Winter June 6, 2016

Taxing Compensation at Tech Start-Ups

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Available at: https://works.bepress.com/richard_westin/20/
COMPENSATION ARRANGEMENTS AT A TECH START-UPS

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America is brimming with cash for start-ups and start-ups need to populate themselves with capable people. That calls for aggressive hiring and enticing compensation. Unfortunately, most of the candidates are likely to have only a faint idea of the income tax implications of what they are being offered by way of financial inducements. The purpose of this writing is to bring those candidates roughly up to speed.

There are numerous forms of proposed compensation. The rest of the article considers the most common kinds, provides an overview of their tax implications and some practical tips along the way.

I. Facing the Employer About Taxes

  Few employees of start-up companies know much about taxes, so their economic decisions are based on wobbly data. What does one do in this lopsided bargaining situation?

  The most straightforward approach is to ask if the company has an opinion from a law firm or accounting firm about how employees will be taxed under their compensation arrangements and if you can see it.

  Another approach is to ask the employer to guarantee the claimed tax results. Most employers will not do so. Who wants to insure tax results? It is hard to blame them. At the same time, if they make claims about favorable tax results, what is so hard about going the extra step and putting it in writing? Some will cave in and cooperate. Expect most to balk.

  Yet another approach is to go find an outsider who can help. The best way is often to contact a friend who went to law school or accounting school and ask your friend to scout out someone who can help.

II. Typical Compensation Proposals

A. Signing Bonus

  This is an attractive offer economically, but the tax implications can be bad. The problem is that under our graduated tax rate system, the proportional tax burden increases as income rises and then eventually flattens out. To give an over-simplified example, someone making $30,000 of net income will pay a modest tax rate of X%. Once she gets into the $150,000 range the tax on the last dollar of income rises to (X+N)%. If she can flatten out the payments so they are paid over several years – hopefully with some interest income for the deferral – the total income taxes paid on that income over the entire payment period will decline. This consideration favors taking the bonus over several years.

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B. Non-compete Clauses –Standard Fare

Employers often insert a requirement in employment agreements to the effect that employees who quit cannot compete with the employer for some limited period of time in some locale that includes the employer’s place of business. Every State has a slightly different body of law on the subject, but the basic rule is that while these terms are legal, they are only enforceable to the extent they are reasonable and limited.

If you are faced with such a proviso in a proposed employment agreement and it seems unfair, get a local lawyer who is experienced in such matters to advise you. This is tricky stuff. Be careful, because if you do quit and you do breach the agreement, the employer might just decide to make an example of you. Litigation is expensive and distracting and can get really nasty.

C. Before You Are Hired: Understanding Deferred Salaries, Bonuses and the Like

Tax planners generally share an optimistic view that their clients’ tax burdens will decline in the future after they retire will be making less money so their income tax rates will decline. These same planners then recommend you consider deferring your compensation to some future period. For some people, especially middle-aged high earners it can make sense, but for young techies it is likely to seem risible. Nevertheless, let’s explore it anyway because it sets the stage for a useful discussion of compensation in the form of stock and options your employer is apt to offer you.

Basically, deferral of compensation is simply a contractual matter. For it to work, you need to enter into a contract with your employer to defer your income before payment day rolls around. You can contractually defer payments to dates later than when your employer originally contracted to defer payments, but to be effective for Federal income tax purposes, the new (or amended) contract must—once again—be signed before the due date for payment under the first contract. Absent a contract in advance, you will have what is known as “constructive receipt” of the income (and so you will be taxed) when the payment is due.

Example, from a true story: Mr. Oates was a life insurance agent who sold a large number of policies. The contract between Oates and the insurance company provided for initial premiums paid to Oates as well as “renewal premiums” payable when the customers renewed contracts that would otherwise expire. Oates had entered into a particular contract to defer payment of the initial premiums. Before the renewal premiums were due (but long after he had performed the services that gave him the right to payment), Oates and the company agreed to a new contract further deferring receipt of the renewal commissions. It worked for Federal income tax purposes. Oates was not taxed until he got actual receipt of the payments due under the second contract and in accordance with that second contract.
D. Recent Limits on Deferring Compensation – Internal Revenue Code
Section 409A

Under recent changes to the law, another thing that you need to take into account when deferring compensation is that if the arrangement ever flunks one or more of the recent requirements for compensation to be deferred, the benefits become immediately taxable to the extent tax deferred income is not subject to a substantial risk of forfeiture. This effectively negates the tax benefits that come with contractually deferring your compensation or bonus.

To avoid this disaster, the arrangement must provide that the compensation for the services be distributed no earlier than:

• separation from service,
• disability,
• death,
• a specified time under the plan,
• a change in ownership or control of the corporation providing the plan, or
• an unforeseeable emergency.

There are further details here. The key to dealing with this intricate subject is to get a solid assurance that any deferred compensation you are offered fully complies with § 409A of the Code and is otherwise watertight from a tax perspective.

E. “Restricted Property” - A Concept One Must Understand

Think in terms of a person who is about to be hired by a start-up with a good deal of runway (money to burn). The company offers stock to its recruits. Should they take it? What are the tax considerations? Is the stock “restricted”? If so, there is no current tax, but there could be trouble down the road.

Now assume the employer is ready to fork over shares of its own common stock, but that it does not want you to take the stock and run, so you agree with the employer that the stock will “vest” (really be yours) at the rate of 25% of the stock every 6 months. The first 25% vests the day you go to work for the company. It is only a start-up so the stock has no ready market and no one really knows what it is worth.

Are you taxed on that 25% block? The answer is, “Yes, unless the stock is restricted.” Once the restrictions lapse, it is taxable. Now we can discuss section 83 of the Code.

Congress waded into the compensation area in a big way when it enacted section 83 and the associated "restricted property” concept. Section 83(a) provides that people who receive stock or other property in exchange for services are taxed when the property becomes theirs, but it contains a big limitation, namely that there is no current tax if the property is non-transferable and subject to a substantial risk of forfeiture for some good reason, such as going to work for a competitor, where that is a meaningful possibility. In our example, we do not really know the facts. For example, can you transfer the stock when it vests? Is it forfeitable if you go to work for a competing employer? You need to get to the bottom of the terms of what the employer is offering you.
The tax risk is that the moment the property becomes transferable or nonforfeitable, the restriction will be said to "lapse," and the full value of the property at that later date will be taxable to you, minus whatever you paid for the property. However – in a really confusing semantic twist --if the language of the restrictions create a substantial risk of forfeiture that follows the property into the hands of a transferee, the owner (you) does not report income under § 83 until the first year when the rights either are (a) no longer subject to a substantial risk of forfeiture or (b) can be transferred free of the restriction. The regulations describe this time as the taxable year in which the transferred property becomes “substantially vested.”

**Example:** Internet.com, Inc. recently hired Silvia, a dynamic young executive, to come to work for them. As part of the bargaining, Internet.com transfers 1,000 shares of its stock outright to Silvia, but the stock certificates bear a legend that says “these shares are nontransferable and forfeitable in accordance with a contract between Silvia and Internet.com.” The alluded-to contract says that the stock will not be transferable for 10 years and that Silvia will forfeit the stock if she goes to work for any other Internet-related company in the next 10 years. Even if the contract said Silvia can transfer the stock right now subject to the forfeiture provision, it does not matter. She is still not taxed on the stock’s value right now, only when the risk of forfeiture expires (“lapses”). In terms of tax lingo, that is when the shares are “substantially vested” and therefore taxed.

The usual way that companies implement their restriction on stock issued to employees is by noting a forfeiture provision on the stock certificate in a manner that binds all transferees of the stock, including innocent buyers.

**The tax problem:** When the 10 years elapse and the stock vests, the then value of the stock (minus whatever she paid for it) is ordinary income. To pay the tax she may, for example, have to sell some stock.

Meaning of the word “forfeiture”: The term “forfeiture” means total loss as well as loss of a potential profit such as where stock must be resold to the employer at the employee's cost if the stipulated condition materializes.

1. **Who Owns the Stock While it is Restricted?**

   As long as the stock in an employer’s hands is not “substantially vested”, it is considered still owned by the employer. As a result, dividends on forfeitable stock are treated as taxable compensation for services that the employer can deduct as compensation. Bad for you because your dividends will attract income taxes.

2. **The Dreaded Section 83(b) Election - Think Carefully**

   There is an important fork in the road here. Section 83(b) allows taxpayers to elect to accelerate
the taxation of the value of restricted property they receive -- such as the stock that Silvia received -- to the day she received the property. That means she pays ordinary income tax on the bargain element (in Sylvia’s case the value of the 1,000 shares) when she gets the shares. This is not as suicidal as it sounds, because if she does so, any subsequent gain will be taxable as a capital gain when she sells the stock. (The benefits of capital gains are discussed below.) The risk to her of a §83(b) election is that if she forfeits the stock, she gets no tax deduction beyond whatever she paid for the stock, despite the fact that she was taxed on the bargain element of her stock purchase by virtue of her election. This makes section 83(b) tricky.

If she does not forfeit the stock, the income tax regulations give her a “basis” in the stock equal to its value when she makes the election, plus what she paid for the stock, if anything. “Basis” means something like “tax cost”. Having more basis is better than having less basis.

**Example:** Silvia makes the section 83(b) election and reports the value of the stock now at $10/share, an honest guess, adding $10,000 of ordinary income to her tax return in for the year she took the job. The company folds up and the stock is worthless. Silvia gets no deduction. She should not have made the election.

**Counter-example:** Same facts, but the stock goes to $100/share over a year later. She sells it over a year later. Silvia reports a gain of $90,000 long-term capital gain, which is a sweet deal compared to reporting $100,000 of ordinary income, which would have been the result if she did not make the section 83(b) election. In retrospect, Internet.com offered her. Very good “tax bait”. The moral: make a private decision as to the probability the company will make it big.

So far, we have looked at the employee's side. What about the employer’s deduction? The answer is that the payor cannot claim a deduction unless and until the employer reports gross income from the property.

3. **Bogus Restrictions Do Not Count**

The nonqualified deferred compensation rules are attractive, and invite lying, especially about forfeiture provisions. The IRS is concerned about this kind of lying and has established its own rules to deal with it. What follows is a rundown on what works and what does not.

The formal rule is that property - such as stock - is subject to a substantial risk of forfeiture only if the recipient's rights to full enjoyment of the property are conditioned on the future performance of substantial services. The regulations mainly approve of forfeitures that depend on performance of genuine services or compliance with an agreement not to compete, but the regulations also recognize that a substantial risk of forfeiture might arise from other conditions that are truly “related to a purpose of the transfer.” An example would be a requirement that stock that was transferred to a top executive has be returned if the company's profits do not reach a specified level. The regulations do not accept a requirement that the employee return the property upon commission of a crime as a substantial risk of forfeiture; that risk is considered baloney, and does not constitute a substantial risk of forfeiture.
A requirement that the property be surrendered or resold to the employer if the employee accepts a position with a competitor or, when he retires, fails to render consulting services when the employer's requests them can invite close IRS scrutiny and had better have a good practical basis. On top of that, even if the restriction is substantial, evidence that the employer is unlikely to enforce it will undermine its substantiality.

“Investment letter” restrictions on resales of stock generally do not create a “substantial risk of forfeiture”. Investment letter stock is basically stock the owner swears was taken for investment as opposed to for resale. Such stock is widespread.

4. Afterword on Nonqualified Stock Options and Section 83

Sometimes §83 works in two steps, starting with the grant of a restricted option to buy stock, followed by a purchase of restricted stock itself, the tax of which can also be deferred under section 83.

The basic rule for options received as compensation for services is that they are taxed only if they are “transferrable”, meaning they have a readily ascertainable fair market value. The regulations defining what makes an option “transferable” are narrow. It is very rare for a typical option granted to an employee -- due to its unusually long life -- to have a “readily ascertainable market value”, even if the stock that the option covers is traded on a stock market. Assuming there is indeed no readily ascertainable value, then the employee defers the value of the option until she buys the stock. At that point, the bargain inherent in the deal is taxable, unless the stock received on exercising the option itself is “restricted.” If it is restricted, there will be no tax until the restrictions lapse.

Example: Zork, the rising executive, recently went to work for Busy Apps, Inc. (“BAI”). BAI stock trades at $10/share on the New York Stock Exchange. There are also BAI options that trade on the New York Stock Exchange, but they all expire 6 months or less after their issue dates. As part of the bargaining, BAI granted Zork the right to buy 1 million shares of BAI for $8/share. The options will remain outstanding for two years, which means they have an unascertainable value because the time that the options are outstanding is so long that they are entirely unlike the 6-month options traded on the stock market. As a result, Zork reports no income when he gets the options. A year later, when BAI stock is selling for $25/share, Zork exercises the option, paying $8/share for the BAI stock. At that point, he bagged a $17/share profit. Unless the BAI stock he buys is “restricted,” he will have to report $17/share of ordinary income from compensation. That may be a good idea if he expects the BAI stock to rise, because once this $17 bargain element is taxed, the BAI stock is a capital asset (with a $25/share “basis”), so if and when he sells it (at a gain (over $25/share), the sale will enjoy favorable long-term capital gains rates. Assuming instead the BAI stock is “restricted” and that the restrictions lapse when the stock is worth $30/share, the result is a $22/share gain (i.e., $30 minus $8 cost), all of which is ordinary income from compensation. At that point Zork’s stock gets a $30 basis, so if it were sold for $30 the next day there would be no gain or loss.
Getting options as part of a compensation package is often crucial to the bargaining over compensation. The employer will generally want the option deal to be taxable to the employee as early as possible so that it can claim the deduction under section 83(h). Again, there is no deduction for the payor unless and until the recipient has taxable income.

F. Standard Stock Options in More Detail

In this deal the employer offers you the right to buy stock of the company at a bargain price. For example, it might grant you the right to buy 1,000 shares in each of the three next years for $5.00 per share, in the hope that the company will gain great value. With luck, you will “exercise” the options and pay for the 3,000 shares over time at prices might lower than market value. It is a powerful offer, but tricky from a tax point of view. What follows is a run-down of the basics.

1. Treatment of the Parties

Federal tax law favors stock options. These are contracts under which the "writer" of the option (a seller, almost surely your employer) agrees to stand ready to sell its stock at a fixed price (known as the “exercise price”) for a certain amount to the person who receives the option, known as the "holder." Normally, the holder will pay money to the writer at the time of writing the option. Section 1234 is the controlling Code section, but it is difficult to read. The important rules are:

- The holder of the option (you) does not report income on issuing the option, which is a sweet deal. Let’s say your employer offers you an option to buy 1,000 shares for $100 per share for the next five years. The option is clearly nontransferable even if, for example, the stock is trading for $110/share there is no tax when you get the right to the option or when the date you can exercise the option rolls around.

- You get no deduction when paying for the option. It is simply a purchase.

- If and when you exercise the option, you have ordinary income to the extent of the bargain element in the deal as of that day. Assume the stock has risen in market value to $150/share. Using the example immediately above, you were granted the right to buy stock for $100/share. Now, when it is worth $150/share and you exercise the option by paying for $100/share), you would be taxed on $50/share as ordinary earned income. Trap: the employer is unlikely to withhold extra taxes on your earnings to cover the tax so you may have a year-end tax bill.

Now, lets say instead you exercised the option just as before but you held the stock for less than year and sold it for $175/share, for a gain of an extra $25/share. This is treated as a gain
from selling stock and is taxable as a short-term capital gain; not great tax wise.

Hold it for over a year after exercise and you have a favorably taxed long-term capital gain.

2. Practical Considerations

One should try to get options. The are simply more powerful than restricted stock because they are “leveraged” in the sense that as the value of the stock rises, the value of the options rise even more.

To put in street terms, you stand to get more bang for each buck you get options.

Another thing, get hold of a copy of the option agreement and read it to figure what the real deal is. For example, a verbal “we will give you stock options, too” is a completely unacceptable proposal. It should be written into your employment agreement or it should be part of an explicit plan that you and the other employees share in. Even if there is a general plan, get a copy of it and read it. There could be numerous surprises.

G. Incentive Stock Options

These tax-favored options are more common for mature companies than young start-ups, but they can be highly attractive because they can produce favorably taxed long-term capital gain and no income from compensation (which would be ordinary income). Here is a brief rundown of how they work. First, the advantages:

• The employee pays no tax when she is granted the option, even if it is exercisable at a price below the market price of the stock.

• Above all, the spread (the difference between the option price and the value of the stock bought pursuant to the option when exercised) does not produce ordinary taxable income.

• The taxable gain is deferred until you sell the stock. The gain on the sale of the stock acquired with the option can be long-term capital gain if you held the stock long enough. The examples below describe the issue.

• They are normally structured to “vest” (really be yours), say 33% per year. There is no tax on vesting.

• They expire after 10 years. Also, the employer may insert its own penalties, such as if you go to work for a competitor. You need to study the terms of the deal closely for bad surprises.

• Now the hard part. The employee must not dispose of the stock acquired on exercise within two years after the option is granted or one year after the option is exercised.
Example:

Your employer grants you an ISO on a certain number of shares on January 27, 2010 (“the grant date”). It is fully vested when granted and has an exercise price of $100/share and the shares were fairly worth $100/share at the time you got the ISO. You exercise the ISO on September 30, 2012 when shares are worth $120 each by paying the employer $100/share. This gives you a $120 basis/share. You sell the stock on the market on May 1, 2013 for $125 each. You passed the two-year test, but you flunked the one-year test because you sold the shares within a year of buying the stock. The sale is a dud (known as a “disqualifying disposition”) and you will have to report a gain of $25 per share. Out of that $25, $20 will be ordinary income – treated as earned income -- and $5 per share ($125 - $120, being the post-exercise gain) will be short-term capital gain (short-term because you did not hold the shares for more than a year.) Bad deal.

Example: Same, but you sold on May 1, 2014. Now you meet all the tests. The result: your $25/share gain is all long-term capital gain. Good deal.

There are further restrictions. Here are the most important ones.

- These options can last up to 10 years, but the exercise price must be at least 100% of the stock's value when the option is granted (more if the holder owns over 10% of the company). So, if the stock is worth $20 when you receive the ISO, you will have to pay at least $20 on exercising the option. The value can be set in good faith, but even this is frequently all but impossible to do. Get an outside appraisal if you can afford it.

- The employee must not be able to transfer the ISO, except at death.

- There is a ceiling on the amount of stock (by value) for which an employee can be granted ISOs in any one year. Specifically, the value of the stock with respect to which an ISO is exercisable for the first time by an employee during any particular calendar year under all employer’s corporate plans – including those of its parent and subsidiary corporations – cannot be over $100,000. N.B: The $100,000 ceiling is measured in the year exercisable when they may be worth far more than when they were acquired. This can create a big bottleneck.

- If one exercises large amounts of ISOs in any one year, the tax benefits of the ISOs are exposed to partial reversal as a result of the alternative minimum tax. This is too complicated to go into here, If you have the problem you can afford to hire a tax lawyer or accountant to advise you.

H. Rare Compensation Arrangements
What follows is a list of offbeat deferred compensation techniques that a young company might offer.

1. Employee Stock Purchase Plans

These are little-used programs that allow employees preferential tax treatment when they exercise their stock options. The exercise price for the options may be as low as 85% of the stock's value, such that an employee could exercise his option immediately on its grant and acquire stock in the employer at a 15% discount. The key authority is section 423 of the Internal Revenue Code. There are extensive requirements for the plan to qualify, most notably the plan must have shareholder approval, must restrict the grant of options to employees, generally has to limit the duration of the options to 27 months, and cannot grant options to employees who own 5% or more of the employer.

If the plan is written correctly, employees get preferential tax treatment.

- Grant. The employee reports no income upon the grant of an option under an employee stock purchase plan, provided the spread is not over 15%. The option must be exercisable only by the employee.

- Exercise. When the employee accepts the employer's offer to sell him optioned stock at the exercise price, the employee does not report any taxable income, but if the plan’s tax law requirements are not met, say because the buyer is no longer an employee, then he generally reports ordinary income in the year of exercise, in the amount of the “spread,” meaning the difference between the value of the stock received and the exercise price he paid.

- When the employee sells shares acquired via the exercise of the employee stock purchase plan, the employee's gain (if any) is generally treated as a capital gain. This gain is the difference between the sale proceeds and the employee's basis in the stock, i.e., the exercise price plus any amount the employee paid to acquire the option. There is a risk here in that if the employee sells the stock before the statutory holding period ends.

- Some gain is taxed as ordinary income on the stock's sale if, when the option was granted, the exercise price was less than the value of the stock. The employee’s ordinary income on selling the stock or at death is the lesser of:

  (1) the spread when the option was granted or

  (2) the excess of the stock's value at the time of disposition or death over the amount paid for the stock.

Example: In 2012, you got an option under an employee stock purchase plan to buy 100 shares of Runway Corp stock. When the option was granted each share was worth $100 (total value of $10,000). In 2013, when the stock was worth $120 per share, you exercised all 100 options, paying an exercise price equal to 85% of
the stock’s value when granted, for a total of $8,500. In 2015 (after the minimum statutory holding period expired), you sell the stock for $120 per share. You must report compensation income in 2015 in the amount by which the value of the disposed stock at the time the option was granted ($10,000) exceeds the $8,500 price you paid for the stock, or $1,500. The rest of the gain ($2,000) is long-term capital gain. Nice.

Warning: The employer’s plan has to clear a lot of technical hurdles in order to get the employees the benefits they expect. The employee’s plan may in fact contain a glitch that undermines the tax benefits. If the employer makes the claim that the plan qualifies, then the employer should commit to that claim in writing. The trouble is it is not easy for a lone prospective employee to dare to insist that the employer show that the plan indeed complies with the tax law.

2. Stock Appreciation Rights – Not Likely

These are offers along the following lines, “If the company’s stock rises by 10% or more over the following 12 months, we will increase your base salary by whatever that percentage is.” These deals are very unlikely to show up in the contact of a start-up because a necessary condition is that the stock is publicly traded, so this discussion is kept to a minimum.

The proposal can be phrased various ways, but the tax implication is simple. Your salary, which produces ordinary income, will produce more ordinary income if it does well. Great, but it has no particular tax advantage.

3. Parachute Payments – Not Likely

These are bonuses contingent on someone else wresting control of your corporate employer. Their usual use is for protecting top management of publicly traded corporations. They produce ordinary income and deduction problems for the payor. In the worst case this might result in a 20% nondeductible excise tax being imposed on you, the recipient of an “excess parachute payment,” under sections 275(a)(6) and 4999. Be careful of these things, but the truth is you are very unlikely to be offered one if you are working for a start-up.

III. The Basics of Taxing Capital Gains and Losses

A. The Basic Considerations

Capital gains and losses are an issue of intense interest to individual taxpayers, for the following reasons:
• A “net capital gain” is taxable at a Federal rate not more than 20% (and generally not more than 15%), compared to a top rate of 39.6% for ordinary income. There can also be an ACA tax. See below.

• A capital loss standing alone has less value than an ordinary loss. This is because only $3,000 per year of net capital losses can offset ordinary income. A capital loss first offsets capital gains, which, if not offset, might be taxed at a relatively low rate. The $3,000 deduction arises only if you are in an overall capital loss position at year-end.

• Some ordinary losses on the disposition of property have the advantage of being fully deductible against ordinary income, such as assets used in a trade or business or victimized by casualty or theft, or a business bad debt loss. Disparities between capital gains and ordinary income are of immense practical importance to taxpayers and occupy a great deal of the time and attention of tax professionals. In this setting, the tax advisors' goals are to produce favorably taxed long-term capital gains, or, if there are losses, ordinary losses. The booby prizes are ordinary income and capital losses.

B. What is a Capital Asset?

Practically anything you can think of as property is property. A key feature is that it has to be transferable. Typical examples, are stocks, stock options, bonds, cars and houses. There are major exceptions for inventory and property held for sale to customers in the ordinary course of business. It is very rare that this issue every crops up in the context of being hired.

C. Calculating Net Capital Gains

The computation of net capital gain can be confusing because of the welter of terms you have to master. The simplest way of thinking of the process is the following. Assume you have four shoe boxes, one marked "long-term capital gains,” another marked "long-term capital losses,” another marked "short-term capital gains,” and a final box marked "short-term capital losses.” “Long-term” means a year and a day or more. Now imagine that each time you sell a capital asset you put a report in the appropriate box, depending on whether the result was a gain or a loss and whether the asset you sold had a long-term or a short-term holding period. A short-term holding period is -- no surprise -- a holding period of one year or less.

At the end of the year you go through a multi-step process. First, you sum the results in each box and get a net figure, which will either be zero, positive of negative for the box. Second, you combine long-term gains and the long-term losses, which will yield a net long-term figure. Third, you go to the short-term boxes, combine the results and comes up with the net short-term result.

If you have a net long-term capital gain and a short-term capital gain, you keep them separate and the net long-term gain is your net capital gain (the prize); likewise, if both net results are negative, you keep both sets separate.
If you have a net long-term capital gain and a net short-term capital loss you offset them. If the net figure is still positive (i.e., a net long-term capital gain), then that figure is your prized “net capital gain.” Finally, if the result from the long boxes was a capital gain, but the short-term capital losses overwhelm that gain, then you will have a net short-term capital loss for the year—generally not helpful.

Any free-standing short-term capital gain that is left over is taxed as ordinary income. Capital losses that were not absorbed in prior years carry forward indefinitely. Any capital loss carry forward from a prior year preserves its character as long- or short-term capital loss, and will offset any capital gains of the current year plus $3,000 of ordinary income.

D. Holding Periods

Property has to be held for a year and a day to be held for a “long-term.” Only such property can enjoy low long-term capital gains rates. The holding period starts when the taxpayer gets legal title to the property, or at an earlier time (if any) when the taxpayer has undertaken the “benefits and burdens” of ownership. That special “benefits and burdens” provision will almost never come into play but in strangely structured deal it is something to watch for.

E. State Taxes on Capital Gains

States with income taxes have not hesitated to tax capital gains. California is especially pricey. You can go to this website to see how heavy the burden in your State is. And, yes, you could move to another State and sell your stock while you reside there. Florida, Texas, Washington and Nevada beckon because they lack personal income taxes, but the move requires serious planning.

The topic of State taxes is taken up again at the end of this article in terms of moving in advance of a stock sale.

The tax benefit of long-term capital gains is slightly eroded. It is actually a little worse because there is also a 3.8% tax on unearned income (including capital gains on selling stock) that is used to fund the Affordable Care Act (ACA).

The ACA tax falls only on people with an adjusted gross income (AGI) above $200,000 and couples filing a joint return with more than $250,000 AGI. Unearned income basically consists of interest, dividends, rents (less expenses), capital gains (less capital losses).

Example: You are single and have AGI of $140,000, before a certain stock sale which produced a gain of $120,000

<table>
<thead>
<tr>
<th>AGI Before Taxable Gain</th>
<th>$140,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on Sale of Stock</td>
<td>120,000</td>
</tr>
</tbody>
</table>
F. Section 1202 Stock – The Sweetest Deal of All

This is a type of stock that enjoys extraordinarily low tax rates, nowadays often no Federal income tax at all and it fits for American (not foreign) tech start-ups. You can Google it. The Code section is long, but understandable with effort. What follows is a sketch of the key points. Disguised under the cloud of words is the biggest tax loophole in America.

Definition

The stock has to be so-called “qualified small business stock (QSBS). Its definition is intricate:

- The stock must not be issued by an S corporation, a special corporation that does not pay income taxes, but instead flows it gains and losses to its shareholders
  - The corporation may not have more than $50 million in assets when and immediately after the stock was issued.
  - You must get the stock on its original issue
  - For most of the time you have the stock, at least 80% of the value of the company’s assets must be used one or more qualified businesses. (A standard tech start-up is “qualified.”)

2. Tax Benefits of the Stock

Here is the bait. If you hold the stock at least five years before selling it, some or all of the gain is exempt from Federal income tax. The non-exempt part of the gain is then generally taxed at a 28% rate. The maximum gain you can exclude on any one investment is the greater of (1) $10 million or (2) 10 times what you paid for the stock. Not bad, except you should not expect this windfall to be available as to California State income taxes. On the other hand, excluded gain is free from the 3.8% ACA tax.

If you got the stock on or after September 28, 2010, the exempt part is 100% of the amount subject to §1202. It is 50% or 75% for stock issued on earlier dates, depending on the issue date. The bad news is that the Alternative Minimum Tax may apply to the excluded portion by adding back, except for the 100% excluded amounts, 7% of the excluded gain as an AMT preference item. Note how this AMT add back does not apply as to the September 28 and later stock, which is another stunning loophole. Guess who has lobbying power in Congress?
This opportunity is available to partners in venture capital partnerships and hedge funds as well as employees of the start-up.

3. Rolling Over Qualified Small Business Stock - Another Loophole

The section 1202 truck hole in the law does not stop with excluding gains. If you did not hold the stock the necessary 5 years, there is a chance to defer taxes of your gain by investing in qualified small business stock thanks to section 1045 of the Code. This recent addition to the tax law lets people roll over gains from the sale of qualified small business stock held for more than six months if they use the proceeds to buy other qualified small business stock within sixty days of getting paid off. In this scenario the taxpayer will report taxable gains only to the extent that the proceeds of the sale exceed the cost of the replacement qualified small business stock. For this purpose “qualified small business stock” has the same meaning as under section 1202 (above) This is a dream deal for investment bankers and venture capitalists, who can roll over the proceeds from selling qualified small business stock of a company they incubated.

Good luck finding “qualified small business stock.” It is around but you need to be in the know to find it.

G. Making the Most of Losses

If corporate stock declines in value or becomes worthless, the investor normally has to report a capital loss. Because of the severe restrictions imposed on capital losses, the result can be an unhappy one, the big problem being that annual capital losses can only offset capital gains for the year plus $3,000 of ordinary income, such as income from a salary. The $3,000 has been around forever and is stingy. The somewhat good news is that net capital losses that exceed the $3,000 carry over to future years indefinitely.

If you lost money on your stock you might be able to perform some tax alchemy. The first thing to do is ask around and see if anyone knows if it is “section 1244 stock.” If it is you are in luck. If nobody knows, then dig a little deeper.

To get specific, section 1244 of the Code opens another door to tax minimization in that it allows individual investors to treat what would otherwise be capital losses on “section 1244 stock” as ordinary losses. This means they can use those losses to offset their regular, which is a very good thing.

Section 1244 stock can include preferred as well as common stock, which can be helpful. The difficulty with § 1244 is that it is loaded with restrictions on its availability, including an annual limitation of $100,000 for spouses filing a joint return, or $50,000 for the rest of us. The excess loss cannot be carried forward. Rather the taxpayer is stuck with trying carefully to recognize exactly $100,000 or $50,000 per year, as the case may be.

So what is section 1244 stock exactly? The answer is it is:

- Stock of an American corporation.
- That is originally issued after August 10, 1993.
- The corporation is a "qualified small business" when the stock is issued.
- The stock is acquired by the taxpayer at its original issue in exchange for money, other property (not including stock), or as compensation for services provided to the corporation.
- Under circumstances where the corporation did not buy any such stock from the shareholder or a related person within two years before or after issuance of the shares for which the exclusion is sought.
- The corporation must not have been bought back a substantial amount of it within one year before or after issuance of the potential § 1244 stock.

Luckily for their owners, most high tech start-ups will be “qualified small businesses.” The term "qualified small business" means a regular American corporation (not a subchapter S corporation for example) whose gross assets of which at all times on or after August 10, 1993 through the issuance of the stock in question do not exceed $50 million (ignoring liabilities). Also, the corporation must be an "active business." There are further details, but it will be very rare that a tech start-up will fail to be a qualified small business.

**IV. Nontaxable Mergers and Consolidations - Thinking Long-Term**

Many corporate acquisitions are done in the form of mergers (where one company absorbs another) or consolidations (two companies become one new company). These deals are tax-free to all the participants as long as various arcane requirements are met, the heart of which is that the shareholders of the target company must wind up holding stock of the acquiring or resulting company. Only stock of the acquiring (or a parent company of the acquirer) can be received tax-free.

Cash will typically produce gains to whoever receives cash to the extent of the cash.

There can also be situations where there are losses, such as in an all cash merger involving a target company that has turned to economic dust, but let’s not concern ourselves with those morbid cases. Some deals are a mixture of cash plus stock; sometimes, as a shareholder, one can select between taking cash only and stock only.

As you can see, there is a chance to pay no tax on your gain, at least until you sell the stock of the acquiring or resulting corporation. Why is the tax law so generous? The justification is that the taxpayer started with stock and ended up with stock, so she did not really change her economic position after a sale or exchange of the target company, then she should not pay income tax. For example, if you go to the opera, check your hat and later leave with someone else’s hat that is just like yours, you cannot be richer. Nothing happened fiscally, so the principle suggests you should pay no tax on the gain from getting different stock.

This principle underlies numerous business transactions, like tax-free mergers of business corporations or tax-free exchanges of stock to people who contribute assets to a corporation in exchange for its stock and formations of partnerships. So, if you own stock of the target company before a merger and you get acquiring company stock, you generally pay no tax, but
the gain or loss that was “pregnant” in the stock you used to own switches over to the stock you got, so if you sell that stock the tax man will catch up with you on that sale. Likewise, your holding period for the stock you got is the same as the holding period of the stock you gave up. This issue can become intensely interesting if a buying company offers its stock as consideration for a acquisition of your employer. It is an area for technical experts.

V. State Taxes and Selling Stock that Has Gained a lot of Value – Can Be Important

So far, all the talk has been of Federal income taxes. There are also State taxes to consider, California’s being the highest. Several important States have no personal income taxes, including Nevada, Washington and Texas.

(ELIMINATE PARAGRAPH INDENTATIONS)

One can change the State one resides in and thereby avoid State income taxation. Succeeding in this basically involves severing as many ties as possible with the current State and forming as many ties as possible with the new State.

Since it is people in California who are most likely to be interested in departure, here is an example, extracted from the California Franchise Tax Board’s publication on who is a resident, FTB Publication 1031 Guidelines for Determining Resident Status — 2013. You will notice a “once a Californian taxpayer always a Californian taxpayer” bias.

“Any individual who is a resident of California continues to be a resident when absent from the state for a temporary or transitory purpose.

An absence from California under an employment-related contract for a period of at least 546 consecutive days may be considered an absence for other than a temporary or transitory purpose. See Safe Harbor under Section E for more information.

Example 3 – Until September 2013, you were a resident of California. At that time, you declared yourself to be a resident of Nevada, where you have a summer home. You continue to spend six or seven months each year at your home in California, which you have retained. You spend only three to four months in Nevada and the rest of the time traveling in other states or countries. You transferred your bank accounts to Nevada. However, you continue to maintain your social club and business connections in California.

Determination: Your declaration of residency in another state does not establish residency in that state. Your closest connections are to California and your absence from California is for temporary or transitory purposes. You are, therefore, a resident of California and are taxed on your income from all sources.”

This is what you are up against. California is broke. It is clinging to revenue and its revenue agents may well be bloodthirsty. The other examples are almost equally depressing. Even if you can make yourself a part year resident and have the Big Bucks come in while you are not a resident of California, California will claim to tax the Big Bucks because they are from
California. The reason for believing this is the following statement on the same page of the Instructions:

“Part-year residents of California are taxed on all income received while a resident and only on income from California sources while a nonresident.”

Notice the slippery insinuation that if you are a nonresident all year you might still be taxed on California income? That is wrong; you are not.

The moral is, you need to really leave. Maybe later you can really come back. In practical terms this means you need to at the very least to sell your home or get out of your lease if you are a tenant. When you face the issue you can bone up on what it takes to make a successful tax getaway.