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Income Classification Pitfalls for Executives of Startups

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The primary financial incentive for a key employee of a startup business is often the prospect of a large financial benefit when the company goes public or is sold to another company for cash, equity, or both. In such situations, the employee will want to structure equity participation in the startup in a way that will allow the employee's "windfall" to be taxed at the favorable rates applicable to long-term capital gain, rather than as ordinary income. Although rate changes in recent years, including the imposition of a 3.8% ("Obamacare") tax on "net investment income," have reduced the difference between the tax rates applicable to the two categories of income, the potential difference in rates remains sizable and does not appear likely to disappear in the near term.[1]

A tension between risk and reward is implicit in the tax planning for such employees. The acquisition of stock—as distinguished from options or other equity-flavored instruments—as early as possible in the lifetime of the venture, provides the maximum potential for characterization of any ultimate gain as long-term capital gain. (Such an acquisition will often be coupled with an election under IRC section 83(b), further discussed below, if the stock is subject to vesting conditions.) However, a purchase of stock by an employee may involve a high level of financial risk, in that the business may fail with the complete loss of any consideration paid for stock. Further, even though an acquisition of stock under compensatory circumstances may result in ordinary income, to the extent that the value of the stock, at the relevant date, is more than the amount paid, a later forfeiture or other disposition of the shares may result in a capital loss the usefulness of which is limited, or in no tax benefit at all.

Conversely, stock options, restricted stock units (a/k/a "phantom stock"), and other forms of deferred compensation typically involve no up-front investment, but they are likely to result in ordinary income in the year of an initial stock offering, sale, or other liquidity event.

In order to maximize the capital gain component of an employee's equity package, an attempt is sometimes made to allocate a portion of the amount ultimately paid to the employee to prior promises of additional equity or to "property" that the employee made available to the business and that is (arguably) separable from past and future services, such as intellectual property developed and owned by the employee, or, conceivably, intangible assets in the nature of "personal goodwill." Commonly, however, the parties have recognized no such other property of substantial value, and last-minute tax planning that attempts to identify it is often fruitless. Such efforts are especially likely to be unproductive where the acquirer, whose own tax motivations often differ from those of the target company's employees, is unwilling to cooperate meaningfully in structuring and tax reporting.

The recent Tax Court memorandum decision of *Brinkley v. Commissioner*[2] reflects many of these considerations.

Facts

Brian Brinkley (Brinkley) was a founder of Zave Networks, Inc. (Zave), a company incorporated in 2006. Brinkley was initially engaged by Zave as an independent contractor, and he became an employee of Zave as its chief technology officer in 2010.

Brinkley initially owned 9.8% of the stock of Zave, and, in addition to cash compensation, he received restricted stock awards. He made section 83(b) elections with respect to any awards that were not immediately vested, with the effect that he was taxable in the year of grant as if the stock had been immediately vested, and he was thereafter treated as the owner of the stock for income tax purposes.

When Brinkley's equity interest in Zave was diluted by reason of multiple rounds of financing, he threatened to leave Zave if his percentage stock ownership were reduced to less than 3%. When additional capital was raised in or around late 2008, Zave agreed to increase Brinkley's stock ownership

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through restricted stock grants to preserve his percentage ownership interest at 3%. Zave apparently never issued to Brinkley the additional shares that would have been required to hold his ownership interest at that level, and, by the time of Zave's sale to Google in 2011, Brinkley's equity interest in Zave, based on the shares actually issued to him, had been reduced to less than 1%.

As part of the overall transaction with Google, Brinkley was required to surrender his stock and to transfer all his intellectual property (the extent and nature of which is not described in the opinion) to, and to become an employee of, Google.

During Zave's negotiations with Google, Zave's directors told Brinkley that, based on an anticipated price of $93 million for the stock of Zave and the number of shares owned by Brinkley, the consideration expected to be paid to him was approximately $800,000. Brinkley objected on the basis of his understanding that he had a 3% ownership interest in Zave. In order to address his objection, Brinkley was offered a letter agreement under which he would be paid compensation equal to the excess of $3.1 million over whatever he would receive as consideration for his shares.

Brinkley consulted with his accountant and with tax attorneys recommended by the accountant, who noted that the proposed letter agreement indicated that bulk of the funds Brinkley expected to receive would be treated as compensation. Brinkley thereupon rejected the proposed letter agreement, but was then offered another letter agreement.

The letter agreement Brinkley signed called for him to receive $3.1 million in exchange for (i) all his stock and stock rights and (ii) his execution of an employment offer letter and of a proprietary information and inventions assignment agreement, all as required by Zave's merger agreement with Google.[3] His rights to receive the stated consideration were conditioned on compliance with the terms of the merger agreement.

The letter agreement also provided, under the heading "Internal Revenue Code Compliance including I.R.C. §409A" (a provision of the Internal Revenue Code that deals with compensation), that Brinkley's payments would be subject to all adjustments, tax withholdings, and escrow provisions required under the merger agreement.

Prior to closing, Brinkley received and read the merger agreement. He did not see schedules to the merger agreement which identified him as a recipient of deferred compensation. Brinkley signed a consent of shareholders approving Zave's entering into the merger agreement, but he did not sign a consent of deferred compensation recipients that was given to service providers of Zave who held stock options or warrants.[4] Brinkley did not have any of his tax advisors review the merger agreement.

Shortly before the closing in September 2011, Zave sent a schedule to its payroll company indicating that Brinkley was to receive $1,879,779 of deferred compensation upon the closing. As a result of the merger, Brinkley received a total of $3,027,515, of which $787,671 was attributed (at least by Zave) to his stock, $360,065 was held in escrow and distributed to him in a later year, and $1,879,779 was delivered in the form of a paycheck that showed "stock compensation pay" subject to ordinary tax withholding as wages.

It was evident from the paycheck that more than half of the total paid to Brinkley in 2011 was being characterized by Zave as compensation. Two months after the closing, one of Brinkley's advisors, who had seen a version of the letter agreement prepared for Brinkley, but not the final version signed by him, wrote to Zave protesting Zave's treatment of the $1,879,779 amount as compensation; Brinkley never received a response to this letter, and he took no further action against Zave.

Brinkley's 2011 income tax return, as prepared by his accountant, reported the "stock compensation pay" amount as part of the purchase price received for Brinkley's stock, and not as compensation. The return included a Form 4852, generally filed by an employee when a Form W-2 is not received or the W-2 that is received is believed to be incorrect, and an attachment to the Form explained Brinkley's position. The explanation quoted language from the letter agreement, in alleged support of Brinkley's claimed treatment of all of the consideration he received in the merger as proceeds from the sale of stock.

The IRS determined a $369,071 income tax deficiency against Brinkley for 2011, on the basis that the amount characterized by Zave as stock compensation pay was taxable as ordinary income, and a penalty of $48,036.

Discussion

The Tax Court stated that Brinkley did not produce credible evidence that the amount he received in exchange for his stock was any more than the $787,671 amount previously determined by Zave. Presumably the amount so determined by Zave was consistent with the amount per share paid to the shareholders as a group.

The court appeared to conclude that, by consenting to be bound to a merger agreement that (on a schedule) identified Zave as a recipient of deferred compensation, and executing a letter agreement to the effect that Zave's payments "will be subject to all adjustments, tax withholdings, if any, and escrow as required in the Merger Agreement," Brinkley effectively acquiesced in the characterization by Zave of the amount he received in excess of $787,671 as compensation. The opinion does not state whether any of those agreements included a provision that required Brinkley to report in a manner consistent with the reporting treatment by Zave.

The discussion in the opinion of the presentation of the transaction on Brinkley's tax return made clear that the court took a dim view of his conduct. The decision notes that, in the explanation included in Brinkley's tax return for his taking a position inconsistent with the Form W-2 received by him, Brinkley included the part of the letter agreement that referred to the stock sale, but omitted the section of the letter agreement that referred to his employment and assignment agreement.

The court concluded that "petitioner obscured his true tax situation from both his tax advisers and the Internal Revenue

Service." The opinion further states that Brinkley "claimed estimated tax payments that he never made to achieve his sought-after tax treatment,"[5] and that the fact "[t]hat he had to fabricate information on his return to order to get this result should have been a clear indicator that what he was doing was improper."

Based on the disposition of the primary issue, there was an understatement of income tax in excess of 10% of the tax required to be shown on Brinkley's return, and the court upheld a penalty for "substantial understatement of income tax." Accordingly, the court did not need to reach the question of whether Brinkley was negligent in upholding the imposition of a penalty.

Brinkley argued that the penalty should be abated, because he acted reasonably and in good faith in relying on his professional tax advisers. The court brushed away this argument and found that Brinkley's asserted reliance was undercut by his failure to disclose to his advisers essential information, such as the amount of stock he owned, Zave's determination of the value of that stock, and the letter agreement he actually signed.

Observations

It is arguable that the opinion in *Brinkley* characterized the taxpayer's conduct more harshly than was deserved, in light of the totality of the circumstances and typical pressures in "doing the deal." Indeed, in at least one case it was argued successfully that a right to receive stock may itself be property, and perhaps a credible argument could have been made that the commitment made by Zave in 2008 to maintain Brinkley's stock ownership at 3% should have been viewed as the equivalent of ownership of the underlying shares for tax purposes.[6]

Had Brinkley been able to persuade Zave to issue in 2008 the additional restricted stock grants to which Zave allegedly committed itself in that year, and had he made a section 83(b) election with respect to any portion of that grant that was not immediately vested, any amounts paid for those shares in 2011 would almost certainly have been reportable as long-term capital gain. In the absence of that, the effort to obtain a long-term capital gain result in 2011 was unlikely to succeed, and ultimately attracted a penalty.

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[1] IRC §§1(h)(1), 1411. Equity structures that maximize the potential for long-term capital gain also tend to help preserve other potential tax benefits that are beyond the scope of this article, such as deferral of tax through a nontaxable "reorganization" and further reduction in tax rates through rules relating to disposition of "qualified small business stock" under IRC section 1202(c).

[2] TC Memo 2014-227.

[3] The execution of the assignment agreement does not, of course, establish that Brinkley owned valuable inventions or other intellectual property, and, so far as appears from the opinion, there was nothing in the record to support allocation of a portion of the consideration to intellectual property rights assigned by Brinkley.

[4] There is no indication in the opinion that Brinkley held any options.

[5] In an apparent effort to bolster his position that had not received "compensation," Brinkley had recharacterized amounts that actually had been withheld from the check delivered to him, under the applicable wage withholding rules, as "estimated tax payments" that he himself had made with respect to his asserted realization of capital gain. Since amounts erroneously withheld would have been creditable against his tax liability in exactly the same manner as estimated tax payments, this bit of attempted self-help seems to have boomeranged against Brinkley, by causing the court to perceive his actions as less than straightforward.

[6] *See Theophilos v. Commissioner,* 85 F.3d 440 (9th Cir. 1996). It seems unlikely, however, that Brinkley treated that commitment as stock or other property when he received it, apparently in 2008, a failure that would have made it difficult to take a contrary position for tax purposes in 2011. Further, if the vesting of that stock or right to receive stock was to be contingent on the performance of services, the stock or stock right probably could not have been taken into income in 2008 absent a contemporaneous election under IRC section 83(b).

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