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Impact of Securities Laws on Taxation of Compensation

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An employee acquiring stock from an employer in connection with the performance of services must generally include the fair market value of the stock, as reduced by any amount paid for it, in income as compensation. In the case of stock acquired through the exercise of an option, the taxable event generally occurs upon exercise of the option. If, however, the stock is subject to a "substantial risk of forfeiture" ("SROF"), as further described below, and is not transferable by the employee, compensation income does not arise until either the stock becomes transferable or the SROF lapses.

The employer is generally required to withhold and pay over to the tax authorities, frequently on the first business day after issuance of the stock, income tax withholding and FICA tax amounts computed by reference to the fair market value of the stock minus any amount paid for the shares. As a condition to exercise, therefore, employers frequently require employees to pay, at the time of exercise, an amount equal to the required tax withholding, as well as the option exercise price. Even if the employee is not required to fund withholding requirements, the employee will still be obligated to pay income taxes in the ordinary course on income arising from receipt of the stock.

For a variety of reasons, including the need to pay any exercise price and tax amounts at the time an option is exercised and a desire to minimize investment risk from the ownership of employer stock and to convert into cash the gain from the option as soon as possible, employees frequently wish to sell all or a major portion of the shares purchased under stock options on the date of exercise or shortly thereafter.

Such sales may be limited or precluded, however, either by the express provisions of U.S. securities laws or by trading restrictions that are imposed by the employer to help assure compliance with those laws. Such restrictions may place an employee holding an option in a difficult financial position, especially if circumstances (such as a termination of employment) compel the employee to accelerate exercise of the option at a time at which the securities law-based restrictions apply and stock received upon exercise cannot readily be converted to cash.

In situations where the immediate disposition of shares purchased under options is legally or contractually restricted, taxpayers have sometimes argued that such restrictions constitute a SROF and prevent the shares from being transferable, such that IRC §83 and the regulations thereunder would defer the recognition of compensation by the employee until such time as the employee is free to dispose of the shares.

IRC §83(c)(3) specifically addresses the impact of the potential for a suit under section 16(b) of the Securities Exchange Act of 1934 (the "Exchange Act") as a SROF. Section 16(b) liability is generally triggered by a purchase and sale (or a sale and purchase) of a registered security within a period of less than six months, by an officer or director of the issuing entity or by certain other persons.

The case law authority outside the scope of IRC §83(c)(3), and with respect to securities law and related restrictions not attributable to section 16(b), is limited and mixed. The IRS, in a recent published ruling (Rev. Rul. 2005-48, 2005-32 I.R.B. __), reiterated its view that restrictions attributable to Rule 10b-5 under the Exchange Act do not constitute a SROF.

Facts in Rev. Rul. 2005-48

On January 2, 2005, E, an employee of Company M, was granted a nonqualified option to buy 100 shares of M common stock at a price of $10 per share, which was the fair market value of such stock on the date of grant.

Although the option was exercisable immediately, the option itself did not have a "readily ascertainable fair market value" at the time of grant. Thus, nothing was required to be included in E's income by reason of the grant of the option.

On May 1, 2005, stock of M was sold in an initial public offering. E agreed, pursuant to a "lock-up" in the underwriting agreement, not to sell any M shares on or before November 1, 2005. M also adopted an Insider Trading Compliance Program (the "ITCP"), presumably to help ensure compliance with securities laws. Under the ITCP, insiders such as E could trade in M shares during 2005 only in the period between November 5 and November 30 of that year.

Neither the lock-up nor the ITCP prevented E at any time from exercising the option.

On August 15, 2005, during the lock-up period and at a time when the stock trading price was more than $10, M exercised his option in full, paid the exercise

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price in cash, and received 100 M shares. The rights of E in the shares were not conditioned on the future performance of services. E was in possession of material nonpublic information concerning M, however, and he would have been subject to suit under Rule 10b-5 if he had sold the option shares immediately after exercise (assuming that the lock-up period and ITCP did not prevent him from doing so).

Analysis

The principal issue addressed in the ruling was whether E was required to recognize compensation under IRC §83 at the time of exercise of the option. Under the rules of section 83, E would not be required to recognize compensation when the stock was acquired if the stock was both (i) not transferable and (ii) subject to a SROF. The ruling concluded that the M stock was not subject to a SROF when purchased by E under the option, so compensation was required to be recognized at that time.

The ruling noted that, if the sale of the stock could subject E to liability under section 16(b) of the Exchange Act, the stock would be considered subject to a SROF and not transferable pursuant to IRC §83(c)(3).

Before 1991, the acquisition of stock pursuant to the exercise of an option was considered a purchase for section 16(b) purposes, such that a sale within 6 months after the purchase could trigger section 16(b) liability. Under rules adopted by the SEC in 1991, however, while the grant of an option with the terms and under the circumstances described above is considered to be a purchase commencing the six-month period for section 16(b) purposes, the exercise of such an option is not considered to be a purchase for such purposes.

Because the option was granted on January 2, 2005, the section 16(b) period for E expired even before the exercise of the option and transfer of shares to E on August 15. Accordingly, the shares as acquired by E were not subject to a SROF by reason of IRC §83(c)(3).

The ruling further concluded that neither the lock-up nor the ITCP imposed a SROF. Under Reg. §1.83-3(c)(1), a risk of forfeiture with respect to property will be considered to be a SROF only if rights to the property are conditioned on the future performance of substantial services, or on the occurrence of a condition related to the purpose of the transfer -- such as, for example, a requirement that the performance of the employee meet certain criteria during a vesting period -- and if there is a substantial possibility of forfeiture if the condition is not satisfied.

Since neither the lock-up nor the ITCP made the rights of E with respect to the shares subject to such a performance requirement, or to any other condition relating to the purpose of the transfer of shares to E, the ruling concluded that the stock as purchased by E was not subject to a SROF.

One of the cases referred to in Rev. Rul. 2005-48 in its analysis of the SROF issue is *Robinson v. Commissioner*, 805 F.2d 38 (1st Cir. 1986). In that case, which took a more liberal view of the SROF rules than does the ruling, an employee who had purchased shares under a stock option was required to sell the shares back to the company at original cost if he desired to sell them less than a year after the exercise of the option.

Reversing a decision of the Tax Court in favor of the government, the Circuit Court of Appeals concluded that the restrictions imposed on the employee with respect to the shares gave rise to a SROF and made the stock not transferable until the restrictions on transfer lapsed. More specifically, the court concluded that the restrictions should be recognized as a SROF because there was a high likelihood of the company's enforcing the restriction if the employee attempted to sell his shares in less than a year, and because the restriction served a significant business purpose -- namely, to prevent the employee from engaging in insider trading.

The ruling indicates that the IRS believes that *Robinson* was wrongly decided. Presumably to firm up the government's litigation position in future cases, the ruling states that the Treasury and the IRS intend to amend regulations under section 83 to “explicitly set forth” the holdings in the revenue ruling.

Rev. Rul. 2005-48 also addressed whether the lock-up and ITCP should be taken into account in valuing the shares transferred to E for purposes of determining the *amount* of compensation resulting from the exercise of the option.

Section 83(a) specifically provides that, for purposes of determining compensation by reason of a transfer of property in connection with the performance of services, the fair market value of the property is determined without regard to any restriction on the employee's transfer of the property, unless the restriction, by its terms, will never lapse (a "non-lapse" restriction). In the circumstances at hand, the lock-up period would expire in the same year as the year of exercise of the option, and the ITCP permitted a sale of shares during a period commencing about three months after the date of exercise of the option; thus, these restrictions did not constitute non-lapse restrictions and were disregarded for purposes of computing the amount of compensation resulting from exercise of the option by E.

Observations

Robinson reflected a generous interpretation as to the types of provisions that may constitute an SROF, and one that is inconsistent with the interpretation of the same "substantial risk of forfeiture" phrase by the IRS in related areas of the tax law, including the new rules on deferred compensation arrangements added to the Code last year. Thus, it is not surprising that the IRS, in Rev. Rul. 2005-48, has taken a contrary, and more restrictive, position regarding the interpretation of the SROF term in the context of section 83.

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[1] The employee can elect under IRC §83(b) to disregard any SROF and to be taxed at the time of receipt of the stock.