



California Corporate & Securities Law

Misery (Taxes) Acquaints A Court With Strange Bedfellows (Sections 83 and 16(b))

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Yesterday, the Ninth Circuit Court of Appeals issued an opinion in a federal tax refund suit that spends a surprising amount of time discussing whether the plaintiff could be subject to suit under Section 16(b) of the Securities Exchange Act of 1934.

In [Strom v. United States](#) (9th Cir. Case No. 09-35175, Apr. 6, 2011), the plaintiff had been granted non-statutory stock options to acquire shares of InfoSpace at an exercise price of \$15 per share. The plaintiff exercised her options on an almost monthly basis during a period when the market price of the shares was very high. The issue in the case was whether the plaintiff could postpone the tax consequences of her exercises because the shares were subject to a substantial risk of forfeiture pursuant to Section 83(c)(3) of the Internal Revenue Code. Section 83(c)(3) provides that a person's interest in property is subject to a substantial risk of forfeiture and not transferable so long as the sale of property at a profit could subject a person to suit under Section 16(b). Thus, the Court of Appeals was required to determine whether the plaintiff could be subject to suit under Section 16(b).

The plaintiff contended that her options were "purchased" under Section 16(b) on each date on which they vested. Because the plaintiff's options vested periodically every six months or less, she claimed that any sale of her stock could have been matched for purposes of Section 16(b). This theory allowed her to defer determination of income until a time when the stock price had dropped.

The Court of Appeals spends quite a bit of time discussing the SEC's analysis in Exchange Act Release No. 34-28,869 (Feb. 21, 1991). Ultimately, the Court held that the vesting of the plaintiff's options did not constitute purchases under Section 16(b). As a result, the plaintiff was not entitled to defer the tax consequences of her non-statutory option exercises under Section 83(c)(3) because she had not demonstrated that she could have been subject to a Section 16(b) suit that had an objectively reasonable chance of success.

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