that does not individually or cumulatively have a significant effect on the human environment. Therefore, neither an environmental assessment nor an environmental impact statement is required.

This rule does not meet the definition of ''rule'' in 5 U.S.C. 804(3)(A) because it is a rule of ''particular applicability.'' Therefore, it is not subject to the congressional review requirements in 5 U.S.C. 801–808.

List of Subjects in 21 CFR Part 529

Animal drugs.

■ Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, 21 CFR part 529 is amended as follows:

PART 529—CERTAIN OTHER DOSAGE FORM NEW ANIMAL DRUGS

■ 1. The authority citation for 21 CFR part 529 continues to read as follows:

Authority: 21 U.S.C. 360b.

■ 2. Section 529.1940 is revised to read as follows:

§ 529.1940 Progesterone intravaginal inserts.

(a) *Specifications.* Each insert contains:

(1) 1.38 grams (g) progesterone in molded silicone over a nylon spine.

(2) 0.3 g progesterone in molded silicone over a flexible nylon spine.

(b) *Sponsor.* See No. 000009 in § 510.600(c) of this chapter for use of the product described in paragraph (a)(1) of this section as in paragraph (e)(1) of this section; and the product described in paragraph (a)(2) of this section as in paragraph (e)(2) of this section.

(c) *Related tolerances.* See § 556.540(a) of this chapter.

(d) *Special considerations*—(1) *Cows and ewes.* Product labeling shall bear the following warnings: ''Avoid contact with skin by wearing protective gloves when handling inserts. Store removed inserts in a sealable container until they can be disposed of in accordance with applicable local, state, and Federal regulations.''

(2) *Cows.* This product is approved with the concurrent use of dinoprost solution on day 6 of the 7-day administration period when used for indications listed in paragraph (e)(1)(ii)(A) of this section. See § 522.690(c) of this chapter.

(e) *Conditions of use*—(1) *Cows*—(i) *Amount.* Administer one intravaginal insert per animal for 7 days. When used for indications listed in paragraph (e)(1)(ii)(A) of this section, administer 25 milligrams (mg) dinoprost (5 milliliters (mL) of 5 mg/mL solution as in § 522.690(a) of this chapter) as a single intramuscular injection one day prior to insert removal.

(ii) *Indications for use*—(A) For synchronization of estrus in suckled beef cows and replacement beef and dairy heifers, for advancement of first postpartum estrus in suckled beef cows, and for advancement of first pubertal estrus in replacement beef heifers.

(B) For synchronization of the return to estrus in lactating dairy cows inseminated at the immediately preceding estrus.

(iii) *Limitations.* Do not use in animals with abnormal, immature, or infected genital tracts; or in beef cows that are fewer than 20 days postpartum; or in beef or dairy heifers of insufficient size or age for breeding. Do not use an insert more than once. To prevent the potential transmission of venereal and bloodborne diseases, the inserts should be disposed after a single use. Administration of vaginal inserts for periods greater than 7 days may result in reduced fertility. Dinoprost solution provided by No. 000009 in § 510.600(c) of this chapter.

(2) *Ewes*—(i) *Amount.* Administer one intravaginal insert per animal for 5 days.

(ii) *Indications for use.* For induction of estrus in ewes (sheep) during seasonal anestrus.

(iii) *Limitations.* Do not use in animals with abnormal, immature, or infected genital tracts; or in ewes that have never lambed. Do not use an insert more than once. To prevent the potential transmission of venereal and bloodborne diseases, the inserts should be disposed after a single use. A pre-slaughter withdrawal period is not required when this product is used according to directions.

Dated: November 3, 2009.

Bernadette Dunham,

Director, Center for Veterinary Medicine.

[FR Doc. E9–27497 Filed 11–16–09; 8:45 am]

BILLING CODE 4160–01–S

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9471]

RIN 1545–BH68

Employee Stock Purchase Plans Under Internal Revenue Code Section 423

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains the final regulations relating to options granted under an employee stock purchase plan as defined in section 423 of the Internal Revenue Code (Code). These final regulations affect certain taxpayers who participate in the transfer of stock pursuant to the exercise of options granted under an employee stock purchase plan. These final regulations provide guidance to assist taxpayers in complying with section 423 in addition to clarifying certain rules regarding options granted under an employee stock purchase plan. This document also contains final regulations under sections 421, 422 and 424 of the Code.

DATES: *Effective Date:* These regulations are effective on November 17, 2009.

Applicability Date: These regulations apply as of January 1, 2010.

FOR FURTHER INFORMATION CONTACT: Thomas Scholz or Ilya Enkishev at (202) 622–6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final amendments to the Income Tax Regulations (26 CFR part 1) under sections 421, 422, 423 and 424 of the Code.

Section 423 was added to the Code by section 221(a) of the Revenue Act of 1964, Public Law 88–272 (78 Stat. 63 (1964)). Changes to the applicable law concerning section 423 were made by sections 1402(b)(1)(C) and 1402(b)(2) of the Tax Reform Act of 1976, Public Law 94–455 (90 Stat. 1731 and 1732–1733 (1976)); section 1001(b)(5) of the Deficit Reduction Act of 1984, Public Law 98–369 (98 Stat. 1011 (1984)); section 1114 of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2451 (1986)); and sections 11801(c)(9)(D)(i), (ii) and 11801(c)(9)(E) of the Omnibus Budget Reconciliation Act of 1990, Public Law 101–508 (104 Stat. 1388–525 (1990)).

Regulations under section 423 were published in the **Federal Register** on June 23, 1966 (TD 6887). These

regulations were amended on September 27, 1979 (TD 7645), October 31, 1980 (TD 7728), and December 1, 1988 (TD 8235). In Notice 2004–55 (2004–34 IRB 319 (August 23, 2004)) (see § 601.601(d)(2)(ii)(*b*)), the IRS and the Treasury Department requested comments concerning whether the existing regulations under section 423 should be amended, and if so, what issues should be addressed.

On July 29, 2008, the Treasury Department published a notice of proposed rulemaking (REG–106251–08) in the **Federal Register** (73 FR 43875) under section 423. A public hearing on the proposed regulations was held on January 15, 2009. Written and electronic comments responding to the notice of proposed rulemaking were received. After consideration of these comments, the Treasury Department adopts the proposed regulations as final regulations, with the modifications set forth in this Treasury decision. The significant revisions are discussed in this preamble.

In general, the income tax treatment of the grant of an option to purchase stock in connection with the performance of services and of the transfer of stock pursuant to the exercise of the option is determined under section 83 and the regulations thereunder. However, section 421 provides special rules for determining the income tax treatment of the transfer of shares of stock pursuant to the exercise of an option if the requirements of sections 422(a) or 423(a), as applicable, are met. Section 422 applies to incentive stock options and section 423 applies to options granted under an employee stock purchase plan (collectively, statutory options).

Under section 421, if a share of stock is transferred to an individual pursuant to the exercise of a statutory option, there is no income at the time of exercise of the option with respect to the transfer and no deduction under section 162 is allowed to the employer corporation with respect to the transfer.

Section 423(a) provides that section 421 applies to the transfer of stock to an individual pursuant to the exercise of an option granted under an employee stock purchase plan if: (i) No disposition of the stock is made within two years from the date of grant of the option or within one year from the date of transfer of the share, and (ii) at all times during the period beginning on the date of grant and ending on the day three months before the exercise of the option, the individual is an employee of either the corporation granting the option or a parent or subsidiary of such corporation, or a corporation (or a parent or subsidiary of such corporation) issuing or assuming a stock option in a transaction to which section 424(a) applies. Section 423(b) sets forth several requirements that must be met for a plan to qualify as an employee stock purchase plan. Section 423(c) provides a special rule that is applicable where the option exercise price is between 85 and 100 percent of the fair market value of the stock at the time the option was granted.

Explanation of Provisions

These final regulations provide a comprehensive set of rules governing stock options issued under an employee stock purchase plan and incorporate substantially all of the rules contained in the existing regulations under section 423. These final regulations are comprised of two sections: Section 1.423–1, applicability of section 421(a); and § 1.423–2, employee stock purchase plan defined. The modifications to the proposed regulations that are included in these final regulations reflect consideration of the comments submitted by taxpayers.

1. General Requirements

The proposed regulations provide that an employee stock purchase plan must meet the requirements of paragraphs (i) through (ix) of § 1.423–2(a)(2) to qualify as an employee stock purchase plan under section 423(b). The proposed regulations also provide that the requirements of paragraphs (iii) through (ix) of § 1.423–2(a)(2) may be satisfied by the terms of the plan or an offering made under the plan. The final regulations adopt these requirements of the proposed regulations, although the numerical designation of the requirements is modified. To emphasize that the requirements of paragraphs (iii) through (ix) of § 1.423–2(a)(2) of the proposed regulations may be satisfied by the terms of the plan or an offering made under the plan, these final regulations separately list these requirements in § 1.423–2(a)(3).

Commenters requested clarification of whether options with terms that are inconsistent with the terms of the plan will be eligible for the special tax treatment of section 421. As provided in § 1.423–2(a)(3) of the proposed regulations, § 1.423–2(a)(4) of these final regulations provides that, if the terms of an option are inconsistent with the terms of the employee stock purchase plan or an offering under the plan, then the option will not be treated as granted under an employee stock purchase plan. However, an option may still qualify for the special tax treatment of section 421, even if the terms of the plan are inconsistent with any of the requirements in § 1.423–2(a)(3) of these final regulations, if the option is granted under an offering with terms that comply with the requirements of § 1.423–2(a)(3). *Example 2* of § 1.423–2(e)(6) of these final regulations illustrates this principle.

2. Offerings Under an Employee Stock Purchase Plan

These final regulations provide further guidance for employee stock purchase plans under which more than one offering is made. As set forth in § 1.423–2(a)(1) of these final regulations, one or more offerings may be made under a plan and the offerings may be consecutive or overlapping. Further, pursuant to section 423(b) and its flush language, the terms of each offering need not be identical. Although the terms of each offering need not be identical, the terms of the plan and each offering together must satisfy the requirements of § 1.423–2(a)(2) and (3) of these final regulations. For example, if overlapping offerings are made under an employee stock purchase plan, then each offering may contain different terms, provided that the terms of each offering (together with the plan) satisfy the requirements of § 1.423–2(a)(3) of these final regulations. Furthermore, when a parent corporation adopts an employee stock purchase plan, it may establish separate offerings with different terms under the plan and designate which subsidiary corporations of the parent corporation may participate in a particular offering, provided that the terms of each offering (together with the plan) satisfy the requirements of § 1.423–2(a)(3). The terms ''parent corporation'' and ''subsidiary corporation'' are defined in § 1.424–1(f) of the regulations.

a. Employees Covered by the Plan

Paragraphs (i) through (iv) of § 1.423–2(e)(1) of the proposed regulations and these final regulations set forth the categories of employees that may be excluded from coverage under an employee stock purchase plan or an offering under the plan. The proposed regulations provide that the exclusions for various categories of employees must be applied in an identical manner to all employees of every corporation whose employees are granted options under the plan. Commenters noted that the requirement of identical exclusions for all offerings under a plan constrains the ability to make future and overlapping offerings that are more (or less) inclusive than prior offerings under the plan. Commenters suggested that the final regulations should permit multiple

offerings under a plan with different exclusions applicable to the one or more corporations whose employees participate in the particular offering under the plan.

These final regulations generally adopt the approach suggested by the commenters. Pursuant to these final regulations, whether the terms of a plan and offering satisfy the requirements of § 1.423–2(e) is made on an offering-by-offering basis. The terms of each offering under a plan may be different, provided the plan and offering together satisfy the requirements of § 1.423–2(a)(2) and (3) of these final regulations. With respect to satisfying the requirements of § 1.423–2(e), the terms of each offering may provide different exclusions of employees, as permitted and within the limitations described in § 1.423–2(e)(1), (2) and (3) of these final regulations. The exclusions established with respect to a particular offering must be applied in an identical manner to all employees of every corporation whose employees are granted options under that particular offering. *Examples 7* and *8* of § 1.423–2(e)(6) of these final regulations illustrate these principles.

Some commenters suggested that the final regulations permit employers to exclude from plan participation employees who are nonresident aliens and who receive no earned income that constitutes income from sources within the United States. Other commenters suggested that the final regulations permit employers to exclude from plan participation employees under a specified age. The IRS and the Treasury Department are aware of the complexities often associated with participation in an employee stock purchase plan by nonresident aliens and employees under a specified age, such as the age of majority. However, section 423 does not provide exclusions for nonresident aliens or employees under a specified age. Accordingly, the IRS and the Treasury Department are constrained by statutory authority from providing a general exclusion from plan participation for employees who are nonresident aliens or employees under a specified age.

One commenter suggested that the final regulations provide additional flexibility by permitting employers to exclude from plan participation highly compensated employees (HCEs) (within the meaning of section 414(q)) on any basis. Section 1.423–2(e)(2)(ii) of the proposed regulations provides that the terms of an employee stock purchase plan may exclude HCEs: (a) with compensation above a certain level, or (b) who are officers or subject to the disclosure requirements of section 16(a) of the Securities Exchange Act of 1934, provided the exclusion is applied in an identical manner to all HCEs of every corporation whose employees are granted options under the plan. These final regulations do not adopt the suggestion that HCEs may be excluded from participation in an employee stock purchase plan on any basis. Instead, these final regulations offer some additional flexibility by providing that, with respect to the exclusion of HCEs, the terms of each offering made under a plan need not be identical with respect to the HCEs, provided the HCEs are excluded as permitted and within the limitations described in § 1.423–2(e)(2)(ii) of these final regulations.

b. Equal Rights and Privileges

Commenters further suggested that the final regulations provide flexibility by permitting employers to make multiple offerings with different rights and privileges applicable to the participants of each offering under a plan. These final regulations generally adopt the approach suggested by the commenters. Pursuant to these final regulations, the determination of whether the terms of an offering satisfy the requirements of § 1.423–2(f) is made on an offering-by-offering basis. The terms of each offering under a plan may be different, provided the plan and offering together satisfy the requirements of § 1.423–2(a)(2) and (3) of these final regulations. However, the rights and privileges established with respect to a particular offering must be applied in an identical manner to all employees of every corporation whose employees are granted options under that particular offering. *Examples 4* and *5* of § 1.423–2(f)(7) of these final regulations illustrate these principles.

3. Maximum Number of Shares That May Be Purchased By an Employee

Commenters asked whether the designation of a maximum number of shares that may be purchased by an employee during the offering is necessary in order for the first day of the offering period to be the date of grant. Consistent with the proposed regulations, § 1.423–2(h)(3) of these final regulations provides that the date of grant will be the first day of an offering period if the terms of an employee stock purchase plan or offering designate a maximum number of shares that may be purchased by each employee during the offering. Similarly, the date of grant will be the first day of an offering if the terms of the plan or offering require the application of a formula to establish, on the first day of the offering, the maximum number of shares that may be purchased by each employee during the offering.

However, § 1.423–2(h)(3) of these final regulations does not require that an employee stock purchase plan or offering designate a maximum number of shares that may be purchased by each employee during the offering or incorporate a formula to establish a maximum number of shares that may be purchased by each employee during the offering. If the maximum number of shares that can be purchased under an option is not fixed or determinable until the date the option is exercised, then the date of exercise will be the date of grant of the option. As discussed in the preamble to the proposed regulations, the $25,000 limit under section 423(b)(8) and the limit on the aggregate number of shares that may be issued under an employee stock purchase plan are not sufficient to establish the maximum number of shares that can be purchased by an employee under an option so that the date of grant will be the first day of the offering. *Examples 1, 2, 3* and *4* in § 1.423–2(h)(4) of these final regulations illustrate these principles.

Commenters also asked whether any particular number of shares is necessary to satisfy the requirement to designate a maximum number of shares that may be purchased during the offering in order for the first day of the offering period to be the date of grant. No particular number of shares is necessary to satisfy this requirement and establish the first day of the offering period as the date of grant for the option. These final regulations adopt § 1.423–2(h)(3) of the proposed regulations to provide that the designation of any maximum number of shares is sufficient to establish the first day of the offering period as the date of grant for the option.

4. Annual $25,000 Limitation

Section 423(b)(8) provides that an employee stock purchase plan must, by its terms, provide that no employee may be permitted to accrue the right to purchase stock under all the employee stock purchase plans of his or her employer corporation and its related corporations at a rate which exceeds $25,000 in fair market value of the stock (determined on the date of grant) for each calendar year in which an option granted to the employee is outstanding. Section 423(b)(8)(A) provides that the right to purchase stock under an option accrues when the option first becomes exercisable.

In drafting the proposed regulations, the Treasury Department and the IRS were aware that taxpayers were interpreting the $25,000 limitation

inconsistently. Certain taxpayers interpreted section 423(b)(8) to mean that the limit increases by $25,000 for each calendar year during which the option is outstanding and exercisable; other taxpayers interpreted the sections to mean that such limit increases for each calendar year during which the option is simply outstanding. Consistent with comments received by the Treasury Department and the IRS in response to Notice 2004–55 (2004–34 IRB 319 (August 23, 2004)), (see § 601.601(d)(2)(ii)(*b*)), the proposed regulations adopted an approach that was generally consistent with the $100,000 limitation for incentive stock options and interpreted section 423(b)(8) to mean that the limit increases by $25,000 for each calendar year during which the option is outstanding and exercisable.

In response to the proposed regulations, several commenters suggested that the Treasury Department and the IRS reconsider the calculation of the $25,000 limitation in section 423(b)(8). Commenters suggested that the regulations adopt an approach that permits an option to accrue at a rate of $25,000 for each calendar year that the option is simply outstanding. Specifically, even though section 423(b)(8)(A) provides that the right to purchase stock actually accrues when the option first becomes exercisable during a calendar year, the first sentence of section 423(b)(8) provides that the limit on accruals is $25,000 ''for each year in which such option is outstanding.'' Upon further consideration and in response to the foregoing comments, these final regulations modify § 1.423–2(i) of the proposed regulations to provide that the limit increases by $25,000 for each calendar year that an option is outstanding. *Example 5* in § 1.423–2(i)(5) of these final regulations has been modified to illustrate this principle.

5. Stockholder Approval Requirements

To qualify as an employee stock purchase plan, section 423(b)(2) requires that the plan be approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted. These final regulations clarify that new stockholder approval is required if there is a change in the shares with respect to which options are issued or a change in the granting corporation. In particular, these final regulations clarify that the stockholders of a subsidiary corporation include the parent corporation and any other stockholders of the subsidiary. Accordingly, these final regulations adopt *Example 1(iii)* in § 1.423–2(c)(5) and *Example 1(iii)* in § 1.422–2(b)(6) of the proposed regulations.

One commenter to the proposed regulations suggested that a conforming change be made to *Example 9(iii)* in § 1.424–1(a)(10) which addresses the substitution of options in the context of an acquisition. *Example 9(iii)* in § 1.424–1(a)(10), as previously set forth in the regulations, requires the stockholders of an acquiring company to approve an amendment of the option plan of an acquired corporate subsidiary to issue parent stock instead of subsidiary stock. The commenter proposed that the example be amended to require the acquiring company (instead of its stockholders) to approve the amendment of the option plan to issue parent stock instead of subsidiary stock. This amendment is consistent with *Example 1(iii)* in § 1.423–2(c)(5) and *Example 1(iii)* in § 1.422–2(b)(6) of these final regulations. Accordingly, *Example 9(iii)* in § 1.424–1(a)(10) of these final regulations has been modified to reflect the adoption of the commenter's suggestion.

Effective/Applicability Date

These regulations apply as of January 1, 2010, and will apply to any statutory option granted on or after that date. Taxpayers may rely on these final regulations for the treatment of any statutory option granted prior to January 1, 2010.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Thomas Scholz and Ilya Enkishev, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805.

■ **Par. 2.** Section 1.421–1, paragraphs (c)(1) and (j)(1) are revised to read as follows:

§ 1.421–1 Meaning and use of certain terms.

* * * * *

(c) *Time and date of granting option.* (1) For purposes of this section and §§ 1.421–2 through 1.424–1, the language ''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 granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. Except as set forth in § 1.423–2(h)(2), a corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable.

* * * * *

(j) *Effective/applicability date*—(1) *In general.* Except for paragraph (c)(1) of this section, the regulations under this section are effective on August 3, 2004. Paragraph (c)(1) of this section is effective on November 17, 2009. Paragraph (c)(1) of this section applies to statutory options granted on or after January 1, 2010.

* * * * *

■ **Par. 3.** Section 1.422–2, paragraph (b)(6), *Example 1* (iii) is revised to read as follows:

§ 1.422–2 Incentive stock options defined.

* * * * *

(b) * * *

(6) * * *

Example 1. * * *

(iii) Assume the same facts as in paragraph (i) of this *Example 1,* except that the plan was adopted on January 1, 2010. Assume further that the plan was approved by the stockholders of S (in this case, P) on March 1, 2010. On January 1, 2012, S changes the plan to provide that incentive stock options for P stock will be granted to S employees

under the plan. Because there is a change in the stock available for grant under the plan, the change is considered the adoption of a new plan that must be approved by the stockholder of S (in this case, P) within 12 months before or after January 1, 2012.

* * * * *

■ **Par. 4.** Section 1.422–5, paragraph (f)(1) is revised to read as follows:

§ 1.422–5 Permissible provisions.

* * * * *

(f) *Effective/applicability date*—(1) *In general.* Except for § 1.422–2(b)(6) *Example 1* (iii), the regulations under this section are effective on August 3, 2004. Section 1.422–2(b)(6) *Example 1* (iii) is effective on November 17, 2009. Section 1.422–2(b)(6) *Example 1* (iii) applies to statutory options granted on or after January 1, 2010.

* * * * *

■ **Par. 5.** Section 1.423–1 is revised to read as follows:

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

(a) *General rule.* Subject to the provisions of section 423(c) and § 1.423–2(k), 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 the individual's exercise of an option granted under an employee stock purchase plan, as defined in § 1.423–2, if the following conditions are satisfied—

(1) The individual makes no disposition of such share before the later of the expiration of the two-year period from the date of the grant of the option pursuant to which such share was transferred or the expiration of the one-year period from the date of transfer of such share to the individual; and

(2) At all times during the period beginning on the date of the grant of the option and ending on the day three months before the date of exercise, the individual was an employee of the corporation granting the option, a related corporation, or a corporation (or a related corporation) substituting or assuming the stock option in a transaction to which section 424(a) applies.

(b) *Cross-references.* For rules relating to the requisite employment relationship, see § 1.421–1(h). For rules relating to the effect of a disqualifying disposition, see section 421(b) and § 1.421–2(b). For the definition of the term ''disposition,'' see section 424(c) and § 1.424–1(c). For the definition of the term ''related corporation,'' see § 1.421–1(i).

(c) *Effective/applicability date.* The regulations under this section are effective on November 17, 2009. The regulations under this section apply to options granted under an employee stock purchase plan on or after January 1, 2010.

■ **Par. 6.** Section 1.423–2 is revised to read as follows:

§ 1.423–2 Employee stock purchase plan defined.

(a) *In general*—(1) The term ''employee stock purchase'' plan means a plan that meets the requirements of paragraphs (a)(2) and (a)(3) of this section. If the terms of the plan do not satisfy the requirements of paragraph (a)(3) of this section, then such requirements may be satisfied by the terms of an offering made under the plan. However, where the requirements of paragraph (a)(3) of this section are satisfied by the terms of an offering, such requirements will be treated as satisfied only with respect to options exercised under that offering. One or more offerings may be made under an employee stock purchase plan. Offerings may be consecutive or overlapping, and the terms of each offering need not be identical provided the terms of the plan and the offering together satisfy the requirements of paragraphs (a)(2) and (a)(3) of this section. The plan and the terms of an offering must be in writing or electronic form, provided that such writing or electronic form is adequate to establish the terms of the plan or offering, as applicable.

(2) To satisfy the requirements of this paragraph (a)(2) and § 1.423–1, the plan must meet both of the following requirements—

(i) The plan must provide that options can be granted only to employees of the employer corporation or of a related corporation (as defined in paragraph (i) of § 1.421–1) to purchase stock in any such corporation (see paragraph (b) of this section); and

(ii) The plan must be approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted (see paragraph (c) of this section).

(3) To satisfy the requirements of this paragraph (a)(3) and § 1.423–1, the terms of the plan or offering must meet all of the following requirements—

(i) An employee cannot be granted an option if, immediately after the option is granted, the employee 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 a related corporation (see paragraph (d) of this section);

(ii) Options must be granted to all employees of any corporation whose employees are granted any options by reason of their employment by the corporation (see paragraph (e) of this section);

(iii) All employees granted options must have the same rights and privileges (see paragraph (f) of this section);

(iv) The option price cannot be less than the lesser of—

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

(B) An amount not less than 85 percent of the fair market value of the stock at the time the option is exercised (see paragraph (g) of this section).

(v) Options cannot be exercised after the expiration of—

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

(B) Twenty-seven months from the date the option is granted, if the option price is not determined in the manner described in paragraph (a)(3)(v)(A) of this section (see paragraph (h) of this section).

(vi) No employee may be granted an option that permits the employee's rights to purchase stock under all employee stock purchase plans of the employer corporation and its related corporations to accrue at a rate that exceeds $25,000 of fair market value of the stock (determined at the time the option is granted) for each calendar year in which the option is outstanding at any time (see paragraph (i) of this section); and

(vii) Options are not transferable by the optionee other than by will or the laws of descent and distribution, and are exercisable, during the lifetime of the optionee, only by the optionee (see paragraph (j) of this section).

(4) The determination of whether a particular option is an option granted under an employee stock purchase plan is made at the time the option is granted. If the terms of an option are inconsistent with the terms of the employee stock purchase plan or the offering under the plan pursuant to which the option is granted, the option will not be treated as granted under an employee stock purchase plan. If an option with terms that are inconsistent with the terms of the plan or an offering under the plan is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and the employee is not granted an option under the offering that qualifies as an option granted under an employee stock purchase plan, the

offering will not meet the requirements of paragraph (e) of this section. Accordingly, none of the options granted under the offering will be eligible for the special tax treatment of section 421. However, if an option with terms that are inconsistent with the terms of the plan or an offering under the plan is granted to an individual who is not entitled to the grant of an option under the terms of the plan or offering, the option will not be treated as an option granted under an employee stock purchase plan but the grant of the option will not disqualify the options granted under the plan or offering. If, at the time of grant, an option qualifies as an option granted under an employee stock purchase plan, but after the time of grant one or more of the requirements of paragraph (a)(3) of this section is not satisfied with respect to the option, the option will not be treated as granted under an employee stock purchase plan but this failure to comply with the terms of the option will not disqualify the other options granted under the plan or offering.

(5) *Examples.* The following examples illustrate the principles of paragraph (a):

Example 1. Corporation A operates an employee stock purchase plan under which options for A stock are granted to employees of A. The terms of an offering provide that the option price will be 90 percent of the fair market value of A stock on the date of exercise. A grants an option under the offering to Employee Z, an employee of A. The terms of the option provide that the option price will be 85 percent of the fair market value of A stock on the date of exercise. Because the terms of Z's option are inconsistent with the terms of the offering, the option granted to Z will not be treated as an option granted under the employee stock purchase plan. Further, unless Z is granted an option under the offering that qualifies as an option granted under the employee stock purchase plan, the offering will not meet the requirements of paragraph (e) of this section and none of the options granted under the offering will be eligible for the special tax treatment of section 421.

Example 2. Corporation B operates an employee stock purchase plan that provides that options for B stock may only be granted to employees of B. Under the terms of the plan, options may not be granted to consultants and other non-employees. B grants an option to Consultant Y, a consultant of B. Because Y is ineligible to receive an option under the plan because Y is not an employee, the grant of the option to Y is inconsistent with the terms of the plan and the option granted to Y will not be treated as an option granted under the employee stock purchase plan. However, the grant of the option to Y will not disqualify the options granted under the plan or any offering because Y was not entitled to the grant of an option under the plan.

Example 3. Corporation C operates an employee stock purchase plan under which options for C stock are granted to employees of C. C grants an option pursuant to an offering under the plan to Employee X, an employee of C who is a highly compensated employee. The terms of the employee stock purchase plan exclude highly compensated employees from participation in the plan. Because X is ineligible to receive an option under the plan by reason of X's exclusion from participation in the plan, the option granted to X will not be treated as an option granted under the employee stock purchase plan. However, the grant of the option to X will not disqualify the options granted under the plan or offering because X was not entitled to the grant of an option under the plan.

Example 4. Corporation D operates an employee stock purchase plan under which options for D stock are granted to employees of D. D grants an option pursuant to an offering under the plan to Employee W, an employee of D. The terms of the option provide that the option price will be 90 percent of the fair market value of D stock on the date of exercise. On the date of exercise, W pays only 85 percent of the fair market value of D stock. Because the terms of W's option are not satisfied, the option granted to W will not be treated as an option granted under the employee stock purchase plan. However, the failure to comply with the terms of the option granted to W will not disqualify the options granted under the plan or offering.

(b) *Options restricted to employees.* An employee stock purchase plan must provide that options can be granted only to employees of the employer corporation (or employees of its related corporations) to purchase stock in the employer corporation (or one of its related corporations). 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 the plan will not qualify for the special tax treatment of section 421. For rules relating to the employment requirement, see § 1.421–1(h).

(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 of applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval, then an employee stock purchase plan must be approved—

(i) By a majority of the votes cast at a duly held stockholder's meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(ii) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (such as, an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

(2) For purposes of the stockholder approval required by this paragraph (c), ordinarily, a plan is adopted when it is approved by the granting corporation's board of directors, and the date of the board's action is the reference point for determining whether stockholder approval occurs within the applicable 24-month period. However, if the board's action is subject to a condition (such as stockholder 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 adoption as the date of the board's action.

(3) An employee stock purchase plan, as adopted and approved, must designate the maximum aggregate number of shares that may be issued under the plan, and the corporations or class of corporations whose employees may be offered options under the plan. A plan that merely provides that the number of shares that may be issued under the plan may not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan does not satisfy the requirements of this paragraph (c)(3). However, the maximum aggregate number of shares that may be issued under the plan may be stated in terms of a percentage of the authorized, issued, or outstanding shares on the date of the adoption of the plan. The plan may specify that the maximum aggregate number of shares available for grants under the plan may increase annually by a specified percentage of the authorized, issued, or outstanding shares on the date of the adoption of the plan. A plan that provides that the maximum aggregate number of shares that may be issued as options under the plan may change based on any other specific circumstances satisfies the requirements of this paragraph only if the stockholders approve an immediately determinable maximum number of shares that may be issued under the plan in any event. If there is more than one employee stock purchase plan under which options may be granted and stockholders of the granting corporation merely approve a maximum aggregate number of shares that are

available for issuance under the plans, the stockholder approval requirements described in paragraph (c)(1) of this section are not satisfied. A separate maximum aggregate number of shares available for issuance pursuant to options must be specified and approved for each plan.

(4) Once an employee stock purchase plan is approved by the stockholders of the granting corporation, the plan need not be reapproved by the stockholders of the granting corporation unless the plan is amended or changed in a manner that is considered the adoption of a new plan, in which case the plan must be reapproved within the prescribed 24-month period. Any increase in the aggregate number of shares that may be issued under the plan (other than an increase merely reflecting a change in the number of outstanding shares, such as a stock dividend or stock split) will be considered the adoption of a new plan requiring stockholder approval within the prescribed 24-month period. Similarly, a change in the designation of corporations whose employees may be offered options under the plan will be considered the adoption of a new plan requiring stockholder approval within the prescribed 24-month period unless the plan provides that designations of participating corporations may be made from time to time from among a group consisting of the granting corporation and its related 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 granting corporation after the adoption and approval of the plan. In addition, a change in the granting corporation or the stock available for purchase under the plan will be considered the adoption of a new plan requiring stockholder approval within the prescribed 24-month period. Any other changes in the terms of an employee stock purchase plan are not considered the adoption of a new plan and, thus, do not require stockholder approval.

(5) *Examples.* The following examples illustrate the principles of this paragraph (c):

Example 1. (i) Corporation E is a subsidiary of Corporation F, a publicly traded corporation. On January 1, 2010, E adopts an employee stock purchase plan under which options for E stock are granted to E employees.

(ii) To meet the requirements of paragraph (c)(1) of this section, the plan must be approved by the stockholders of E (in this case, F) within 12 months before or after January 1, 2010.

(iii) Assume the same facts as in paragraph (i) of this *Example 1,* except that the plan was approved by the stockholders of E (in this case, F) on March 1, 2010. On January 1, 2012, E changes the plan to provide that options for F stock will be granted to E employees under the plan. Because there is a change in the stock available for grant under the plan, under paragraph (c)(4) of this section, the change is considered the adoption of a new plan that must be approved by the stockholders of E (in this case, F) within 12 months before or after January 1, 2012.

Example 2. (i) Assume the same facts as in paragraph (i) of *Example 1,* except that on March 15, 2011, F completely disposes of its interest in E. Thereafter, E continues to grant options for E stock to E employees under the plan.

(ii) The new E options are granted under a plan that meets the stockholder approval requirements of paragraph (c)(1) of this section without regard to whether E seeks approval of the plan from the stockholders of E after F disposes of its interest in E.

(iii) Assume the same facts as in paragraph (i) of this *Example 2,* except that under the plan as adopted on January 1, 2010, only options for F stock are granted to E employees. Assume further that, after F disposes of its interest in E, E changes the plan to provide for the grant of options for E stock to E employees. Because there is a change in the stock available for purchase or grant under the plan, under paragraph (c)(4) of this section, the stockholders of E must approve the plan within 12 months before or after the change to the plan to meet the stockholder approval requirements of paragraph (c) of this section.

Example 3. (i) Corporation G maintains an employee stock purchase plan providing options for G stock. Corporation H does not maintain an employee stock purchase plan. On May 15, 2010, G and H consolidate under State law to form one corporation. The new corporation is named Corporation H. The consolidation agreement describes the G plan, including the maximum aggregate number of shares available for issuance under the plan after the consolidation. Additionally, the consolidation agreement states that the plan will be continued by H after the consolidation. The consolidation agreement is approved by the stockholders of G and H on May 1, 2010. H assumes the plan formerly maintained by G and continues to grant options under the plan to all eligible employees, but the options are for H stock.

(ii) Because there is a change in the granting corporation (from G to H) and the stock available for purchase, under paragraph (c)(4) of this section, H is considered to have adopted a new plan. Because the plan is fully described in the consolidation agreement, including the maximum aggregate number of shares available for issuance under the plan, the approval of the consolidation agreement by the stockholders constitutes approval of the plan. Thus, the stockholder approval of the consolidation agreement satisfies the stockholder approval requirements of paragraph (c)(1) of this section, and the plan is considered to be adopted by H and approved by its stockholders on May 1, 2010.

Example 4. Corporation I adopts an employee stock purchase plan on November 1, 2010. On that date, there are two million shares of I stock outstanding. The plan provides that the maximum aggregate number of shares that may be issued under the plan may not exceed 15 percent of the number of shares of I stock outstanding on November 1, 2010. Because the maximum aggregate number of shares that may be issued under the plan is designated in the plan, the requirements of paragraph (c)(3) of this section are met.

Example 5. (i) Corporation J adopts an employee stock purchase plan on March 15, 2010. The plan provides that the maximum aggregate number of shares of J stock available for issuance under the plan is 50,000, increased on each anniversary date of the adoption of the plan by 5 percent of the then outstanding shares. Because the maximum aggregate number of shares is not designated under the plan, the requirements of paragraph (c)(3) of this section are not met.

(ii) Assume the same facts as in paragraph (i) of this *Example 5,* except that the plan provides that the maximum aggregate number of shares available under the plan is the lesser of (a) 50,000 shares, increased each anniversary date of the adoption of the plan by 5 percent of the then-outstanding shares, or (b) 200,000 shares. Because the maximum aggregate number of shares that may be issued under the plan is designated as the lesser of two numbers, one of which provides an immediately determinable maximum aggregate number of shares that may be issued under the plan in any event, the requirements of paragraph (c)(3) of this section are met.

(d) *Options granted to certain shareholders*—(1) An employee stock purchase plan or offering must, by its terms, provide that an employee cannot be granted an option if the 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 a related corporation. In determining whether the stock ownership of an employee equals or exceeds this 5 percent limit, the rules of section 424(d) (relating to attribution of stock ownership) shall apply, and stock that the employee may purchase under outstanding options (whether or not the 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 this paragraph (d) 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 employee whose stock ownership (as determined under this paragraph (d)) exceeds the limitation set forth in this paragraph (d), no portion of the 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 the employer corporation (or a related corporation) that is owned by the employee is made by comparing the voting power or value of the shares owned (or treated as owned) by the employee to the aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option to the employee. 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 employee or any other person.

(3) *Examples.* The following examples illustrate the principles this paragraph (d):

Example 1. Employee V, an employee of Corporation K, owns 6,000 shares of K common stock, the only class of K stock outstanding. K has 100,000 shares of its common stock outstanding. Because V owns 6 percent of the combined voting power or value of all classes of K stock, K cannot grant an option to V under K's employee stock purchase plan. If V's father and brother each owned 3,000 shares of K stock and V did not own any K stock, then the result would be the same because, under section 424(d), an individual is treated as owning stock held by the person's father and brother. Similarly, the result would be the same if, instead of actually owning 6,000 shares, V merely held an option on 6,000 shares of K stock, irrespective of whether the transfer of stock under the option could qualify for the special tax treatment of section 421, because this paragraph (d) provides that stock the employee may purchase under outstanding options is treated as stock owned by such employee.

Example 2. Assume the same facts as in *Example 1,* except that K is a 50 percent subsidiary corporation of Corporation L. Irrespective of whether V owns any L stock, V cannot receive an option from L under L's employee stock purchase plan because he owns 5 percent of the total combined voting power of all classes of stock of a subsidiary of L, in this example, K. An employee who owns (or is treated as owning) stock in excess of the limitation of this paragraph (d), in any corporation in a group of related 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. Employee U is an employee of Corporation M. M has only one class of stock, of which 100,000 shares are issued and outstanding. Assuming U does not own (and is not treated as owning) any stock in M or in any related corporation of M, M may grant an option to U under its employee stock purchase plan for 4,999 shares, because immediately after the grant of the option, U would not own 5 percent or more of the combined voting power or value of all classes of M stock actually issued and outstanding at such time. The 4,999 shares that U would be treated as owning under this paragraph (d) would not be added to the 100,000 shares actually issued and outstanding immediately after the grant for purposes of determining whether U's stock ownership exceeds the limitation of this paragraph (d).

Example 4. Assume the same facts as in *Example 3* but instead of an option for 4,999 shares, M grants U 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 because U's stock ownership exceeds the limitation of this paragraph (d).

(e) *Employees covered by plan*—(1) Subject to the provisions of this paragraph (e) and the limitations of paragraphs (d), (f) and (i) of this section, an employee stock purchase plan or offering must, by its terms, provide that 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 that corporation, except that one or more of the following categories of employees may be excluded from the coverage of the plan or offering—

(i) Employees who have been employed less than two years;

(ii) Employees whose customary employment is 20 hours or less per week;

(iii) Employees whose customary employment is for not more than five months in any calendar year; and

(iv) Highly compensated employees (within the meaning of section 414(q)).

(2) A plan or offering does not fail to satisfy the coverage provision of paragraph (e)(1) of this section in the following circumstances—

(i) The plan or offering excludes employees who have completed a shorter period of service or whose customary employment is for fewer hours per week or fewer months in a calendar year than is specified in paragraphs (e)(1)(i), (ii) and (iii) of this section, provided the exclusion is applied in an identical manner to all employees of every corporation whose employees are granted options under the plan or offering.

(ii) The plan or offering excludes highly compensated employees (within the meaning of section 414(q)) with compensation above a certain level or who are officers or subject to the disclosure requirements of section 16(a) of the Securities Exchange Act of 1934, provided the exclusion is applied in an identical manner to all highly compensated employees of every corporation whose employees are granted options under the plan or offering.

(3) Notwithstanding paragraph (e)(1) of this section, employees who are citizens or residents of a foreign jurisdiction (without regard to whether they are also citizens of the United States or resident aliens (within the meaning of section 7701(b)(1)(A))) may be excluded from the coverage of an employee stock purchase plan or offering under the following circumstances—

(i) The grant of an option under the plan or offering to a citizen or resident of the foreign jurisdiction is prohibited under the laws of such jurisdiction; or

(ii) Compliance with the laws of the foreign jurisdiction would cause the plan or offering to violate the requirements of section 423.

(4) No option granted under a plan or offering that excludes from participation any employees, other than those who may be excluded under this paragraph (e), and those barred from participation by reason of paragraphs (d), (f) and (i) of this section, can be regarded as having been granted under an employee stock purchase plan. If an option is not granted to any employee who is entitled to the grant of an option under the terms of the plan or offering, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. However, a plan that, by its terms, permits all eligible employees to elect to participate in an offering will not violate the requirements of this paragraph solely because eligible employees who elect not to participate in the offering are not granted options pursuant to such offering.

(5) For purposes of this paragraph (e), the existence of the employment relationship between an individual and the corporation participating under the plan will be determined under § 1.421–1(h).

(6) *Examples.* The following examples illustrate the principles of this paragraph (e):

Example 1. Corporation N has a stock purchase plan that meets all the requirements of paragraphs (a)(2) and (a)(3) of this section except that options are not required to be granted to employees whose weekly rate of pay is less than $1,000. As a matter of corporate practice, however, N grants options under its plan to all employees, irrespective of their weekly rate of pay. Even though N's plan is operated in compliance with the requirements of this paragraph (e), N's plan is not an employee stock purchase plan because the terms of the plan exclude a category of employees that is not permitted under this paragraph (e).

Example 2. Assume the same facts as in *Example 1,* except that the first offering under N's plan provides that options will be granted to all employees of N. The terms of

the first offering will be treated as part of the terms of N's plan, but only for purposes of the first offering. Because the terms of the first offering satisfy the requirements of this paragraph (e), stock transferred pursuant to options exercised under the first 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.

Example 3. Corporation O has a stock purchase plan that excludes from participation all employees who have been employed less than one year. Assuming all other requirements of paragraphs (a)(2) and (a)(3) of this section are satisfied, O's plan qualifies as an employee stock purchase plan under section 423.

Example 4. Corporation P has a stock purchase plan that excludes from participation clerical employees who have been employed less than two years. However, non-clerical employees with less than two years of service are permitted to participate in the plan. P's plan is not an employee stock purchase plan because the exclusion of employees who have been employed less than two years applies only to certain employees of P and is not applied in an identical manner to all employees of P. If, instead, P's plan excludes from participation all employees (both clerical and non-clerical) who have been employed less than two years, then P's plan would qualify as an employee stock purchase plan under section 423 assuming all other requirements of paragraphs (a)(2) and (a)(3) of this section are satisfied.

Example 5. Corporation Q has a stock purchase plan that excludes from participation all officers who are highly compensated employees (within the meaning of section 414(q)). Assuming all other requirements of paragraphs (a)(2) and (a)(3) of this section are satisfied, Q's plan qualifies as an employee stock purchase plan under section 423.

Example 6. Corporation R maintains an employee stock purchase plan that excludes from participation all highly compensated employees (within the meaning of section 414(q)), except highly compensated employees who are officers of R. R's plan is not an employee stock purchase plan because the exclusion of all highly compensated employees except highly compensated employees who are officers of R is not a permissible exclusion under paragraph (e)(2)(ii) of this section.

Example 7. Corporation S is the parent corporation of Subsidiary YY and Subsidiary ZZ. S maintains an employee stock purchase plan with both YY and ZZ participating in the same offering under the plan. Under the terms of the offering under the plan, all employees of YY and ZZ are permitted to participate in the plan with the exception of ZZ's highly compensated employees with annual compensation greater than $300,000. None of the options granted under the offering will be considered granted under an employee stock purchase plan because the exclusion of highly compensated employees with annual compensation greater than $300,000 is not applied in an identical manner to all employees of YY and ZZ granted options in the same offering.

Example 8. Assume the same facts as in *Example 7,* except that Corporation S establishes separate offerings under the plan for YY and ZZ. Under the terms of the separate offering for YY, all employees of YY are permitted to participate in the plan. Under the terms of the separate offering established for ZZ, all employees of ZZ are permitted to participate in the plan with the exception of ZZ's highly compensated employees with annual compensation greater than $300,000. The options granted under the separate offering for YY will be considered granted under an employee stock purchase plan. Further, the options granted under the separate offering for ZZ will be considered granted under an employee stock purchase plan because the exclusion of highly compensated employees with annual compensation greater than $300,000 is applied in an identical manner to all employees of ZZ granted options in the same offering.

Example 9. The laws of Country A require that options granted to residents of Country A be transferable during the lifetime of the option recipient. Corporation T has a stock purchase plan that excludes residents of Country A from participation in the plan. Because compliance with the laws of Country A would cause options granted to residents of Country A to violate paragraph (j) of this section, T may exclude residents of Country A from participation in the plan. Assuming all other requirements of paragraph (a)(2) of this section are satisfied, T's plan qualifies as an employee stock purchase plan under section 423.

(f) *Equal rights and privileges*—(1) Except as otherwise provided in paragraphs (f)(2) through (f)(6) of this section, an employee stock purchase plan or offering must, by its terms, provide that all employees granted options under the plan or offering shall have the same rights and privileges. 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 the 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 the options will be treated as having been granted under an employee stock purchase plan for purposes of section 421.

(2) The requirements of this paragraph (f) do not prevent the maximum amount of stock that 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.

(3) A plan or offering will not fail to satisfy the requirements of this paragraph (f) because the plan or offering provides that no employee may purchase more than a maximum amount of stock fixed under the plan or offering.

(4) A plan or offering will not fail to satisfy the requirements of this paragraph (f) if, in order to comply with the laws of a foreign jurisdiction, the terms of an option granted under a plan or offering to citizens or residents of such foreign jurisdiction (without regard to whether they are also citizens of the United States or resident aliens (within the meaning of section 7701(b)(1)(A))) are less favorable than the terms of options granted under the same plan or offering to employees resident in the United States.

(5)(i) Except as provided in this paragraph and paragraph (f)(5)(ii) of this section, a plan or offering permitting one or more employees to carry forward amounts that were withheld but not applied toward the purchase of stock under an earlier plan or offering and apply the amounts towards the purchase of additional stock under a subsequent plan or offering will be a violation of the equal rights and privileges under paragraph (f)(1) of this section. However, the carry forward of amounts withheld but not applied toward the purchase of stock under an earlier plan or offering will not violate the equal rights and privileges requirement of paragraph (f)(1) of this section, if all other employees participating in the current plan or offering are permitted to make direct payments toward the purchase of shares under a subsequent plan or offering in an amount equal to the excess of the greatest amount which any employee is allowed to carry forward from an earlier plan or offering over the amount, if any, the employee will carry forward from an earlier plan or offering.

(ii) A plan or offering will not fail to satisfy the requirements of this section merely because employees are permitted to carry forward amounts representing a fractional share, that were withheld but not applied toward the purchase of stock under an earlier plan or offering and apply the amounts toward the purchase of additional stock under a subsequent plan or offering.

(6) Paragraph (f) does not prohibit the delaying of the grant of an option to any employee who is barred from being granted an option solely by reason of the employee's failing to meet a minimum service requirement set forth in paragraph (e)(1) of this section until the employee meets such requirement.

(7) *Examples.* The following examples illustrate the principles of this paragraph (f):

Example 1. Corporation U has an employee stock purchase plan that provides

that the maximum amount of stock that each employee may purchase under the offering is one share for each $100 of annual gross pay. The plan meets the requirements of this paragraph (f).

Example 2. Corporation V has an employee stock purchase plan that provides that the maximum amount of stock that each employee may purchase under the offering is one share for each $100 of annual gross pay up to and including $10,000, and two shares for each $100 of annual gross pay in excess of $10,000. The plan will not meet the requirements of this paragraph (f) because the amount of stock that may be purchased under the plan is not based on a uniform relationship to the total compensation of all employees.

Example 3. Corporation W has an employee stock purchase plan that provides that options to purchase stock in an amount equal to ten percent of an employee's annual salary at a price equal to 85 percent of the fair market value on the first day of the offering will be granted to all employees other than those who have been employed less than 18 months. In addition, the plan provides that employees who have not yet met the minimum service requirements on the first day of the offering will be granted similar options on the date the 18 month service requirement has been attained. The plan meets the requirements of this paragraph (f).

Example 4. Corporation X is the parent corporation of Subsidiary AA, Subsidiary BB and Subsidiary CC. X maintains an employee stock purchase plan with AA, BB and CC participating in the same offering under the plan. Under the terms of the offering under the plan, options to purchase stock at a price equal to 90 percent of the fair market value at the time the option is exercised will be granted to all employees. Certain employees of AA are residents of Country B. The laws of Country B provide that options granted to employees who are residents of Country B must have a purchase price not less than 95 percent of the fair market value at the time the option is exercised. The plan will not fail to satisfy the requirements of this paragraph (f) merely because the residents of Country B are granted options under the plan to purchase stock at a price equal to 95 percent of the fair market value at the time the option is exercised.

Example 5. Assume the same facts as in *Example 4,* except that Corporation X establishes two separate offerings under the plan: A separate offering for the employees of AA and a separate offering for the employees of BB and CC. Under the separate offering for the employees of BB and CC, options are granted to all employees with an exercise price equal to 90 percent of the fair market value at the time the option is exercised. Under the separate offering for the employees of AA, options are granted to all employees with an exercise price equal to 95 percent of the fair market value at the time the option is exercised. The plan does not violate the equal rights and privileges requirement of this paragraph (f) merely because the exercise price of options granted under one offering is less than the exercise price of options granted under a separate offering.

Example 6. Corporation Y maintains an employee stock purchase plan. Employee T is employed by Y. T is granted an option under the current offering to purchase a maximum of 100 shares of Y stock at an option price equal to 85 percent of the fair market value of the stock at exercise. The plan permits the carry forward of withheld but unused amounts from an earlier offering. Prior to the exercise date, $2000 of T's salary has been withheld and is available to be applied toward the purchase of Y stock. On the exercise date, the fair market value of Y stock is $20 per share. T is able to purchase 100 shares of Y stock at $17 per share for an aggregate purchase price of $1700. T can carry forward $300 to the subsequent offering. Each employee in the subsequent offering other than T will be permitted to make direct payments toward the purchase of shares under the subsequent offering in a maximum amount of $300 less any amount the employee has carried forward from an earlier offering. The plan does not violate the equal rights and privileges requirement of this paragraph (f).

(g) *Option price*—(1) An employee stock purchase plan or offering 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 the option is granted, or

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

(2) For purposes of determining the option price, the fair market value of the stock may be determined in any reasonable manner, including the valuation methods permitted under § 20.2031–2. However, the option price must meet the minimum pricing requirements of this paragraph (g). For general rules relating to the option price, see § 1.421–1(e). For rules relating to the determination of when an option is granted, *see* §§ 1.421–1(c) and 1.423–2(h)(2). Any option that does not meet the minimum pricing requirements of this paragraph (g) will not be treated as an option granted under an employee stock purchase plan irrespective of whether the plan or offering satisfies those requirements. If an option that does not meet the minimum pricing requirements is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and the employee is not granted an option under such offering that qualifies as an option granted under an employee stock purchase plan, the offering will not meet the requirements of paragraph (e) of this section. Accordingly, none of the options granted under the offering will be eligible for the special tax treatment of section 421.

(3) 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, then the requirement of this paragraph (g) 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, then the option cannot meet the requirement of this paragraph (g) 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, because that result was not certain to occur under the terms of the option.

(4) *Examples.* The following examples illustrate the principles of this paragraph (g):

Example 1. Corporation Z has an employee stock purchase plan that provides that the option price will be 85 percent of the fair market value of the stock on the first day of the offering (which is the date of grant in this case), or 85 percent of the fair market value of the stock at exercise, whichever amount is the lesser. Upon the exercise of an option issued under Z's plan, Z agrees to accept an option price that 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 this paragraph (g) and cannot qualify for the special tax treatment of section 421.

Example 2. Corporation AA has an employee stock purchase plan that provides that the option price is set at 85 percent of the fair market value of AA stock at exercise, but not less than $80 per share. On the first day of the offering (which is the date of grant in this case), the fair market value of AA stock is $100 per share. The option satisfies the requirement of this paragraph (g), and can qualify for the special tax treatment of section 421.

Example 3. Assume the same facts as in *Example 2,* except that the option price is set at 85 percent of the fair market value of AA stock at exercise, but not more than $80 per share. This option cannot satisfy the requirement of this paragraph (g) irrespective of whether, at the time the option is exercised, 85 percent of the fair market value of AA stock is $80 or less.

(h) *Option period*—(1) An employee stock purchase plan or offering must, by its terms, provide that options granted under the plan cannot be exercised after the expiration of 27 months from the date of grant unless, under the terms of the plan or offering, the option price is 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 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 five years from the date of grant. If the requirements of this paragraph (h) are not met by the terms of the plan or offering, then options issued under such plan or offering will not be treated as options granted under an employee stock purchase plan irrespective of whether the options, by their terms, are exercisable beyond the period allowable under this paragraph (h). An option that provides that the option price is 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 the stock at grant. However, if the option provides that the option price is 85 percent of the fair market value of the stock at exercise, but not more than some other fixed amount determined in accordance with the provisions of paragraph (g) of this section, then irrespective of the price paid on exercise, the option period must not be more than 27 months.

(2) Section 1.421–1(c) provides that, for purposes of §§ 1.421–1 through 1.424–1, the language ''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 granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. With respect to options granted under an employee stock purchase plan, the principles of § 1.421–1(c) shall be applied without regard to the requirement that the minimum option price must be fixed or determinable in order for the corporate action constituting an offer of stock to be considered complete.

(3) The date of grant will be the first day of an offering if the terms of an employee stock purchase plan or offering designate a maximum number of shares that may be purchased by each employee during the offering. Similarly, the date of grant will be the first day of an offering if the terms of the plan or offering require the application of a formula to establish, on the first day of the offering, the maximum number of shares that may be purchased by each employee during the offering. It is not required that an employee stock purchase plan or offering designate a maximum number of shares that may be purchased by each employee during the offering or incorporate a formula to establish a maximum number of shares that may be purchased by each employee during the offering. If the maximum number of shares that can be purchased under an option is not fixed or determinable until the date the option is exercised, then the date of exercise will be the date of grant of the option.

(4) *Examples.* The following examples illustrate the principles of this paragraph (h):

Example 1. (i) Corporation BB has an employee stock purchase plan that provides that the option price will be the lesser of 85 percent of the fair market value of the stock on the first day of an offering or 85 percent of the fair market value of the stock on the last day of the offering. Options are exercised on the last day of the offering. One million shares of BB stock are reserved for issuance under the plan. The plan provides that no employee may be permitted to purchase stock under the plan at a rate that exceeds $25,000 in fair market value of the BB stock (determined on the date of grant) for each calendar year during which an option granted to the employee is outstanding. The terms of each option granted under an offering provide that a maximum of 500 shares may be purchased by the option recipient during the offering. Because the maximum number of shares that can be purchased under the option is fixed and determinable on the first day of the offering, the date of grant for the option is the first day of the offering.

(ii) Assume the same facts as in paragraph (i) of *Example 1,* except that BB's plan excludes all employees who have been employed less than 18 months. The plan provides that employees who have not yet met the minimum service requirements on the first day of an offering will be granted an option on the date the 18-month service requirement has been attained. With respect to those employees who have been employed less than 18 months on the first day of an offering, the date of grant for the option is the date the 18-month service requirement has been attained.

Example 2. Assume the same facts as in paragraph (i) of *Example 1,* except that the terms of each option granted do not provide that a maximum of 500 shares may be purchased by the option recipient during the offering. Notwithstanding the fixed number of shares reserved for issuance under the plan and the $25,000 limitation set forth in the plan, the maximum number of shares that can be purchased under the option is not fixed or determinable until the last day of the offering when the option is exercised. Therefore the date of grant for the option is the last day of the offering when the option is exercised.

Example 3. Corporation CC has an employee stock purchase plan that provides that the option price will be 85 percent of the fair market value of the stock on the last day of the offering. Options are exercised on the last day of the offering. Each offering under the plan begins on January 1 and ends on December 31 of the same calendar year. The terms of each option granted under an offering provide that the maximum number of shares that may be purchased by any employee during the offering equals $25,000 divided by the fair market value of the stock on the first day of the offering. The maximum number of shares that can be purchased under the option is fixed and determinable on the first day of the offering and therefore the date of grant for the option is the first day of the offering.

Example 4. Assume the same facts as in *Example 3* except that the terms of each option granted under an offering provide that the maximum number of shares that may be purchased by any employee during the offering equals 10 percent of the employee's annual salary (determined as of January 1 of the year in which the offering commences) divided by the fair market value of the stock on the first day of the offering. The maximum number of shares that can be purchased under the option is fixed and determinable on the first day of the offering and therefore the date of grant for the option is the first day of the offering.

(i) *Annual $25,000 limitation*—(1) An employee stock purchase plan or offering must, by its terms, provide that no employee may be permitted to purchase stock under all the employee stock purchase plans of the employer corporation and its related corporations at a rate that exceeds $25,000 in fair market value of the stock (determined at the time the option is granted) for each calendar year in which any option granted to the employee is outstanding at any time. In applying the foregoing limitation—

(i) The right to purchase stock under an option accrues 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 that has accrued under one option granted pursuant to the plan may not be carried over to any other option.

(2) If an option is granted under an employee stock purchase plan that satisfies the requirement of this paragraph (i), but the option gives the optionee the right to buy stock in excess of the maximum rate allowable under this paragraph (i), then no portion of the 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 the employee is not granted an option under the offering that qualifies as an option granted under an employee stock purchase plan, then the offering will not meet the requirements of paragraph (e) of this section. Accordingly, none of the options granted under the offering will be eligible for the special tax treatment of section 421.

(3) The limitation of this paragraph (i) applies only to options granted under employee stock purchase plans and does not limit the amount of stock that an employee may purchase under incentive stock options (as defined in section 422(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 that an employee may purchase under an employee stock purchase plan, except for purposes of the 5-percent stock ownership provision of paragraph (d) of this section.

(4) Under the limitation of this paragraph (i), an employee may purchase up to $25,000 of stock (based on the fair market value of the stock at the time the option was granted) in each calendar year during which an option granted to the employee under an employee stock purchase plan is outstanding. Alternatively, an employee 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 that the employee purchases does not exceed $25,000 in fair market value of the stock (determined at the time the option was granted) for each calendar year in which any option was outstanding. If, in any calendar year, the employee holds two or more outstanding options granted under employee stock purchase plans of the employer corporation, or a related corporation, then the employee's purchases of stock attributable to that year under all options granted under employee stock purchase plans must not exceed $25,000 in fair market value of the stock (determined at the time the options were granted). Under an employee stock purchase plan, an employee may not purchase stock in anticipation that the option will be outstanding in some future year. Thus, the employee may purchase only the amount of stock that does not exceed the limitation of this paragraph (i) for the year of the purchase and for preceding years during which the option was outstanding. Thus, the amount of stock that may be purchased under an option depends on the number of years in which the option is actually outstanding. The amount of stock that 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, then 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, then stock purchased pursuant to the exercise of such an option will be applied first, to the extent allowable under this paragraph (i), against the $25,000 limitation for the earliest year in which the option was outstanding, then, against the $25,000 limitation for each succeeding year, in order.

(5) *Examples.* The following examples illustrate the principles of this paragraph (i):

Example 1. Assume that Corporation DD maintains an employee stock purchase plan and that Employee S is employed by DD. On June 1, 2010, DD grants S an option under the plan to purchase a total of 750 shares of DD stock at $85 per share. On that date, the fair market value of DD stock is $100 per share. The option provides that it may be exercised at any time but cannot be exercised after May 31, 2012. Under this paragraph (i), the option must not permit S to purchase more than 250 shares of DD stock during the calendar year 2010, because 250 shares are equal to $25,000 in fair market value of DD stock determined at the time of grant. During the calendar year 2011, S may purchase under the option an amount of DD stock equal to the difference between $50,000 in fair market value of DD stock (determined at the time the option was granted) and the fair market value of DD stock (determined at the time of grant of the option) purchased during the year 2010. During the calendar year 2012, S may purchase an amount of DD stock equal to the difference between $75,000 in fair market value of the stock (determined at the time of grant of the option) and the total amount of the fair market value of the stock (determined at the time of grant of the option) purchased under the option during the calendar years 2010 and 2011. S may purchase $25,000 of stock for the year 2010, and $25,000 of stock for the year 2012, although the option was outstanding for only a part of each of such years. However, S may not be granted another option under an employee stock purchase plan of DD or a related corporation to purchase stock of DD or a related corporation during the calendar years 2010, 2011, and 2012, so long as the option granted June 1, 2010, is outstanding.

Example 2. Assume the same facts as in *Example 1,* except that the option granted to S in 2010 is terminated in 2011 without any part of the option having been exercised, and that subsequent to the termination and during 2011, S is granted another option under DD's employee stock purchase plan. Under that option, S may be permitted to purchase $25,000 of stock for 2011. The failure of S to exercise the option granted to S in 2010, does not increase the amount of stock that S may be permitted to purchase under the option granted to S in 2011.

Example 3. Assume the same facts as in *Example 1,* except that, on May 31, 2012, S exercised the option granted to S in 2010, and purchased 600 shares of DD stock. Five hundred shares, the maximum amount of stock that could have been purchased in 2011, under the option, are treated as having been purchased for the years 2010 and 2011. Only 100 shares of the stock are treated as having been purchased for 2012. After S's exercise of the option on May 31, 2012, S is granted another option under DD's employee stock purchase plan. S may be permitted under the new option to purchase for 2012 stock having a fair market value of no more than $15,000 at the time the new option is granted.

Example 4. Corporation EE maintains an employee stock purchase plan and Employee R is employed by EE. On August 1, 2010, EE grants R an option under the plan to purchase 150 shares of EE stock at $85 per share during each of the calendar years 2010, 2011, and 2012. On that date, the fair market value of EE stock is $100 per share. The option provides that it may be exercised at any time during years 2010, 2011, and 2012. Because this option permits R to purchase only $15,000 of EE's stock for each year the option is outstanding, R could be granted another option by EE, or by a related corporation, in year 2010, permitting R to purchase an additional $10,000 of stock during each of the calendar years 2010, 2011, and 2012.

Example 5. Corporation FF maintains an employee stock purchase plan and Employee Q is employed by FF. On September 1, 2010, FF grants Q an option under the plan that will be automatically exercised on August 31, 2011, and August 31, 2012. The terms of the option provide that no more than 150 shares may be purchased on each date that the option is automatically exercised. On August 31, 2011, Q may purchase under the option an amount of FF stock equal to $50,000 in fair market value of FF stock (determined at the time the option was granted). On August 31, 2012, Q may purchase under the option an amount of FF stock equal to the difference between $75,000 in fair market value of Q stock (determined at the time the option was granted) and the fair market value of Q stock (determined at the time of grant of the option) purchased during year 2011.

(j) *Restriction on transferability.* An employee stock purchase plan or offering must, by its terms, provide that options granted under the plan are not transferable by the optionee other than by will or the laws of descent and distribution, and must be exercisable, during the optionee's lifetime, only by the optionee. For general rules relating to the restriction on transferability required by this paragraph (j), *see* § 1.421–1(b)(2). For a limited exception to the requirement of this paragraph (j), see section 424(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, this paragraph (k)

provides additional rules that 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 the share. In that case, upon the disposition of the share by the employee after the expiration of the two-year and the one-year holding periods, or upon the employee's death while owning the share (whether occurring before or after the expiration of such periods), there shall be included in the employee'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.

(ii) For purposes of applying the rules of this paragraph (k), 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 this paragraph (k) shall be included in the employee's gross income for the taxable year in which the disposition occurs, or for the taxable year closing with the employee's death, whichever event results in the application of this paragraph (k).

(iii) The application of the special rules provided in this paragraph (k) shall not affect the rules provided in section 421(a) with respect to the employee 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 employee, as provided in this paragraph (k), no income results to the employee at the time the stock is transferred to the employee, and no deduction under section 162 is allowable at any time to the employer corporation or a related corporation with respect to such amount.

(iv) If, during the employee's lifetime, the employee exercises an option granted under an employee stock purchase plan, but the employee dies before the stock is transferred to the employee pursuant to the exercise of the option, then for the purpose of sections 421 and 423, on the employee's death, the stock is deemed to be transferred immediately to the employee, and immediately thereafter, the employee is deemed to have transferred the stock to the employee's executor, administrator, trustee, beneficiary by operation of law, heir, or legatee, as the case may be.

(2) If the special rules provided in this paragraph (k) are applicable to the disposition of a share of stock by an employee, then the basis of the share in the employee's hands at the time of the disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in the employee's gross income under this paragraph (k). However, the basis of a share of stock acquired after the death of an employee by the exercise of an option granted to the employee under an employee stock purchase plan shall be determined in accordance with the rules of section 421(c) and § 1.421–2(c). If the special rules provided in this paragraph (k) are applicable to a share of stock upon the death of an employee, then the basis of the 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 the decedent's gross income under this paragraph (k). See *Example (9)* of this paragraph (k) with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) *Examples.* The following examples illustrate the principles of this paragraph (k):

Example 1. On June 1, 2010, Corporation GG grants to Employee P, an employee of GG, an option under GG's employee stock purchase plan to purchase a share of GG stock for $85. The fair market value of GG stock on such date is $100 per share. On June 1, 2011, P exercises the option and on that date GG transfers the share of stock to P. On January 1, 2013, P sells the share for $150, its fair market value on that date. P's income tax return is filed on the basis of the calendar year. The income tax consequences to P and GG are as follows—

(i) Compensation in the amount of $15 is includible in P's gross income for the year 2013, 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), because the value is less than the fair market value of the share on the date of disposition ($150). For the purpose of computing P's gain or loss on the sale of the share, P's cost basis of $85 is increased by $15, the amount includible in P's gross income as compensation. Thus, P's basis for the share is $100. Because the share was sold for $150, P realizes a gain of $50, which is treated as long-term capital gain; and

(ii) GG is not entitled to any deduction under section 162 at any time with respect to the share transferred to P.

Example 2. Assume the same facts as in *Example 1,* except that P sells the share of GG stock on January 1, 2014, for $75, its fair market value on that date. Because $75 is less than the option price ($85), no amount in respect of the sale is includible as compensation in P's gross income for the year 2014. P's basis for determining gain or loss on the sale is $85. Because P sold the share for $75, P realized a loss of $10 on the sale that is treated as a long-term capital loss.

Example 3. Assume the same facts as in *Example 1,* except 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, 2011, when the option is exercised, the fair market value of the stock is $120 per share so that P pays $108 for the share of the stock. Compensation in the amount of $10 is includible in P's gross income for the year 2013, 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, P's cost basis of $108 is increased by $10, the amount includible in P's gross income as compensation. Thus, P's basis for the share is $118. Because the share was sold for $150, P realizes a gain of $32 that is treated as long-term capital gain.

Example 4. Assume the same facts as in *Example 1,* except that the option provides that the option price shall be the lesser of 95 percent of the fair market value of the stock on the first day of the offering period and 95 percent of the fair market value of the stock on the day the option is exercised. On June 1, 2011, when the option is exercised, the fair market value of the stock is $120 per share. P pays $95 for the share of the stock. Compensation in the amount of $5 is includible in P's gross income for the year 2013, 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 ($95) is $55; 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 ($95), is $5. Accordingly, $5, the lesser, is includible in gross income. In this situation, P's cost basis of $95 is increased by $5, the amount includible in P's gross income as compensation. Thus, P's basis for the share is $100. Because the share was sold for $150, P realizes a gain of $50 that is treated as long-term capital gain.

Example 5. Assume the same facts as in *Example 1,* except that instead of selling the share on January 1, 2013, P makes a gift of the share on that day. In that case $15 is includible as compensation in P's gross income for 2013. P's cost basis of $85 is increased by $15, the amount includible in P's gross income as compensation. Thus, P'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 6. Assume the same facts as in *Example 2,* except that instead of selling the share on January 1, 2014, P makes a gift of the share on that date. Because 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 P's gross income for 2014. P'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 7. Assume the same facts as in *Example 1,* except that after acquiring the share of stock on June 1, 2011, P dies on August 1, 2012, at which time the share has a fair market value of $150. Compensation in the amount of $15 is includible in P's gross income for the taxable year closing with P's death, $15 being the difference between the option price ($85) and the fair market value of the share when the option was granted ($100), because such value is less than the fair market value at date of death ($150). The basis of the share in the hands of P's estate is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example 8. Assume the same facts as in *Example 7,* except that P dies on August 1, 2011, at which time the share has a fair market value of $150. Although P's death occurred within one year after the transfer of the share to P, the income tax consequences are the same as in *Example 7.*

Example 9. Assume the same facts as in *Example 1,* except that the share of stock was issued in the names of P and P's spouse jointly with right of survivorship, and that P and P's spouse sold the share on June 15, 2012, for $150, its fair market value on that date. Compensation in the amount of $15 is includible in P's gross income for the year 2012, the year of the disposition of the share. The basis of the share in the hands of P and P's spouse 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 P's gross income. The gain of $50 on the sale is treated as long-term capital gain, and is divided equally between P and P's spouse.

Example 10. Assume the same facts as in *Example 1,* except that the share of stock was issued in the names of P and P's spouse jointly with right of survivorship, and that P predeceased P's spouse on August 1, 2012, at which time the share had a fair market value of $150. Compensation in the amount of $15 is includible in P's gross income for the taxable year closing with his death. See *Example 7.* The basis of the share in the hands of P's spouse as survivor is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example 11. Assume the same facts as in *Example 10,* except that P's spouse predeceased P on July 1, 2012. Section 423(c) does not apply in respect of the death of P's spouse. Upon the subsequent death of P on August 1, 2012, the income tax consequences in respect of P's taxable year closing with the date of P's death, and in respect of the basis of the share in the hands of P's estate, are the same as in *Example 7.* If P had sold the share on July 15, 2012 (after the death of P's spouse), for $150, its fair market value at that time, the income tax consequences would be the same as in *Example 1.*

(l) *Effective/applicability date.* The regulations under this section are effective on November 17, 2009. The regulations under this section apply to options granted under an employee stock purchase plan on or after January 1, 2010.

■ **Par. 6.** Section 1.424–1, paragraphs (a)(10) *Example 9* (iii) and (g)(1) are revised to read as follows:

§ 1.424–1 Definition and special rules applicable to statutory options.

(a) * * *

(10) * * *

Example 9. * * * (iii) Assume the same facts as in paragraphs (i) and (ii) of this *Example 9.* Assume further that as part of the acquisition, X amends its plan to allow future grants under the plan to be grants to acquire Y stock. Because the amendment of the plan to allow options on a different stock is considered the adoption of a new plan under § 1.422–2(b)(2)(iii), the stockholders of X (in this case, Y) must approve the plan within 12 months before or after the date of the amendment of the plan. If the stockholders of X (in this case, Y) timely approve the plan, the future grants to acquire Y stock will be incentive stock options (assuming the other requirements of § 1.422–2 have been met).

* * * * *

(g) *Effective/applicability date*—(1) *In general.* Except for § 1.424–1(a)(10) *Example 9* (iii), the regulations under this section are effective on August 3, 2004. Section 1.424–1(a)(10) *Example 9* (iii) is effective on November 17, 2009. Section 1.424–1(a)(10) *Example 9* (iii) applies to statutory options granted on or after January 1, 2010.

* * * * *

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

Approved: November 9, 2009.

Michael F. Mundaca,

Acting Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. E9–27452 Filed 11–16–09; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9470]

RIN 1545–BH69

Information Reporting Requirements Under Internal Revenue Code Section 6039

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains the final regulations relating to the return and information statement requirements under section 6039 of the Internal Revenue Code (Code). These regulations reflect changes to section 6039 made by section 403 of the Tax Relief and Health Care Act of 2006. These regulations affect corporations that issue statutory stock options and provide guidance to assist corporations in complying with the return and information statement requirements under section 6039.

DATES: *Effective Date:* These regulations are effective on November 17, 2009.

Applicability Date: For dates of applicability, *see* §§ 1.6039–1(g) and 1.6039–2(e).

FOR FURTHER INFORMATION CONTACT: Thomas Scholz or Ilya Enkishev at (202) 622–6030 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–2129. Responses to this collection of information are required to assist taxpayers with the completion of their income tax returns for the taxable year in which a disposition of stock acquired under a statutory option occurs.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.