

Part I

Section 83.—Property Transferred in Connection with the Performance of Services

26 CFR 1.83-3: Meaning and Use of Certain Terms - Substantially Vested

Rev. Rul. 2005-48

ISSUE

If an employee exercises a nonstatutory option more than six months after grant, but is subject to restrictions on his ability to sell the stock obtained through exercise of the option under rule 10b-5 under the Securities Exchange Act of 1934 and the contractual provisions described below, is the employee required to recognize income under section 83 of the Internal Revenue Code at the time of the exercise of the option?

FACTS

On January 2, 2005, Employee E, an employee of Company M, is granted a nonstatutory option to purchase M common stock. Although the option is immediately exercisable, it has no readily ascertainable fair market value when it is granted. Under the option, Employee E has the right to purchase 100 shares of M stock for \$10 per share, which is the fair market value of an M share on the date of grant of the option.

On May 1, 2005, M sells its common stock in an initial public offering. As required under the Underwriting Agreement, Employee E agrees not to sell, otherwise dispose of, or hedge any common shares, options, warrants, or convertible securities of M from May 1 through November 1 of 2005 (“the lock-up period”).

Also on May 1, 2005, M adopts an Insider Trading Compliance Program, under which, as applied to 2005, insiders (such as Employee E) may trade M shares only between November 5 and November 30 of that year (“the trading window”). Under the Program, if Employee E trades M shares outside the trading window without M’s permission, M has the right to terminate Employee E’s employment. However, the exercise of nonstatutory options for M shares is not prohibited under the referenced agreements.

On August 15, 2005 (during the lock-up period and outside the trading window), M stock is trading on an established securities market at more than \$10 per share. On that date, Employee E fully exercises the option, paying the exercise price in cash, and receives 100 M shares. Employee E’s rights in the shares received as a result of the exercise are not conditioned upon the future performance of substantial services. As of that date, Employee E is in the possession of material nonpublic information concerning M that would subject him to liability under Rule 10b-5 under the Securities Exchange Act of 1934 (“Exchange Act”), 17 C.F.R. § 240.10b-5, if Employee E sold the M shares while in possession of such information.

LAW AND ANALYSIS

Section 83(a) provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess

of the fair market value of the property at the first time that the rights to the property are either transferable or not subject to a substantial risk of forfeiture ("substantially vested"), whichever occurs earlier, over the amount paid for the property is included in the gross income of the service provider in the first taxable year in which the rights to the property are substantially vested.

For purposes of section 83, a "transfer" of property occurs when a person acquires a beneficial ownership interest in the property (disregarding any "lapse restriction"). See section 1.83-3(a)(1) of the Income Tax Regulations.

Under section 1.83-3(h), a restriction which, by its terms, will never lapse (also referred to as a "nonlapse restriction") is a permanent limitation on the transferability of property that will require the transferee of the property to sell (or offer to sell) the property at a price determined under a formula and that will continue to apply and be enforced against the transferee or any subsequent holder (other than the transferor). An obligation to resell (or to offer to sell) the transferred property to a specific person or persons at its fair market value at the time of the sale is not a nonlapse restriction.

The term "lapse restriction" means a restriction other than a nonlapse restriction and includes (but is not limited to) a restriction that carries a substantial risk of forfeiture. See section 1.83-3(i).

For purposes of section 83, property is substantially nonvested when it is both subject to a "substantial risk of forfeiture" and is "nontransferable" within the meaning of sections 1.83-3(c) and (d), respectively. Property is substantially vested when it is either transferable or not subject to a substantial risk of forfeiture.

Whether a risk of forfeiture is substantial (or not) depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person or the occurrence of a condition related to the purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Property is not subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of the property to the employee upon the return of the property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, is not a substantial risk of forfeiture. See section 1.83-3(c)(1).

For purposes of section 83, the rights of a person in property are "transferable" if the person can transfer any interest in the property to any person other than the transferor of the property, but only if the transferee's rights in the property are not subject to a substantial risk of forfeiture. Accordingly, property is transferable if the person performing the services or receiving the property can sell, assign, or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to any person other than the transferor of the property, and if the transferee is not required to give up the property or its value in the event that the substantial risk of forfeiture materializes. See section 1.83-3(d).

Section 83(e)(3) provides that section 83(a) does not apply to the transfer of an option without a readily ascertainable fair market value. However, section 83(a) does apply to such an

option at the time that it is exercised, sold, or otherwise disposed of. If the option is exercised, section 83(a) applies to the transfer of property pursuant to the exercise. If the option is sold or otherwise disposed of in an arm's length transaction, section 83(a) applies to the transfer of money or other property received in the same manner as it would have applied to the transfer of property pursuant to an exercise of the option. See section 1.83-7(a) of the regulations.

Under section 83(c)(3) of the Code and section 1.83-3(j) of the regulations, if the sale of property at a profit within six months after the purchase of the property could subject a person to suit under section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b), the person's rights in the property are treated as subject to a substantial risk of forfeiture, and as not transferable, until the earlier of (1) the expiration of such six-month period, or (2) the first day on which the sale of the property at a profit will not subject the person to suit under section 16(b). Because, when enacting section 83(c)(3), Congress decided that the only provision of the securities law that would delay taxation under that section would be section 16(b), potential liability for insider trading under Rule 10b-5, for example, does not cause rights in property taxable under section 83 to be substantially nonvested.

Section 16(b) liability is triggered by either a "purchase and sale" or a "sale and purchase" of a security registered under section 12 of the Exchange Act, 15 U.S.C. § 78l, within a period of less than six months by an officer, director, or greater-than-10-percent owner of the corporation that issued the security. 15 U.S.C. §§ 78p(a) and (b). The combination of a purchase and a sale event (in either order) within a six-month period is what triggers section 16(b) liability.

Before May 1, 1991, the acquisition of stock as the result of the exercise of an option was viewed as a "purchase" for section 16(b) purposes. Thus, the six-month period under section 16(b) was measured from the date an option was exercised.

However, effective May 1, 1991, the Securities and Exchange Commission ("SEC") adopted new rules under section 16; thereafter, for purposes of that section, derivative securities, including options, generally were treated as the functional equivalents of stock ownership. Ownership Reports and Trading by Officers, Directors and Principal Security Holders, SEC Release No. 34-28869, 56 Fed. Reg. 7242, 7248 (Feb. 21, 1991). Stated another way, the SEC recognized "that holding derivative securities is functionally equivalent to holding the underlying equity securities for purposes of Section 16, since the value of the derivative securities is a function of or related to the value of the underlying equity security." *Id.* Accordingly, the SEC determined that the acquisition of an option should be deemed the significant event for purposes of section 16(b), not the exercise. *Id.*

In implementing this change, the SEC provided that any acquisition or disposition of an option involves either a "purchase" or "sale" for section 16(b) purposes. 17 C.F.R. §§ 240.16b-6(a), 240.16a-1(c), and 240.16a-1(b). The SEC exempted from section 16(b) exercises and conversions of options that (like Employee E's) have a fixed exercise price due at the exercise or conversion, other than options that are out-of-the-money at the time of exercise. 17 C.F.R. § 240.16b-6(b). In other words, after May 1, 1991, the six-month holding period under section 16(b) is measured from the date an option is granted, not when it is exercised (with exceptions not applicable here). Thus, after May 1, 1991, section 16(b) interacts with section 83 as follows: if, for example, shares are acquired through the exercise of a nonstatutory option in a

transfer taxable under the rules of section 83, the holder of the shares would not be subject to section 16(b) liability as a result of an immediate sale of the shares unless the sale occurred during the six-month period beginning with the date of grant of the option. Even if an optionee exercises an option and sells the underlying shares within six months of the date of grant of the option, an exemption from liability under section 16(b) may be available under other provisions of the SEC rules. See 17 C.F.R. §§ 240.16b-3(d)(1) and (2). If such an exemption is available within six months of the date of grant, the compensation income attributable to the employee's exercise of the option is includable in the employee's gross income on the later of the date of exercise and the date the exemption becomes available. If such an exemption is not available within six months from the date of grant, the compensation income attributable to the employee's exercise of the option would be includable in the employee's gross income on the later of the date of exercise or the date that is six months from the date of grant.

Applying the above rules, because the option is granted to Employee E on January 2, 2005, the section 16(b) period applicable to the option expires on July 2 of that year. Accordingly, the section 16(b) period expires *before* the date that Employee E exercises the option and the M shares are transferred to Employee E (on August 15). Thus, the shares are not subject to a substantial risk of forfeiture under section 83(c)(3) as a result of section 16(b). Moreover, neither the Underwriting Agreement nor the Insider Trading Compliance Program imposes a substantial risk of forfeiture, because the provisions of those agreements do not condition Employee E's rights in the shares upon anyone's "future performance (or refraining from performance) of substantial services" or on a "condition related to a purpose of the transfer" of the shares to Employee E. Accordingly, neither section 83(c)(3) nor the provisions of those agreements preclude taxation under section 83 when the shares resulting from exercise of the option are transferred to Employee E. These conclusions are consistent with the court's decision in Tanner v. Comm'r., 117 T.C. 237 (2001), *aff'd*, No. 02-60463 (5th Cir. Mar. 26, 2003); but see Robinson v. Comm'r., 805 F.2d 38 (1st Cir. 1986), *rev'g*, 82 T.C. 444 (1984).

Additionally, the restrictions imposed by the referenced agreements and Rule 10b-5 on Employee E's sales (or other trading) of the M shares are "lapse restrictions," because the restrictions imposed by the Underwriter's Agreement and Rule 10b-5 are temporary and the restrictions imposed by the Insider Trading Compliance Program are inapplicable during the window period. Accordingly, these restrictions are ignored when valuing the shares. See section 83(a).

The Department of the Treasury and the Internal Revenue Service intend to amend the § 83 regulations to explicitly set forth the holdings in this revenue ruling.

HOLDING

Under section 83, the compensation income attributable to Employee E's exercise of the option for M shares is includible in Employee E's gross income when the shares obtained through exercise of the option are transferred to Employee E, and the amount of compensation income is determined without regard to the share-transfer restrictions imposed by the Underwriter's Agreement and the Insider Trading Compliance Program.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Hughes of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further

information regarding this revenue ruling, contact Mr. Hughes or Robert Misner at (202) 622-6030 (not a toll-free number).