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# Options in the Web 2.0 Bubble

**By Christopher Karachale • Wood & Porter • San Francisco**

The latest Internet bubble appears to have arrived. Goldman Sachs' recent $450 million investment in Facebook boosted the value of the company to more than $50 billion. And Facebook isn't the only site surfing this latest Internet wave. D.S.T. Global, run by Russian billionaire Yuri Milner, has poured hundreds of millions of dollars over the past two years in other Internet companies such as Groupon and Zynga.

Bankers, venture capitalists, lawyers and investors in Silicon Valley have not let this zeal go unappeased. Stock in these still-private companies is now being traded on exchanges such as SecondMarket and SharesPost. New classes of stock such as FF shares and "F" class shares have been devised. These classes of stock allow the latest crop of Internet entrepreneurs to maintain control of their tech companies as they ride their private start-ups from the crest of the wave into the tube of corporate growth.

Just as in the first Internet bubble, equity compensation is the Big Kahuna. Such compensation remains an important incentive for today's Internet companies and their employees. Nonstatutory stock options—and increasingly restricted stock units—represent an integral tool for attracting and retaining talent in this latest bubble.

Yet as new as the latest social networking mania is, one wonders if the mistakes and missteps of the past are really behind us. Already we have a new batch of paper millionaires, and many more will ride the latest waves to riches. However, to avoid the shoals that inevitably become visible when the bubble bursts, it may be wise to review a recent case from the last Internet bubble regarding the taxation of nonstatutory stock options.

## A Cautionary Tale

Our cautionary tale begins with InfoSpace.com, an Internet directory founded by early Microsoft employee Naveen Jain. *Strom v. U.S.*, 2010 U.S. App. LEXIS 27146 (9th Cir. 2010) involves the appropriate

ALSO IN THIS ISSUE

tax treatment of stock options owed by Bernee D. Strom, the former President and COO of InfoSpace. Strom was hired in November 1998 and granted the right to purchase 750,000 shares of InfoSpace stock at $15 per share. Her rights to the shares vested over a period of years.

Strom exercised the options and purchased the shares in September and December 1999. Then she exercised more options monthly through July 2000. All of this occurred at the veritable height of the first Internet bubble.

During these halcyon days, a share of InfoSpace stock was trading for as much as $1,305 (March 2000). During Strom's tenure, InfoSpace merged with three companies including INEX Corporation, Prio Inc. and Go2Net. However, beginning in January 2000, Strom appears to have become concerned about ethical issues regarding Jain's business practices. And that led to her gradual exit.

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## Bitter End

Strom remained on InfoSpace's board until April 2000, and remained president of an InfoSpace subsidiary until June 2000. On June 30, 2000, she severed all connections with InfoSpace. Strom's departure coincided with a precipitous drop in InfoSpace share values. By January 2001, shares were trading at $55 to $64 and by April 2001 the price had reached a low of $22 a share.

Of course, as the recipient of nonstatutory stock options, Strom's income was directly tied to the share price at the time of exercise. Strom had not made an Internal Revenue Code Section ("Code Sec.") 83(b) election for any of her options or shares. That made the income attributable to her exercise of the InfoSpace options doubly painful as ordinary.

On her 1999 federal income tax return, Strom appropriately reported as gross income the difference between the market value of the InfoSpace stock on the dates she exercised her options and the $15 option price. InfoSpace withheld federal income and Medicare taxes from Strom's wages for 1999 with respect to that income. However, on her 2000 federal income tax returns, Strom did not report any income related to her exercise of InfoSpace options, even though she had exercised options that year.

Interestingly, InfoSpace also did not withhold income tax with respect to Strom's exercise of stock options in 2000. Yet it did withhold Medicare tax premised on her realizing income by exercising those options. Strom then sought a refund for the income tax and Medicare taxes paid in 1999 and 2000. When the IRS denied it, she filed suit in district court.

## Navigating Code Sec. 83

Strom's argument for the refund demonstrates the complicated timing rules of Code Sec. 83. Under Code Sec. 83(a), an individual generally realizes income upon exercising a compensatory nonstatutory stock option that does not have a readily ascertainable fair market value at the time it is granted. [*P.J. LoBue*, SCt, 56-2 USTC ¶9607, 351 US 243 (1956).] Absent an 83(b) election, the difference between the fair market value at the time of exercise and the price at which the option was granted is ordinary income.

However, there are important—and, in Strom's case, potential cost saving—exceptions. Even after the exercise of the option, a taxpayer does not have to recognize income until the taxpayer's rights to the stock are transferable or are no longer subject to a substantial risk of forfeiture (SRF). [Code Sec. 83(a).] Typically, the IRS and courts look to all facts and circumstances to determine whether rights in property are subject to an SRF or are transferable.

However, Congress has codified one example of an SRF. Code Sec. 83(c)(3) provides:

> So long as the sale of property at a profit could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934, such person's rights in such property are—(A) subject to a substantial risk of forfeiture, and (B) not transferable.

Section 16(b) of the Securities Exchange Act of 1934 ("Section 16(b)") imposes strict liability for any short-swing profits obtained by corporate insiders through the purchase and/or sale of corporate securities within a six-month window. In essence, Section 16(b) serves as a backstop by preventing corporate insiders from purchasing and selling (or selling and purchasing) shares based on their inside knowledge about the fate of the company.

The Treasury has also promulgated guidance on what constitutes an SRF. Reg. §1.83-3(k) provides that property is subject to an SRF and is not transferable as long as the property is subject to a restriction on transfer to comply with the "Pooling-of-Interests Accounting" rules set forth in SEC Accounting Series Releases Numbered 130 and 135. These pooling-of-interests accounting rules can impact mergers where the business combination involves sharing rights and risks among shareholders.

## The Web of SRF and Transferability

Invoking Code Sec. 83(c)(3) and Reg. §1.83-3(k), Strom argued that she did not have to recognize income from the exercise of her options until 2001. Even though the options vested and were exercised in 1999 and 2000, the SRFs provided by the Code and regulations allowed her to defer recognition of income until 2001 (when the fair market value of the shares was in the $50 range) rather than 1999 and early 2000 (when the fair market value of the shares was over $1,000). The difference was clearly worth fighting for.

For purposes of the Code Sec. 83(c)(3) analysis, Strom was clearly a corporate insider. Consequently, she argued that her shares were subject to an SRF. She had potential liability under Section 16(b) from the time she first exercised her options (September 1999) until December 23, 2000 (or six months after her last vesting date).

Strom pointed out that the last vesting date of her options should be used to start the six-month clock running for purposes of the purchase date test under Section 16(b). Of course, the Code Sec. 83(c)(3) argument only pushed the recognition of income to the end of December 2000. To get beyond that, Strom brought up the mergers with INEX Corporation, Prio Inc. and Go2Net. Under Reg. §1.83-3(k), these deals prevented her from transferring her shares of InfoSpace throughout 1999 and 2000. According to Strom, only in 2001 did her shares finally become transferable and no longer subject to the SRF by virtue of the pooling-of-interests accounting rules.

## Options Looking up

In the U.S. District Court (*M.G. Strom*, DC-WA, 2008-2 USTC ¶50,632, 583 FSupp2d 1264 (2008)), Strom was surprisingly successful. The trial court acknowledged the broad language of Code Sec. 83(c)(3): "plaintiff need not show that the sale could have subjected her *to liability* under [Section] 16(b): all she needs to show is that she could have been subjected *to suit*." [583 FSupp2d, at 1269–70 (emphasis added).] The court then analyzed the application of the Section 16(b) short swing prohibition for purposes of nonstatutory options.

After reviewing SEC authorities, court cases and matters of practicality, the trial court concluded that the *acquisition date* of the option—not its vesting date—starts the clock ticking on the six-month short-swing rule. The court noted Strom was granted the InfoSpace options in 1998. That date was

therefore the purchase date under Section 16(b). This meant the SRF was lifted in 1999 and 2000.

Despite its review of authorities regarding the application of Section 16(b) to Strom's options, the court was clear on one thing: The rules were not clear. In fact, given the dearth of authorities, the court offered Strom a respite. Plainly, it was not frivolous for Strom to argue she *could* have been subject to a suit under Section 16(b) for her short-swing profits six months after the date her options *vested*. Code Sec. 83(c)(3) merely speaks in terms of being subject to "suit" (not "liability"). Thus, the court agreed that Strom might have been subject to suit on a sale six months after the last date of vesting. She presumably could have been forced to marshal resources and argue about the Section 16(b) short swing rules.

The district court conceded that a suit under Section 16(b) to recover Strom's profits based on vesting dates would have failed as a matter of law. But this was beside the point. She had shown that she *could* have been subject to suit and that was enough. The court agreed that the SRF was in place until six months after her last vesting date, or December 23, 2000.

## Merger Implications

The district court did not, however, agree that the pooling-of-interest accounting rules pushed the recognition of income into 2001. It was true that during Strom's tenure, InfoSpace had merged with three different companies. The chronology of these mergers is not clear from the trial or appellate court decisions. However, Strom argued that those mergers came within the Reg. §1.83-3(k) rules and prevented her from having to recognize the income until 2001.

The SEC Accounting Series Releases mentioned in Reg. §1.83-3(k) preclude post-merger sales of stock until the financial results covering at least 30 days of post-merger combined operations have been published. The district court pointed out that these releases don't address or appear to even contemplate delaying the realization of income from the exercise of stock options.

Strom argued that the SEC Accounting Series Releases should be read to include *pre*-merger stock sales, which would have affected potential sales she *could* have made. The trial court was unconvinced and ruled that Strom faced no SRF because of the pooling-of-interest rules. Thus, the district court ruled that Code Sec. 83(c)(3) prevented Strom from recognizing gain from the exercise of her options until December 23, 2000, but Reg. §1.83-3(k) did not further delay the recognition of income.

## Limiting Options

Strom and the IRS cross-appealed to the Ninth Circuit. There Strom appears to have argued again that the six-month Section 16(b) short-swing profit rule started with the vesting (rather than the grant) of her options. Even if it did not, she argued the uncertainty of the law meant she still might have been subject to *suit* under Section 16(b).

Moreover, Strom once again argued that the InfoSpace's mergers prevented her from transferring her shares under Reg. §1.83-3(k). The court sensibly examined the meaning of Code Sec. 83(c)(3). Like the trial court, the Ninth Circuit ruled that the six-month window for the Section 16(b) short-swing profits rule applied when Strom *acquired* her options.

Reviewing the language of the statute and the contextual application of the rule, the court defined the standard for the application of Code Sec. 83(c)(3):

> … the best interpretation of Code Sec. 83(c)(3) is that a taxpayer may defer the calculation and recognition of income if there is an objectively reasonable chance that a suit under Section 16(b) based on a sale of her stock would have succeeded. That standard roughly equates to a determination of whether a reasonably prudent and legally sophisticated person would not have sold her stock, because, if a Section 16(b) suit had been brought against her, she likely would have been forced to forfeit the profit obtained by the sale (or, at a minimum, she would have faced substantial legal expenses defending herself against a claim not readily dismissed). [2010 U.S. App. LEXIS 27146, 18–19.]

The Ninth Circuit then applied this standard to Strom. The court held that a reasonably prudent and legally sophisticated person in Strom's position would have felt free to sell her shares. According to the court, Code Sec. 83(c)(3) and Section 16(b) make for "strange bedfellows" since the purposes of the tax law and the regulatory law are distinct. [*Id.,* at 22.]

Nevertheless, the appellate court found that the frivolous standard originally applied by the district court was improper. The reasonably prudent person is the standard to test for instances of possible suit under Section 16(b) for purposes of Code. Sec. 83(c)(3). Strom simply couldn't carry this burden so she could not defer tax on the exercise of her options by virtue of the codified SRF.

In reviewing Strom's Reg. §1.83-3(k) argument, Ninth Circuit found another point of disagreement with the district court. Just as it had read Code Sec. 83(c)(3) more narrowly than the district court, it read Reg. §1.83-3(k) more broadly. The court stated that there appeared to be nothing in the language of Reg. §1.83-3(k) preventing the application of the rule to officers' *pre*-merger (as opposed to *post*-merger) sales of stock.

The trial court had failed to develop an adequate factual record of what restrictions InfoSpace had in place to comply with pooling-of-interests accounting rules. Thus, the Ninth Circuit remanded the case to the district court to determine if Strom could defer the recognition of income from the exercise of her stock options by virtue of Reg. §1.83-3(k).

## Elephant in the Room

The Ninth Circuit's opinion is surprising in several respects. By remanding the matter for review of the highly technical and factually underdeveloped Reg. Sec. 1.83-3(k) issue, the court forced Strom and other taxpayers to hold their breaths. How will this subtle issue involving the pooling-of-interests accounting rules be applied? Assuming that the parties do not settle, the court on remand may find Reg. §1.83-3(k) to be a helpful tool allowing executives to defer recognition of income where a series of mergers coincide with the exercise of their options. Of greater interest is the fact that the appellate court does not acknowledge what must have been the elephant in the (court)room.

Recall that Strom decided to leave InfoSpace because of her concerns over founder Naveen Jain's business practices. It turns out that same U.S. District Court for the Western District of Washington that heard Strom's case had ruled that Jain engaged in prohibited short-swing trading in violation of Section 16(b). See *Dreiling v. Jain*, DC-WA, 281 FSupp2d 1234 (2003). In May and April of 1999, Jain had purchased and sold InfoSpace shares realizing a profit of over $200 million in patent violation of the six-month short-swing rules. After a Section 16(b) suit, the district court ordered Jain to pay a total of $247,122,712 in 2003.

Jain eventually settled for $65 million. Given this additional fact, Strom's Code Sec. 83(c)(3) arguments may take on an added layer of plausibility. Indeed, it appears that one of the very reasons Strom may have left InfoSpace was Jain's security violations, including violations of Section 16(b).

Surely she must have been concerned about her own potential liability as the President and COO of InfoSpace. This fact appears to have colored, at least in part, the lower court's finding that it was not frivolous for Strom to argue she might have been subject to a Code Sec. 16(b) suit. Perhaps the district court was attempting to help Strom (even if subtly) by providing a standard that would create an SRF for her exercised options. It is hard to know.

## Conclusion

The *Strom* cases provide a cautionary tale for Internet moguls of the Web 2.0 bubble. First, when options are involved, it is of paramount importance to determine whether a limit on transferability or an SRF exists once the option is exercised. These mechanisms may allow deferral of income recognition. Plus, they can be exceedingly beneficial where stock prices are fluctuating, especially in an economic bubble.

Second, be careful of the complex interaction of securities and tax laws. As the Ninth Circuit acknowledged, these two bodies of law make strange bedfellows. If these latest Internet paper millionaires are not careful, they may find themselves washed out to sea.