis of any share of stock acquired by the exercise of a restricted stock option under this paragraph, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 424(c)(1). The basis of the share shall not be increased by reason of the inclusion of the value of the restricted stock option in the estate for estate tax purposes.

(ii) (a) In the case of an employee dying after December 31, 1956, the basis of any share of stock acquired by the exercise of an option under this paragraph, determined under section 1011, shall be increased by an amount equal to the portion of the basis of the option attributable to such share. For example, if a statutory option to acquire 10 shares of stock has a basis of \$100, the basis of one share acquired by a partial exercise of the option, determined under section 1011, would be increased by 1/10th of \$100, or \$10. The option acquires a basis, determined under section 1014(a), only if the transfer of the share pursuant to the exercise of such option qualifies for the special tax treatment provided by section 421(a). To the extent the option is so exercised, in whole or in part, it will acquire a basis equal to its fair market value at the date of the employee's death or, if an election is made under section 2032, its value at its applicable valuation date. In certain cases, the basis of the share is subject to the adjustments provided by (b) and (c) of this subdivision, but such adjustments are only applicable in the case of an option which is subject to section 422(c)(1), 423(c), or 424(c)(1).

(b) If the amount which would have been includible in gross income under section 422(c)(1), 423(c), or 424(c)(1) had the employee exercised the option on the date of his death and held the share at the time of his death exceeds the amount which is includible in gross income under such section, the basis of the share, determined under (a) of this subdivision, shall be reduced by such excess. For example, if \$15 would have been includible in the gross income of the employee had he exercised the option and held such share at the time of his death, and only \$10 is includible under section 422(c)(1), 423(c), or 424(c)(1), the basis of the share, determined under (a) of this subdivision, would be reduced by \$5. For purposes of determining the amount which would have been includible in gross income under section 422(c)(1), 423(c), or 424(c)(1), if the employee had exercised the option and held such share at the time of his death, the amount which would have been paid for the share shall be computed as if the option had been exercised on the date the employee died.

(c) If the amount includible in gross income under section 422(c)(1), 423(c), or 424(c)(1), exceeds the portion of the basis of the option attributable to the share, the basis of the share, determined under (a) of this subdivision, shall be increased by such excess. Thus, if \$15

is includible in gross income under such section, and the basis of the option with respect to the share is \$10, the basis of the share, determined under (a) of this subdivision, will be increased by \$5.

(iii) If a statutory option is not exercised by the estate of the individual to whom the option was granted, or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual, the option shall be considered to be property which constitutes a right to receive an item of income in respect of a decedent to which the rules of sections 691 and 1014(c) apply.

(iv) The application of this subparagraph may be illustrated by the following examples:

Example (1). On June 1, 1955, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for \$85. The fair market value of the X Corporation stock on such date was \$100 per share. On June 1, 1956, E died. The fair market value of X Corporation stock on such date exceeded \$100 per share and the fair market value of the option on the applicable valuation date was \$35. On August 1, 1964, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was \$90. The estate is required by section 424(c)(1) to include \$5 in its gross income as compensation. Since E died before January 1, 1957, the basis of the share is \$90 (the \$85 paid for the stock plus the \$5 includible in gross income as compensation), and the basis of the share is not increased by reason of the inclusion of the value of the option in the estate of E (see section 1014(d) (as in effect with respect to taxable years ending before January 1, 1957)). Thus, no gain or loss is realized on the disposition of the share since the basis of the share is equal to the sale price.

Example (2). On June 1, 1964, the X Corporation granted to E, an employee, an option under its employee stock purchase plan to purchase a share of X Corporation stock for \$85. The fair market value of X Corporation stock on such date was \$100 per share. On June 1, 1966, E died. The fair market value of X Corporation stock on such date exceeded \$100 per share and the fair market value of the option on the applicable valuation date was \$35. On August 1, 1966, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was \$120. The basis of the share is \$120 (the \$85 paid for the stock plus the \$35 basis of the option). When the share is sold for \$120, the estate is required to include \$15 in its gross income as compensation. Since \$15 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)(b) of this subparagraph does not apply. Moreover, since the \$15 includible in the gross income of the estate does not exceed the basis of the option (\$35), subdivision (ii)(c) of this subparagraph does not apply. Since the basis of the stock and the sale price are the same, no gain or loss is realized by the estate on the disposition of the share.

Example (3). Assume the same facts as in example (2), except that the fair market value of the share of stock at the time of its sale was \$90. The basis of the share, determined under subdivision (ii)(a) of this subparagraph, is \$120 (the \$85 paid for the stock plus the \$35 basis of the option). When the share is sold for \$90, the estate is

required to include \$5 in its gross income as compensation. If the employee had exercised the option and held the share at the time of his death, \$15 would have been includible in gross income as compensation for the taxable year ending with his death. Since such amount exceeds by \$10 the amount which the estate is required to include in its gross income, subdivision (ii)(b) of this subparagraph applies, and the basis of the share (\$120), determined under subdivision (ii)(a) of this subparagraph is reduced by \$10. Accordingly, the basis is \$110, and a capital loss of \$20 is realized on the disposition of the share.

Example (4). Assume the same facts as in example (2), except that the fair market value of the option on the applicable valuation date was \$5, and that the fair market value of X Corporation stock on the date the employee died did not exceed \$100. The basis of the share, determined under subdivision (ii)(a) of this subparagraph, is \$90 (the \$85 paid for the stock plus the \$5 basis of the option). When the share is sold for \$120, the estate is required to include \$15 in its gross income as compensation. Since such amount exceeds by \$10 the basis of the option, subdivision (ii)(c) of this subparagraph applies, and the basis of the share (\$90), determined under subdivision (ii)(a) of this subparagraph, is increased by \$10. Accordingly, the basis is \$100 and a capital gain of \$20 is realized on the disposition of the share.

Example (5). Assume the same facts as in example (2), except that on June 1, 1966, the date the employee died, the fair market value of X Corporation stock was \$98, and that on June 1, 1967, the alternate valuation date, the fair market value of the stock had declined substantially, and the fair market value of the option was \$5. On August 1, 1967, the estate of E exercised the option and sold the share when its fair market value was \$92. The basis of the share, determined under subdivision (ii)(a) of this subparagraph, is \$90 (the \$85 paid for the stock plus the \$5 basis of the option). When the share is sold for \$92, the estate is required to include \$7 in its gross income as compensation. Since \$13 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)(b) of this subparagraph applies, and the basis of the share (\$90), determined under subdivision (ii)(a) of this subparagraph, is reduced by \$6 to \$84. Furthermore, since the \$7 that the estate is required to include in its gross income when the share is sold for \$92 exceeds by \$2 the basis of the option, subdivision (ii)(c) of this subparagraph applies, and the basis of the share (\$84), determined under subdivision (ii)(a) and (ii)(b) of this subparagraph, is increased by \$2. Accordingly, the basis is \$86 and a capital gain of \$6 is realized on the disposition of the share.

(d) **Exercise by deceased employee during lifetime.** If a statutory option is exercised by an individual to whom the option was granted and the individual dies before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), section 421(a) does not become inapplicable if the executor or administrator of the estate of such individual, or any person who acquired such stock by bequest or inheritance or by reason of the death of such individual, disposes of such stock before the expiration of such applicable holding period. This rule does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss.

(e) **Incorporation by reference.** Any requirement that an option expressly contain or state a prescribed limitation or term will be considered met if such limitation or term is set forth in a statutory option plan and is incorporated by reference by the option. Thus, if a statutory option plan expressly provides that no option granted thereunder shall be exercisable after five years from the date of grant, and if an option granted thereunder expressly provides that the option is granted subject to the terms and limitations of such plan, the option will be regarded as being, by its terms, not exercisable after the expiration of 5 years from the date such option is granted.

§ 1.422 Statutory provisions; qualified stock options.

Sec. 422. Qualified stock options—(a) In general. Subject to the provisions of subsection (c)(1), section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of a qualified stock option if—

(1) No disposition of such share is made by such individual within the 3-year period beginning on the day after the day of the transfer of such share, 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, such individual was an employee of either 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 425(a) applies.

(b) **Qualified stock option.** For purposes of this part, the term "qualified stock option" means an option granted to an individual after December 31, 1963 (other than a restricted stock option granted pursuant to a contract described in section 424(c)(3)(A)), 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 of the granting corporation within 12 months before or after the date such plan is adopted;

(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 5 years from the date such option is granted;

(4) Except as provided in subsection (c)(1), 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 exercisable while there is outstanding (within the meaning of subsection (c)(2)) any qualified stock option (or restricted stock option) which was granted, before the granting of such option, to such individual to purchase stock in his employer corporation or in a corporation which (at the time of the granting of such option) is a parent or subsidiary corporation of the employer corporation, or in a predecessor corporation of any of such corporations;

(6) Such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribu-

tion, and is exercisable, during his lifetime, only by him; and

(7) Such individual, immediately after such option is granted, does not own stock possessing more than 5 percent of the total combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation; except that if the equity capital of such corporation or corporations (determined at the time the option is granted) is less than \$2,000,000, then, for purposes of applying the limitation of this paragraph, there shall be added to such 5 percent the percentage (not higher than 5 percent) which bears the same ratio to 5 percent as the difference between such equity capital and \$2,000,000 bears to \$1,000,000.

(c) *Special rules*—(1) *Exercise of option when price is less than value of stock.* If a share of stock is transferred pursuant to the exercise by an individual of an option which fails to qualify as a qualified stock option under subsection (b) because there was a failure in an attempt, made in good faith, to meet the requirement of subsection (b) (4), the requirement of subsection (b) (4) shall be considered to have been met, but there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income for the taxable year in which such option is exercised, an amount equal to the lesser of—

(A) 150 percent of the difference between the option price and the fair market value of the share at the time the option was granted, or

(B) The difference between the option price and the fair market value of the share at the time of such exercise.

The basis of the share acquired shall be increased by an amount equal to the amount included in his gross income under this paragraph in the taxable year in which the exercise occurred.

(2) *Certain options treated as outstanding.* For purposes of subsection (b) (5)—

(A) Any restricted stock option which is not terminated before January 1, 1965, and

(B) Any qualified stock option granted after December 31, 1963,

shall be treated as outstanding until such option is exercised in full or expires by reason of the lapse of time. For purposes of the preceding sentence, a restricted stock option granted before January 1, 1964, shall not be treated as outstanding for any period before the first day on which (under the terms of such option) it may be exercised.

(3) *Options granted to certain shareholders.* For purposes of subsection (b) (7)—

(A) The term "equity capital" means—

(i) In the case of one corporation, the sum of its money and other property (in an amount equal to the adjusted basis of such property for determining gain), less the amount of its indebtedness (other than indebtedness to shareholders), and

(ii) In the case of a group of corporations consisting of a parent and its subsidiary corporations, the sum of the equity capital of each of such corporations adjusted, under regulations prescribed by the Secretary or his delegate, to eliminate the effect of intercorporate ownership and transactions among such corporations;

(B) The rules of section 425(d) shall apply in determining the stock ownership of the individual; and

(C) Stock which the individual may purchase under outstanding options shall be treated as stock owned by such individual.

If an individual is granted an option which permits him to purchase stock in excess of the limitation of subsection (b) (7) (determined by applying the rules of this paragraph), such option shall be treated as meeting the requirement of subsection (b) (7) to

the extent that such individual could, if the option were fully exercised at the time of grant, purchase stock under such option without exceeding such limitation. The portion of such option which is treated as meeting the requirement of subsection (b) (7) shall be deemed to be that portion of the option which is first exercised.

(4) *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 a qualified stock option makes a disposition of such share within the 3-year period 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.

(5) *Certain transfers by insolvent individuals.* If an insolvent individual holds a share of stock acquired pursuant to his exercise of a qualified stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary, in any proceeding under the Bankruptcy Act or any other similar insolvency proceeding, neither such transfer nor any other transfer of such share for the benefit of his creditors in such proceeding, shall constitute a "disposition of such share" for purposes of subsection (a) (1).

(6) *Application of subsection (b) (5) where options are for stock of same class in same corporation.* The requirement of subsection (b) (5) shall be considered to have been met in the case of any option (referred to in this paragraph as "new option") granted to an individual if—

(A) The new option and all outstanding options referred to in subsection (b) (5) are to purchase stock of the same class in the same corporation, and

(B) The new option by its terms is not exercisable while there is outstanding (within the meaning of paragraph (2)) any qualified stock option (or restricted stock option) which was granted, before the granting of the new option, to such individual to purchase stock in such corporation at a price (determined as of the date of grant of the new option) higher than the option price of the new option.

[Sec. 422 as added by sec. 221(a), Rev. Act 1964 (78 Stat. 63)]

§ 1.422-1 Qualified stock options—general rules.

(a) *Applicability of section 421(a).*

(1) (i) Subject to the provisions of section 422(c) (1), the special rules of income tax treatment provided in section 421(a) are applicable with respect to the transfer of a share of stock to an individual pursuant to his exercise of a qualified stock option provided that the following conditions are satisfied—

(a) The individual must make no disposition of such share before the expiration of the 3-year period beginning on the day after the day of the transfer of such share, and

(b) 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, the individual was an employee of either the corporation granting the option, a

related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

(ii) For rules relating to the requisite employment relationship, see paragraph (h) of § 1.421-7.

(2) (i) An exception to the holding period requirement of section 422(a) (1) is provided with respect to certain transfers by insolvent individuals. If an insolvent individual holds a share of stock acquired pursuant to his exercise of a qualified stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary in any proceeding under the Bankruptcy Act or any other similar insolvency proceeding (such as an assignment for the benefit of creditors, a composition, etc.), neither such transfer, nor any other transfer of such share for the benefit of the insolvent individual's creditors in such proceeding shall constitute a disposition of such share for the purpose of section 422(a) (1). For the purpose of this subparagraph, an individual is an insolvent only if his liabilities exceed his assets, or if he is unable to satisfy his liabilities as they become due.

(ii) Notwithstanding that a transfer by the trustee or other fiduciary is not treated as a disposition for the purpose of section 422(a) (1), such transfer may constitute a sale or exchange for purposes of recognizing capital gain or loss with respect to the share so transferred. For example, if the trustee transfers the share to a creditor in the insolvency proceeding in complete or partial satisfaction of such creditor's claim against the insolvent individual, capital gain or loss must be recognized by the insolvent individual to the extent of the difference between the fair market value of the share on the date of such transfer and the adjusted basis of such share. To the extent any transfer by the trustee or other fiduciary (other than a transfer back to the insolvent individual) is not for the exclusive benefit of the creditors in such insolvency proceeding, such transfer will be treated as a disposition for purposes of section 422(a) (1). Similarly, if the trustee or other fiduciary transfers the share back to the insolvent individual, any subsequent disposition of the share which is not made in respect of the insolvency proceeding and for the exclusive benefit of the creditors in such proceeding will be treated as a disposition for purposes of section 422(a) (1).

(b) *Failure to satisfy holding period.* (1) The special tax treatment of section 421(a) is not applicable with respect to the transfer of a share of stock pursuant to the exercise of a qualified stock option if the individual disposes of the share before the expiration of the 3-year period beginning on the day after the day of the transfer of such share to him. For general rules relating to the effect of such a disqualifying disposition, see section 421(b) and paragraph (b) of § 1.421-8. For definition of the term "disposition", see section 425(c) and paragraph (c) of § 1.425-1.

(2) If an individual who has acquired a share of stock by the exercise of a qualified stock option makes a disqualifying disposition of such share, and if such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to the individual, then, under section 422(c)(4), the amount includible in the gross income of such individual, and deductible from the income of his employer corporation, its parent or subsidiary corporation or a corporation issuing on assuming an option in a transaction to which section 425(a) applies, 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. Thus, the limitation does not apply when the disqualifying disposition is a sale described in section 1091 (relating to loss from wash sales of stock or securities), a gift, or a sale described in section 267(a)(1) (relating to sales between related persons), since a loss sustained in any such transaction would not be recognized. Subject to the limitation provided by section 422(c)(4) and this subparagraph, the amount of compensation attributable to the exercise of the option is determined under § 1.421-6 and paragraph (b) of § 1.421-8.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, X Corporation grants a qualified stock option to A, an employee of X Corporation, entitling A to purchase one share of X Corporation stock. On June 1, 1965, A exercises his option and the share of X Corporation stock is transferred to him on June 10, 1965. In order to meet the 3-year holding period requirement of section 422(a)(1), A must not dispose of the share acquired by exercise of his qualified stock option before June 11, 1968.

Example (2). Assume the same facts as in example (1) and assume further that the option price was \$100, the fair market value of X Corporation stock on June 1, 1964, and that the fair market value of X Corporation stock was \$200 on June 1, 1965, the date of exercise. A makes a disposition by selling his share on June 1, 1967, for \$250. Under § 1.421-6 (relating to options to which sec. 421 does not apply) the amount of compensation attributable to A's exercise is \$100 (the difference between the fair market value of the share at the date of exercise, \$200, and the amount paid for the share, \$100). Because the amount realized, \$250, is greater than the value of the stock at exercise, section 422(c)(4) does not apply and thus does not affect the amount includible as compensation in A's gross income and deductible by X. A must include in his gross income for the taxable year in which the sale occurred \$100 as compensation and \$50 as capital gain (\$250, the amount realized from the sale, less A's basis of \$200, the \$100 paid for the share plus the \$100 increase in basis resulting from the inclusion of that amount in A's gross income as compensation attributable to the exercise of the option). For its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of \$100 for compensation attributable to A's exercise of the qualified stock option.

Example (3). Assume the same facts as in example (2), except that A sells the share for \$150. Under section 422(c)(4), A must in-

clude only \$50 (the excess of the amount realized on such sale, \$150, over the adjusted basis of the share, \$100) in his gross income as compensation attributable to the exercise of his qualified stock option instead of the \$100 which otherwise would have been includible as compensation under § 1.421-6. A realizes no capital gain or loss as a result of the sale, since his basis for the share is \$150 (the \$100 which he paid for the share, plus the \$50 increase in basis resulting from the inclusion of that amount in A's gross income as compensation attributable to the exercise of the option). For its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of \$50 for compensation attributable to A's exercise of the qualified stock option.

Example (4). Assume the same facts as in example (2), except that A sells the share for \$50. The limitation of section 422(c)(4) applies and A is not required to include any amount in gross income as compensation attributable to the exercise of his qualified stock option. A is allowed a capital loss of \$50 (the difference between the amount realized on the sale, \$50, and the adjusted basis of the share, \$100). X Corporation is not allowed any deduction for compensation attributable to A's exercise of the qualified stock option and disqualifying disposition.

Example (5). Assume the same facts as in example (3) except that A sells the share to his son for \$150. Under section 267, a loss sustained in such a sale would not be recognized. Therefore, the limitation of section 422(c)(4) does not apply. Accordingly, under § 1.421-6, A must include \$100 (the difference between the fair market value of the share at the date of exercise, \$200, and the amount paid for the share, \$100) in his gross income as compensation attributable to the exercise of his qualified stock option in the taxable year in which the disqualifying disposition occurred. A will recognize no capital gain or loss on the transaction. X Corporation will be allowed a \$100 deduction for compensation paid to A in its taxable year in which the disqualifying disposition occurred.

Example (6). Assume the same facts as in example (3) except assume that, as a result of the failure of a good-faith attempt to set the option price at the fair market value of X Corporation stock on the date of grant, the option price was set at \$90 instead of \$100. Under section 422(c)(1), A includes \$15 (the lesser of 150 percent of the difference between the option price, \$90, and the fair market value of the share at grant, \$100; or the difference between the option price, \$90, and the fair market value of the share at exercise, \$200) in his gross income as compensation in the year of exercise. Under section 421(a)(2), X Corporation is allowed no deduction at such time. Upon his sale of the share, A will include \$45 (the excess of the amount realized on such sale, \$150, over the adjusted basis of the share, \$105 (\$90, the option price, plus \$15, the amount included in A's gross income as compensation at exercise)) in his gross income as compensation attributable to his exercise in the taxable year in which the disqualifying disposition occurs. A will have no capital gain or loss as a result of such sale. Under section 422(c)(4), X Corporation will be allowed a deduction of \$45 as compensation attributable to A's exercise, in the taxable year of A's disqualifying disposition.

§ 1.422-2 Qualified stock options defined.

(a) **Qualified stock option defined.** (1) (i) The term "qualified stock option" means an option which meets the requirements of section 422(b)(1) through (7) and this section. Section 422(b)(1)

requires that a qualified stock option be granted pursuant to a plan which meets certain requirements. See paragraph (b) of this section. However, options granted after December 31, 1963, and before January 1, 1965, need not be granted under an option plan to be qualified stock options. See paragraph (b)(4) of this section. Section 422(b)(2) provides that in order for an option to be a qualified stock option it must be granted within 10 years of the adoption of the plan or the date of stockholder approval, whichever is earlier. In order to grant qualified stock options after the expiration of such 10-year period, a new plan must be adopted and approved. See paragraph (c) of this section. A new plan may retain all of the terms of the old plan or may include new terms. Paragraphs (3) through (6) of section 422(b) establish certain requirements which must be met by the terms of a qualified stock option. An option which, when granted, does not by its terms meet these requirements cannot be a qualified stock option. See paragraphs (d) through (g) of this section. However, if the terms of an option granted after December 31, 1963, are amended before January 1, 1965, to permit the option to satisfy the requirements of section 422(b)(3), (4), or (5), such amendment will be given retroactive effect. See paragraphs (d)(2), (e)(3), and (f)(3)(ii) of this section. In addition, if the terms of an option are amended at any time to permit such option to meet the requirement of section 422(b)(6), such amendment will be given retroactive effect. See section 425(h)(3)(B) and paragraph (e)(5)(ii) of § 1.425-1. Section 422(b)(7) bars the grant of a qualified stock option to any employee whose stock ownership exceeds the limits provided by such section. To the extent the grant of an option entitles the employee to purchase stock in excess of such limitation, the option cannot be a qualified stock option. See paragraph (h) of this section.

(ii) The determination of whether a particular option is a qualified stock option is made at the time such option is granted. Accordingly, except as is otherwise specifically provided by sections 421 through 425 and the regulations thereunder, events subsequent to the grant of an option cannot affect the status of the option. For example, an option which is granted to an employee whose stock ownership exceeds the limitation provided by section 422(b)(7) is not a qualified stock option when granted and can never become a qualified stock option, irrespective of whether the individual's stock ownership is within such limitation at the time such option is exercised.

(2) Section 422 and this section do not apply to an option which is a restricted stock option.

(b) **Option plan.** (1) A qualified stock option granted after December 31, 1964, must be granted pursuant to a plan which is approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted. The approval of the stock-

holders must comply with all applicable provisions of the corporate charter and bylaws, and the law of the State of incorporation and must represent the express consent of stockholders holding at least a majority of the voting stock of the corporation voting in person or by proxy at a duly held stockholders' meeting. Thus, if neither the charter, bylaws or applicable State law prescribes the degree of stockholder approval required for the granting of qualified options, the approval of stockholders holding a majority of the voting stock of the corporation voting at a duly held meeting will suffice. However, if the applicable law requires that stockholders holding two-thirds of the voting stock must approve the granting of such options, such two-thirds requirement must be met.

(2) The plan required by section 422 must be approved within 12 months before or after the date the plan is adopted. Ordinarily, a plan is adopted when approved by the board of directors and the date of such board action will be the reference point for determining whether stockholder approval comes within the 12-month period. However, if the board's action is subject to a condition, such as shareholder approval, or the happening of a particular event, the plan is adopted on the date the condition is met or the event occurs, unless the board's resolution fixes the date of approval as the date of the board's action.

(3) The plan as adopted and approved must designate the aggregate number of shares which may be issued under the plan and the employees or class of employees eligible to receive options under the plan. A plan which merely provides that the number of shares which may be issued under options shall not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan will not satisfy the requirement that the plan state the aggregate number of shares which may be issued under options. However, the maximum number of shares which may be issued under the plan may be stated in terms of a percentage of either the authorized, issued or outstanding shares at the date of the adoption of the plan. The requirement that the plan as adopted and approved must indicate the class of employees (or the employees) eligible to receive options will be considered satisfied by a general designation of the class of employees eligible to receive options under the plan. Thus, such designations as "key employees of the grantor corporation", "all salaried employees of the grantor corporation and its subsidiaries, including subsidiaries which become such after adoption of the plan" or "all employees of the corporation" will meet this requirement. Moreover, this requirement will be considered satisfied although the board of directors or another group is given authority to select the particular employees who are to receive options from a described class and to determine the number of shares to be optioned to each such employee. The provisions relating to the aggregate number of shares to be

issued under the plan and the class of employees (or the employees) eligible to receive options under the plan, are the only provisions of a stock option plan which require stockholder approval for purposes of section 422(b)(1). Any increase in the aggregate number of shares which may be issued under the plan (other than an increase merely reflecting a change in capitalization such as a stock dividend or stock split-up), or change in the designation of the employees or class of employees eligible to receive options under the plan will be considered as the adoption of a new plan requiring stockholder approval within the prescribed 12-month period. Any other changes in the terms of a qualified stock option plan may be made without such changes being considered the adoption of a new plan. An option intended by the grantor corporation to be a qualified option will be treated as having been issued pursuant to a plan notwithstanding that the terms of the option conflict with certain terms of the plan unless such option is issued to an employee not eligible to receive options under the plan or options have been issued on stock in excess of the aggregate number of shares which may be issued under the plan. A stock option plan which otherwise meets the requirements of section 422(b)(1) and this paragraph may be availed of for the granting of qualified stock options although the adoption and approval of such plan occurred before January 1, 1964.

(4) In the case of an option granted after December 31, 1963, and before January 1, 1965, section 422(b)(1) and (2), and this paragraph do not apply. Thus, an option granted during the calendar year 1964, which meets the requirements of section 422(b)(3) through (7), will be a qualified stock option irrespective of whether such option is granted pursuant to a plan; or, if granted pursuant to a plan, irrespective of whether such option was granted within 10 years from the date such plan was adopted or approved by shareholders, and irrespective of whether such plan specifies the employees or class of employees to whom options may be granted or the number of shares which may be granted under options.

(c) *Duration of plan.* A qualified stock option must be granted within 10 years from the date the option plan (required by section 422(b)(1) and paragraph (b) of this section) is adopted, or the date such plan is approved by the stockholders, whichever is earlier. Thus, a plan for the granting of qualified stock options expires 10 years after the adoption or approval of such plan, whichever is earlier. This is equally true whether the adoption or approval occurred before January 1, 1964 (as in the case of a restricted stock option plan which met the requirement of section 422(b)(1) when adopted and approved), or after such date. For example, a restricted stock option plan which was adopted June 1, 1958, and approved August 1, 1956, and which otherwise met the requirements of section 422(b)(1) and paragraph (b) of this section may be availed

of for the granting of qualified stock options only through May 31, 1966, after which date the plan will expire for purposes of section 422(b)(1) and (2).

(d) *Period for exercising options.* (1) A qualified stock option by its terms must not be exercisable after the expiration of 5 years from the date the option is granted. Except as provided by subparagraph (2) of this paragraph, an option which does not contain such a provision when granted cannot be a qualified stock option.

(2) An exception to the requirement of section 422(b)(3) and this paragraph is provided in the case of options granted after December 31, 1963, and before January 1, 1965. If, at the time of grant, such an option did not contain the provision required by section 422(b)(3) and this paragraph, the option may be amended before January 1, 1965, to add such a provision and such amendment will not be treated as a modification under section 425(h)(1) or § 1.425-1. Furthermore, the amendment will be considered as retroactive to the date of grant of the option and will in no way affect such grant.

(e) *Option price.* (1) In general, the option price of a qualified stock option must not be less than the fair market value of the stock subject to the option at the time the option is granted. For general rules relating to the option price see paragraph (e) of § 1.421-7. For rules relating to the determination of when an option is granted, see paragraph (c) of § 1.421-7. The option price may be determined in any manner so long as the minimum price possible under the terms of the option cannot (except as provided by section 422(c)(1) and subparagraph (2) of this paragraph) be less than the fair market value of the stock at the date of grant.

(2) (i) Under section 422(c)(1), if a share of stock is transferred to an individual pursuant to his exercise of an option which fails to qualify as a qualified stock option because there was a failure of an attempt, made in good faith, to meet the requirements of section 422(b)(4) and subparagraph (1) of this paragraph, the requirements of such section and subparagraph shall be considered to have been met. However, in such a case there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in the gross income of the individual for his taxable year in which such option is exercised, an amount equal to the lesser of—(a) 150 percent of the difference between the option price and the fair market value of the stock at the time the option was granted, or (b) the difference between the option price and the fair market value of the stock at the time of such exercise. The basis of the stock acquired shall be increased by an amount equal to the amount included in the gross income of the individual.

(ii) Whether there was a good-faith attempt to set the option price at not less than the fair market value of the stock subject to the option at the time the option was granted depends on the facts

and circumstances surrounding the case. For example, in the case of a publicly held stock which was actively traded in an established market at the time the option was granted, determining the fair market value of such stock by any reasonable method using market quotations would establish that a good-faith attempt to meet the requirements of section 422(b)(4) and this paragraph was made. On the other hand, in the case of a stock which is not publicly traded, if it is shown, for example, that the fair market value of the stock at the date of grant was based upon an average of the fair market values as of such date set forth in the opinions of completely independent and well-qualified experts, such a showing will establish that there was a good-faith attempt to meet the requirements of section 422(b)(4) and this paragraph. However, amounts treated as unstated interest under section 483 and the regulations thereunder, if attributable to the exercise of options granted after December 31, 1964, and amounts paid as interest under a deferred payment arrangement are not includible as part of the "option price". See paragraph (e)(1) of § 1.421-7. In the case of an option granted after July 1, 1966, an attempt to set the option price at not less than fair market value will not be regarded as made in good faith where an adjustment of the option price to allow for the application of section 483 results in the option price being lower than the fair market value on which the option price was based.

(3) A further exception to the requirement of section 422(b)(4) and subparagraph (1) of this paragraph is provided in the case of options granted after December 31, 1963, and before January 1, 1965. An amendment to the terms of such an option made before January 1, 1965, to satisfy the requirements of section 422(b)(4) and subparagraph (1) of this paragraph will not be considered a modification for purposes of section 425(h) and § 1.425-1. Furthermore, the amendment will be considered as retroactive to the date of grant of the option, and will in no way affect such grant.

(f) *Prior outstanding options.* (1) (i) Section 422(b)(5) provides that a qualified stock option must, by its terms, not be exercisable while there is outstanding any qualified or restricted stock option which was granted, before the granting of the new qualified stock option, to the individual to purchase stock in his employer corporation, or in a corporation which, at the time of the granting of the new qualified stock option, is a parent or subsidiary corporation of the employer corporation, or a predecessor corporation of any of such corporations. Thus, in general, under section 422(b)(5), a qualified stock option must not be exercisable until all qualified and restricted stock options which were previously granted to the individual by the grantor corporation, or by related or predecessor corporations, have been exercised in full or have expired solely by reason of the lapse of time. The limitation of section 422(b)(5) applies irre-

spective of whether the transfer of stock pursuant to such prior outstanding restricted or qualified stock options can qualify for the special tax treatment of section 421. The exercisability of a qualified stock option is not affected by options which are not qualified or restricted stock options.

(ii) If the new qualified stock option being granted to the individual, and all the outstanding qualified and restricted stock options previously granted to the individual, are to purchase stock of the same class in the same corporation, section 422(c)(6) provides that the requirement of section 422(b)(5) will be considered to have been met if the new option by its terms is not exercisable while there is outstanding (within the meaning of section 422(c)(2)) any such previously granted option with an option price (determined as of the date of grant of the new option) higher than the option price of the new option. Thus, a qualified stock option to which section 422(c)(6) applies may be exercisable without regard to a prior outstanding option to purchase stock of the same class in the same corporation, if the option price payable under such prior outstanding option is not greater than the price of the new option.

(iii) The restriction imposed by section 422(b)(5) (or sec. 422(c)(6)(B)) must be set forth in the terms of the option unless the individual in fact has no prior outstanding qualified or restricted stock options (or restricted stock options previously granted which will become outstanding at a future time) to purchase stock of the grantor corporation, a related corporation, or a predecessor corporation of any of such corporations, at the time the new qualified stock option is granted. An option which incorporates by reference the provision of a plan containing the restrictions required by section 422(b)(5) (or 422(c)(6)(B)) will be treated as an option which by its terms sets forth such restrictions. Except as provided by this subdivision, if an option is granted which does not contain the restriction imposed by section 422(b)(5), either expressly or by incorporation by reference, such option cannot be a qualified stock option, irrespective of whether such restriction is in fact complied with at the time the option is exercised, and irrespective of whether the plan under which the option is granted contains the restriction required by section 422(b)(5). If the terms of an option granted after December 31, 1963, and before January 1, 1965, are amended before January 1, 1965, to satisfy the requirements of this subdivision, the amendment will not be considered a modification for purposes of section 425(h) and § 1.425-1, the amendment will be considered as retroactive to the date of grant of the option, and the amended option will be treated as an outstanding qualified stock option as of the date of the original grant.

(2) For purposes of section 422(b)(5) and this paragraph, the term "predecessor corporation" means a corporation which was a party to a transaction described in section 425(a) (irrespective of

whether a substitution or assumption under such section was in fact effected) with the grantor corporation, or a corporation which, at the time the new qualified stock option is granted, is a related corporation of the grantor corporation, or a predecessor corporation of any of such corporations.

(3) (i) Except as is otherwise provided by this subparagraph, for purposes of section 422(b)(5), a qualified or restricted stock option is treated as outstanding according to its original terms until such option is exercised in full or expires by reason of the lapse of time. Thus, for example, if an option outstanding according to its terms for 5 years is revised to shorten to 1 year the period during which it may be exercised, such option is treated as outstanding for 5 years from the original date of grant for purposes of section 422(b)(5), notwithstanding the revision. If any portion of such an option is not exercised, such portion will be treated as outstanding until the expiration of the maximum period for which such portion, according to the terms of the option when granted, could have been exercised under any circumstances. A qualified or restricted stock option previously held by an individual and replaced in a transaction to which section 425(a) applies will not thereafter be treated as outstanding. However, if a qualified or restricted stock option is modified and under section 425(h) such modification is considered as the granting of a new option (even though for other purposes only one option is regarded as being in existence), the original qualified or restricted stock option continues for the purposes of section 422(b)(5) to be outstanding, and may prevent an exercise of the new qualified or restricted stock option until the original option has, by its original terms, expired.

(ii) A restricted stock option granted before January 1, 1964, will not be treated as outstanding for any period before the first day on which (under the terms of such option) it may be exercised. If such an option is exercisable in installments, each installment will be treated as a separate option for purposes of this rule, with each installment becoming outstanding as of the first day it becomes exercisable under the terms of the option. However, this special rule does not affect the date on which the option is treated as granted. Thus, such a restricted stock option affects the exercise of a qualified stock option granted subsequent to the grant of such a restricted stock option to the extent the qualified stock option is not exercised before the restricted stock option becomes outstanding. See example (7) under subparagraph (4) of this paragraph.

(iii) A restricted stock option terminated before January 1, 1965, will not be treated as outstanding irrespective of the reason for which such option was terminated. If, under this subdivision, the number of shares subject to a restricted stock option is reduced, such option will be treated as outstanding for purposes of section 422(b)(5) only with respect to such reduced number of shares.

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). S Corporation is a subsidiary of P Corporation. In 1963 E was an employee of S Corporation and was granted a restricted stock option by S to buy S stock. In June of 1964 E left S and became an employee of X Corporation, where he was granted a qualified stock option to purchase X stock. X Corporation is neither a related nor predecessor corporation of P or S. On June 1, 1965, E leaves X to become an employee of P Corporation, and on such date E is granted a qualified stock option by P to purchase P stock. E's restricted stock option to buy S stock was not cancelled during 1964, and both his restricted stock option on S stock and his qualified stock option on X stock are outstanding on June 1, 1965, when E is granted a qualified stock option to purchase P stock. In order to meet the requirement of section 422(b)(5), E's qualified stock option on P stock must, by its terms, not be exercisable until E's restricted stock option on S stock is exercised in full or expires solely by reason of the lapse of time.

Example (2). E is an employee of P Corporation. E holds a restricted stock option granted June 1, 1963, and a qualified stock option granted June 1, 1965. Both options were granted to him by P to purchase P stock. E has been granted no other qualified or restricted stock options by P, a related corporation, or a predecessor corporation of any of such corporations. The price payable under E's restricted stock option as of June 1, 1965, is \$100; the option price of E's qualified stock option is \$90. On June 1, 1966, P grants another qualified stock option to E to purchase P stock at \$95. Under section 422(b)(5) and (c)(6), neither of E's qualified stock options may be exercisable until E's restricted stock option is exercised in full or expires solely by reason of the lapse of time. Assuming the restricted stock option is fully exercised on June 1, 1967, E will be free to exercise either his 1965 or 1966 qualified stock option.

Example (3). Assume the same facts as in example (2). On November 30, 1964, P cancels E's restricted stock option and in exchange therefor issues a qualified stock option to E in place of the cancelled restricted stock option. For purposes of section 422(b)(5), E's restricted stock option is treated as terminated and no longer outstanding as of such date, and will not affect the exercise of E's 1964, 1965, or 1966 qualified stock options. The qualified stock option issued in place of E's restricted stock option will be treated as outstanding for purposes of section 422(b)(5) as of November 30, 1964.

Example (4). Assume the same facts as in example (3) except assume that the cancellation of the restricted stock option takes place on November 30, 1965, and that the new option is a qualified stock option as of such date. Assume further that the option prices are as follows:

Restricted stock option.....	\$100
Qualified stock option (granted June 1, 1965).....	90
Qualified stock option (granted November 30, 1965, upon cancellation of restricted stock option).....	85
Qualified stock option (granted June 1, 1966).....	95

and that each qualified stock option runs 5 years from grant, and that the restricted stock option, according to its terms when granted, would have expired solely by reason of the lapse of time at the close of business on May 31, 1969. Under section 422(b)(5), and (c)(2) and (6), E's restricted stock option is treated as outstanding according to its original terms when granted, and E can-

not exercise any of his qualified stock options until June 1, 1969 (the first day after the expiration of the original period for which E's restricted stock option was granted). On June 1, 1969, E's June 1, 1965, qualified stock option will be fully exercisable. E's November 30, 1965, qualified stock option will not be exercisable until after the full exercise or expiration of E's June 1, 1965, qualified stock option. The exercise of E's June 1, 1966, qualified stock option is barred only by E's restricted stock option. Thus, upon the expiration of E's restricted stock option, E is free to exercise either his June 1965 qualified stock option, or his June 1966 qualified stock option, while the exercise of his November 1965 qualified stock option must await the full exercise or expiration of his June 1965 qualified stock option.

Example (5). Assume the same facts as in example (4). On June 1, 1968, P Corporation sells all of its assets to M Corporation, and on such date E becomes an employee of M Corporation. Assume further that M Corporation substitutes new options to purchase M stock for the P options held by E, in a transaction to which section 425(a) applies. For purposes of section 422(b)(5), each M Corporation option received by E in substitution of a P Corporation option will be treated as outstanding to the same extent and in the same manner as the P option which it replaces. Thus, none of the M options received by E in substitution for his qualified stock options on P stock may be exercisable before June 1, 1969, and the M option issued in substitution for E's November 1965, qualified stock option may be exercisable only after the full exercise or expiration of the M option issued in substitution for E's June 1, 1965, option on P stock. If, in 1969, E is granted another qualified stock option by M Corporation, such qualified stock option will be subject to the qualified stock options granted by M to E in 1968 in substitution for E's qualified stock options to purchase P stock. The qualified stock options to purchase P stock which were replaced by M in the transaction to which section 425(a) applied will not be treated as outstanding for any purpose under section 422(b)(5).

Example (6). Assume the same facts as in example (5) except assume that M does not effect a substitution or assumption of E's P Corporation qualified stock options under section 425(a). Although P is neither a parent nor subsidiary of M, for purposes of section 422(b)(5), P is a predecessor corporation of M Corporation. Accordingly, any qualified stock options granted to E by M (or its parent or subsidiary corporations, or a predecessor corporation of any of such corporations) must, by their terms, not be exercisable until the expiration of the option periods for all of E's qualified and restricted stock options granted to E by P Corporation. Section 422(c)(6) cannot apply to permit E to exercise his M options before the expiration of the option periods of his P options because not all of E's qualified and restricted stock options which are outstanding (within the meaning of section 422(c)(2)) are to purchase stock of the same class in the same corporation.

Example (7). F is an employee of N Corporation. Prior to January 1, 1964, N granted a restricted stock option to F to purchase 100 shares of N Corporation stock at a price of \$100 per share. The option is exercisable in installments as follows: 20 shares on or after June 1, 1965; another 40 shares on or after June 1, 1967; and the last 40 shares on or after June 1, 1969. Under section 422(c)(2), each installment of F's restricted stock option will be treated as becoming outstanding as of the first day on which such installment may be exercised. Thus, under the facts given, any qualified stock options

granted to F by N Corporation to purchase N stock at less than \$100 per share will be affected by F's restricted stock option as follows: Before June 1, 1965, F may exercise such qualified stock options without regard to his restricted stock option; between May 31, 1965, and June 1, 1967, F may exercise such qualified stock options only after the full exercise of the first installment of his restricted stock option; between May 31, 1967, and June 1, 1969, F may exercise such qualified stock options only after the full exercise of the first and second installments of his restricted stock option; after May 31, 1969, F may exercise such qualified stock options only after the full exercise or expiration of all installments of his restricted stock option.

Example (8). F is an employee of N Corporation. On January 1, 1966, N grants F a qualified option to purchase 100 shares of N Corporation stock at a price of \$100 a share at any time prior to January 1, 1971. The stock is then selling at \$100 a share. On January 1, 1967, when the stock was selling at \$95 a share, N modified the option to permit F to exercise the option at any time prior to January 1, 1972. Under section 425(h) N's modification is treated as the granting of a new option to F. Although for other purposes F, after the modification, has one option to purchase 100 shares of N Corporation stock at a price of \$100 a share at any time prior to January 1, 1972, for purposes of section 422(b)(5), F is regarded as having two options, an "original" option to purchase 100 shares at \$100 a share prior to January 1, 1971, and a modified option to purchase 100 shares at \$100 a share prior to January 1, 1972. If the terms of the modified option include the language of section 422(c)(6)(B), so that section 422(b)(5) does not apply, the modified option will be exercisable immediately as there is no prior outstanding option to purchase stock at a higher price.

Example (9). F is an employee of N Corporation. On January 1, 1966, N grants F a qualified option to purchase 100 shares of N Corporation stock at a price of \$100 a share at any time prior to January 1, 1971. The stock is then selling at \$100 a share. On January 1, 1967, when the stock was selling at \$95 a share, N modified the option to permit F to purchase 100 shares of N Corporation stock at a price of \$95 a share and to exercise the option at any time prior to January 1, 1972. Under section 425(h) N's modification is treated as the granting of a new option to F. Although for other purposes F, after the modification, has one option to purchase 100 shares of N Corporation at a price of \$95 a share at any time prior to January 1, 1972, for purposes of section 422(b)(5), F is regarded as having two options. Thus, F may not exercise the modified option until January 1, 1971, as until that date, the original option is regarded as outstanding. If the option period had not been extended, F would never have been able to exercise the modified option because of the limitation of section 422(b)(5) and the existence, for the purposes of that section, of a prior outstanding option having the same expiration date as the new option.

(g) **Restriction on transferability.** A qualified stock option must, by its terms, not be transferable by the individual to whom it is granted otherwise than by will or the laws of descent and distribution, and must be exercisable, during the lifetime of such individual, only by him. For general rules relating to the restriction on transferability required by section 422(b)(6), see paragraph (b)(2) of § 1.421-7. For a limited exception to the requirement of section 422(b)(6), see section 425(h)(3).

(h) *Options granted to certain shareholders.* (1) (i) In general, an option is not a qualified stock option to the extent that, immediately after such option is granted, the optionee owns stock possessing more than 5 percent of the total combined voting power or value of all classes of stock of the employer corporation, or a related corporation of such corporation. Section 422(c)(3) provides that, in applying the limitation of section 422(b)(7), the rules of section 425(d) (relating to attribution of stock ownership) shall apply in determining the stock ownership of the individual, and stock which the individual may purchase under outstanding options (whether or not such options qualify for the special tax treatment afforded by section 421(a)) shall be treated as stock owned by the individual. An option is outstanding for purposes of sections 422(b)(7) and 422(c)(3) although under its terms it may be exercised only in installments or after the expiration of a fixed period of time. The rules of section 422(c)(2) which are applied in determining whether an option is outstanding for purposes of section 422(b)(5) do not apply with respect to section 422(b)(7) and paragraph (c)(3).

(ii) The determination of the percentage of the total combined voting power or value of all classes of stock of his employer corporation (or a related corporation of such corporation) that is owned by the individual is made by comparing the voting power or value of the shares owned (or treated as owned) by the individual to the aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option to such individual. The aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option does not include the voting power or value of treasury shares or shares authorized for issue under outstanding options held by the individual or any other person.

(2) If an individual is granted an option which permits him to purchase stock in excess of the limitation of section 422(b)(7) (determined by applying the rules of section 422(c)(3) and this paragraph), such option shall be treated as meeting the requirement of section 422(b)(7) to the extent that such individual could, if the option were exercised in full at the time of grant, purchase stock under such option without exceeding such limitation. If shares in excess of the number allowable under section 422(b)(7) are transferred to the individual under an option, such shares will not be treated as transferred pursuant to the exercise of a qualified stock option, irrespective of whether the stock ownership of the individual at the time of such transfer exceeds the limitation of section 422(b)(7). The shares purchased under an option described in this subparagraph which will be treated as shares transferred pursuant to the exercise of a qualified stock option will be the first shares acquired under the option. If more shares are acquired in any one exercise of the option than can qualify as

being transferred pursuant to the exercise of a qualified stock option under the rules of section 422(b)(7) and this paragraph, the individual must designate which shares are to be treated as having been transferred pursuant to the exercise of a qualified stock option.

(3) (i) If at the time the option is granted the combined equity capital of the employer corporation and its related corporations does not exceed \$2,000,000, the 5-percent limitation of section 422(b)(7) is increased by adding to such 5 percent the percentage (not higher than 5 percent) which bears the same ratio to 5 percent as the difference between such combined equity capital and \$2,000,000 bears to \$1,000,000. Thus, if the employer corporation and its related corporations have combined equity capital of \$1,000,000 or less, an employee may be granted a qualified stock option so long as the value or voting power of the stock owned (or treated as owned) by such employee does not exceed 10 percent of the total combined voting power or value of all classes of stock of any of such corporations.

(ii) (a) Section 422(c)(3) provides that the term "equity capital" means, in the case of one corporation, the sum of its money and other property (in an amount equal to the adjusted basis of such property for determining gain), less the amount of its indebtedness (other than indebtedness to shareholders). In the case of a group of corporations consisting of a parent and its subsidiary corporations, the term "equity capital" means the sum of the equity capital of each of such corporations adjusted in the manner provided by (b) of this subdivision.

(b) In determining the equity capital of a corporation which is a member of a group of corporations consisting of a parent and its subsidiary corporations, the following adjustments shall be made:

(i) The sum of the money and other property (in an amount equal to the adjusted basis of such property for determining gain) of such corporation shall be reduced by the amount included in the equity capital of such corporation in respect of: stock owned by such corporation in any other corporation in the group; cash, property, or services due such corporation by any other corporation in the group; inventory owned by such corporation, to the extent the adjusted basis (for determining gain) of such inventory includes profits realized by any other corporation in the group; and fixed assets owned by such corporation, to the extent the adjusted basis (for determining gain) of such fixed assets includes profits realized by any other corporation in the group; and

(ii) The total indebtedness of such corporation which is taken into account in determining its equity capital shall be reduced by the amount of such indebtedness which is owed to any other corporation in the group.

In making the reductions required by this subdivision, no adjustments shall be made to reflect any minority interest in intercompany profits, indebtedness, or

stock ownership; and no reduction is required to be made in respect of amounts representing profits in the inventory or fixed assets of a corporation arising from intercompany transactions which occurred before such corporation became a member of the group.

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). E, an employee of M Corporation, owns 6,000 shares of the common stock of M Corporation, the only class of M stock outstanding. M has 100,000 shares of its common stock outstanding. M's equity capital (as defined by section 422(c)(3) and this paragraph) exceeds \$2,000,000. Since E owns 6 percent of the combined voting power or value of all classes of M Corporation stock, M cannot grant a qualified stock option to E. Any option granted to E which purports to be a qualified stock option will be treated as a compensatory option, and as such, subject to the rules of § 1.421-6 of the regulations. If E's father and brother each owned 3,000 shares of M stock, and E owned no M stock in his own name, the result in this case would be the same, since under section 425(d) a person is treated as owning stock held by his father and his brother. Similarly, the result would be the same if, instead of actually owning 6,000 shares, E merely held an option on 6,000 shares of M stock, irrespective of whether the transfer of stock under such option could qualify for the special tax treatment of section 421, since section 422(c)(3)(C) provides that stock which the individual may purchase under outstanding options shall be treated as stock owned by such individual.

Example (2). Assume the same facts as in example (1) and assume further that M is a subsidiary corporation of P Corporation. Irrespective of whether E owns any P stock, and irrespective of the amount of P's equity capital or number of P shares outstanding, E cannot receive a qualified stock option from P. This results from E's ownership of more than 5 percent of the total combined voting power of all classes of stock of a subsidiary of P Corporation, i.e., M Corporation. Thus, an individual who owns (or is treated as owning) stock in excess of the limitation of section 422(b)(7), in any corporation in a group of corporations, consisting of a parent and its subsidiary corporations, cannot receive a qualified stock option from any corporation in the group.

Example (3). F is an employee of R Corporation. R's equity capital is in excess of \$2,000,000. R has only one class of stock, of which 100,000 shares are issued and outstanding. Assuming F owns no stock in R or in any parent or subsidiary of R for purposes of section 422(b)(7), R can grant a qualified stock option to F for 5,000 shares, since immediately after the grant of the option F will be treated as owning 5,000 shares of a total of 100,000 shares actually issued and outstanding at such time. The 5,000 shares which F will be treated as owning by reason of section 422(c)(3)(C) will not be added to the 100,000 shares actually issued and outstanding immediately after the grant for purposes of determining whether F's stock ownership exceeds the limitation of section 422(b)(7).

Example (4). Assume the same facts as in example (3) and assume further that on June 1, 1965, R grants F an option, purporting to be a qualified stock option, for 5,200 shares at an option price of \$100 per share, the fair market value of R stock on such date. This option will only be a qualified stock option to the extent of 5,000 shares. Assume R transfers 5,000 shares to F pursuant to F's partial exercise of the option. Such transfer

can qualify for the special tax treatment of section 421. However, no further transfer of shares pursuant to an exercise of this option can qualify for the special tax treatment of section 421, since the option was not a qualified stock option when granted to the extent it covered more than 5,000 shares. This is true although F's stock ownership immediately after the transfer of the 5,000 shares to him does not exceed the 5-percent limitation of section 422(b)(7), since F owns only 5,200 shares (5,000 shares outright, plus 200 shares by reason of section 422(c)(3)(C)) of a total 105,000 shares actually issued and outstanding (the 100,000 shares issued and outstanding when the option was granted to F, plus an additional 5,000 shares issued and outstanding as a result of F's exercise).

Example (5). E is an employee of P Corporation. P owns 60 percent in value of the stock of S Corporation, and P and S have combined equity capital (as defined by section 422(c)(3)(A)(ii) and subparagraph (3) of this paragraph) of \$1,600,000. Since the combined equity capital of P and S is less than \$2,000,000, there may be added to the 5-percent limitation of section 422(b)(7) the additional percentage which bears the same proportion to 5 percent as the difference between the combined equity capital of P and S and \$2,000,000 (\$2,000,000 minus \$1,600,000, or \$400,000) bears to \$1,000,000. Accordingly, there may be added to the 5-percent limitation of section 422(b)(7) an additional 2 percent (\$400,000 is to \$1,000,000, as 2 percent is to 5 percent), resulting in a limitation of 7 percent (5 percent plus 2 percent) for purposes of section 422(b)(7). Thus, an option which otherwise meets the requirements of section 422(b) and which is granted to E by P or S to purchase the stock of either of such corporations will meet the requirement of section 422(b)(7) to the extent that, immediately after such option is granted, E will not own (or be treated as owning) stock in either P or S possessing more than 7 percent of the total combined voting power or value of all classes of the stock of either of such corporations which is actually issued and outstanding at such time. If, at the time the option is granted, E owns stock possessing more than 7 percent of the total combined voting power or value of the stock of either P or S, the option could not qualify as a qualified stock option, irrespective of which corporation's stock was the subject of the option.

§ 1.423 Statutory provisions; employee stock purchase plans.

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 December 31, 1963 (other than a restricted stock option granted pursuant to a plan described in section 424(c)(3)(B)), 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 6 months 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 425(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 percent 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. For purposes of this paragraph, the rules of section 425(d) shall apply in determining the stock ownership of an individual, and stock which the employee may purchase under outstanding options shall be treated as stock owned by the employee;

(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) Officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees;

(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 percent of the fair market value 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 percent 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) Five 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 fair market value 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.

For purposes of paragraphs (3) to (9), inclusive, where additional terms are contained in an offering made under a plan, such additional terms shall, with respect to options exercised under such offering, be treated as a part of the terms of such plan.

(c) **Special rule where option price is between 85 percent and 100 percent of value of stock.** If the option price of a share of stock acquired by an individual pursuant to a transfer to which subsection (a) applies was less than 100 percent of the fair market value of such share at the time such option was granted, then, in the event of any disposition of such share by him which meets the holding period requirements of subsection (a), or in the event of his death (when occurring) while owning such share, there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies, an amount equal to the lesser of—

(1) The excess of the fair market value of the share at the time of such disposition or death over the amount paid for the share under the option, or

(2) The excess of the fair market value of the share at the time the option was granted over the option price.

If the option price is not fixed or determinable at the time the option is granted, then for purposes of this subsection, the option price shall be determined as if the option were exercised at such time. In the case of the disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount so includible in his gross income.

[Sec. 423 as added by sec. 221(a), Rev. Act 1964 (78 Stat. 63)]

§ 1.423-1 Applicability of section 421 (a).

(a) **General rule.** Subject to the provisions of section 423(c) and paragraph (k) of this section, the special rules of income tax treatment provided in section 421(a) apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted after December 31, 1963, under an employee stock purchase plan provided that the following conditions are satisfied—

(1) The individual must make no disposition of such share within 2 years from the date of the granting of the option, nor within 6 months 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 three months before the date of such exercise, the individual must be an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

(b) *Cross-references.* For rules relating to the employment relationship, see paragraph (h) of § 1.421-7. For rules relating to the effect of a disqualifying disposition, see section 421(b) and paragraph (b) of § 1.421-8. For definition of the term "disposition", see section 425(c) and paragraph (c) of § 1.425-1.

§ 1.423-2 Employee stock purchase plan defined.

(a) *In general.* (1) The term "employee stock purchase plan" means a plan which meets the requirements of paragraphs (1) through (9) of section 423(b). If the terms of the plan do not satisfy the requirements of paragraphs (3) through (9) of section 423(b), such requirements may be satisfied by the terms of an offering made under such plan. However, in such a case, such requirements will be treated as satisfied only with respect to options exercised under such offering.

(2) The determination of whether a particular option is an option granted under an employee stock purchase plan is made at the time such option is granted. If the terms of an option are inconsistent with the terms of the employee stock purchase plan or an offering under such a plan, the option will not be treated as granted under an employee stock purchase plan. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b) (4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b) (4). If such an option is granted to an individual who is not entitled to the grant of an option under the terms of the plan or offering, such option will not be treated as an option granted under an employee stock purchase plan, and the grant of the option will not disqualify the plan or the options granted under such plan or offering.

For example, an option granted to an individual who is ineligible to receive an option under an employee stock purchase plan by reason of his ownership of 5 percent or more of the voting power or value of the stock of the grantor corporation (or a related corporation of such corporation), will not be treated as an option granted under an employee stock purchase plan, and the grant of such an option will not disqualify options granted under such plan from the special tax treatment of section 421. If all the options granted under an offering do not give the respective optionees the same rights and privileges, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. If, at the time an option is granted, it qualifies as an option granted under an employee stock purchase plan, but the terms of the option are not in fact met, the option will not qualify for the special tax treat-

ment of section 421. However, the failure of such an option to qualify for the special tax treatment of section 421, will not disqualify other options granted under the plan.

(b) *Options restricted to employees.* An employee stock purchase plan must provide that options are to be granted only to employees of the employer corporation or of its related corporations to purchase stock in any such corporation. If such a provision is not included in the terms of the plan, the plan will not be an employee stock purchase plan and options granted under such plan will not qualify for the special tax treatment of section 421. For rules relating to the employment requirement, see paragraph (h) of § 1.421-7.

(c) *Stockholder approval.* (1) An employee stock purchase plan must be approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted. The approval of the stockholders must comply with all applicable provisions of the corporate charter and bylaws, and the law of the State of incorporation and must represent the express consent of stockholders holding at least a majority of the voting stock of the corporation voting in person or by proxy at a duly held stockholders' meeting. Thus, if neither the charter, bylaws or applicable State law prescribes the degree of stockholder approval required for the granting of qualified options, the approval of stockholders holding a majority of the voting stock of the corporation voting at a duly held meeting will suffice. However, if the applicable State law requires that stockholders holding two-thirds of the voting stock must approve the granting of such options, such two-thirds requirement must be met.

(2) The plan required by section 423 must be approved within 12 months before or after the date the plan is adopted. Ordinarily, a plan is adopted when approved by the board of directors and the date of such board action will be the reference point for determining whether stockholder approval comes within the 12-month period.

(3) The plan as adopted and approved must designate the aggregate number of shares which may be issued under the plan, and the corporations or class of corporations whose employees will be offered options under such plan. A plan which merely provides that the number of shares which may be issued under options shall not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan will not satisfy the requirement that the plan state the aggregate number of shares which may be issued under options. However, the maximum number of shares which may be issued under the plan may be stated in terms of a percentage of either the authorized, issued or outstanding shares at the date of the adoption of the plan. The provisions relating to the aggregate number of shares to be issued under the plan and the employees (or class of employees) eligible to receive options under the plan,

are the only provisions of a stock option plan which require stockholder approval for purposes of section 423(b) (1).

(4) Any increase in the aggregate number of shares which may be issued under the plan (other than an increase merely reflecting a change in capitalization such as a stock dividend or stock split-up) will be treated as the adoption of a new plan requiring approval of the stockholders within 12 months of such adoption. Similarly, a change in the designation of corporations whose employees may be offered options under the plan will be treated as the adoption of a new plan requiring stockholder approval unless the plan provides that designations of participating corporations may be made from time to time from among a group consisting of the grantor corporation and its parent or subsidiary corporations. The group from among which such changes and designations are permitted without additional stockholder approval may include corporations having become parents or subsidiaries of the grantor after the adoption and approval of the plan. Any other changes in the terms of an employee stock purchase plan may be made without such changes being considered the adoption of a new plan.

(5) A plan which otherwise meets the requirements of section 423(b) and this section may be used as an employee stock purchase plan although the adoption and approval of such plan occurred before January 1, 1964.

(d) *Options granted to certain shareholders.* (1) An employee stock purchase plan must by its terms provide that no employee can be granted an option if such employee, immediately after the option is granted, owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or its parent or subsidiary corporation. In determining whether the stock ownership of an employee equals or exceeds this 5 percent limit, the rules of section 425(d) (relating to attribution of stock ownership) shall apply, and stock which the employee may purchase under outstanding options (whether or not such options qualify for the special tax treatment afforded by section 421(a)) shall be treated as stock owned by the employee. An option is outstanding for purposes of section 423(b) (3) although under its terms it may be exercised only in installments or after the expiration of a fixed period of time. If an option is granted to an individual whose stock ownership (as determined under this paragraph for purposes of section 423(b) (3)) exceeds the limitation of section 423(b) (3), no portion of such option will be treated as having been granted under an employee stock purchase plan.

(2) The determination of the percentage of the total combined voting power or value of all classes of stock of his employer corporation (or a related corporation of such corporation) that is owned by the individual is made by comparing the voting power or value

of the shares owned (or treated as owned) by the individual to the aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option to such individual. The aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option does not include the voting power or value of treasury shares or shares authorized for issue under outstanding options held by the individual or any other person.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). E, an employee of M Corporation, owns 6,000 shares of the common stock of M Corporation, the only class of M stock outstanding. M has 100,000 shares of its common stock outstanding. Since E owns 6 percent of the combined voting power or value of all classes of M Corporation stock, M cannot grant an option to E under M's employee stock purchase plan. If E's father and brother each owned 3,000 shares of M stock and E owned no M stock in his own name, the result in this case would be the same, since under section 425(d) a person is treated as owning stock held by his father and his brother. Similarly, the result would be the same if, instead of actually owning 6,000 shares, E merely held an option on 6,000 shares of M stock, irrespective of whether the transfer of stock under such option could qualify for the special tax treatment of section 421, since section 423(b)(3) provides that stock which the employee may purchase under outstanding options shall be treated as stock owned by such employee.

Example (2). Assume the same facts as in example (1) and assume further that M is a subsidiary corporation of P Corporation. Irrespective of whether E owns any P stock, E cannot receive an option from P under P's employee stock purchase plan since he owns 5 percent of the total combined voting power of all classes of stock of a subsidiary of P Corporation, i.e., M Corporation. Thus, an individual who owns (or is treated as owning) stock in excess of the limitation of section 423(b)(3), in any corporation in a group of corporations, consisting of a parent and its subsidiary corporations, cannot receive an option under an employee stock purchase plan from any corporation in the group.

Example (3). F is an employee of R Corporation. R has only one class of stock, of which 100,000 shares are issued and outstanding. Assuming F owns no stock in R or in any parent or subsidiary of R for purposes of section 423(b)(3), R can grant an option to F under its employee stock purchase plan for 4,999 shares, since immediately after the grant of the option, F would not own 5 percent or more of the combined voting power or value of all classes of R stock actually issued and outstanding at such time. The 4,999 shares which F would be treated as owning under section 423(b)(3) would not be added to the 100,000 shares actually issued and outstanding immediately after the grant for purposes of determining whether F's stock ownership exceeds the limitation of section 423(b)(3).

Example (4). Assume the same facts as in example (3) and assume further that on June 1, 1965, R grants F an option, purportedly under its employee stock purchase plan, for 5,000 shares. No portion of this option will be treated as granted under an employee stock purchase plan.

(e) *Employees covered by plan.* (1) [Reserved]

(2) For purposes of section 423(b)(3) the existence of the employment relationship between an individual and the corporation participating under the plan will be determined under paragraph (h) of § 1.421-7 (relating to employment relationship).

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). M Corporation has a stock purchase plan which meets all the requirements of section 423(b) except that by its terms, options are not required to be granted to employees whose weekly rate of pay is less than \$100. As a matter of corporate practice, M grants options under its plan to all employees, irrespective of their weekly rate of pay. M's plan is not an employee stock purchase plan.

Example (2). Assume the same facts as in example (1) and assume further that the first offering under M's plan provides by its terms that options will be granted to all employees of M Corporation. With respect to options exercised under such offering the terms of such offering will be treated as part of the terms of M's plan. Accordingly, stock transferred pursuant to options exercised under such offering will be treated as stock transferred pursuant to the exercise of options granted under an employee stock purchase plan for purposes of section 421.

(f) *Equal rights and privileges.* (1) An employee stock purchase plan must, by its terms, provide that all employees granted options under such plan shall have the same rights and privileges; however, a plan will not fail to satisfy this requirement merely because the amount of stock which may be purchased by any employee under such plan is determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation of employees, or because the plan provides that no employee may purchase more than a maximum amount of stock fixed under the plan. Thus, the provisions applying to one option under an offering (such as the provisions relating to the method of payment for the stock and the determination of the purchase price per share) must apply to all other options under such offering in the same manner. If all the options granted under a plan or offering do not, by their terms, give the respective optionees the same rights and privileges, none of such options shall be treated as having been granted under an employee stock purchase plan for purposes of section 421.

(2) The requirements of section 423(b)(5) and this paragraph do not prevent the maximum amount of stock which an employee may purchase from being determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation, of all employees. For example, if an employee stock purchase plan provides that the maximum amount of stock which each employee may purchase under the offering is one share for each \$100 of annual gross pay, options granted under such offering will be treated as meeting the requirement of section 423(b)(5). However, such a provision must not exclude employees from participation under the plan or offering. For example, a plan which provides for

the grant of options based on one share for each \$100 of annual gross pay in excess of \$10,000 will not meet the requirements of section 423(b)(5).

(3) [Reserved]

(g) *Option price.* (1) An employee stock purchase plan must, by its terms, provide that the option price will not be less than the lesser of—

(i) An amount equal to 85 percent of the fair market value of the stock at the time such option is granted, or

(ii) An amount which under the terms of the option may not be less than 85 percent of the fair market value of the stock at the time such option is exercised.

For definition of the term "option price", and general rules relating to such term, see paragraph (e) of § 1.421-7. For rules relating to the determination of when an option is granted, see paragraph (c) of § 1.421-7. Any option which does not meet the minimum pricing requirements of section 423(b)(6) and this paragraph will not be treated as granted under an employee stock purchase plan irrespective of whether the plan itself or the offering satisfies such requirements. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b)(4).

(2) The option price may be stated either as a percentage or as a dollar amount. If the option price is stated as a dollar amount, the requirement of section 423(b)(6) and this paragraph can only be met by a plan or offering in which the price is fixed at not less than 85 percent of the fair market value of the stock at the time the option is granted. If the fixed price is less than 85 percent of the fair market value of the stock at grant, the option cannot meet the requirement of section 423(b)(6) even if a decline in the fair market value of the stock results in such fixed price being not less than 85 percent of the fair market value of the stock at the time the option is exercised, since such a result was not certain to occur under the terms of the option.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). M Corporation has an employee stock purchase plan which provides that the option price will be 85 percent of the fair market value of the stock at grant, or 85 percent of the stock at exercise, whichever amount is the lesser. Upon the exercise of an option issued under M's plan, M agrees to accept an amount which is less than the minimum amount allowable under the terms of such plan. Notwithstanding that the option was issued under an employee stock purchase plan, the transfer of stock pursuant to the exercise of such option does not satisfy the requirement of section 423(b)(6) and cannot qualify for the special tax treatment of section 421.

Example (2). Assume the same facts as in example (1) and assume further that at the time of grant, the fair market value of M Corporation stock is \$100 per share and that the option price is set at 85 percent of the fair market value of M stock at exercise, but not less than \$80 per share. The option satisfies the requirement of section 422(b)(6), and can qualify for the special tax treatment of section 421.

Example (3). Assume the same facts as in example (2), except assume that the option price is set at 85 percent of the fair market value of M stock at exercise, but not more than \$80 per share. This option cannot satisfy the requirement of section 423(b)(6) irrespective of whether, at the time the option is exercised, 85 percent of the fair market value of M stock is \$80 or less.

(h) *Option period.* An employee stock purchase plan must, by its terms, provide that options granted under such plan cannot be exercised after the expiration of 27 months from the date of grant unless, under the terms of such plan, the option price is to be not less than 85 percent of the fair market value of the stock at the time of the exercise of the option. If the option price is to be not less than 85 percent of the fair market value of the stock at the time the option is exercised, then the option period provided under the plan must not exceed 5 years from the date of grant. If the requirement of section 423(b)(7) is not met by the terms of the plan or offering, options issued under such plan or offering will not be treated as options granted under an employee stock purchase plan irrespective of whether such options, by their terms, are exercisable beyond the period allowable under section 423(b)(7) and this paragraph. An option which provides that the option price is to be not less than 85 percent of the fair market value of the stock at exercise may have an option period of 5 years irrespective of whether the fair market value of the stock at exercise is more or less than the fair market value of such stock at grant. However, if the option provides that the option price is to be 85 percent of the fair market value of the stock at exercise, but not more than some other fixed amount, then irrespective of the price paid on exercise, the option period must not be more than 27 months.

(i) *Restriction on amount of optioned stock.* (1) Under section 423(b)(8), an employee stock purchase plan must, by its terms, provide that no employee may be permitted to purchase stock under all the employee stock purchase plans of his employer corporation and its related corporations at a rate which exceeds \$25,000 in fair market value of such stock (determined at the time the option is granted) for each calendar year in which any such option granted to such individual is outstanding at any time. In applying the limitation of section 423(b)(8)—

(i) The right to purchase stock under an option is deemed to accrue when the option (or any portion thereof) first becomes exercisable during the calendar year;

(ii) 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

(iii) 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.

If an option is granted under an employee stock purchase plan which satisfies the requirement of section 423(b)(8), but such option gives the optionee the right to buy stock in excess of the maximum rate allowable under such section and this paragraph, no portion of such option will be treated as having been granted under an employee stock purchase plan. Furthermore, if the option was granted to an employee entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 421.

(2) The limitation of section 423(b)(8) and this paragraph applies only to options granted under employee stock purchase plans and does not limit the amount of stock which an employee may purchase under qualified stock options (as defined in section 422(b)), restricted stock options (as defined in section 424(b)), or any other stock options (except those to which section 423 applies). Stock purchased under options to which section 423 does not apply will not limit the amount which an employee may purchase under an employee stock purchase plan, except for purposes of the 5-percent stock ownership provision of section 423(b)(3).

(3) Under the limitation of section 423(b)(8), an individual may purchase up to \$25,000 of stock (based on the fair market value of such stock at the time the option was granted) in each calendar year during which an option granted to such individual under an employee stock purchase plan is outstanding. Alternatively, an individual may purchase more than \$25,000 of stock (based on the fair market value of such stock at the time the option was granted) in a calendar year, so long as the total amount of stock which he purchases does not exceed \$25,000 in fair market value of such stock (determined at the time the option was granted) for each calendar year in which the option was outstanding. If in any calendar year the individual holds two or more outstanding options granted under employee stock purchase plans of his employer corporation, or a related corporation of such corporation, his purchases of stock attributable to such year under all such options must not exceed \$25,000 in fair market value of such stock (determined at the time such options were granted). Under an employee stock purchase plan, an individual may not purchase stock in anticipation that the option will be outstanding for some future year. Thus, the individual may

purchase only the amount of stock which does not exceed the limitation of section 423(b)(8) for the year of the purchase and for preceding years during which the option was outstanding. Thus, the amount of stock which may be purchased under an option depends on the number of years in which the option is actually outstanding. The amount of stock which may be purchased under an employee stock purchase plan may not be increased by reason of the failure to grant an option in an earlier year under such plan, or by reason of the failure to exercise an earlier option. For example, if an option is granted to an individual and expires without having been exercised at all, the failure to exercise the option does not increase the amount of stock which such individual may be permitted to purchase under an option granted in a year following the year of such expiration. If an option granted under an employee stock purchase plan is outstanding in more than one calendar year, stock purchased pursuant to the exercise of such an option will be applied first, to the extent allowable under section 423(b)(8) and this paragraph, against the \$25,000 limitation for the earliest year in which such option was outstanding, then, against the \$25,000 limitation for each succeeding year, in order. For example, if an individual purchases \$60,000 in fair market value of stock (determined at the time the option was granted) by the exercise of an option granted under an employee stock purchase plan of his employer corporation, and if such option was outstanding in 3 calendar years, then \$25,000 in fair market value of such stock (determined at the time the option was granted) will be attributed to the first calendar year in which such option was outstanding, another \$25,000 in fair market value of such stock will be attributed to the second calendar year in which such option was outstanding, and the remaining \$10,000 in fair market value of such stock will be attributed to the last calendar year in which such option was outstanding. Thus, the individual may receive a right under another option granted under such employee stock purchase plan (or under an employee stock purchase plan of a parent or subsidiary corporation of his employer corporation) entitling him to purchase another \$15,000 in fair market value of such stock (determined as of the date such option is granted) for such last calendar year.

(4) The application of section 423(b)(8) and this paragraph may be illustrated by the following examples:

Example (1). Assume that P Corporation maintains an employee stock purchase plan and that E is employed by P. On June 1, 1964, P grants E an option under the plan to purchase a total of 750 shares of P stock at \$85 per share. On such date, the fair market value of P stock is \$100 per share. The option provides that it cannot be exercised after May 31, 1966. Under section 423(b)(8), the option must not permit E to purchase more than 250 shares of P stock during the calendar year 1964, since 250 shares are equal to \$25,000 in fair market value of P stock determined at the time of grant. During the

calendar year 1965, E may purchase under such option an amount of P stock equal to the difference between \$50,000 in fair market value of P stock (determined at the time the option was granted) and the fair market value of P stock (determined at the time of grant of the option) purchased during 1964. During the calendar year 1966, E may purchase an amount of P stock equal to the difference between \$75,000 in fair market value of such stock (determined at the time of grant of the option) and the total amount of the fair market value of such stock (determined at the time of grant of the option) purchased under such option during the calendar years 1964 and 1965. E may purchase \$25,000 of stock for the year 1964 and \$25,000 of stock for the year 1966, although the option was outstanding for only a part of each of such years. However, E may not be granted another option under an employee stock purchase plan of P or a related corporation to purchase stock of any of such corporations during the calendar years 1964, 1965, and 1966, so long as the option granted June 1, 1964, is outstanding. If this option permitted E to purchase only \$15,000 of P's stock for each year it is outstanding, then E could be granted another option by P, or by a related corporation, in 1964, permitting him to purchase an additional \$10,000 of stock for each year it is outstanding.

Example (2). Assume the same facts as in example (1), and assume further that the option granted to E in 1964 is terminated in 1965 without any part of such option having been exercised, and that subsequent to such termination and during 1965, E is granted another option under P's employee stock purchase plan. Under such option, E may be permitted to purchase \$25,000 of stock for 1965. On the other hand, if, in 1966, E exercised the option granted to him in 1964 and purchased 600 shares of P stock, 500 shares, the maximum amount of stock which could have been purchased in 1965 under the option, is treated as having been purchased for the years 1964 and 1965. Thus, only 100 shares of the stock are treated as having been purchased for 1966, and E may be permitted under the new option to purchase for 1966 stock having a fair market value of \$15,000 at the time the new option is granted.

(j) *Restriction on transferability.* An employee stock purchase plan must, by its terms, provide that options granted under such plan are not transferable by the optionee otherwise than by will or the laws of descent and distribution, and must be exercisable, during his lifetime, only by him. For general rules relating to the restriction on transferability required by section 423(b)(9), see paragraph (b)(2) of § 1.421-7. For a limited exception to the requirement of section 423(b)(9), see section 425(h)(3).

(k) *Special rule where option price is between 85 percent and 100 percent of value of stock.* (1) (i) If all the conditions necessary for the application of section 421(a) exist, section 423(c) provides additional rules which are applicable in cases where, at the time the option is granted, the option price per share is less than 100 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 6-month holding periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the

sale or exchange of a capital asset) the lesser of—

(a) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time the option was granted, or

(b) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time of such disposition or death.

For purposes of applying the rules of section 423(c) and this paragraph, if the option price is not fixed or determinable at the time the option is granted, the option price will be computed as if the option had been exercised at such time. The amount of compensation resulting from the application of section 423(c) and this paragraph shall be included in the individual's gross income for the taxable year in which the disposition occurs, or for the taxable year closing with his death, whichever event results in the application of section 423(c).

(ii) The application of the special rules provided in section 423(c) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 423(c), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If, during his lifetime, the individual exercises an option granted under an employee stock purchase plan, but such individual dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of sections 421 and 423, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) If the special rules provided in section 423(c) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 423(c). However, the basis of a share of stock acquired after the death of an employee by the exercise of an option granted to such employee under an employee stock purchase plan shall be determined in accordance with the rules of section 421(c) and paragraph (c) of § 1.421-8. If the special rules provided in section 423(c) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's

death of any amount in his gross income under section 423(c). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, the X Corporation grants to E, an employee, an option under X's employee stock purchase plan to purchase a share of X Corporation's stock for \$85. The fair market value of the X Corporation stock on such date is \$100 per share. On June 1, 1965, E exercises the option and on that date the X Corporation transfers the share of stock to E. On January 1, 1967, E sells the share for \$150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) compensation in the amount of \$15 is includible in E's gross income for 1967, the year of the disposition of the share. The \$15 represents the difference between the option price (\$85) and the fair market value of the share on the date the option was granted (\$100), since such value is less than the fair market value of the share on the date of disposition (\$150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of \$85 is increased by \$15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$100. Since the share was sold for \$150, E realizes a gain of \$50, which is treated as long-term capital gain; (ii) the X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

Example (2). Assume the same facts as in example (1), except assume that E sells the share of X Corporation stock on January 1, 1968, for \$75, its fair market value on that date. Since \$75 is less than the option price (\$85), no amount in respect of the sale is includible as compensation in E's gross income for 1968. E's basis for determining gain or loss on the sale is \$85. Since E sold the share for \$75, E realized a loss of \$10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume the same facts as in example (1), except assume that the option provides that the option price shall be 90 percent of the fair market value of the stock on the day the option is exercised. On June 1, 1965, when the option is exercised, the fair market value of the stock is \$120 per share so that E pays \$108 for the share of the stock. Compensation in the amount of \$10 is includible in E's gross income for 1967, the year of the disposition of the share. This is determined in the following manner: The excess of the fair market value of the stock at the time of the disposition (\$150) over the price paid for the share (\$108) is \$42; and the excess of the fair market value of the stock at the time the option was granted (\$100) over the option price, computed as if the option had been exercised at such time (\$90), is \$10. Accordingly, \$10, the lesser, is includible in gross income. In this situation, E's cost basis of \$108 is increased by \$10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$118. Since the share was sold for \$150, E realizes a gain of \$32, which is treated as long-term capital gain.

Example (4). Assume the same facts as in example (1), except assume that instead of selling the share on January 1, 1967, E makes a gift of the share on that day. In such case, \$15 is includible as compensation in E's gross income for 1967. E's cost basis of \$85 is increased by \$15, the amount includible

ble in E's gross income as compensation. Thus, E's basis for the share is \$100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (5). Assume the same facts as in example (2) except assume that instead of selling the share on January 1, 1968, E makes a gift of the share on that date. Since the fair market value of the share on that day (\$75) is less than the option price (\$85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1968. E's basis for the share is \$85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is \$75 (fair market value of the share at the date of gift).

Example (6). Assume the same facts as in example (1), except assume that after acquiring the share of stock on June 1, 1965, E dies on August 1, 1966, at which time the share has a fair market value of \$150. Compensation in the amount of \$15 is includible in E's gross income for the taxable year closing with his death, such \$15 being the difference between the option price (\$85) and the fair market value of the share when the option was granted (\$100), since such value is less than the fair market value at date of death (\$150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

Example (7). Assume the same facts as in example (6), except assume that E dies on August 1, 1965, at which time the share has a fair market value of \$150. Although E's death occurred within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

Example (8). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E and his wife sold the share on June 15, 1966, for \$150, its fair market value on that date. Compensation in the amount of \$15 is includible in E's gross income for 1966, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is \$100, that is, the cost of \$85 increased by the amount of \$15 includible as compensation in E's gross income. The gain of \$50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (9). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E predeceased his wife on August 1, 1966, at which time the share had a fair market value of \$150. Compensation in the amount of \$15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

Example (10). Assume the same facts as in example (9), except assume that E's wife predeceased him on July 1, 1966. Section 423(c) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1966, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1966 (after the death of his wife), for \$150, its fair market value at that time, the income tax consequences would be the same as in example (1).

§ 1.424 Statutory provisions; restricted stock options.

Sec. 424. Restricted stock options—(a) In general. Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise after 1949 of a restricted 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 6 months after the transfer of such share to him, and

(2) At the time he exercises such option—

(A) He is an employee of either 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 425(a) applies, or

(B) He ceased to be an employee of such corporations within the 3-month period preceding the time of exercise.

(b) **Restricted stock option.** For purposes of this part, the term "restricted stock option" means an option granted after February 26, 1945, and before January 1, 1964 (or, if it meets the requirements of subsection (c)(3), an option granted after December 31, 1963), 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) At the time such option is granted—

(A) The option price is at least 85 percent of the fair market value at such time of the stock subject to the option, or

(B) In the case of a variable price option, the option price (computed as if the option had been exercised when granted) is at least 85 percent of the fair market value of the stock at the time such option is granted;

(2) 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;

(3) 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. This paragraph shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value of the stock subject to the option, and such option either by its terms is not exercisable after the expiration of 5 years from the date such option is granted or is exercised within one year after August 16, 1954. For purposes of this paragraph, the provisions of section 425(d) shall apply in determining the stock ownership of an individual; and

(4) Such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted, if such option has been granted on or after June 22, 1954.

(c) **Special rules—(1) Options under which option price is between 85 percent and 95 percent of value of stock.** If no disposition of a share of stock acquired by an individual on his exercise after 1949 of a restricted stock option is made by him within 2 years from the date of the granting of the option nor within 6 months after the transfer of such share to him, but, at the time the restricted stock option was granted, the option price (computed under subsection (b)(1)) was less than 95 percent of the fair market value at such time of such share, then, in the event of any disposition of such share by him, or in the event of his death (whenever occurring) while owning such share, there shall be included as compensa-

tion (and not as gain upon the sale or exchange of a capital asset) in his gross income, for the taxable year in which falls the date of such disposition or for the taxable year closing with his death, whichever applies—

(A) In the case of a share of stock acquired under an option qualifying under subsection (b)(1)(A), an amount equal to the amount (if any) by which the option price is exceeded by the lesser of—

(i) The fair market value of the share at the time of such disposition or death, or

(ii) The fair market value of the share at the time the option was granted; or

(B) In the case of stock acquired under an option qualifying under subsection (b)(1)(B), an amount equal to the lesser of—

(i) The excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(ii) The excess of the fair market value of the share at the time the option was granted over the option price (computed as if the option had been exercised at such time).

In the case of a disposition of such share by the individual, the basis of the share in his hands at the time of such disposition shall be increased by an amount equal to the amount so includible in his gross income.

(2) **Variable price option.** For purposes of subsection (b)(1), the term "variable price option" means an option under which the purchase price of the stock is fixed or determinable under a formula in which the only variable is the fair market value of the stock at any time during a period of 6 months which includes the time the option is exercised; except that in the case of options granted after September 30, 1958, such term does not include any such option in which such formula provides for determining such price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised.

(3) **Certain options granted after December 31, 1963.** For purposes of subsection (b), an option granted after December 31, 1963, meets the requirements of this paragraph if granted pursuant to—

(A) A binding written contract entered into before January 1, 1964, or

(B) A written plan adopted and approved before January 1, 1964, which (as of January 1, 1964, and as of the date of the granting of the option)—

(i) Met the requirements of paragraphs (4) and (5) of section 423(b), or

(ii) Was being administered in a way which did not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.

[Sec. 424 as added by sec. 221(a), Rev. Act 1964 (78 Stat. 63)]

§ 1.424-1 Applicability of section 421 (a).

(a) **In general.** (1) Subject to the provisions of section 424(c), the special rules of income tax treatment provided in section 421(a) apply with respect to the transfer of a share of stock to an individual pursuant to his exercise after 1949 of a restricted stock option provided that—

(i) The individual makes no disposition of such share within 2 years from the date of the granting of the option, nor within 6 months after the transfer of such share to him; and

(ii) At the time he exercised such option—

(a) The individual is an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, or

(b) The individual ceased to be an employee of such corporations within the 3-month period preceding the time of such exercise.

(2) For general rules relating to the employment relationship, see paragraph (h) of § 1.421-7. For rules relating to the employment relationship when there has been a transaction described in section 425(a) (relating to corporate reorganizations, liquidations, etc.) see § 1.425-1. For rules relating to the effect of a disqualifying disposition, see section 421(b) and paragraph (b) of § 1.421-8. For definition of the term "disposition", see section 425(c) and paragraph (c) of § 1.425-1.

(b) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). On June 1, 1958, X Corporation grants a restricted stock option to A, an employee of X Corporation, to purchase a share of X stock. A continues to be employed by X Corporation until February 1, 1964, when X sells the plant where A is employed to M Corporation, an unrelated corporation. On such date, A becomes employed by M. A continues to be employed by M Corporation until June 1, 1964, when A exercises his option on X Corporation. Section 421 is not applicable to this exercise, because on June 1, 1964, A was not employed by the corporation which granted the option or by a related corporation of such corporation, nor was he employed by any of such corporations within three months before June 1, 1964.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated, and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 425(a). If A exercises the option to purchase the share of M stock on June 1, 1964, section 421 is applicable, for A is then employed by a corporation which issued an option under section 425(a).

Example (3). Assume that P Corporation owns all of the stock of S Corporation and grants a restricted stock option to E, an employee of S Corporation. If E exercises the option, section 421 is applicable since E is employed by a corporation which is a subsidiary of the corporation which granted the restricted stock option.

§ 1.424-2 Restricted stock option.

(a) *Restricted stock option defined.* (1) A "restricted stock option" is an option granted after February 26, 1945, and before January 1, 1964 (or, if it meets the requirements of section 424(c)(3), an option granted after December 31, 1963), to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or a related corporation, to purchase stock of any such corporations, but, except in the case of options described in subparagraph (2) of this paragraph, only if—

(i) At the time such option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option;

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

(iii) 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 either of the employer corporation or of its parent or subsidiary corporation; and

(iv) In the case of options granted after June 21, 1954, such option by its terms is not exercisable after the expiration of ten years from the date on which such option was granted.

For purposes of applying the rule of subdivision (i) of this subparagraph to a variable price option (as defined by section 424(c)(2) and paragraph (c) of this section) under which the option price is determined by a formula described in paragraph (c) of this section, the option price shall, notwithstanding any provision of the option, be computed as if such option is exercised on the day when it is granted. For example, if on June 15, 1959, an option is granted providing that the option price shall be \$10 under the average fair market value of the stock during the month in which the option is exercised or the average fair market value of the stock during the preceding month, whichever is lower, and if on June 15, 1959, the value of the stock subject to the option is \$100 a share, to determine if the option meets the requirement of subdivision (i) of this subparagraph, it is necessary to determine the average fair market value of the stock during the months of May and June 1959. If such lower average fair market value is \$95 or more, the option meets the requirement of subdivision (i) of this subparagraph.

(2) Regardless of the extent to which the individual to whom the option is granted owns stock of either the employer corporation, or of a related corporation, an option is a restricted stock option if—

(i) Such option is granted after February 26, 1945, to such individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or a related corporation, to purchase stock of any of such corporations;

(ii) At the time such option is granted the option price is at least 110 percent of the fair market value at such time of the stock subject to the option;

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

(iv) Such option by its terms is not exercisable after the expiration of 5 years from the date on which such option was granted or is exercised within 1 year after August 16, 1954.

(3) In determining the amount of stock owned by an individual for the purpose of applying the 10 percent test of section 424(b)(3), the rules of section 425(d) (relating to attribution of stock ownership) shall apply. See § 1.425-1.

(4) For general rules relating to the employment relationship, see paragraph (h) of § 1.421-7. For general rules relating to the restriction on transferability required by section 424(b)(2) and this paragraph, see paragraph (b)(2) of § 1.421-7. For modification of certain options so as to conform to the requirements of section 424(b)(2), see section 425(h)(3).

(b) *Special rule where option price is between 85 percent and 95 percent of value of stock.* (1) (i) If all the conditions necessary for the application of section 421(a) exist, section 424(c)(1) provides additional rules which are applicable in cases where, at the time the restricted stock option is granted, the option price per share is less than 95 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 6-month holding periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) an amount determined in the following manner. If, at the time the option was granted, the option price was fixed or determinable, and was at least 85 percent of the fair market value of the stock subject to such option, such amount shall be the amount, if any, by which the option price is exceeded by the lesser of the fair market value of the share at the time the option was granted or the fair market value of the share at the time of such disposition or death. However, in the case of a variable price option (as defined by section 424(c)(2) and paragraph (c) of this section) under which the option price (computed as if the option had been exercised when granted) at the time the option was granted was at least 85 percent of the fair market value of the stock subject to such option, such amount shall be whichever of the following amounts is the lesser:

(a) The excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(b) The excess of the fair market value of the share at the time the option was granted over the option price, computed as if the option had been exercised at such time.

The amount of such compensation shall be included in the individual's gross income for the taxable year in which the disposition occurs or for the taxable year closing with his death, whichever event results in the application of section 424(c)(1) and this paragraph.

(ii) The application of the special rules provided in section 424(c) shall not affect the rules provided in section

421(a) with respect to the individual exercising the option, the employer corporation, or a related corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 424(c)(1), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or a related corporation with respect to such amount.

(iii) If the individual exercises a restricted stock option during his lifetime and dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of section 421, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) If the special rules provided in section 424(c) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 424(c)(1). However, in the case of a share of stock acquired by the exercise of a restricted stock option after the death of the employee to whom the option was granted, the basis of such share shall be determined in accordance with the rules of section 421(c) and paragraph (c) of § 1.421-8. If the special rules provided in section 424(c)(1) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 424(c)(1). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1959, the X Corporation grants to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for \$85. The fair market value of the X Corporation stock on such date is \$100 per share. On June 1, 1965, E exercises the option and on that date the X Corporation transfers the share of stock to E. On January 1, 1967, E sells the share for \$150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) Compensation in the amount of \$15 is includible in E's gross income for 1967, the year of the disposition of the share. The \$15 represents the difference between the option price (\$85) and the fair market value of the share on the date the option was granted (\$100), since such value is less than the fair market value of the share on the date of disposition (\$150). For the purpose of computing E's gain or loss on the

sale of the share, E's cost basis of \$85 is increased by \$15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$100. Since the share which is treated as long-term capital gain; was sold for \$150, E realizes a gain of \$50, (ii) the X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

Example (2). Assume the same facts as in example (1), except assume that E sells the share of X Corporation stock on January 1, 1968, for \$75, its fair market value on that date. Since \$75 is less than the option price (\$85), no amount in respect of the sale is includible as compensation in E's gross income for 1968. E's basis for determining gain or loss on the sale is \$85. Since E sold the share for \$75, E realized a loss of \$10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume the same facts as in example (1), except assume that the option provides that the option price shall be 90 percent of the fair market value of the stock on the day the option is exercised. On June 1, 1965, when the option is exercised, the fair market value of the stock is \$120 per share so that E pays \$108 for the share of stock. Compensation in the amount of \$10 is includible in E's gross income for 1967, the year of the disposition of the share. This is determined in the following manner. The excess of the fair market value of the stock at the time of the disposition (\$150) over the price paid for the share (\$108) is \$42; and the excess of the fair market value of the stock at the time the option was granted (\$100) over the option price, computed as if the option had been exercised at such time (\$90), is \$10. Accordingly, \$10, the lesser, is includible in gross income. In this situation, E's cost basis of \$108 is increased by \$10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$118. Since the share was sold for \$150, E realizes a gain of \$32, which is treated as long-term capital gain.

Example (4). Assume the same facts as in example (1), except assume that instead of selling the share on January 1, 1967, E makes a gift of the share on that day. In such case, \$15 is includible as compensation in E's gross income for 1967. E's cost basis of \$85 is increased by \$15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (5). Assume the same facts as in example (2) except assume that instead of selling the share on January 1, 1968, E makes a gift of the share on that date. Since the fair market value of the share on that day (\$75) is less than the option price (\$85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1968. E's basis for the share is \$85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is \$75 (fair market value of the share at the date of gift).

Example (6). Assume the same facts as in example (1), except assume that after acquiring the share of stock on June 1, 1965, E dies on August 1, 1966, at which time the share has a fair market value of \$150. Compensation in the amount of \$15 is includible in E's gross income for the taxable year closing with his death, such \$15 being the difference between the option price (\$85) and the fair market value of the share when the option was granted (\$100), since such value is less than the fair market value at date of death (\$150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

Example (7). Assume the same facts as in example (6), except assume that E dies on August 1, 1966, at which time the share has a fair market value of \$150. Although E's death occurred within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

Example (8). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E and his wife sold the share on June 15, 1966, for \$150, its fair market value on that date. Compensation in the amount of \$15 is includible in E's gross income for 1966, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is \$100, that is, the cost of \$85 increased by the amount of \$15 includible as compensation in E's gross income. The gain of \$50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (9). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E predeceased his wife on August 1, 1966, at which time the share had a fair market value of \$150. Compensation in the amount of \$15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

Example (10). Assume the same facts as in example (9), except assume that E's wife predeceased him on July 1, 1966. Section 424(c) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1966, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1966 (after the death of his wife), for \$150, its fair market value at that time, the income tax consequences would be the same as in example (1).

(c) **Variable price option defined.** (1) For purposes of section 424 and this section, the term "variable price option" means an option under which the option price is determined by a formula in which the only variable is the fair market value of the stock at any time during a period of six consecutive months which includes the day on which such option is exercised. Except as provided in subparagraph (2) of this paragraph, such formula may provide for determining such price by reference to such value on any particular day in such 6-month period, or by reference to an average value of the stock over either the whole of such 6-month period or over any shorter period included in such 6-month period. Such 6-month period may begin with, end with, or in any other manner span the day on which such option is exercised. Such formula may also depend upon factors other than such value of the stock, but such other factors must not be variable and must be fixed in the option when granted. For example, such formula may provide that the option price shall be 85 percent of the value of the stock on the day the option is exercised, but such price shall not be less than \$85, nor more than \$110. Another

example of a formula which meets the requirements of this paragraph is a provision that the option price shall be 95 percent of the fair market value of the stock on the day the option is exercised but not more than \$95. However, the requirements of this paragraph are not met by a formula which provides that if the profits of the employer for the year do not exceed \$100,000, the option price shall be \$15 under the fair market value of the stock the option is exercised, but if such profits exceed \$100,000, the option price shall be \$20 under such value of the stock. For an example of how to determine whether an option which contains a formula meeting the requirements of this paragraph also meets the requirement that the option price must be at least 85 percent of the fair market value of the stock at the time the option is granted, see paragraph (a) (1) of § 1.424-2.

(2) In the case of an option granted after September 30, 1958, the term "variable price option" does not include any option in which the formula provides for determining the option price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised. Whether an option meets the requirement of this paragraph shall be determined solely by reference to the terms of the option, and the circumstances existing at the time the option is granted or exercised are immaterial. Thus, an option, granted after September 30, 1958, and containing a pricing formula which takes into consideration the value of the stock at any time before the option is exercised, is subject to the new limitation and does not meet the requirement of this paragraph, even though the option price is not actually based upon such prior fair market value either at the time the option is exercised or at the time the option price is computed as if it were exercised for the purpose of applying the 85 percent test of section 424(b) (1). For example, a formula which provides that the option price is to be 45 percent of the fair market value of the stock 30 days before the date on which the option is exercised, but not more than \$85, will not qualify under this paragraph since under this formula the price may be determinable by reference to a higher prior value. On the other hand, a formula which provides that the option price is to be 90 percent of the average value of the stock during the month the option is exercised or the average value of the stock during the preceding month, whichever is lower, will qualify. In the case of an option granted after September 30, 1958, the only way that a formula which provides for determining the option price by reference to the fair market value of the stock at a time before the option is exercised can come within the requirement of this paragraph is to provide that the option price is to be determined by reference to such fair market value only if such fair market value is not greater than the average fair mar-

ket value of the stock during the month in which the option is exercised. If under the terms of an option the price is to be determined by reference to the fair market value of the stock at a time before the option is exercised, whether such value is higher or lower than the average fair market value of the stock during the month the option is exercised, such option will not be considered a restricted stock option since the option price may be based upon the prior value of the stock when such value exceeds the average fair market value of the stock during the month the option is exercised. However, if an option provides for determining the option price by reference to a prior fair market value of the stock only when such value is lower than such average value of the stock, such option can qualify as a restricted stock option. The average fair market value of the stock during the month in which the option is exercised means such value during the calendar month the option is exercised and not merely during a 30- or 31-day period including the time the option is exercised. To compute the average fair market value of the stock for the month, it will be necessary to ascertain the fair market value of the stock for each day during the month, including those days which are not business days. In ascertaining the fair market value of the stock for each day, the generally accepted principles for ascertaining such value will be applied.

(d) *Certain options granted after December 31, 1963.* (1) In general, the term "restricted stock option" means only a stock option which is granted after February 26, 1945, and before January 1, 1964, and which meets the requirements of section 424(b) and paragraph (a) of this section. However, section 424(c) (3) provides that if an option is granted after December 31, 1963, and such option meets the requirements of section 424(b) and this section, the option will be treated as a restricted stock option, provided such option is granted pursuant to—

(i) A binding written contract entered into before January 1, 1964, or

(ii) A written plan adopted and approved before January 1, 1964, which (as of January 1, 1964, and as of the date of the granting of the option)—

(a) Met the requirements of section 423(b) (4) and (5) and paragraphs (e) and (f) of § 1.423-2 (relating to employees covered by the plan, and equal rights and privileges, respectively), or

(b) Was being administered in a way which did not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees.

In determining whether an option is granted pursuant to a plan described in subdivision (ii) of this subparagraph, the terms of any written offering that was made on or before January 1, 1964, will be treated as a part of the terms of the plan.

(2) For purposes of section 424(c) (3) (A) and this paragraph, a binding writ-

ten contract means only a written contract under which the employee has an enforceable right to compel the grant or modification (as defined by section 425 (h) and paragraph (e) of § 1.425-1) of a restricted stock option, or to obtain damages upon the breach of such contract. A contract which provides that the individual's right to a restricted stock option is contingent upon the happening of an event (including the passage of time) may satisfy the requirements of section 424(c) (3) (A). However, if the event itself, or the determination of whether the event has occurred, rests with the board of directors or any other individual or group (other than an arbitrator), the contract will not be treated as giving the employee an enforceable right for purposes of section 424(c) (3) (A) or this paragraph.

(3) (i) For purposes of applying section 424(c) (3) (B) with respect to options granted after December 31, 1963, and before October 1, 1967, the adoption and approval of a plan required by such section and this paragraph will be deemed to have occurred if the plan was adopted and approved on or before December 31, 1963, in the manner required by the applicable law of the State of incorporation. Thus, an option granted within such period pursuant to a restricted stock option plan which was not approved by the stockholders of the grantor corporation, but which was adopted by an authorized executive committee and approved by the board of directors of the grantor corporation before January 1, 1964, will meet the requirements of section 424(c) (3) (B) relating to adoption and approval, provided that the granting of options pursuant to such a plan is not contrary to the applicable State law. However, with respect to options granted on or after October 1, 1967, the approval required by section 424(c) (3) (B) must comply with all applicable provisions of the corporate charter and bylaws and the law of the State of incorporation and must represent the express consent of stockholders holding at least a majority of the voting stock of the corporation voting in person or by proxy at a duly held stockholders' meeting. The plan as adopted and approved must designate the aggregate number of shares which may be issued under the plan, and the corporations or class of corporations whose employees may be offered options under such plan. A plan which merely provides that the number of shares which may be issued under options shall not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan will not satisfy the requirement that the plan state the aggregate number of shares which may be issued under options. However, the maximum number of shares which may be issued under the plan may be stated in terms of a percentage of either the authorized, issued or outstanding shares at the date of the adoption of the plan. Any increase in the aggregate number of shares which may be issued under the plan (other than an increase merely re-

flecting a change in capitalization such as a stock dividend or stock split-up) will be treated as the adoption of a new plan requiring stockholder approval. Similarly, a change in the designation of corporations whose employees may be offered options under the plan will be treated as the adoption of a new plan requiring stockholder approval unless the plan provides that designations of participating corporations may be made from time to time from among a group consisting of the grantor corporation and its parent or subsidiary corporations. The group from among which such changes and designations are permitted without additional stockholder approval may include corporations having become parents or subsidiaries of the grantor after the adoption and approval of the plan. Any other changes in the terms of a restricted stock option plan may be made without such changes being considered the adoption of a new plan.

(ii) A plan may qualify under section 424(c) (3) (B) (i) and paragraph (1) (i) (b) of this paragraph even though coverage thereunder is limited to employees who have either reached a designated age or have been employed for a designated number of years, or who are employed in certain designated departments or are in other classifications, provided that the effect of coverage of such employees does not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. Furthermore, a plan (which is not otherwise discriminatory) will not be considered discriminatory merely because options are granted only to full-time employees (rather than employees working 20 hours per week or more), or because employees with less than 6 months employment per taxable year are omitted (rather than employees whose annual employment is for not more than 5 months per taxable year).

(4) An option issued or assumed in a transaction to which section 425(a) applies is treated as a continuation of the option previously held by such individual. Accordingly, if the option previously held by the individual was a restricted stock option (whether or not such restricted stock option was granted before, on, or after December 31, 1963), the option received in the transaction to which section 425(a) applies will be treated as a restricted stock option irrespective of whether such option meets the requirements of section 424(c) (3).

§ 1.425 Statutory provisions; definitions and special rules.

Sec. 425. *Definitions and special rules—*
(a) *Corporate reorganizations, liquidations, etc.* For purposes of this part, the term "issuing or assuming a stock option in a transaction to which section 425(a) applies" means a substitution of a new option for the old option, or an assumption of the old option, by an employer corporation, or a parent or subsidiary of such corporation, by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation, if—

(1) The excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or as-

sumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(2) The new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

For purposes of this subsection, the parent-subsidiary relationship shall be determined at the time of any such transaction under this subsection.

(b) *Acquisition of new stock.* For purposes of this part, if stock is received by an individual in a distribution to which section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies, and such distribution was made with respect to stock transferred to him upon his exercise of the option, such stock shall be considered as having been transferred to him on his exercise of such option. A similar rule shall be applied in the case of a series of such distributions.

(c) *Disposition—*(1) *In general.* Except as provided in paragraph (2), for purposes of this part, the term "disposition" includes a sale, exchange, gift, or a transfer of legal title, but does not include—

(A) A transfer from a decedent to an estate or a transfer by bequest or inheritance;

(B) An exchange to which section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies; or

(C) A mere pledge or hypothecation.

(2) *Joint tenancy.* The acquisition of a share of stock in the name of the employee and another jointly with the right of survivorship or a subsequent transfer of a share of stock into such joint ownership shall not be deemed a disposition, but a termination of such joint tenancy (except to the extent such employee acquires ownership of such stock) shall be treated as a disposition by him occurring at the time such joint tenancy is terminated.

(d) *Attribution of stock ownership.* For purposes of this part, in applying the percentage limitations of sections 422(b) (7), 423(b) (3), and 424(b) (3)—

(1) The individual with respect to whom such limitation is being determined shall be considered as owning the stock owned, directly or indirectly, by or for his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(2) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

(e) *Parent corporation.* For purposes of this part, the term "parent corporation" means any corporation (other than the employer corporation) in an unbroken chain of corporations ending with the employer corporation if, at the time of the granting of the option, each of the corporations other than the employer corporation owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(f) *Subsidiary corporation.* For purposes of this part, the term "subsidiary corporation" means any corporation (other than the employer corporation) in an unbroken chain of corporations beginning with the employer corporation if, at the time of the granting of the option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50 percent or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(g) *Special rule for applying subsections (e) and (f).* In applying subsections (e) and (f) for purposes of section 422(a) (2), 423(a) (2), and 424(a) (2), there shall be substituted for the term "employer corporation" wherever it appears in subsections (e) and (f) the term "grantor corporation", or the term "corporation issuing or assuming a stock option in a transaction to which section 425(a) applies", as the case may be.

(h) *Modification, extension, or renewal of option—*(1) *In general.* For purposes of this part, if the terms of any option to purchase stock are modified, extended, or renewed, such modification, extension, or renewal shall be considered as the granting of a new option.

(2) *Special rules for sections 423 and 424 options.* (A) In the case of the transfer of stock pursuant to the exercise of an option to which section 423 or 424 applies and which has been so modified, extended, or renewed, then, except as provided in subparagraph (B), the fair market value of such stock at the time of the granting of such option shall be considered as whichever of the following is the highest:

(i) The fair market value of such stock on the date of the original granting of the option,

(ii) The fair market value of such stock on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value of such stock at the time of the making of any intervening modification, extension, or renewal.

(B) Subparagraph (A) shall not apply with respect to a modification, extension, or renewal of a restricted stock option before January 1, 1964 (or after December 31, 1963, if made pursuant to a binding written contract entered into before January 1, 1964), if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months before the date of the modification, extension, or renewal, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest.

(3) *Definition of modification.* The term "modification" means any change in the terms of the option which gives the employee additional benefits under the option, but such term shall not include a change in the terms of the option—

(A) Attributable to the issuance or assumption of an option under subsection (a);

(B) To permit the option to qualify under sections 422(b) (6), 423(b) (9), and 424(b) (2); or

(C) In the case of an option not immediately exercisable in full, to accelerate the time at which the option may be exercised.

If a restricted stock option is exercisable after the expiration of 10 years from the date such option is granted, subparagraph (B) shall not apply unless the terms of the option are also changed to make it not exercisable after the expiration of such period.

(i) *Stockholder approval.* For purposes of this part, if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval.

(j) *Cross references.* For provisions requiring the reporting of certain acts with respect to a qualified stock option, options granted under employer stock purchase plans, or a restricted stock option, see section 6039.

[Sec. 425 as added by sec. 221(a), Rev. Act 1964 (78 Stat. 63)]

§ 1.425-1 Definitions and special rules applicable to statutory options.

(a) *Corporate reorganizations, liquidations, etc.* (1) (i) The term "issuing or assuming a stock option in a transaction to which section 425(a) applies" means, for purposes of sections 421 through 425, a substitution of a new option for an old option, or an assumption of such old option, by an employer corporation, or a related corporation of such corporation, by reason of a corporate transaction (as defined by subdivision (ii) of this subparagraph), if—

(a) The excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(b) The new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

(ii) For purposes of this section, the term "corporate transaction" means any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any purchase or acquisition of property or stock by any corporation, any separation of a corporation (including a spin-off or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation, if such action by such corporation results in a significant number of employees being transferred to a new employer or discharged, or in the creation or severance of a parent-subsidiary relationship.

(2) (i) A change in the terms of an option attributable to the issuance or assumption of an option by reason of a corporate transaction (as defined under section 425(a) and subparagraph (1) (ii) of this paragraph) is not a modification of such option. See section 425(h) (3) and paragraph (e) of this section. Thus, section 425(a), in effect, provides rules under which a new employer, or a parent or subsidiary of a new employer, may by reason of a corporate transaction assume a statutory option granted by the former employer or parent or subsidiary thereof, or issue a new statutory option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution being considered as a modification of the option. For example, section 425(a) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume statutory options which had been granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Cor-

poration wishes to grant to such employees a statutory option to purchase its stock in place of the statutory option which they had to purchase stock of X Corporation.

(ii) Section 425(a) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a statutory option granted by the employer or parent or subsidiary thereof, or issue a new statutory option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 425(a) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a statutory option to buy stock of X Corporation in place of a statutory option which they have to purchase the stock of Y Corporation.

(iii) Section 425(a) applies only when the assumption or substitution occurs by reason of a corporate transaction as defined in this paragraph. Thus, section 425(a) may apply where as a result of a corporate transaction a statutory option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 425(a) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph). However, a corporation which has issued an option may not substitute a new option for such option under section 425(a). See, however, paragraph (e) of this section.

(3) For section 425(a) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 425(a) may apply where the option which is being assumed or replaced expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 425(a) cannot be applied to revive a statutory option which, for reasons not related to the corporate transaction, expires before it can properly be assumed or replaced under section 425(a). For section 425(a) to apply, the assumed or substituted option must qualify as a statutory option.

(4) (i) Section 425(a) does not apply if the terms of the assumed or substituted option confer on the employee more favorable benefits than he had under the old option. Section 425(a) can apply to a corporate transaction only if, on a share by share comparison, the ratio of the option price to the fair market value of the stock subject to the option immediately after the substitution or assumption is no more favorable to the optionee than the ratio of the option price to the fair market value of the stock subject to the old option immediately before such substitution or assumption. The

number of shares subject to an option issued or assumed may be adjusted to compensate for any change in the aggregate spread between the aggregate option price and the aggregate fair market value of the stock subject to the option immediately after the substitution or assumption as compared to the aggregate spread between the option price and the aggregate fair market value of the stock subject to the option immediately before such substitution or assumption. Such an adjustment will not prevent section 425(a) from applying to such substitution or assumption.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). On June 1, 1965, P Corporation acquires 100 percent of the stock of S Corporation and on such date S becomes a subsidiary of P Corporation. Also on such date, P Corporation substitutes a qualified stock option to purchase P stock for a qualified stock option to purchase S stock held by E, an employee of S. Assume that E's S option had 3 years to run on the date of the substitution. If the P option granted to E in substitution for his S option runs for more than 3 years from the date of the substitution, section 425(a) cannot apply, since the effect of such an option would be to give E an additional benefit which he did not enjoy under his S option.

Example (2). E is an employee of S Corporation. E holds a qualified stock option which was granted to him by S to purchase 60 shares of S stock at \$12 per share. On June 1, 1967, S Corporation is merged into P Corporation, and on such date P substitutes a qualified stock option to purchase P stock for E's qualified stock option to purchase S stock. Immediately before the substitution, the fair market value of S stock was \$32 per share; immediately after the substitution, the fair market value of P stock is \$24 per share. The new option entitles E to buy P stock at \$9 per share. Since on a share by share comparison the ratio of the new option price (\$9 per share) to the fair market value of P stock immediately after the substitution (\$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 S stock immediately before the substitution (\$32 per share) ($9/24 = 12/32$), the requirement of subparagraph (4) (i) of this paragraph is met. The number of shares subject to E's option to purchase P stock is set at 80. Since the excess of the aggregate fair market value over the aggregate option price of the stock 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 stock subject to E's old option to purchase S stock, $1,200 (60 \times \$32 \text{ minus } 60 \times \$12)$, the requirement of subparagraph (1) (i) (a) of this paragraph is met. Thus, section 425(a) may apply to the substitution.

Example (3). Assume the same facts as in example (2), except assume that the fair market value of S stock immediately before the substitution was \$8 per share and that the option price was \$10 per share, and that the fair market value of P stock immediately after the substitution is \$12 per share. P sets the new option price at \$15 per share. Since on a share by share comparison the ratio of the new option price (\$15 per share) to the fair market value of P stock immediately after the substitution (\$12 per share) is not more favorable to E than the ratio of the old option price (\$10 per share) to the fair market value of S stock immediately before the substitution (\$8 per share)

(15 $\frac{1}{2}$ = 18), the requirement of subparagraph (4) (1) of this paragraph is 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 substitution, 2 shares of P stock are worth \$24, which is what 3 shares of S stock were worth immediately before the substitution ($2 \times \$12 = 3 \times \8). Thus, to completely replace E's S option, E should have received an option to purchase 40 shares of P stock, i.e., 2 shares of P for each 3 shares of S which E could have purchased under his old option ($\frac{2}{3} = 40\%$). Since E's new option covers 20 shares of P stock, it is clear that P has replaced only $\frac{1}{2}$ of E's stock option. The portion of E's stock option which was not replaced by P is an outstanding stock option to purchase stock of a predecessor corporation of P Corporation for purposes of section 422(b) (5) and (c) (2).

(5) For the purpose of applying section 425(a), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 425(a), be considered to have been granted the option which the employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 425(a) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 425(a) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. However, if the old option was a qualified or restricted stock option, any portion of such option which is not substituted or assumed in a transaction to which section 425(a) applies will be treated as an outstanding option to purchase stock of a predecessor corporation of the new employer or grantor corporation. See section 422(b) (5) and (c) (2) and paragraph (f) of § 1.422-2. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the statutory option which E has, entitling him to purchase 100 shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at \$50 a share, was granted when the stock had a fair market value of \$50 a share, and the stock was worth \$100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth \$50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of

Y Corporation at \$25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Corporation at \$25 a share in substitution for his right to purchase 50 of the shares covered by the old option. However, if the option to purchase X stock was a qualified or restricted stock option, then to the extent the old option is not assumed or a new option issued in substitution therefor in a transaction to which section 425(a) applies, such old option will be treated as an outstanding option under section 422(c) (2) for purposes of section 422(b) (5). See paragraph (f) of § 1.422-2.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in § 20.2031-2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's-length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.

(8) For the purpose of applying section 425(a) and this paragraph, the determination of whether the parent-subsidary relationship exists shall be based upon circumstances existing immediately after the corporate transaction.

(b) *Acquisition of new stock.* (1) Section 425(b) provides that the rules provided by sections 421 through 425 which are applicable with respect to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to stock acquired by a distribution or an exchange to which section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies. Stock so acquired shall, for purposes of sections 421

through 425, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such acquisitions. With respect to such acquisitions, section 425(b) does not make inapplicable any of the provisions of section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036).

(2) The application of this paragraph may be illustrated by the following example:

Example. If, with respect to stock transferred pursuant to the timely exercise of a statutory option, there is a distribution of new stock to which section 305(a) is applicable, and if there is a disposition of such new stock before the expiration of the applicable holding period required with respect to the stock originally acquired pursuant to the exercise of such option, such disposition makes section 421 inapplicable to the transfer of the original stock pursuant to the exercise of the option to the extent that the disposition effects a reduction of the individual's total interest in the old and new stock. However, if the new stock, as well as the old stock, is not disposed of before the expiration of the holding period required with respect to the original stock acquired pursuant to the exercise of the option, the special tax treatment provided by section 421 is applicable to both the original shares and the shares acquired by virtue of the distribution to which section 305(a) applies.

(c) *Disposition of stock.* (1) For purposes of sections 421 through 425, the term "disposition" includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(i) A transfer from a decedent to his estate or a transfer by bequest or inheritance; or

(ii) An exchange to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036); or

(iii) A mere pledge or hypothecation. However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(2) A share of stock acquired by an individual pursuant to the exercise of a statutory option is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, any termination of such joint ownership (other than a termination effected by the death of a joint owner) is a disposition of such share, except to the extent the individual reacquires ownership of the share. For example, if such individual and his joint owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a statutory option and a share of stock is trans-

ferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share. However, a termination of joint ownership resulting from the death of one of the owners is not a disposition of such share. For determination of basis in the hands of the survivor where joint ownership is terminated by the death of one of the owners, see section 1014.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, the X Corporation grants to E, an employee, a qualified stock option to purchase 100 shares of X Corporation stock at \$100 per share, the fair market value of X Corporation stock on that date. On June 1, 1965, while employed by X Corporation, E exercises the option in full and pays X Corporation \$10,000, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of \$12,000. Before June 1, 1968, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1965, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to its transfer to E of the stock. E's basis for such 100 shares is \$10,000.

Example (2). Assume the same facts as in example (1), except assume that on August 1, 1968, three years and two months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for \$13,000 which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of \$3,000 (\$13,000 minus E's basis of \$10,000), which is treated as long-term capital gain.

Example (3). Assume the same facts as in example (2), except assume that on August 1, 1968, E makes a gift of the 100 shares of Y Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of \$10,000 becomes the donee's basis for determining gain or loss.

Example (4). Assume the same facts as in example (1), except assume that on May 1, 1968, two years and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for \$13,000. The special rules of section 421(a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within three years from the date the shares were transferred to him.

Example (5). Assume the same facts as in example (1), except assume that E dies on September 1, 1965, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1965, of the qualified stock option. On the date of death, the fair market value of the stock is \$12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If the stock is valued as of the date of E's death for estate tax purposes, the basis of the 100 shares in the hands of the executor is \$12,500.

Example (6). Assume the same facts as in example (1), except assume that on June 1, 1965, when the option is exercised by E the 100 shares are transferred by X to E and his wife W, as joint owners with right of survivorship, and that E dies on July 1, 1965. Neither the transfer into joint ownership nor the termination of such joint ownership by E's death is a disposition. Because E has made no disqualifying disposi-

tion of the shares, section 421(a) is applicable and E realizes no income at death with respect to the shares even though he held the stock less than 3 years after the transfer of the shares to him pursuant to his exercise of a qualified stock option. See paragraph (b)(2) of § 1.421-8.

(d) **Attribution of stock ownership.** Section 425(d) provides that in determining the amount of stock owned by an individual for purposes of applying the percentage limitations of section 422(b)(7), 423(b)(3), and 424(b)(3), stock of the employer corporation or of a related corporation which is owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. Also, for such purpose, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

(e) **Modification, extension, or renewal of option.** (1) Section 425(h) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a statutory option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) of an option in any taxable year of the optionee which begins after December 31, 1963, except that section 425(h)(1) and this paragraph shall not apply to any change made before January 1, 1965, in the terms of an option granted after December 31, 1963, to permit such option to meet the requirements of section 422(b)(3), (4), or (5), and the regulations thereunder. See paragraphs (d), (e), and (f), of § 1.422-2, relating to period for exercising options, option price, and prior outstanding options, respectively, in the case of qualified stock options.

(2) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(3) Except as otherwise provided in subparagraph (4) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for purposes of applying the rules of sections 423(b)(6), and 424(b)(1)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(4) (i) In the case of a modification, extension, or renewal of a restricted stock option before January 1, 1964 (or

after December 31, 1963, if made pursuant to a binding written contract entered into before January 1, 1964), the rules of subparagraph (3) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1962, a restricted stock option was granted to purchase before July 1, 1965, a share of stock for \$85. The fair market value of such stock on June 1, 1962, was \$100. On June 15, 1963, when the fair market value of the stock is \$60, such option is extended so that it is exercisable at any time before July 1, 1966, at \$55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1963, is as follows:

1962		1963	
June	\$100	January	\$90
July	90	February	80
August	80	March	70
September	70	April	60
October	80	May	60
November	80		
December	90		

The aggregate of such values is \$950. When this sum is divided by 12, the result is \$79.17, which is an amount less than 80 percent of the fair market value of the stock (\$100) when the option was granted. Accordingly, when the option is extended on June 15, 1963, the option price could have been reduced as low as \$51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to \$960 or more, the rules of subparagraph (3) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(5) (i) The time or date when an option is modified, extended, or renewed

shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (c) of § 1.421-7. For purposes of sections 421 through 425, the term "modification" means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change which provides more favorable terms for the payment for the stock purchased under the option, is a modification. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(ii) (a) A change in the number or price of the shares of stock subject to an option merely to reflect a stock dividend, or stock split-up, is not a modification of the option.

(b) A change in the number or price of the shares of stock subject to an option to reflect a corporate transaction (as defined by paragraph (a) (1) (ii) of this section) is not a modification of the option provided that the excess of the aggregate fair market value (determined immediately after such corporate transaction) of the shares subject to the option immediately after such change over the aggregate new option price of such shares is not more than the excess of the aggregate fair market value of the shares subject to the option immediately before the transaction over the aggregate former option price of such shares, and provided that the option after such change does not give the employee additional benefits which he did not have before such change. The ratio of the option price immediately after the change to the fair market value of the stock subject to the option immediately after the corporate transaction must not be more favorable to the optionee on a share by share comparison than the ratio of the old option price to the fair market value of the stock subject to the option immediately before such transaction. A reduction in the option price of an option, other than as specifically provided for in this section, is a modification of such option.

(c) The application of (b) of this subdivision may be illustrated by the following example:

Example. E, an employee of P Corporation, holds a qualified stock option granted to him by P to buy 90 shares of P stock at \$36 per share. P Corporation is a party to a corporate transaction (as defined by paragraph (a) (1) (ii) of this section) which results in a decline in the fair market value of P stock. Immediately before such transaction the fair market value of P stock was \$64 per share. Immediately after such transaction, the fair market value of P stock is \$48 per share. Two weeks after such transaction, P proposes to amend E's option in order to reflect the decline in the fair market value of P stock attributable to the transaction. At such time, the fair market value

of P stock is \$50 per share. However, since the change was not made at the time of the transaction, the fair market value of P stock at the time of the change is irrelevant for purposes of determining whether the change comes under the rule of (b) of this subdivision. P changes the terms of E's option to lower the option price to \$27 per share and to increase the number of shares subject to the option to 120. No other terms of the option are changed. The aggregate fair market value (determined immediately after the corporate transaction) of the shares subject to the option immediately after the change is \$5,760 (\$48 x 120). The aggregate option price of the shares subject to the option immediately after the change is \$3,240 (\$27 x 120). Thus, the excess of such fair market value over such option price is \$2,520 (\$5,760 - \$3,240). The aggregate fair market value of the stock subject to the option immediately before the corporate transaction is \$5,760 (\$64 x 90). The aggregate option price for the stock subject to the option immediately before the change is \$3,240 (\$36 x 90). Thus, the excess of such fair market value over such option price is \$2,520 (\$5,760 - \$3,240). Accordingly, the excess after the change does not exceed the excess before the corporate transaction. Moreover, the ratio of the option price immediately after the change (\$27 per share) to the fair market value of P stock immediately after the transaction (\$48 per share) is not more favorable to E on a share by share comparison than the ratio of the old option price (\$36 per share) to the fair market value of P stock immediately before the transaction (\$64) ($27/48 = 36/64$). For purposes of section 425(h), the changes made do not confer additional benefits on E which he did not have before the change. Accordingly, the changes do not constitute a modification of E's option.

(iii) Any change in the terms of an option for the purpose of qualifying the option as a statutory option grants additional benefits and, therefore, is a modification. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution in order to meet the requirements of section 422(b) (6), 423 (b) (9), or 424(b) (2), such change is not a modification, provided that in any case where the purpose of the change is to meet the requirements of section 424(b) (2) the option is at the same time changed so that it is not exercisable after the expiration of ten years from the date the option was granted. Where an option is not immediately exercisable in full, a change in the terms of such option to accelerate the time at which the option (or any portion thereof) may be exercised is not a modification for purposes of section 425(h) and this section. A modification results where an option is revised to insert the language required by section 422(c) (6) (B).

(iv) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(6) A statutory option may, as a result of a modification, extension, or renewal, thereafter cease to be a statutory option, or any option may, by modification, extension, or renewal, thereafter become a statutory option. Moreover, a qualified option after a modification may not be exercisable in accordance with its terms because of the requirements of section 422(b) (5) and section 422(c) (6). See paragraph (f) (3) (i) of § 1.422-2 and examples (8) and (9) of paragraph (f) (4) of § 1.422-2.

(7) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, the X Corporation grants to an employee an option under X's employee stock purchase plan to purchase 100 shares of the stock of X Corporation at \$90 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is \$100 per share. On February 1, 1965, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be \$80 per share. On February 1, 1965, the fair market value of the X Corporation stock is \$90 per share. Under section 425(h), the X Corporation is deemed to have granted an option to the employee on February 1, 1965. Such option shall be treated as an option to purchase at \$80 per share 100 shares of stock having a fair market value of \$100 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February 1, 1965. The exercise of such option by the employee after February 1, 1965, is not the exercise of a statutory option.

Example (2). On June 1, 1964, the X Corporation grants to an employee an option under X's employee stock purchase plan to purchase 100 shares of X Corporation stock at \$90 per share, exercisable after December 31, 1965, and on or before June 1, 1966. On June 1, 1964, the fair market value of X Corporation's stock is \$100 per share. On February 1, 1965, X Corporation modifies the option to provide that the option shall be exercisable on or before September 1, 1966. On February 1, 1965, the fair market value of X Corporation stock is \$110 per share. Under section 425(h), X Corporation is deemed to have granted an option to the employee on February 1, 1965, to purchase at \$90 per share 100 shares of stock having a fair market value of \$110 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February 1, 1965. The exercise of such option by the employee is not the exercise of a statutory option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1965, before the date of the modification of the option. Any exercise of the option after February 1, 1965, the date of the modification, is not the exercise of a statutory option. See example (1) in this subparagraph. The exercise of the option on January 15, 1965, pursuant to which 50 shares were acquired, is the exercise of a statutory option.

Example (4). On June 1, 1964, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at \$80 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is \$100 per share. On February 1, 1965, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the em-

ployee may purchase at \$80 per share will be 250. On February 1, 1965, the fair market value of X Corporation stock is \$80 per share. Under these facts, the X Corporation has granted two options, one option (not a statutory option) with respect to 100 shares having been granted on June 1, 1964, and the other option (a qualified stock option) with respect to the additional 150 shares having been granted on February 1, 1965. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

PAR. 8. Section 1.691(c) is amended by revising section 691(c)(2)(B) and by adding a historical note. These amended and added provisions read as follows:

§ 1.691(c) Statutory provisions; recipients of income in respect of decedents; deduction for estate tax.

Sec. 691. Recipients of income in respect of decedents. * * *

(c) Deduction for estate tax. * * *

(2) Method of computing deduction. * * *

(B) The net value for estate tax purposes of all the items described in subsection (a)(1) shall be the excess of the value for estate tax purposes of all the items described in subsection (a)(1) over the deductions from the gross estate in respect of claims which represent the deductions and credit described in subsection (b). Such net value shall be determined with respect to the provisions of section 421(c)(2), relating to the deduction for estate tax with respect to stock options to which part II of subchapter D applies.

[Sec. 691(c) as amended by sec. 221(c)(2), Rev. Act 1964 (78 Stat. 75)]

PAR. 9. Paragraph (c)(1) and example (1) of paragraph (d) of § 1.691(c)-1 are amended to read as follows:

§ 1.691(c)-1 Deduction for estate tax attributable to income in respect of a decedent.

(c) Amounts deemed to be income in respect of a decedent. * * *

(1) The value for estate tax purposes of stock options in respect of which amounts are includible in gross income under section 421(b) (prior to amendment by section 221(a) of the Revenue Act of 1964), in the case of taxable years ending before January 1, 1964, or under section 422(c)(1), 423(c), or 424(c)(1), whichever is applicable, in the case of taxable years ending after December 31, 1963. See section 421(d)(6) (prior to amendment by sec. 221(a) of the Revenue Act of 1964), in the case of taxable years ending before January 1, 1964, and section 421(c)(2), in the case of taxable years ending after December 31, 1963.

(d) Examples. * * *

Example (1). X, an attorney who kept his books by use of the cash receipts and disbursements method, was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued in his estate at \$1,000, and to accrued bond interest, which was valued in his estate at \$500. In all, \$1,500 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate \$150 for business expenses for

which his estate was liable and \$50 for taxes accrued on certain property which he owned. In all, \$200 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was \$185,000 and, considering deductions of \$15,000 and an exemption of \$60,000, his taxable estate amounted to \$110,000. The estate tax on this amount is \$23,700 from which is subtracted a \$75 credit for State death taxes leaving an estate tax liability of \$23,625. In the year following the closing of X's estate, the fee in the amount of \$1,200 was collected by X's son, who was the sole beneficiary of the estate. This amount was included under section 691(a)(1)(C) in the son's gross income. The son may deduct, in computing his taxable income for such year, \$260 on account of the estate tax attributable to such income, computed as follows:

(i) Value of income described in section 691(a)(1) included in computing gross estate	\$1,500
(ii) Deductions in computing gross estate for claims representing deductions described in section 691(b)	200
(iii) Net value of items described in section 691(a)(1)	1,300
(2)(i) Estate tax	23,625
(ii) Less: Estate tax computed without including \$1,300 (item (1)(iii)) in gross estate	23,235
(iii) Portion of estate tax attributable to net value of items described in section 691(a)(1)	390
(3)(i) Value in gross estate of items described in section 691(a)(1) received in taxable year (fee)	1,000
(ii) Value in gross estate of all income items described in section 691(a)(1) (item (1)(i))	1,500
(iii) Part of estate tax deductible on account of receipt of \$1,200 fee (1,000/1,500 of \$390)	260

Although \$1,200 was later collected as the fee, only the \$1,000 actually included in the gross estate is used in the above computations. However, to avoid distortion, section 691(c) provides that if the value included in the gross estate is greater than the amount finally collected, only the amount collected shall be used in the above computations. Thus, if the amount collected as the fee were only \$500, the estate tax deductible on the receipt of such amount would be 500/1,500 of \$390, or \$130. With respect to taxable years ending before January 1, 1964, see paragraph (d)(3) of § 1.421-5 for a similar example involving a restricted stock option. With respect to taxable years ending after December 31, 1963, see paragraph (c)(3) of § 1.421-8 for a similar example involving a stock option subject to the provisions of part II of subchapter D.

PAR. 10. Paragraph (d) of § 1.1012-1 is amended to read as follows:

§ 1.1012-1 Basis of property—cost.

(d) Special rules. For special rules for determining the basis for gain or loss in the case of vessels acquired through the Maritime Commission (or its successor), see sections 510 and 511 of the Merchant Marine Act of 1936 (46 U.S.C. 1160, 1161). For special rules for determining the unadjusted basis of property recovered in respect of war losses, see sec-

tion 1336. For special rules with respect to taxable years beginning before January 1, 1964, for determining the basis for gain or loss in the case of a disposition of a share of stock acquired pursuant to the timely exercise of a restricted stock option where the option price was between 85 percent and 95 percent of the fair market value of the stock at the time the option was granted, see paragraph (b) of § 1.421-5. See sections 423(c)(1) or 424(c)(1), whichever is applicable, for special rules with respect to taxable years ending after December 31, 1963 for determining the basis for gain or loss in the case of the disposition of a share of stock acquired pursuant to the timely exercise of a stock option described in such sections. See section 422(c)(1) for special rule with respect to taxable years ending after December 31, 1963, for determining the basis for gain or loss in the case of an exercise of a qualified stock option.

PAR. 11. Paragraph (c) of § 1.1014-1 is amended to read as follows:

§ 1.1014-1 Basis of property acquired from a decedent.

(c) Property to which section 1014 does not apply. Section 1014 shall have no application to the following classes of property:

(1) Property which constitutes a right to receive an item of income in respect of a decedent under section 691; and

(2) Restricted stock options described in section 421 which the employee has not exercised at death if the employee died before January 1, 1957. In the case of employees dying after December 31, 1956, see paragraph (d)(4) of § 1.421-5. In the case of employees dying in a taxable year ending after December 31, 1963, see paragraph (c)(4) of § 1.421-8 with respect to an option described in part II of subchapter D.

PAR. 12. There are inserted immediately after § 1.6038-2 the following new sections:

§ 1.6039 Statutory provisions; returns required in connection with certain stock options.

Sec. 6039. Information required in connection with certain options—(a) Requirement of reporting. Every corporation—

(1) Which in any calendar year transfers a share of stock to any person pursuant to such person's exercise of a qualified stock option or a restricted stock option, or

(2) Which in any calendar year records (or has by its agent recorded) a transfer of the legal title of a share of stock—

(A) Acquired by the transferor pursuant to his exercise of an option described in section 423(c) (relating to special rule where option price is between 85 percent and 100 percent of value of stock), or

(B) Acquired by the transferor pursuant to his exercise of a restricted stock option described in section 424(c)(1) (relating to options under which option price is between 85 percent and 95 percent of value of stock), shall, for such calendar year, make a return at such time and in such manner, and setting forth such information, as the Secretary or his delegate may by regulations prescribe. For purposes of the preceding sentence, any option which a corporation treats as a qualified stock option, a restricted stock option, or

an option granted under an employee stock purchase plan, shall be deemed to be such an option. A return is required by reason of a transfer described in paragraph (2) of a share only with respect to the first transfer of such share by the person who exercised the option.

(b) *Statements to be furnished to persons with respect to whom information is furnished.* Every corporation making a return under subsection (a) shall furnish to each person whose name is set forth in such return a written statement setting forth such information as the Secretary or his delegate may by regulations prescribe. The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a) was made.

(c) *Identification of stock.* Any corporation which transfers any share of stock pursuant to the exercise of an option described in subsection (a) (2) shall identify such stock in a manner adequate to carry out the purposes of this section.

(d) *Cross references.* For definition of—

(1) The term "qualified stock option", see section 422(b).

(2) The term "employee stock purchase plan", see section 423(b).

(3) The term "restricted stock option", see section 424(b).

[Sec. 6039 as added by sec. 221(b)(1), Rev. Act 1964 (78 Stat. 73)]

§ 1.6039-1 Information returns required of corporations with respect to certain stock option transactions occurring on or after January 1, 1964.

(a) *Requirement of return under section 6039(a)(1).* Every corporation which transfers stock to any person pursuant to such person's exercise on or after January 1, 1964, of a qualified stock option described in section 422(b), or a restricted stock option described in section 424(b), shall make, for each calendar year in which such a transfer occurs, an information return on Form 3921 with respect to each transfer made during such year. The return shall include the following information:

(1) The name, address and employer identification number of the corporation transferring the stock;

(2) The name, address, and identifying number of the person to whom the share or shares of stock were transferred;

(3) The name and address of the corporation the stock of which is the subject of the option (if other than the corporation transferring the stock);

(4) The date the option was granted;

(5) The date the shares were transferred to the person exercising the option;

(6) The fair market value of the stock at the time the option was exercised;

(7) The number of shares of stock transferred pursuant to the option;

(8) The type of option under which the transferred shares were acquired; and

(9) Such other information as may be required by the return or by the instructions issued with respect thereto.

(b) *Requirement of return under section 6039(a)(2).* (1) Every corporation which records, or has by its agent recorded, a transfer of the title to stock acquired by the transferor pursuant to

his exercise on or after January 1, 1964, of—

(i) An option granted under an employee stock purchase plan which meets the requirements of section 423(b), and with respect to which the special rule of section 423(c) applied, or

(ii) A restricted stock option which meets the requirements of section 424(b), and with respect to which the special rule of section 424(c)(1) applies,

shall make, for each calendar year in which such a recorded transfer of title to such stock occurs, an information return on Form 3922 with respect to each transfer containing the information required by subparagraph (2) of this paragraph.

(2) The return required by subparagraph (1) of this paragraph shall contain the following information:

(i) The name and address of the corporation whose stock is being transferred;

(ii) The name, address, and identifying number of the transferor;

(iii) The date such stock was transferred to the transferor;

(iv) The number of shares to which title is being transferred; and

(v) The type of option under which the transferred shares were acquired.

(3) If the return required by this paragraph is made by the authorized "transfer agent" of the corporation, it shall be deemed to have been made by the corporation. The term "transfer agent", as used in this paragraph, means any designee authorized to keep the stock ownership records of a corporation and to record a transfer of title of the stock of such corporation on behalf of such corporation.

(4) Where a corporation is required by this paragraph to make an information return for the calendar year, such return will only have to supply information relating to the first recorded transfer of title to the share or shares of stock. Thus, for example, if the owner has record title to a share or shares of stock transferred to a recognized broker or financial institution and the stock is subsequently sold by such broker or institution (on behalf of the owner) the corporation is only required to report information relating to the transfer of record title to the broker or financial institution. Similarly, a return is required when a share of stock is transferred by the optionee to himself and another person (or persons) as joint tenants, tenants by the entirety or tenants in common. However, when stock is originally issued to the optionee and another person (or persons) as joint tenants, or as tenants by the entirety, and a stock certificate was not previously actually issued to the optionee as a sole owner, the return required by this paragraph shall be made (at such time and in such manner as is provided by this section with respect to a transfer by the optionee) in respect of the first transfer of the title to such stock by the optionee.

(5) Every corporation which transfers any share of stock pursuant to the exercise of an option described in this para-

graph shall identify such stock in a manner sufficient to enable the accurate reporting of the transfer of record title to such shares. Such identification may be accomplished by assigning to the certificates of stock issued pursuant to the exercise of such options a special serial number, or color.

(c) *Time, place, and manner of filing.*

(1) The returns on Forms 3921 and 3922 required by section 6039(a)(1) and (2) and paragraphs (a) and (b) of this section shall be filed as attachments to a summary report on Form 4067 which must be signed by the person required to file the returns or its duly authorized agent. With respect to returns on Form 3921, the summary report on Form 4067 shall indicate the number of returns filed, the number of shares transferred pursuant to exercise of options, the dates on which the options exercised were offered or granted, the fair market value of shares subject to option on such dates, the method by which such value was determined, the type of options under which the transferred shares were acquired, and such other information as may be required by the form or by the instructions issued with respect thereto. With respect to returns on Form 3922, the summary report on Form 4067 shall indicate the number of returns filed, the number of shares transferred, the type of options under which the transferred shares were acquired and such other information as may be required by the form or by the instructions issued with respect thereto. The summary report on Form 4067 and the attached returns on Forms 3921 and 3922 required for any calendar year shall be filed on or before February 28 of the following year with any of the Internal Revenue Service Centers.

(2) If a return is made by the authorized "transfer agent" of the corporation, as described in paragraph (b)(3) of this section, it shall be filed with the district director for the district where the income tax return of the principal corporation is filed after the close of the calendar year for which the return is required, but on or before February 28th of the following calendar year.

(3) For provisions relating to the extension of time for filing the returns required by this section, see § 1.6081-1.

(4) For provisions relating to the time for performance of an act when the last day prescribed for performance falls on Saturday, Sunday, or a legal holiday, see § 301.7503-1 of this chapter (Regulations on Procedure and Administration).

(d) *Stock to which this section applies.* The rules of this section shall apply to any full share of stock acquired pursuant to the exercise of any qualified or restricted stock option, or any option granted under an employee stock purchase plan, irrespective of whether the transfer of stock pursuant to such exercise qualified for the special tax treatment of section 421 and the regulations thereunder. In addition, the rules of paragraph (b) of this section shall apply to any full shares of stock received in respect of stock which was originally acquired pursuant to the exercise of an option described in the preceding sen-

tence. See section 425(b). For definitions of the terms "exercise" and "transfer" see paragraphs (f) and (g) of § 1.421-7. A return is required under paragraph (b) of this section irrespective of whether the transfer of title constitutes a disposition of such stock as defined by section 425(c).

§ 1.6039-2 Statements to persons with respect to whom information is furnished.

(a) *Requirement and form of statement.* Every corporation required to make a return on Form 3921 or 3922 under section 6039(a) and § 1.6039-1 shall furnish to each person whose identifying number is (or should be) shown on such return a written statement containing the information required to be shown on such return. This requirement may be met by furnishing a copy of the appropriate return to such person. A statement shall be considered to be furnished to a person within the meaning of this section if it is mailed to such person at his last known address.

(b) *Time for furnishing statements—*
(1) *In general.* Each statement required by this section to be furnished to any person for a calendar year shall be furnished to such person on or before January 31 of the year following the year for which the statement is required.

(2) *Extension of time.* For good cause shown upon written application of the corporation required to furnish statements under this section, the district director may grant an extension of time not exceeding 30 days in which to furnish such statements. The application shall be addressed to the district director with whom the income tax returns of the applicant-corporation are filed and shall contain a full recital of the reasons for requesting the extension to aid the district director in determining the period of the extension, if any, which will be granted. Such a request in the form of a letter to the district director signed by the applicant (or its agent) will suffice as an application. The application shall be filed on or before the date prescribed in subparagraph (1) of this paragraph for furnishing the statements required by this section.

(3) *Last day for furnishing statement.* For provisions relating to the time for performance of an act when the last day prescribed for performance falls on Saturday, Sunday, or a legal holiday, see § 301.7503-1 of this chapter (Regulations on Procedure and Administration).

(c) *Penalty.* For provisions relating to the penalty provided for failure to furnish a statement under this section, see § 301.6678-1 of this chapter (Regulations on Procedure and Administration).

PAR. 13. Paragraph (c) of § 1.6071-1 is amended to read as follows:

§ 1.6071-1 Time for filing returns and other documents.

(c) *Time for filing certain information returns.* (1) For provisions relating to the time for filing returns of partnership income, see paragraph (e) (2) of § 1.6031-1.

(2) For provisions relating to the time for filing information returns by banks with respect to common trust funds, see § 1.6032-1.

(3) For provisions relating to the time for filing information returns by certain organizations exempt from taxation under section 501(a), see paragraph (e) of § 1.6033-1.

(4) For provisions relating to the time for filing returns by trusts claiming charitable deductions under section 642(c), see paragraph (c) of § 1.6034-1.

(5) For provisions relating to the time for filing information returns by officers, directors, and shareholders of foreign personal holding companies, see §§ 1.6035-1 and 1.6035-2.

(6) For provisions relating to the time for filing information returns with respect to certain stock option transactions, see paragraph (c) of § 1.6039-1.

(7) For provisions relating to the time for filing information returns by persons making certain payments, see § 1.6041-6.

(8) For provisions relating to the time for filing information returns regarding payments of dividends, see paragraph (d) of § 1.6042-1, and paragraph (c) of § 1.6042-2 (relating to returns for calendar years after 1962).

(9) For provisions relating to the time for filing information returns by corporations with respect to contemplated dissolution or liquidations, see paragraph (a) of § 1.6043-1.

(10) For provisions relating to the time for filing information returns by corporations with respect to distributions in liquidation, see paragraph (a) of § 1.6043-2.

(11) For provisions relating to the time for filing information returns with respect to payments of patronage dividends, see paragraph (b) of § 1.6044-1, and paragraph (d) of § 1.6044-2 (relating to returns for calendar years after 1962).

(12) For provisions relating to the time for filing information returns with respect to formation or reorganization of foreign corporations, see § 1.6046-1.

(13) For provisions relating to the time for filing information returns regarding certain payments of interest, see paragraph (c) of § 1.6049-1.

(14) For provisions relating to the time for filing information returns with respect to payment of wages in the form of group-term life insurance, see paragraph (b) of § 1.6052-1.

PAR. 14. Paragraph (b) of § 1.6091-1 is amended to read as follows:

§ 1.6091-1 Place for filing returns or other documents.

(b) *Place for filing certain information returns.* (1) For the place for filing returns of partnership income, see paragraph (e) (1) of § 1.6031-1.

(2) For the place for filing information returns by banks with respect to common trust funds, see § 1.6032-1.

(3) For the place for filing information returns by certain organizations exempt from taxation under section 501(a), see paragraph (e) of § 1.6033-1.

(4) For the place for filing information returns by trusts claiming charitable deductions under section 642(c), see paragraph (c) of § 1.6034-1.

(5) For the place for filing information returns by officers, directors, and shareholders of foreign personal holding companies, see paragraph (d) of § 1.6035-1 and paragraph (d) of § 1.6035-2.

(6) For the place for filing information returns relating to certain stock option transactions, see paragraph (c) of § 1.6039-1.

(7) For the place for filing returns of information reporting certain payments on Forms 1099 and 1096, see § 1.6041-6.

(8) For the place for filing returns of information regarding payments of dividends, see paragraph (d) of § 1.6042-1 and paragraph (c) of § 1.6042-2 (relating to returns for calendar years after 1962).

(9) For the place for filing information returns by corporations relating to contemplated dissolution or liquidation, see paragraph (a) of § 1.6043-1.

(10) For the place for filing information returns by corporations relating to distributions in liquidation, see paragraph (a) of § 1.6043-2.

(11) For the place for filing returns of information regarding payments of patronage dividends, see paragraph (b) of § 1.6044-1, and paragraph (d) of § 1.6044-2 (relating to returns for calendar years after 1962).

(12) For the place for filing information returns relating to formation or reorganization of foreign corporations, see paragraph (e) of § 1.6046-1.

(13) For the place for filing information returns regarding certain payments of interest, see paragraph (c) of § 1.6049-1.

(14) For the place for filing information returns with respect to payment of wages in the form of group-term life insurance, see paragraph (b) of § 1.6052-1.

PAR. 15. Section 301.6652 is amended by revising section 6652(a), and by adding a historical note. These amended and added provisions read as follows:

§ 301.6652 Statutory provisions; failure to file certain information returns.

Sec. 6652. Failure to file certain information returns—(a) Returns relating to payments of dividends, etc., and certain transfers of stock. In the case of each failure—

(1) To file a statement of the aggregate amount of payments to another person required by section 6042(a) (1) (relating to payments of dividends aggregating \$10 or more), section 6044(a) (1) (relating to payments of patronage dividends aggregating \$10 or more), or section 6049(a) (1) (relating to payments of interest aggregating \$10 or more),

(2) To make a return required by section 6039(a) (relating to reporting information in connection with certain options) with respect to a transfer of stock or a transfer of legal title to stock, or

(3) To make a return required by section 6052(a) (relating to reporting payment of wages in the form of group-term life insurance) with respect to group-term life insurance on the life of an employee, on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not to willful ne-

glect, there shall be paid (upon notice and demand by the Secretary or his delegate and in the same manner as tax), by the person failing to file a statement referred to in paragraph (1) or failing to make a return referred to in paragraph (2) or (3), \$10 for each such failure, but the total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed \$25,000.

[Sec. 6652 as amended by sec. 85, Technical Amendments Act 1958 (72 Stat. 1664); sec. 19(d), Rev. Act 1962 (76 Stat. 1057); sec. 221(b) (2), Rev. Act 1964 (78 Stat. 74)]

PAR. 16. The last sentence of paragraph (a) (1) of § 301.6652-1 is revised, and paragraphs (c), (d) and (e) of § 301.6652-1 are deleted, and new paragraphs (c), (d), (e), (f) and (g) are added thereto. These revised and added provisions read as follows:

§ 301.6652-1 Failure to file certain information returns.

(a) *Returns with respect to payments made in calendar years after 1962—*(1) *Payments of dividends, interest, or patronage dividends aggregating \$10 or more.* In the case of each failure to file a statement required by—

(i) Section 6042(a) (1), relating to information returns with respect to payments of dividends aggregating \$10 or more in a calendar year, in effect with respect to payments made after December 31, 1962,

(ii) Section 6044(a) (1), relating to information returns with respect to certain payments by cooperatives aggregating \$10 or more in a calendar year, in effect with respect to payments made on or after the first day of the first taxable year of the cooperative beginning after December 31, 1962, with respect to patronage occurring on or after such first day, or

(iii) Section 6049(a) (1), relating to information returns with respect to payments of interest aggregating \$10 or more in a calendar year, in effect with respect to payments made after December 31, 1962, and the regulations under such section, within the time prescribed for filing such statement (determined with regard to any extension of time for filing), there shall be paid by the person failing to so file the statement \$10 for each such statement not so filed. However, the total amount imposed on the delinquent person for all such failures under section 6652(a) and this section during any calendar year shall not exceed \$25,000.

(c) *Returns with respect to reporting payments of wages in the form of group-term life insurance provided in a calendar year after December 31, 1963.* In the case of each failure to file a return required by section 6052(a), relating to reporting payment of wages in the form of group-term life insurance provided for any employee on his life in a calendar year after December 31, 1963, and the regulations under such section, within the time prescribed for filing such return (determined with regard to any extension of time for filing), there shall be paid by the person failing to

so file such return \$10 for each such return not so filed. However, the total amount imposed on the delinquent person for all such failures under section 6652(a) and this section during any calendar year shall not exceed \$25,000.

(d) *Returns with respect to transfer of stock or record title thereto pursuant to options exercised on or after January 1, 1964.* In the case of each failure to file a statement of the transfer of stock or of record title thereto as required by section 6039(a) and the regulations under such section within the time prescribed for filing such statement (determined with regard to any extension of time for filing), there shall be paid by the corporation failing to so file such statement, \$10 for each such statement not so filed. However, the total amount imposed on the delinquent corporation for all such failures under section 6652(a) and this section during any calendar year shall not exceed \$25,000.

(e) *Manner of payment.* The penalty imposed under section 6652 and this section on any person shall be paid in the same manner as tax upon the issuance of a notice and demand therefor.

(f) *Showing of reasonable cause.* The penalty imposed by section 6652 shall not apply with respect to a failure to file a statement within the time prescribed if it is established to the satisfaction of the district director or the director of the regional service center that such failure was due to reasonable cause and not to willful neglect. An affirmative showing of reasonable cause must be made in the form of a written statement, containing a declaration that it is made under the penalties of perjury, setting forth all the facts alleged as a reasonable cause.

(g) *Alcohol and tobacco taxes.* For penalties for failure to file certain information returns with respect to alcohol and tobacco taxes, see, generally, subtitle E of the Code.

PAR. 17. Section 301.6678 is amended by revising section 6678 and by adding a historical note. These amended and added provisions read as follows:

§ 301.6678 Statutory provisions; failure to furnish certain statements.

Sec. 6678. *Failure to furnish certain statements.* In the case of each failure to furnish a statement under section 6039(b), 6042(c), 6044(e), 6049(c) and 6052(b) on the date prescribed therefor to a person with respect to whom a return has been made under section 6039(a), 6042(a) (1), 6044(a) (1), 6049(a) (1), or 6052(a), respectively, unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid (upon notice and demand by the Secretary or his delegate and in the same manner as tax), by the person failing to so furnish the statement, \$10 for each such statement not so furnished, but the total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed \$25,000.

[Sec. 6678 as added by sec. 19(e), Rev. Act 1962 (76 Stat. 1058) and as amended by secs. 204(c) (2), 221(b) (3), Rev. Act 1964 (78 Stat. 37, 75)]

PAR. 18. Paragraph (a) of § 301.6678-1 is amended by adding thereto new subparagraphs (4) and (5). These added provisions read as follows:

§ 301.6678-1 Failure to furnish statements.

(a) *In general.* * * *

(4) Under section 6039(b) and § 1.6039-2 to a person with respect to whom a return has been made under section 6039(a), relating to information returns with respect to certain stock option transactions occurring in a calendar year, or

(5) Under section 6052(b) and § 1.6052-2 to a person with respect to whom a return has been made under section 6052(a), relating to information returns with respect to payment of wages in the form of group-term life insurance provided for an employee on his life.

(Sec. 7805, Internal Revenue Code of 1954; 68A Stat. 917; 26 U.S.C. 7805)

[F.R. Doc. 66-6923; Filed, June 23, 1966; 8:47 a.m.]

Title 46—SHIPPING

Chapter IV—Federal Maritime Commission

SUBCHAPTER B—REGULATIONS AFFECTING MARITIME CARRIERS AND RELATED ACTIVITIES

[General Order 15; Amdt. I]

PART 533—FILING OF TARIFFS BY TERMINAL OPERATORS

Compliance

On October 5, 1965, the Federal Maritime Commission published in the FEDERAL REGISTER final rules governing the filing of tariffs by terminal operators (30 F.R. 12681). The rules provided that terminal operators were required to comply with the rules within 180 days from the effective date of the rules. Thereafter, certain railroads which operate terminal facilities petitioned the U.S. Court of Appeals for the District of Columbia Circuit to review the rules, alleging inter alia that the rules were invalid because the Commission was attempting to exercise jurisdiction committed by Congress to the Interstate Commerce Commission. The railroads apparently construed the Commission's notice promulgating the rules as evidence of an intent by the Commission to regulate the regulations and practices of terminal facilities insofar as cargo carried to or from piers by railroads is concerned, and since the Interstate Commerce Commission regulates the rates, regulations and practices of terminal facilities utilized by and for rail traffic, the railroads anticipated the exercise of concurrent jurisdiction by the two agencies, something they assert is prohibited by section 33 of the Shipping Act, 1933.

Following the filing of the petition to review in the court of appeals, we postponed the effective date of the rules until the court disposed of the review suit (31 F.R. 2429). On March 9, 1966, the railroads, the Federal Maritime Commission, and the United States moved the court of appeals to stay all proceedings in the case until May 16,

1966, in order to allow the Interstate Commerce Commission opportunity to consider the problems raised by the case and determine whether or not it should intervene. On March 18, 1966, the court granted the motion to stay. Subsequently, we proposed certain changes in the rules and in our opinion promulgating the rules to the Interstate Commerce Commission in order to satisfy the objection of that Commission. The Interstate Commerce Commission agreed that the changes satisfied their objection, and, accordingly, we moved the court of appeals on May 18, 1966, for leave to amend the rules. On June 13, 1966 the court granted the motion—

conditioned upon (1) the Commission's issuance of the amended order within 15 days from the date of this order and (2) the Commission's agreement to stay the effectiveness of its order pending final disposition of this case in this court. * * *

We accept those conditions.

In promulgating the rules in question, the Federal Maritime Commission did not intend to decide the question of whether it has jurisdiction over regulations and practices of railroad-operated terminals insofar as cargo carried to or from the piers by railroads is concerned. In promulgating the rules, the Federal Maritime Commission is simply requiring that railroad-operated terminals which handle cargo delivered by modes of transportation other than rail, file with this Commission all separately stated terminal rates and rules and regulations affecting those rates.

A reading of our opinion promulgating the rules under review indicates to us that it is susceptible of an interpretation that we asserted jurisdiction to regulate regulations and practices relating to rail traffic.

The following portion of our opinion provides the basis for that interpretation:

Specific charges for marine terminal services performed in connection with cargo moving on common carriers by water, however, are subject to Federal Maritime Commission jurisdiction. If the function is of a marine terminal nature, no matter what the identity of the person performing such function, it is subject to Federal Maritime Commission jurisdiction. If the Commission were to regulate only the services performed by railroad marine terminals in connection with truck traffic, and not regulate identical services performed for rail traffic, the door would be open to discrimination by railroads against truck cargo in favor of their own rail cargo.

We hereby strike the foregoing quotation from our previous opinion.

Additionally, we think that any burden on the railroads resulting from duplication of tariff filings will be greatly minimized by the following change. We are allowing terminal operators who file tariffs with the Interstate Commerce Commission to file with us copies of those tariffs rather than requiring them to prepare new tariffs for filing only with us. Many of the railroads have been following this procedure in the past

even though there have not been any formal requirements relating to tariff filings with this Commission.

Therefore, pursuant to section 4 of the Administrative Procedure Act (5 U.S.C. 1003) and sections 17, 21, and 43 of the Shipping Act, 1916 (46 U.S.C. 816, 820, and 841a), § 533.5 of Title 46, CFR, is hereby amended by the addition of the following sentence:

§ 533.5 Compliance with this part and other terminal tariff filing requirements.

* * * Terminal Operators who file tariffs with the Interstate Commerce Commission pursuant to statute or rule of that Commission may satisfy the requirements of this part by filing with the Federal Maritime Commission a copy of any such tariff filed with the Interstate Commerce Commission.

The Commission is of the opinion that the notice and public procedure afforded by section 4(a) of the Administrative Procedure Act (5 U.S.C. 1003) are unnecessary in this instance, as this amendment clarifies the intent of the original order and relieves restrictions imposed by the rules as originally issued. In accordance with our notice issued previously and as recited above, the effective date of these rules is postponed pending disposition by the Court of Appeals of the review suit now pending.

By the Commission.

[SEAL]

THOMAS LISI,
Secretary.

[F.R. Doc. 66-6929; Filed, June 23, 1966;
8:48 a.m.]

Title 49—TRANSPORTATION

Chapter I—Interstate Commerce Commission

SUBCHAPTER A—GENERAL RULES AND REGULATIONS

[S.O. 983-A]

PART 95—CAR SERVICE

Distribution of Boxcars

At a session of the Interstate Commerce Commission, Railroad Safety and Service Board, held in Washington, D.C., on the 20th day of June A.D. 1966.

Upon further consideration of Service Order No. 983 (31 F.R. 6060, 7469) and good cause appearing therefor:

It is ordered, That:

Section 95.983 *Distribution of Boxcars*, be and it is ordered vacated and set aside.

(Secs. 1, 12, 15, 24 Stat. 379, 383, 384, as amended; 49 U.S.C. 1, 12, 15, 17(2). Interprets or applies secs. 1(10-17), 15(4), 40 Stat. 101, as amended 54 Stat. 911; 49 U.S.C. 1(10-17), 15(4), 17(2))

It is further ordered, That this order shall become effective at 11:59 p.m., June 21, 1966; that copies of this order and direction shall be served upon the Association of American Railroads, Car Service Division, as agent of the railroads subscribing to the car service and

per diem agreement under the terms of that agreement; and that notice of the order shall be given to the general public by depositing a copy in the office of the Secretary of the Commission at Washington, D.C., and by filing it with the Director, Office of the Federal Register.

By the Commission, Railroad Safety and Service Board.

[SEAL]

H. NEIL GARSON,
Secretary.

[F.R. Doc. 66-6932; Filed, June 23, 1966;
8:48 a.m.]

[Rev. S.O. 985-A]

PART 95—CAR SERVICE

Distribution of Boxcars

At a session of the Interstate Commerce Commission, Railroad Safety and Service Board, held in Washington, D.C., on the 20th day of June A.D. 1966.

Upon further consideration of Revised Service Order No. 985 (31 F.R. 7468, 8064) and good cause appearing therefor:

It is ordered, That:

Section 95.985 *Distribution of boxcars*, be and it is ordered vacated and set aside.

(Secs. 1, 12, 15, 24 Stat. 379, 383, 384, as amended; 49 U.S.C. 1, 12, 15, 17(2). Interprets or applies secs. 1(10-17), 15(4), 40 Stat. 101, as amended 54 Stat. 911; 49 U.S.C. 1(10-17), 15(4), 17(2))

It is further ordered, That this order shall become effective at 11:59 p.m., June 21, 1966; that copies of this order and direction shall be served upon the Association of American Railroads, Car Service Division, as agent of the railroads subscribing to the car service and per diem agreement under the terms of that agreement; and that notice of the order shall be given to the general public by depositing a copy in the office of the Secretary of the Commission at Washington, D.C., and by filing it with the Director, Office of the Federal Register.

By the Commission, Railroad Safety and Service Board.

[SEAL]

H. NEIL GARSON,
Secretary.

[F.R. Doc. 66-6933; Filed, June 23, 1966;
8:48 a.m.]

[S.O. 986]

PART 95—CAR SERVICE

Distribution of Boxcars

At a session of the Interstate Commerce Commission, Railroad Safety and Service Board, held in Washington, D.C., on the 21st day of June A.D., 1966.

It appearing, that there is presently a shortage of boxcars to meet current requirements on the railroads named in paragraph (a) herein; that forthcoming grain harvests will further greatly deplete an inadequate supply of boxcars; that prompt and uninterrupted movement of grains from farms to terminals is essential to prevent spoilage and con-