ARTICLE

TAXING FOUNDERS' STOCK

Victor Fleischer

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Founders of a start-up usually take common stock as a large portion of their compensation for current and future labor efforts. By electing to pay a nominal amount of ordinary income tax on the speculative value of the stock when it is received, founders pay tax on any appreciation at the long-term capital gains rate. In a recent HARVARD LAW REVIEW *article, Professors Ron Gilson and David Schizer argued that this practice of paying founders with tax-favored "cheap stock" is an efficient subsidy for entrepreneurship. I disagree.*

This Article argues that the preferential tax treatment of founders' stock cannot be normatively justified. The economic efficiency case for a tax preference for founders' stock is weak: tax is a clumsy policy instrument, and tax has a limited effect on entrepreneurial entry. Geographic, cultural, and business factors are far more important, as are non-tax legal factors like immigration policy, employment law, bankruptcy, and securities law.

The case for reform is compelling. Taxing founders at a low rate is a conspicuous loophole in the fabric of our progressive income tax system, uniquely undermining our shared commitment to equal opportunity and distributive justice. Founders' stock is often bequeathed to heirs who receive a step up in basis, leaving a legacy of dynastic wealth that is exempt from the income tax and subject only to the rather dodgy application of the estate tax.

While it would be normatively desirable to tax gains from founders' stock at the same rate as labor income, fixing the problem is not administratively feasible within our current tax system. I offer solutions that policymakers might consider as part of a broader tax reform and deficit reduction effort.

I. INTRODUCTION

Founders of a start-up usually receive common stock as a large portion of their compensation for current and future labor efforts. When structured correctly, founders' stock allows entrepreneurs to

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defer paying tax until they sell the stock and—more importantly—allows them to pay tax at the lower long-term capital gains rate.[1] While founders' stock[2] has some attributes of a long-term, risky investment, the founders' income nonetheless represents (mostly) a return on human capital rather than financial capital. As such, gain from the appreciation of founders' stock can also be thought of as labor income that would normally be treated as compensation for services rendered and taxed at ordinary income rates, just like other forms of compensation.[3] The tax treatment of founders' stock as investment income rather than labor income is what allows entrepreneurs to pay tax at a lower rate than ordinary employees or corporate executives.[4]

This tax break for founders came into existence as an unintended consequence of a 1969 amendment to the tax code. The amendment, codified as section 83 of the tax code, curbed the abusive deferral of income from restricted stock awards to corporate executives.[5] Under

[1] The long-term capital gains rate is currently 15%. Founders' stock sometimes qualifies for the special rate that applies to qualified small business stock under § 1202, which (for certain companies formed in 2009 and 2010) allows for exclusion of 75% of gains measured from the ordinary income tax baseline, or about a 9% tax rate, not taking deferral or inflation into account. For simplicity, I assume in this paper that the QSBS rules will not materially affect the tax incentives of entrepreneurs in 2011 and beyond, and reference only the long-term capital gains rate.] *[update to reflect Sept. 2010 legislation]*

[2] The term "founders' stock" is not a technical term found in the tax code or legal documents. Rather, the term is widely used in the industry to distinguish between the stock issued to founders when they start a company and stock issued to investors in exchange for capital.

[3] Executives who receive stock or stock options are typically taxed at ordinary rates on the value of the equity received at the time of grant or when the options are exercised. See generally §§ 61, 83, [add cite to regs]. Employees who receive Incentive Stock Options, or ISOs, are taxed at capital gains rates in limited circumstances.

[4] The deferral and conversion of labor income into low-taxed capital gain is conceptually similar to the tax treatment of carried interest. See Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 NYU L. Rev. 1 (2008) (critiquing ability of investment fund managers to convert labor income into capital gains). The economic subsidy argument is plausible for founders; it is implausible to think that an economic subsidy is necessary to produce an adequate supply of private equity fund managers. Fund managers appear to be adequately compensated by the private labor market.

[5] See Senate Report 91-552, 1969-3 Cum. Bull. 500 ("The present law treatment of restricted stock plans is significantly more generous than the treatment specifically provided in the law for other types of similarly funded deferred compensation

this regime, executives of most companies now pay tax at ordinary income rates when they receive stock awards; they pay capital gains tax (or recognize capital losses) only on later changes in the stock price. By treating the receipt of stock as a taxable event when the stock is vested,[6] section 83 normally makes it impossible to both defer service income and convert that service income into capital gain. Section 83 also contains an election—the § 83(b) election—which allows executives to accelerate their recognition of ordinary income on restricted stock to the time of the award, even if their ownership of the stock is subject to vesting or other restrictions.[7]

In the case of founders, this § 83(b) election is an Easter egg: a delightful hidden loophole in what was supposed to be a revenue-raising correction to a timing provision of the code. If advised by competent counsel, founders now routinely make the § 83(b) election, accelerating the ordinary income portion of the tax hit to the point in time where the value of the company is speculative and arguably worthless—the proverbial founding moment when two engineers with an idea start working out of a Silicon Valley garage. By making the election, the founders transform their compensation for future services into capital

arrangements."). See also id. at 500-01 ("To the extent that a restricted stock plan can be considered a means of giving employees a stake in the business, the committee believes the present tax treatment of these plans is inconsistent with the specific rules provided by Congress in the case of qualified stock options, which were considered by Congress as the appropriate means by which an employee could be given a shareholder's interest in the business.").

[6] Section 83(a) imposes tax when the stock is vested ("not subject to a substantial risk of forfeiture") or transferable, whichever occurs earlier. For ease of exposition, I assume that stock which is vested is not subject to other continuing conditions or restrictions that might allow further deferral under section 83.

Founders' stock usually vests over a period of three to five years. In the language of section 83, stock which is "not subject to a substantial risk of forfeiture" is treated as property that was transferred to the employee in exchange for services, and thus subject to tax at ordinary rates like other forms of compensation.

[7] The 83(b) election was intended to provide flexibility, allowing employees to treat the stock award as compensation in the year it was received. See Senate Report 91-552, 1969-3 Cum. Bull. 502 ("To add flexibility, the committee adopted a provision allowing recipients of restricted property the option of treating it as compensation in the year it is received, even though it is nontransferable and subject to a substantial risk of forfeiture."). To guard against gamesmanship, the stock must be valued as if it were unrestricted, and the employer's deduction is limited to the amount included by the employee as income. Furthermore, the employee receives no basis in the stock for purposes of measuring loss on forfeiture; if the property is forfeited, no deduction is allowed.

gain on the appreciation of the stock.[8] Founders are taxed at ordinary income rates only on the liquidation value of the stock, which happens to be zero. The appreciation potential or "option value" of the common stock (its only real value at that point) is not taxed until the "option" is eventually exercised and the stock sold, and even then it is only taxed at capital gains rates.[9] By contrast, an actual stock option would give rise to ordinary income.[10]

Founders' stock—not high executive salaries and bonuses—accounts for much of the growing inequality of wealth in the United States. But policymakers from both sides of the aisle rationalize the tax subsidy as a critical feature of the legal infrastructure of entrepreneurship. President Obama's new initiative on entrepreneurship, for example, would exempt the first $10 million of gains from founders' stock.[11] Many academics agree with this approach. In a recent *Harvard Law Review* article, Professors Ron Gilson and David Schizer argued that the favorable tax treatment of founders' stock is a well-designed subsidy for entrepreneurship.[12] Their article was descriptive,

[8] Founders' stock in a firm with newly-funded company with debt or preferred equity in the capital structure is economically equivalent to an at-the-money call option on the common stock of the firm. Unlike founders' stock, however, exercise of a call option would generate ordinary income, not capital gain, on the difference between the strike price and the market value of the stock at the time of exercise.

[9] Common stock of a firm with a large amount of debt or senior equity performs economically more like an option than an equity interest. Surprisingly, the routine reporting of gains for from founders' stock is almost certainly wrong under current law. Treasury Regulation § 1.83[cite] suggests that, in the industry standard form, the correct result is to recharacterize the common stock as an option. By recharacterizing the grant of common stock as an option grant, the transaction would be ineligible the section 83(b) election and would, instead, generate ordinary income when the stock was later sold or otherwise obtained a readily ascertainable fair market value.

[10] Nonqualified stock options give rise to ordinary income when exercised. Incentive Stock Options (ISOs) can achieve tax results similar to founders' stock, subject to limitations. See § 422.

[11] Cite to White House proposal.

[12] Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 909-15 (2003) (highlighting valuation rules as subsidy); id. at 910 ("Specifically, the government's tolerance of aggressively low valuations might be understood as a form of tax subsidy for high-tech startups, targeted at a critical feature of the venture capital contracting process: the high-intensity performance incentives provided to managers of early-stage companies. The IRS allows a substantial portion of a

not normative: they argued that the founder stock subsidy explains the VCs' use of convertible preferred stock. Given this analytic focus, they chose not consider whether the tax break for founders was normatively justified in the first place.[13] This Article takes a step back analytically and answers the question that Gilson & Schizer set aside: *Should* founders be taxed at a low rate?

Principles of distributive justice establish a prima facie case for reform. The tax treatment of founders' stock is a conspicuous loophole in the fabric of the progressive income tax, allowing the very wealthiest Americans to pay tax at a low rate. Most of the FORBES 400[14] accumulated their wealth in the form of lightly-taxed founders' stock, or through founders' stock inherited with a stepped-up tax basis. The top ten on the most recent list, for example, includes no athletes, movie stars, lawyers, doctors, investment bankers, or fund managers—only founders and their heirs.[15]

The recent fight about extending the Bush tax cuts—i.e., raising marginal ordinary income tax rates on the rich—had little relevance for this privileged group of founders and heirs, as the income they enjoy comes from the sale of stock taxed at lower long-term capital gains rates. Increasing the tax rate on gains from founders' stock would raise significant revenue and induce larger amounts of charitable giving. As it stands, this entrepreneurial wealth is taxed at a low rate or not at all, allowing founders to leave behind a legacy of dynastic wealth subject only to the rather dodgy application of the estate tax.

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high-tech startup manager's compensation—in effect, wages for services—to be taxed as capital gain, instead of as ordinary income.").

[13] Id. at 910 ("We take no position here about the wisdom of this goal …"); id. at 915 ("Ultimately, though, our point here is not to advocate particular forms of venture capital subsidies; indeed, we have not addressed the substantive case for a subsidy at all. Rather, we want only to highlight the unusual characteristics of the indirect subsidy that has developed.").

[14] The Forbes 400 is a popular business magazine's annual list of the richest Americans.

[15] The top 10 are Bill Gates (Microsoft), Warren Buffett (Berkshire Hathaway), Larry Ellison (Oracle), Michael Bloomberg (Bloomberg), two Koches (Koch Industries), and four Waltons (Walmart). See *The 400 Richest Americans 2009*, FORBES.COM, *available at* http://www.forbes.com/lists/ 2009/54/rich-list-09The-400-RichestAmericansRank.html (site last visited Sept. 13, 2010).

But what if founders *should* be treated better than other employees? Founders and venture capitalists argue that entrepreneurial wealth is different from all other forms of wealth. Concerns about distributive justice and inequality should be set aside, they argue, in light of the new jobs created by entrepreneurship. Successful new companies don't merely make founders rich; these new firms ignite the dynamic capitalism that enriches all of us.[16] This narrative appeals to our collective aspiration to a society marked by resourcefulness, creativity, imagination, ambition, and class mobility. The problem is that the story does not logically lead to the conclusion that founders should not pay tax.[17]

In places like Silicon Valley and Boulder, it is taken as a matter of faith that a low tax rate on founders' stock increases the number of venture-backed entrepreneurs. Despite years of searching and multiple studies, however, economists offer little empirical support for the claim.[18] The evidence instead suggests that tax policy has a very small marginal effect on entrepreneurial entry. The effect, rather, is mostly inframarginal: the tax benefit goes mainly to entrepreneurs who would have started businesses anyway. Nor is there empirical evidence suggesting that those who might be influenced, on the margins, are the "right" kind of entrepreneurs who create growth businesses with positive externalities. Tax policy did not lead Zuckerberg, Gates, Jobs or Ellison to start companies. Both economic theory and empirical studies show that tax policy is less important than geographic,[19] cultural, and environmental factors.[20] Moreover, tax policy is less important than other elements of the legal infrastructure, such as intellectual property law, immigration law, bankruptcy law,[21] securities law,[22] ERISA,[23] and employment law.[24] If entrepreneurship must be subsidized (and I'm not sure that it should be), there are more effec-

[16] Baumol & Litan, Good Capitalism, Bad Capitalism.

[17] I am not making a claim about whether entrepreneurial wealth is critical to the American dream. The point is that if we want to subsidize entrepreneurship, tax policy is not the most effective method of doing so.

[18] See Poterba, Gentry. Cf. Shane, ILLUSIONS OF ENTREPRENEURSHIP.

[19] AnnaLee Saxenian, REGIONAL ADVANTAGE.

[20] Baumol & Litan, GOOD CAPITALISM, BAD CAPITALISM.

[21] Ayotte cite.

[22] SOX cites.

[23] Prudent investor rule.

[24] non-competes

tive methods than by providing an unjustified tax break to the wealthy.[25]

While it would be normatively desirable to eliminate the tax subsidy and instead tax gains from founders' stock as labor income, fixing the problem is not administratively feasible within our current tax system. I first discuss four possible changes that, while working within the basic framework of current tax law, would prove too difficult to administer. These approaches are:

1) changing the procedures for the valuation of founders' stock at the time of grant (the *closed transaction* approach),

2) treating all realized gains by non-passive investors as labor income (the *open transaction* approach),

3) splitting gains into labor and capital components by imputing a maximum financial return on the founders' cash and property investment and treating the balance as labor income (the *qualified capital* approach), or

4) imputing ordinary income to founders based on value of capital provided by investors (the *cost-of-capital* approach).

These four approaches assume that policymakers are politically constrained by the basic structure of our current system: (1) an income tax with (2) a preference for capital gains and (3) a realization doctrine that allows deferral of unrealized gains. These constraints make any

[25] The second problem is a structural one. The capital gains preference is the regulatory mechanism for delivering the tax break on founders' stock, and the capital gains preference is a blunt instrument. Tax academics have long recognized that the capital gains preference lacks a good normative justification. The more recent academic literature identifies the lock-in effect—the taxpayer's incentive to defer unrealized gains—as the most plausible justification for a lower capital gains rate. A recent paper by economist Bill Gentry documents that U.S. households have large amounts of unrealized gains in active business assets; he argues that a low tax rate on founders' stock reduces the lock-in of these unrealized gains, potentially creating social welfare gains by easing the transition from start-up or family business to professionally-managed company. Cite to Gentry draft. But the ready availability of tax planning techniques that mitigate or eliminate the lock-in problem suggests that this concern about welfare losses created by the lock-in effect is overstated. See discussion infra part __.

founders' stock reform effort administratively challenging to implement and easily undermined by aggressive tax planning, lobbying efforts, and political favoritism.

Better solutions would need to be implemented as part of more sweeping reforms of the tax system, such as:

5) eliminating the capital gains preference,

6) reforming the estate tax,

7) adopting a consumption tax, or

8) adopting a *dual income tax system*, which combines a low proportional tax rate on capital income with a high, progressive tax rate on labor income.

I conclude that because of the administrative challenges associated with implementing reform under the current system, the structural distortion created by taxing founders at a low rate would be best addressed as part of a broader fundamental tax reform effort.

I make three principal contributions to the academic literature. First, I rebut the argument by Professors Gilson & Schizer that the tax treatment of founders' stock is a well-designed subsidy for entrepreneurship. If the normative case for the tax break is weaker than Gilson & Schizer suggest, then if policymakers still wish to subsidize entrepreneurship, they may wish to do so by other methods.[26]

Second, I establish that the tax treatment of founders' stock encapsulates a critical design flaw of our tax system. An income tax system with a capital gains preference is unable to cleanly separate returns to human capital from returns to financial capital. This structural design flaw creates dizzying administrative complexity, traps for the unwary, and it undermines the very goals of vertical equity and

[26] For example, Congress could provide support for math, science and engineering programs from pre-K through university, provide "start-up" immigration visas for foreign entrepreneurs and engineers), or expand the funding support for basic scientific research through agencies like the NIH, NSF, NASA and NOAA. Taxing founders' stock at a low rate is not the best policy instrument to achieve President Obama's vision of an entrepreneurial, competitive society.

distributive justice that a progressive income tax purportedly addresses. This Article thus identifies an important new reason to consider fundamental tax reform.

Third, as in my prior work, this Article uses knowledge of institutional detail to dissect one issue—the tax treatment of founders' stock—and uses this analysis to illuminate more fundamental issues of regulatory design.[27] Founders' stock is a prism that changes how one views the classic tax policy debates about the capital gains preference, moving to a consumption tax, and estate tax reform.[28]

The remainder of this Article is organized as follows. Following this Introduction, Part II describes the tax treatment of founders' stock under current law and the scope of the subsidy. I motivate the paper by discussing how the founders' stock subsidy poses a challenge to both progressive and proportional tax ideals. Part III refines the inquiry by analytically separating the issues of deferral and conversion. I show that certain aspects of the deferral of gains are arguably justified by the theoretical and administrative problems associated with taxing unrealized gains on human capital. The conversion of labor income into capital gain, by contrast, is best understood as a tax subsidy or tax expenditure. Part III also clarifies the relevance of losses and substitute taxation. Part IV analyzes the efficiency case for taxing founders at a low rate. I discuss the two primary arguments in favor of a low tax rate: (1) incentivizing entrepreneurial entry and (2) easing the lock-in effect caused by the realization doctrine. Part V turns to possible solutions and questions of regulatory design. Part VI concludes.

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[27] Victor Fleischer, *Regulatory Arbitrage*, 89 TEXAS L. REV. (2010). Entrepreneurs tend to be a more sympathetic group than other taxpayers I have written about, like private equity fund managers, Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 NYU L. Rev. 1 (2008), Stephen Schwarzman, Victor Fleischer, *Taxing Blackstone*, TAX L REV. (2008), corporate executives, David I. Walker & Victor Fleischer, *Book-Tax Conformity and Executive Compensation*, Tax L. Rev. (2009), or sovereign wealth funds. Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 NYU L. Rev. (2009).

[28] One might think, based on existing literature, that (1) the capital gains preference is mainly geared toward financial capital, not human capital; (2) our income tax is more progressive than a consumption tax would be, and (3) the estate tax acts as an effective backstop to the income tax. This Article uses founders' stock to demonstrate in a concrete way why each of these traditional tax policy lessons is wrong.

II. THE TAX TREATMENT OF FOUNDERS' STOCK

A. Typical Use of Founders' Stock

Suppose two entrepreneurs, Mark and Eduardo,[29] form a new start-up, NewCo. Mark and Eduardo locate outside equity investors—venture capitalists—to finance the new venture.[30] The founders contribute no tangible assets and only $25,000 of financial capital. Their primary contribution is human capital: their experience, their technical expertise and knowhow, and an implicit promise of future services to the company. They also contribute a small amount of intellectual property—say, the software code for a social networking website.

The VCs contribute $5 million to NewCo in exchange for stock. The VCs' primary contribution is money, but they also provide non-monetary contributions: they take seats on the board of directors, obtain various control rights and negative covenants, and they make an implicit promise to provide management advice and mentorship to Mark and Eduardo. Finally, the VCs make an implicit promise to participate in later rounds of financing if the company meets certain milestones.

With this venture capital investment in mind, Mark and Eduardo organize NewCo as a corporation rather than a partnership or LLC.[31] While similar economic arrangements can be made using an LLC, some practical drawbacks associated with LLCs keep the C Corporation entrenched as the industry-standard form.[32] The equity investment of both the founders and the VCs therefore takes the form of stock rather than partnership interests.

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[29] THE SOCIAL NETWORK (Columbia Pictures 2010).

[30] Start-ups often take on debt as well; the introduction of debt into the capital structure does not normally affect the tax issues discussed herein. For more on the debt financing of venture-backed companies, see Darian Ibrahim, Venture Debt article.

[31] Victor Fleischer, *The Rational Exuberance of Structuring Silicon Valley Start-ups*; Joseph Bankman, *The Structure of Silicon Valley Start-Ups*.

[32] Rational Exuberance.

Mark and Eduardo take common stock—subject to new vesting requirements imposed by the VCs—while the VCs receive newly-issued convertible preferred stock. Both tax and non-tax motivations determine the structure of the deal. From a business standpoint, the VCs need a structure that addresses the critical transaction costs that pose a barrier to contracting—chiefly, the information asymmetry between the founders and the investors and the strategic behavior risk that results from letting the founders build a company with someone else's money. The liquidation preference of the preferred stock performs this role, protecting the VCs' investment in the start-up if things go badly. The liquidation preference also ensures that only founders who expect a startup to generate an extraordinary return on investment will accept VC money on these terms. Founders of a slow-growth business, by contrast, will seek financing from banks, or friends and family, or they will bootstrap using cash generated by the business itself. The conversion feature of the convertible preferred stock allows the VCs to convert into common and participate in residual profits if things go well.[33]

The use of convertible preferred stock also facilitates tax planning. Specifically, using a separate class of stock allows the founders to report to the taxing authorities a low (or nil) valuation on their common stock.[34] To illustrate, imagine a simpler structure in which both the founders and the VCs take common stock. Suppose the VCs invest $5 million into NewCo in exchange for 1 million shares of NewCo common stock, which comprises one-third of the common stock outstanding after the investment. Mark and Eduardo retain one million shares each, or two-thirds of the total common stock. On these facts, NewCo would have an implied pre-money valuation of $10 million, and a post-money valuation of $15 million. If the VCs' shares are worth $5 million, or $5 per share—a price negotiated at arms' length—each founder's common shares, if unrestricted, would arguably also be worth the same amount. Because each founder received this stock in exchange for the performance of current and future services, each would face a huge tax bill for services they have yet to per-

[33] Sometimes early stage investors use convertible debt, which performs economically much like convertible preferred stock.

[34] See Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874 (2003).

form.[35] If, as is typical, the stock is restricted and vests over a four-year period, the realization of the income would be deferred until the restrictions lapse, but the character of the income would be ordinary and would be recognized as it vests, even if there is no cash available to pay the tax.

The use of convertible preferred stock avoids this punitive result. Section 83 governs the timing of the taxation of property exchanged for services. The section was enacted in 1969 to address gamesmanship with restricted stock; companies were paying executives in stock and putting restrictions on the stock so executives could defer recognition of tax until they sold the stock, at which point they reported capital gains on the appreciation of the stock. Section 83 counters this gambit by giving executives a choice. Either:

> (1) the executives treat the exchange as an *open transaction* under § 83(a) until the stock is unrestricted, at which point they report the then current market value of the stock as ordinary income (less any amount originally paid for the stock), or
>
> (2) they elect under § 83(b) to treat the exchange as a *closed transaction*, recognizing ordinary income immediately on the value of the stock (without regard to restrictions, and less any amount paid for the stock), in which case any appreciation in the stock is capital gain, and any loss is a capital loss.

The idea behind section 83 is that executives can defer tax until they own the stock free and clear, or they can pay capital gain on the appreciation in the value of the stock in the interim, but they cannot do both.

So how do founders, unlike other corporate executives, get *both* deferral and conversion? The VCs' use of convertible preferred stock allows the founders to make a § 83(b) election and artificially accelerate the recognition of income to the very beginning of the company—a point in time when the IRS is in no position to challenge the low valuation of the founders' common stock.

[35] Section 83(a) requires the service provider to recognize the value of property received without regard to restrictions on transferability.

The strategy works as follows. Mark and Eduardo organize NewCo as a corporation and take common stock. Each founder makes a protective § 83(b) election to recognize ordinary income on the value of the common stock received, less any amount paid. Mark contributes $25,000 worth of software code and Eduardo contributes $25,000 cash. Each reports that amount as the fair value of the common stock received. Mark and Eduardo therefore recognize no ordinary income at all. At the same time, they secure venture financing. In exchange for the $5 million investment, the VCs take convertible preferred stock in NewCo. On these facts, most tax advisors would bless the founders' § 83(b) election filing and reporting of zero income for services. From that point forward, the founders are treated like other investors in the company, with gains and losses treated as capital, not ordinary.[36]

The loophole arises because the common stock has no current liquidation value. In economic terms, each founder holds the equivalent of an at-the-money call option on 1/3 of the assets of the firm. If the value of the firm (which currently holds $5 million in cash) were to increase to $8 million, Mark and Eduardo would each receive $1 million in liquidation.[37] Unlike an actual stock option, however, which would generate ordinary income to the service providers once exercised,[38] the founders convert the character of the income into capital gain by taking common stock with nominal liquidation value and then making the § 83(b) election.[39]

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[36] If the § 83(b) property is sold at a loss, and the property is a capital asset in the hands of the taxpayer, the loss is a capital loss. If the property is forfeited while substantially nonvested, however, the loss is limited to the amount paid for the property over any amount realized through the forfeiture. See Treas. Reg. § 1.83-2(a).

In the founders' stock scenario, the § 83(b) election is always made unless omitted by oversight. See Matt Galligan, *To 83(b) or Not to 83(b), There Is No Question,* in David Cohen & Brad Feld, DO MORE FASTER (2010) (reporting his costly oversight of the 83(b) election as a first-time entrepreneur). The founders hold their shares of NewCo as they vest and appreciate in value, but recognize no income until there is a sale or other disposition of the stock.

[37] The preferred stock would receive the first $5 million, and it would then participate in further distributions on an as-converted basis, which would give the VCs, Mark and Eduardo a 1/3 each claim on the $3 million of assets remaining in the firm. The payout to each founder is equivalent to buying 1/3 of the assets of the firm ($2.66MM) for the strike price of $1.66MM, netting $1MM.

[38] § 83(e)(3); Treas. Reg. § 1.83-7. The amount of ordinary income would be the value of the stock less any amount paid (i.e. the strike price of the option).

[39] The irony is that section 83 was intended to reduce tax-motivated structuring of executive compensation. The 83(b) election, which permits founders to elect to

The use of convertible preferred stock thus creates a regulatory arbitrage opportunity by exploiting the difference between the liquidation value and option value of the common stock.[40] For tax purposes, founders report the liquidation value of the stock, adding only a nominal amount for the option value. Because NewCo stock is privately-held, valuation is more art than science, and one practitioner has noted that the IRS has never successfully challenged a founder's valuation of common stock under these circumstances.[41]

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value the stock within thirty days of issuance and treat the stock grant as a closed transaction, was designed for operating companies, not start-ups. With seasoned companies, the fact that the 83(b) election accelerates the recognition of ordinary income acts as a check against gamesmanship.

[40] One might wonder why this common-preferred structure is so prevalent in venture capital start-ups but not elsewhere. The reason is that the arbitrage opportunity is only valuable under specific conditions: (1) the company must be organized as a corporation, (2) the option value of the common stock must be significantly greater than the liquidation value of the stock, (3) the employer's tax rate is lower than the employee's tax rate, and (4) the company cannot publicly-traded or otherwise have a readily ascertainable fair market value.

The first condition is necessary to fit into the established industry practice for making 83(b) elections with low valuations. In the partnership context, one can achieve similar tax planning goals by using a profits interest in a partnership.

The second condition (high option value) is necessary to allow founders to report the low valuation of the stock.

The third condition (low employer tax rate) is necessary to avoid the substitute taxation that occurs when an employer understates a valuable deduction. I discuss this condition in more detail below in section [x].

The fourth condition (no readily ascertainable fair market value) reduces tax risk. Once stock is exchanged in arms-length transaction at a higher price that reflects the true option value of the stock, it becomes risky for founders to report a lower valuation on the stock than the price they would be able to receive on the open market. While this risk exists for privately-held corporations as well—such as when a newly-founded corporation sells common stock to angel investors not long after issuing common stock to founders—the ready availability of a market value for publicly-traded stock makes any departure from that value more difficult to defend.

It is worth noting, then, that the founders' stock "loophole" is also available to other executives, including the executives or privately-held portfolio companies of private equity funds. Common stock of any leveraged firm resembles a call option. While the founder stock strategy (also known as the "common-preferred" strategy) is available in other contexts, the remainder of this paper will focus on founders of new start-ups. If the normative case for subsidizing founders is weak, it seems likely that the case for subsidizing private equity fund managers or portfolio company executives is even weaker.

[41] Bartlett. If NewCo was incorporated prior to the VC investment, the founders could treat the contribution of $50,000 as a tax-free contribution to capital under §

It's not self-evident to me that this tax strategy—known as the "cheap stock" or "thin common" strategy—actually works under current law. Treasury Regulation § 1.83-3(a)(1) states that a transfer of property for section 83 purposes takes place "when a person acquires a beneficial ownership interest in such property." While the founders have several indicia of ownership, such as voting rights and claims on residual cash flows, the regulations go on to explain that the grant of an option does not constitute a transfer of property, and in certain circumstances where the stock grant "may be in substance the same as the grant of an option," section 83 will not apply.[42] If section 83 does not apply, the stock grant would instead be treated as an open transaction, and founders would recognize ordinary income when the stock is later sold. A substance over form challenge under the section 83 regulations would not require the IRS to prove a specific valuation; rather, all the government would have to show is that, under the facts and circumstances, the stock grant resembles an at-the-money or out-of-the-money call option.[43] The IRS' practice of not challenging this structure, however, is consistent with its administrative practice in other similar situations, and the IRS practice of non-enforcement presumably gives sufficient comfort to practitioners who advise founders to report a zero value on the stock.

B. Why Founders' Stock Matters

Start-ups usually fail. In those cases, founders walk away with nothing but some hard-earned experience. From a tax policy standpoint, the failure to tax the founders on the value of their labor income might appear to be good regulatory design, as it saves us the trouble of

351. If the original contribution by the founders is old and cold, subsequent investors can take common stock without triggering a realization event. If the IRS steps the two transactions together, however, the founders risk the recognition of ordinary income based on the higher valuation of the later arms-length investment. The use of preferred stock avoids this tax risk.

[42] See Treas. Reg. § 1.83-3(a)(2); (a)(4) ("An indication that no transfer has occurred is the extent to which the conditions relating to a transfer are similar to an option."); (a)(6) (risk of loss); (a)(7), Example (5) (stock grant equivalent to an at-the-money call option recharacterized as an option).

[43] Common stock can always be bifurcated into liquidation and option value, thus giving all stock grants some degree of option resemblance. A significant risk of loss, however, is sufficient to make the stock grant qualify as a "transfer" for purposes of section 83. See Treas. Reg. § 1.83-3(a)(6). **[update to reflect case law]**

trying to refund tax losses to founders for foregone wages that had been constructively paid and deemed reinvested in the start-up.

But sometimes start-ups succeed. And when they do succeed, it's sometimes in winner-take-all fashion. Massive gains can accrue when a founder, through some combination of luck, skill, and nerve, exploits the right opportunity at the right time.[44] In those cases, taxing the founders at a low rate (or not at all) conflicts with fundamental precepts of our tax system. Taxing successful founders at a low rate is regressive rather than progressive, and it undermines most conceptions of distributive justice.

Skeptical readers may wonder if it's appropriate to set tax policy based on the "home runs" rather than the many founders who capture a modest return on their sweat equity. A founder who sells his company for $200,000 after three years might justly complain, if subject to tax at ordinary rates, about the bunching of income moving him into a higher tax bracket. For the moment, then, assume that any policy proposal to change the tax treatment of founders' stock exempts the first $1 million of gains from tax. Such an exemption would be consistent with current law. The more important question, from both an economic and distributive justice standpoint, is how we tax extraordinary gains.

Progressive tax ideals. Most tax scholars and many citizens share a commitment to progressivity in the tax system: average tax rates should rise with income. The tax treatment of founders' stock represents a critical design flaw in a progressive income tax system. A lower tax rate on investors' capital gains also presents a challenge to a progressive income tax system, although one might justify the capital gains preference for investors by reasoning that investors' savings have already been taxed once. In the case of founders, however, it is their labor, not their savings, which receives preferential tax treatment.

The low taxation of gains from founder's stock contributes to the broader trend of increasing inequality, particularly at the very top of the scale.[45] [*insert findings from Saez.*] Inequality is a problem that

[44] See, e.g., THE SOCIAL NETWORK (Columbia Pictures 2010).
[45] Saez, Sanchirico.

cannot be addressed solely by raising marginal ordinary income tax rates. Indeed, raising tax rates on ordinary income only increases the subsidy to founders by widening the gap between the tax treatment of founders and others. If the effective tax rate of the top 0.1% of the population is close to 15%, we ought to examine more closely both what this means for distributive justice and the most plausible justifications for the status quo.

Proportional tax ideals. Not everyone shares a commitment to progressivity.[46] Proposals for flat, proportional, and consumption-based taxes enjoy significant popular support. But few people, even among those skeptical of redistribution, openly support a regressive regime where average tax rates fall as income rises.[47] Because the low taxation of founders' stock allows founders and their heirs to pay income tax at 15% or not at all, a distribution of tax burdens where successful founders pay less represents a loophole even within an alternative system that aspires to flat or proportional taxation.

Consider the following hypothetical. Assume that instead of an income tax, we instead had only a consumption tax. Assume that there were no administrative costs, so the tax was imposed in the form of a federal retail sales tax imposed at the point of sale. Further assume a flat rate of 35% on all expenditures would be revenue neutral with the current system. Under this system, should founders of successful start-up companies stand in a special line and pay only a 15% tax at the grocery store, drugstore, or car dealership? Should the heir of a founder stand in a special VIP line and pay no sales tax at all? Because a lower tax rate on income leaves more after-tax income available for consumption, tax scholars recognize the similarity of the hypothetical to the status quo. But when presented with the hypothetical, founders, VCs and others proponents of the status quo under the income tax often favor treating all consumers equally in a consumption tax system.

The reasons for this different intuition are unclear to me. Perhaps the best explanation is the muddying confusion caused by the capital gains preference generally. Under the status quo, people are aware

[46] Even among those who believe that some redistribution is appropriate, there is reasonable disagreement about whether redistribution should be achieved through taxing or through spending.

[47] The optimal income tax literature produces this result, but only when coupled with a demogrant.

that investors pay a lower rate of income tax than employees, and it seems unjust to make founders pay tax like ordinary employees when, like investors, their income is uncertain from year to year. In a consumption tax system, by contrast, people intuit that because no tax on capital income would be imposed until that income were available for consumption, founders would already be on equal footing with investors, and no further preferential treatment would be appropriate. Whatever the source of the intuition, I have not yet found anyone who openly supports a regressive consumption tax system where average rates fall as the level of consumption increases. This suggests to me that the support for a founder stock subsidy is grounded in concerns about efficiency, or perhaps equity vis-à-vis investors, rather than a sense that entrepreneurial income should always receive special treatment.

Distributive Justice. The most plausible distributive justice case is a utilitarian argument grounded in the efficiency gains that that might result if a low tax rate on entrepreneurs leads to more entrepreneurship. Utilitarian approaches to tax policy usually start by recognizing the declining marginal utility of wealth; one additional dollar means more to you than to Bill Gates. Transferring a dollar from Gates to you increases your utility more than it decreases his. But if, by creating a tax system that allows Gates to hold on to more dollars, Gates and other entrepreneurs found companies that create new jobs and knowledge spillovers, it's possible that those positive externalities associated with entrepreneurship make everyone better off. Even accounting for the social costs associated with increasing inequality, it's still possible that the benefits of entrepreneurship outweigh the harms of burdening the poor with a higher rate of tax than the rich. For the utilitarian case to lead to this result, however, one would have to show empirically that a lower tax rate creates more entrepreneurs, and it would be helpful to show that tax has first-order effects that would tend to outweigh the social harms that result from having to tax other people at a higher rate.

The status quo fares even worse under egalitarian theories of distributive justice. Resource egalitarianism, for example, emphasizes equal chances, not equal outcomes. Taxing founders at a low tax rate hinders two primary goals of resource equality: (1) ensuring that the poor and middle class have equal opportunity to advance in society, and (2) ensuring that the wealthy and their heirs enjoy higher levels of

consumption and status based on their efforts and not the happenstance of brute luck.[48] By leaving entrepreneurial wealth (mostly) untaxed, the status quo gives the heirs of founders a significant head start over others. This head start occurs by the happenstance of birth, not hard work.[49] And founders themselves routinely acknowledge that luck plays a role in their success.[50]

From an resource equality standpoint, taxing entrepreneurial wealth at a low rate is inconsistent with either "leveling up" resources (helping the poor) or "leveling down" resources by spreading the wealth around (to coin a phrase). First consider the case for "leveling up"—that is, investigating whether the status quo helps the poor enjoy an equal opportunity to advance, or instead whether it might be appropriate for the tax and transfer system to "level up" resources to allow them to do so. It is unusual for the children of poor households to grow up and become entrepreneurs, at least of the type that benefit from the founders' stock subsidy. The founders' stock subsidy is a resource that is mostly available to the middle class and the rich.[51] One might argue that the poor might benefit indirectly by the redistribution of entrepreneurial wealth through charitable contributions, but there is some reason to doubt that the charitable tax subsidies, as currently structured, consistently promote distributive justice in a meaningful way.[52] The additional wealth enjoyed by successful founders advantages their heirs more than it indirectly helps the poor.

Similarly, there is a strong case for "leveling down" and at least some redistribution from rich to poor, consistent with the notion that unequal resources are justified only by effort and not brute luck. The

[48] See Alstott, Miranda Fleischer.

[49] One might try to justify the head start by viewing the family, including heirs, as the relevant taxable unit. Zelenak. Most philosophers would not view the hard work of parents to justify unequal resources allocated to sons and daughters. Even if one did view the family, including sons and daughters, as the taxable unit, the unequal resources provided to grandchildren is even more difficult to justify. Moreover, even for the founders themselves, luck plays a significant role in determining who becomes wealthy.

[50] See, e.g., Vivek Wadwha et al., *The Anatomy of an Entrepreneur: Making of a Successful Entrepreneur*, at 10 (73% rate "good fortune" as extremely important, very important or important; only 9% rate it as not at all important) (Kauffman Foundation 2009, available at http://www.kauffman.org/uploadedFiles/making-of-a-successful-entrepreneur.pdf (site last visited February 12, 2011).

[51] Data on importance of professional networks.

[52] See Miranda Fleischer.

founders themselves have a valid claim to retaining a significant portion of their wealth based on their work effort, although whether they have a stronger claim than a doctor, a lawyer, a venture capitalist or an athlete is not clear. Their heirs, who become wealthy by happenstance of birth, cannot (within a resource equality framework) justly claim entitlement to higher status or consumption by reason of their parents' wealth. An estate tax or inheritance tax could provide a partial solution here, as I discuss in Part V.

In sum, the tax treatment of founders' stock matters because it contributes to inequality, particularly at the very top of the scale. The strongest distributive justice case in favor of the status quo is a utilitarian argument that the positive externalities associated with entrepreneurship justify a government policy that subsidizes entrepreneurship. Accepting, for the sake of argument, that the positive externality case is true, Part IV evaluates whether tax is the optimal policy instrument for delivering that government subsidy. Before turning to that question, however, Part III clarifies the nature of the tax subsidy.

III. Defining the Subsidy

This section clarifies the nature and scope of the founders' stock subsidy in two ways. First, I analytically separate the issue of deferral from the issue of conversion, in each case by comparison to an ideal income tax. Some aspects of deferral of economic income from the appreciation of founders' stock are normatively justified by theoretical objections to taxing unrealized human capital. The conversion of labor income into capital gain, by contrast, is best thought of as a departure from the ideal that requires further normative justification. I then clarify the application of the "joint tax perspective," which is the idea that distributive justice concerns associated with the founders' stock subsidy should be ignored if substitute taxation exists, i.e., if the revenue lost on account of the subsidy is made up through higher taxes elsewhere in the structure, in this case in the form of potentially smaller compensation deductions by the start-up.

A. Deferral

Founders defer tax on their labor income, but the problem differs from the usual problems posed by deferral of executive compensation.[53] The deferral associated with founders' stock results from three distinct components: (1) the failure of the income tax to reach forgone earnings when the founders decide to work for themselves rather than someone else, (2) low-balling the estimate of the value of common stock received at the time of grant, and (3) the failure of the income tax to reach unrealized gains on investment income.

Deferral of foregone earnings. Consider, first, the failure of the income tax to reach forgone earnings. In an ideal income tax,[54] we would impose an income tax on an entrepreneur's forgone market earnings, as the decision to work for oneself can be viewed as a pre-tax investment in one's own business.[55] In Haig-Simons terms, where income is equal to consumption plus savings, working for oneself creates a problem because one's labor is converted into an increase in savings on one side of the equation, but it is not reflected in income on the other side. In this way entrepreneurs are favored over wage earners who make an after-tax investment in the same business; this violates the premise of an ideal income tax system that treats all sources of income equally.

In the non-ideal income tax system that we have, of course, we routinely allow taxpayers to avoid imputed income on forgone market earnings (as well as many other activities) notwithstanding the distortions. On the margins, there is a tax incentive to work for oneself rather than someone else. But whether this distortion is normatively undesirable depends on one's baseline, and few supporters of the ideal income tax would be willing to follow it through to its logical extreme.

Suppose that we somehow taxed the entrepreneur on the value of the deferral, perhaps by imposing an interest surcharge on the tax

[53] The tax treatment of deferred compensation has been recently addressed by § 409A, which applies when companies set aside wages on behalf of executives or other employees, sometimes investing the deferred earnings on their behalf. Section 409A does not apply to founders' stock.

[54] I use "ideal" in the usual sense of an income tax as designed by perfect political institutions, costlessly administered, with perfect compliance. An ideal income tax may not be preferable to other alternatives in the real world. Rather, the concept is useful in advancing our understanding of the relevant trade-offs.

[55] William A. Klein, *Timing in Personal Taxation*, 6 J. LEGAL STUD. 461, 464 (1977).

when it is collected.[56] An entrepreneur would then be treated the same as a wage earner. But an entrepreneur who creates value through the sweat of his brow, while now treated the same as the wage earner, would be disadvantaged compared to someone who creates value through innate human capital. Imagine a genius biology professor, suddenly struck with an idea for an invention, who patents the idea and transfers the patent to venture-backed biotech company in exchange for common stock. The company then hires managers to commercialize the patent while the genius returns to her job as a biology professor. The professor has performed no services for the company; she has merely made a (pre-tax) contribution of capital in the form of intellectual property. On what basis would we impose a surtax on the professor to treat her the same as the entrepreneur who, endowed with drive and ambition rather than scientific brilliance, must provide services to the company he owns?

The paradox here, first identified by Bill Klein, is that (1) a non-ideal income tax system provides favorable tax treatment to those who provide services for themselves, and (2) an ideal income tax system—if we somehow overcame the practical difficulties—would have to tax endowment or innate human capital.[57] Few scholars find the idea of taxing endowment attractive. The first problem is valuation. It is difficult to measure endowment except as manifested through arms-length labor market transactions, which are absent when one works for oneself. A second problem, known as the "enslaving the beachcomber" objection, notes that if you are taxed in advance based on your maximum ability to generate income, you may be forced to change careers (say, by becoming a lawyer instead of a law professor) in order to pay the tax.[58]

The paradox is avoided if we choose consumption rather than income as our baseline. In an ideal consumption tax, the deferral of tax associated with founders' stock is normatively justified and entirely appropriate. So long as the founders' wealth is locked up in equity, it

[56] It is a deferral rather than an exclusion because the value of the entrepreneur's labor is transferred to the business, and the entrepreneur will recognize this increase in value as income when selling the business.

[57] Kaplow makes a similar point.

[58] Whether this objection is, in fact, worse than the burden of the income tax on employment decisions is a matter of debate. See Kirk Stark's essay.

is not available for consumption.[59] Within an income tax system, both the practical challenges to measuring unrealized gains from human capital investment and the normative undesirability of measuring innate human capital suggests that allowing entrepreneurs to defer the income from forgone market earnings is a plausible second-best solution.

The deferral of foregone wages, while it may be justified, nonetheless represents a tax preference compared to the tax treatment of other wage earners. This tax preference, which I refer to elsewhere as the "entrepreneurial risk subsidy," persists even if we were to tax entrepreneurs on an accrual basis at ordinary income rates. It derives from the fact that entrepreneurs make a pre-tax labor investment in their own business.

Valuation games. The second component of deferral arises when the entrepreneur makes a low valuation of the common stock received at the time of grant. Unlike the deferral of forgone earnings, it results from administrative difficulties and not a normative justification. With a proper valuation of the common stock, deferral would be limited to the entrepreneurial risk subsidy and unrealized gains from further appreciation of the stock.

Founders' stock is subject to a wide range of potential valuations. Using a standard Black-Scholes calculator, assuming a currently price for NewCo at $5 per share, a strike price of $5 per share, a risk-free interest rate of 1%, a time until expiration of 4 years, and a volatility of 50%, each founder receives common stock worth nearly $2 million each. Many practitioners, by contrast, would advise Mark and Eduardo to take the tax position that the stock was worth $25,000, or the value of the cash that they actually contributed to the company. The founders each benefit from the deferral of about $2 million of income for four years, at which point the income may be recognized if the stock is sold. In two economically similar contexts, the IRS has recognized the impracticability of ex ante valuation: (1) the receipt of a stock option with no readily ascertainable fair market value, and (2) the receipt of a partnership profits interest. In each of these cases, the

[59] After the stock appreciates in value, the founders could borrow money using the stock as collateral, and use the borrowed funds to consume. In a cash flow consumption tax, however, unlike an income tax, the borrowed money would be included in the tax base.

deferral benefit is simply accepted as a structural flaw of the tax system.[60]

One might object to being taxed currently on the option value of common stock received in exchange for the promise of future services, as it would represent a tax on unrealized human capital. In that sense it resembles an endowment tax. But it is important to note that the tax on the option value would be elective: a founder could always decide not to opt-in to the § 83(b) regime. Under section 83(a), the default regime, income would not be recognized until the stock is fully vested, at which point the founder would recognize the current value of the stock as ordinary income. In this sense opting in to the section 83(b) regime would be a talent-revealing election;[61] the more certain that the entrepreneur is about the future success of the company, the more likely he would be to elect to accelerate income by making the section 83(b) election. In my view, the electivity of the regime defuses endowment tax objections; the entrepreneur can always treat the stock grant as an open transaction, wait and see how things turn out, enjoy the more modest benefits of deferral without conversion, and pay tax later at ordinary rates.

Unrealized investment appreciation. Once the founders have received common stock, it may appreciate in their hands. If the receipt of the common stock was taxed correctly with an honest valuation, the deferral of income post-grant is, as a general matter, no more objectionable than the deferral of gains on other unrealized investments the founder may hold. Few scholars view the deferral of income on unrealized investments as normatively preferable in an ideal income tax.[62] But practical considerations make it difficult to think about moving to a mark-to-model system for privately-held property.

In sum, the failure to tax forgone earnings unless and until realized in some market transaction may be normatively justified because taxing forgone earnings would, by taxing unrealized human capital, either impede personal autonomy in a manner similar to an endowment tax or disadvantage entrepreneurs who create value through labor vis-à-vis those who create value through the contribution of ideas

[60] But see David M. Schizer, *Realization as Subsidy*.
[61] Cite to Two and Twenty.
[62] Schenk realization paper.

alone. Deferral that is created by understating the value of property received in exchange for services, however, is not normatively justified. Nor is the deferral on unrealized investment gains on founders' stock justified, although it may be compelled by practical considerations. The desirability of eliminating deferral thus turns largely on administrative concerns, which I discuss in Part IV.

B. Conversion

The founder's conversion of labor income taxed at ordinary rates into investment income taxed at capital gains rates is difficult to defend on a normative basis, setting aside (for the moment) administrative concerns. Efficiency-based arguments might support taxing founder stock at a lower rate than wage income, and I discuss those theories in detail in part III. What is important to establish first is that taxing founder stock at a low rate represents a departure from the ideal income tax, and it is useful to distinguish this departure from the Haig-Simons baseline from the usual capital gains preference.

The ideal Haig-Simons baseline usually holds not only that income from all sources should be taxed, but also that income from different sources should be taxed at the same rate. This principle extends to income from investments, whether in the form of dividends or capital gains. The tax expenditure tables therefore include the capital gains preference as a tax expenditure, including gains from founders stock.

With respect to founders' stock, the departure from Haig-Simons is threefold: (1) conversion of the (deferred) forgone market earnings from ordinary income into capital gain, and (2) low valuation of the initial grant, which understates service income and overstates investment income, and (3) taxation of the investment of the common stock as capital gain.

Conversion of Forgone Market Earnings. Consider first the conversion of forgone market earnings. Recall that the deferral of forgone market earnings, while a departure from an ideal income tax, was consistent with a widely-shared commitment to personal liberty and minimal government intrusion. It does not follow, however, that when that income is later realized in the form of a portion of the sales pro-

ceeds from the common stock, the income should face a lower tax rate than other forms of income. Endowment tax concerns are absent. The government need not measure innate human capital or unrealized returns to human capital; the question is whether, once gains are realized, we should tax entrepreneurial returns on human capital at the same rate as ordinary labor returns on human capital.

The fact that entrepreneurial returns are risky does not, in and of itself, justify a lower tax rate. Many forms of labor income are contingent and risky. We tax as ordinary income an investment banker's bonus, a real estate agent's commission, an author's royalties, and a lawyer's contingency fee. Nor does the long-term nature of the founder's commitment to the start-up differ in a material way from the banker, realtor, author or lawyer. Each example similarly reflects a long-term investment of human capital.[63]

Undervaluation. As discussed above, founders often understate the true value of the common stock they receive at the time of grant, thereby converting high-taxed service income into low-taxed investment income. An ideal income tax treats all sources of income equally, and so the valuation gamesmanship represents a departure from an ideal income tax baseline.

The capital gains preference generally. Finally, because we treat the founders' contribution as an investment, the stock they hold is a capital asset, and they benefit from the usual capital gains preference.[64] Even if we taxed the stock grant appropriately at ordinary income rates, further appreciation in the stock would benefit from the usual capital gains preference. It is well understood that taxing capital gains at a lower rate than wage income is a departure from an ideal income tax. To justify this conversion, one must imagine an independent normative justification.

C. Losses

One possible independent justification for the tax preference for founders' stock could be the asymmetric treatment of gains and losses

[63] Of course, one might normatively justify a lower tax rate on the forgone market earnings in terms of subsidizing an activity with positive externalities.

[64] Discuss Cal Johnson's paper.

under current law. In our example, assuming we had no capital gains preference, Mark and Eduardo could be taxed at a 35% rate on any realized gains. Having made only a $25,000 actual cash investment, however, the founders would recognize only a small tax loss if things didn't work out.

The problem is that a loss would only be appropriate if the taxpayer has recognized ordinary income and reinvested the cash, taking a basis in the investment, setting up a situation where the effective tax rate on losses might be lower than the statutory rate. Suppose that, rather than making the § 83(b) election, Mark and Eduardo recognized income of $2 million each under § 83(a) when their stock vested. Each would take a basis in the stock and take a capital loss of $2 million if things didn't work out. The loss would be subject to the overly-stringent loss-limitation rules, reducing the effective tax rate on the loss, depending on the availability of other capital gains. But often lost in this analysis is the fact the loss limitation rules are relaxed for qualified small business stock (QSBS), allowing many founders to offset up to $100,000 of ordinary income in the year the stock is sold. In many cases, the asymmetry thus tilts the other way, allowing a higher rate of deduction on losses than rate of income on gains.

More importantly, the fact that the loss limitation rules might apply to a taxpayer who paid tax upfront to establish a basis in the stock and would take a loss later does not lead to the conclusion that a lower tax rate is appropriate for founders who defer paying tax, have no basis in the stock, and benefit from the exclusion of foregone wages whether things work out or not.[65] The founders' argument here is like that of a jockey complaining that while his share of the purse would be taxed, the government doesn't give him any money when his horse loses. While the horse's owner, having invested after-tax cash in the training of the horse, might have a valid complaint about loss limitations, the jockey, having contributed pre-tax labor, does not.

[65] Another useful way to frame the problem is to think of the tax on founders' stock as a tax on extraordinary return to labor, not a tax on extraordinary returns to capital. We normally think that tax rates on capital should be symmetric, burdening only the risk-free rate of return on capital. But taxes on returns to labor are always asymmetric, creating the primary tax base in any tax system.

D. The Joint Tax Perspective

Scholars sometimes dismiss the tax treatment of founders' stock as a trivial problem by noting that the start-up's deduction is limited to the amount the founder includes in income.[66] Assuming that the employer and the employee have the same tax rate, there is no loss to the Treasury if the founder understates his or her income, as the employer will be understating its deduction by the same amount.

The joint tax perspective is often critical to understanding tax planning. Whether equity compensation is generally tax-advantaged depends in a significant way on the tax treatment of the employer.[67] In the context of the tax treatment of stock options, for example, David Walker and I have argued that maintaining consistency in the timing of the employee's inclusion and the employer's deduction is an important constraint on gamesmanship.[68]

In the start-up context, however, the usual simplifying assumption that the employer and the employee have the same tax rate is problematic. Founders are typically professionals in a high tax bracket, even after they leave a large employer for a start-up.[69] Start-ups take a while to become profitable and often have no taxable income for several years. Excess deductions for salary, research, and other expenditures generate substantial net operating losses (NOLs). These NOLs are potentially valuable to acquiring companies, but the value of the NOLs must be discounted for the time value of money, and restrictions on the use of NOLs by acquiring companies depresses the value further.[70] In tax planning for a start-up, then, it is unsurprising that the concerns of the founders dominate the concerns of the employer. While the understatement of the employer's deduction may, in

[66] § 83(h).

[67] Knoll, Walker, Yale, Polsky.

[68] David I. Walker & Victor Fleischer, *Book/Tax Conformity and Equity Compensation*, 62 TAX L. REV. 399 (2009).

[69] See Wasserman paper; Noam Wasserman, *Executive Compensation and the Founder Discount* (showing that founders of IT companies make about $30,000 less annual cash compensation than similarly situated non-founders, but that average cash compensation for founders ranges $160,000 for small companies to $190,000 for larger start-ups) (http://founderresearch.blogspot.com/2005/09/executive-compensation-and-founder.html, site last visited February 12, 2011).

[70] [discuss empirical estimates]. Also add discussion from Gilson & Scholes paper on transaction costs, loss of other tax benefits.

the long run, produce some extra revenue for the Treasury, the joint tax perspective is of limited use in analyzing the tax treatment of founders' stock.

In some circumstances—indeed, some of the "home run" success cases that create the largest problem from a distributive justice point of view[71]—start-ups become profitable fairly quickly and could benefit from larger compensation deductions. The Treasury loses money when Sergey Brin pays tax on his labor income at capital gains rates, but it gains money when Google cannot deduct the value of his services. Even in these "home run" cases, however, the employer's effective corporate tax rate is often substantially lower than the founders' ordinary income tax rate, especially once employment taxes and state taxes are accounted for. (Google's overall effective tax rate in 2009 was 22%.)[72] The joint tax perspective provides some reassurance that the public fisc is partially protected in some cases, but it hardly makes the problem disappear.

Moreover, it is unclear to me whether the joint tax perspective solves distributive justice concerns. The premise of the joint tax perspective is that, so long as one party or another pays tax, we should be indifferent as to the distribution of the tax burden between the two. To be more precise, it is usually assumed that assignment of the remittance obligation to one party or the other is economically insignificant; either way, the market will determine where the economic burden of the tax falls. If an executive pays no tax on compensation and the employer gets no corresponding deduction, it is assumed that because labor markets are competitive and executives evaluate compensation on an after-tax basis, the tax benefit will be capitalized by the employer, and the executive will pay an implicit tax in the form of lower wages, thus shifting the economic burden of the employer's lost tax deduction back to the executive. While I understand the theory, it's not clear to me that the implicit tax assumption holds true in an environment with high transaction costs—specifically, where information costs related to

[71] I am indebted to Ethan Yale for this observation.

[72] See Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, Bloomberg.com, Oct. 21, 2010, available at http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html. [discuss Google's marginal U.S. corporate tax rate, which might be higher or lower than its average global rate.]

the value of tax assets are high, and where agency costs related to deal structuring are substantial.

To illustrate, consider the use of tax receivable agreements when a company goes public. When a company goes public, restructuring may create new tax assets in the hands of the public company, such as goodwill that can be amortized over 15 years. The amortization creates a tax benefit to the public company and can be used to shelter operating income going forward. In this circumstance it has become typical for the selling founders to enter into an agreement with the public company to shift the economic benefit of the reduction in taxes from the company back to the founders. Tax receivable agreements are often used in other going-public transactions, such as when a private equity fund takes a portfolio company public, or when a public company spins off a subsidiary.

One reason these tax receivable agreements exist is that public investors are perceived as being terrible at pricing tax assets. When investors price a stock, they may not fully price in the value of future tax benefits. In a world with perfect information, the investors should react to the tax receivable agreement by paying less for the shares. But they do not, and founders take advantage of this fact by entering into a tax receivable agreement to recover the economic benefit of the tax asset.[73] What this example suggests to me is that in the case of a start-up going public, where information and agency costs are high, founders who have taken their compensation in the form of founders' stock, thereby depriving the company of a tax deduction it would have otherwise received for compensation paid, may not pay an implicit tax in the form of a reduced IPO price. The economic burden of the lost tax deduction is shifted from founders to public shareholders (or other stakeholders burdened by the corporate tax) even in situations where the tax rate of the company and the founder are roughly the same. As such, the founders' ability to pay tax on their compensation at lower capital gains rates creates distributive justice concerns even in those cases where the employer's tax rate is as high as the founders.

[transition paragraph]

[73] This arrangement also creates an arbitrage opportunity by allowing the company to amortize the goodwill at ordinary rates while the founders recognize income on the tax payments at capital gains rates.

IV. THE EFFICIENCY CASE

What happens if we consider the optimal tax rate on founders' stock from an efficiency perspective? Ideal income tax analysis starts from the baseline that all income should be taxed equally regardless of source, thus allowing the broadest base of income and the lowest possible overall rates. Policymakers may wish to depart from the ideal, however, for administrative reasons or to promote social policy goals. If an activity generates positive externalities, for example, a lower tax rate on that activity could make everyone better off.

A. Entrepreneurial Entry

The economic literature often advances the view that entrepreneurship creates positive externalities. In *Good Capitalism, Bad Capitalism*, Baumol, Litan & Schramm make a persuasive case that entrepreneurship is a key component to a dynamic, growth-friendly economy. They identify the key attributes of the "entrepreneurial capitalism" of the United States, with its combination of bold innovation by small firms and incremental innovation by large firms. They argue that entrepreneurial capitalism creates more long-term economic growth, prosperity, and advancement of democratic values than the state-guided capitalism of Southeast Asia, the oligarchic capitalism of Latin America, Russia and the Gulf states, or the big firm capitalism of Continental Europe and Japan. In the same vein, other economic research suggests that most new, lasting jobs are created by start-ups and rapidly growing firms, not by large, established firms.

The need to subsidize entrepreneurship and encourage entrepreneurial entry is often cited as a reason—of late, one of the few possibly compelling reasons—for taxing capital gains at a lower rate. The theoretical case is straightforward. If founders' stock is taxed at a lower rate than wages, then the tax system encourages workers, on the margins, to become entrepreneurs. Moreover, because the tax benefits accrue only to successful entrepreneurs, the tax system provides this subsidy only to workers who gauge that they have a reasonable likelihood of success if they go out and start a company.

The problem is that the empirical support for the tax subsidy argument is weak. Anecdotal evidence makes me skeptical that tax is of

first-order importance, as most entrepreneurs keep a steely focus on questions of technology, customers, and business models, not tax. The effect of the tax subsidy is mostly inframarginal, rewarding entrepreneurs for activity they would have conducted anyway.[74] Still, one cannot dismiss the likelihood that tax has some effect at the margins, as it undoubtedly would if the tax rate on founders' stock were increased to 100%.[75]

Defining entrepreneurship. Several factors make it difficult to draw firm conclusions about the relationship between tax and entrepreneurial entry. First, because of the way that tax data is reported, it's difficult to distinguish between (1) entrepreneurs and (2) the self-employed who work for themselves because no one else will hire them. The recent recession has created a boom in "entrepreneurship" as the unemployed and underemployed do what they can to eke out a living. But there is little evidence that this sort of accidental entrepreneurship leads to the same sort of bold innovation and positive knowledge spillovers that venture-backed start-ups are said to promote. Defining entrepreneurship is a vexing problem in the economic literature, which typically counts as an entrepreneur anyone who is self-employed. Ironically, this definition excludes founders, the very group that we presumably ought to care about the most from a capital gains tax policy perspective. (Founders usually work for an externally-financed start-up corporation, not for themselves.)

In a recent article, for example, Professors Gentry and Hubbard provide a theoretical model and empirical support for the proposition that increasing the progressivity of the income tax discourages entrepreneurial entry.[76] But by relying on self-employment as the relevant measure of entrepreneurial entry, their study tells us little about the optimal tax rate on founders' stock. All it tells us is that the behavior of people *other than* founders is sometimes responsive to tax rates.

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[74] Cf. Norway. http://www.inc.com/magazine/20110201/in-norway-start-ups-say-ja-to-socialism.html.

[75] A higher tax rate doesn't necessarily dampen economic activity, as investors may scale up investment to offset the expected tax implications of gains and losses. Importantly, however, the U.S. tax system imposes substantial restrictions on tax losses, and this asymmetric treatment of gains and losses means that tax tends to discourage investment in risky activities.

[76] William M. Gentry & R. Glenn Hubbard, Tax Policy and Entrepreneurial Entry, 90 AER Papers & Proceedings 283 (2000).

Moreover, as they concede, "whether such encouragement [of entrepreneurial entry] is efficient (that is, stimulating the most talented entrepreneurs)" is not yet known.[77]

A blunt device. Second, as economist James Poterba has noted, cutting the capital gains rate is a relatively blunt device for subsidizing entrepreneurship.[78] Poterba notes that the capital gains rate, while relevant to founders, is not relevant to tax-exempt investors who provide most of the investment capital to the sector. And he notes that less than one-third of reported capital gains are the result of corporate equity, and only a small fraction of the gains on equity are related to venture capital investments.[79] The strongest evidence of tax-sensitivity among entrepreneurs is based on interview data from the 1960s, when top marginal ordinary income rates ranged from 70 to 91 percent. In 1986, by contrast, when the capital gains preference was briefly eliminated, the various data series "provide very little support for the view that the supply of entrepreneurial activity declined" in the two years following the elimination of the tax subsidy.[80]

Knowledge of institutional detail and tax law. Third, the tax code is a complicated beast. Economists, who are sometimes slow to appreciate the value of an extensive knowledge of tax law in all its intricate detail, may not always fully grasp how it applies in practice. The problem is even more acute in the field of entrepreneurship, where knowledge of the practices of venture capital contracting is often relevant to the tax issues. One recent article, for example, investigates the relationship between taxes and entrepreneurial risk-taking, concluding that tax is of first-order importance.[81] But the model and empirical data in that paper are based on the assumption that unsuccessful firms retain pass-through tax status (so as to pass through losses to taxable individual investors) and successful firms incorporate only once they have profits, using the lower corporate tax rate as a tax shelter. The authors exploit this "option to incorporate" to draw their conclusions about the effect of tax on entrepreneurial activity. They claim that

[77] Id.

[78] James M. Poterba, Capital Gains Tax Policy Toward Entrepreneurship, 42 National Tax Journal 375 (1989).

[79] Id.

[80] Poterba. [more]

[81] Julie Berry Cullen & Roger H. Gordon, *Taxes and entrepreneurial risk-taking: Theory and evidence for the U.S.*, 91 J. PUB. ECON. 1479 (2007).

"start-up firms almost invariably are noncorporate,"[82] and they use, as their measure of entrepreneurial firms, firms with noncorporate business losses.[83] But the devil is in the institutional detail. The study tells us nothing about venture capital backed start-ups, which almost always incorporate at the beginning of the venture.[84] Their measure of entrepreneurial firms, in fact, perfectly *excludes* the group of entrepreneurs that, from a tax policy standpoint, we might want to subsidize. In sum, the design of empirical research in this area is hampered by data sets that cannot distinguish between the founder of a start-up and the self-employed, and research questions are often muddied by the institutional detail of venture capital contracting against the backdrop of a complicated tax code.

Deferral. Finally, deferral provides another reason to think that the nominal tax rate on founders' stock may not be of first-order importance to entrepreneurs. Gains from founders' stock are usually deferred for several years, and this deferral benefit lowers the effective tax rate substantially. Changing the nominal capital gains rate thus has a muted effect on ex ante incentives.[85] Indeed, it is hard to imagine that an entrepreneur, trying to figure out how to find money and form a team to commercialize a new technology for a customer market that doesn't exist yet spends a lot of time thinking about, in the unlikely event that they hit a home run, whether their tax rate will be 20% or 40% when they sell their stock five or ten or twenty years down the road.

First-order effects. Many other factors, meanwhile, are of first-order importance to the rate of entrepreneurial entry. Perhaps the most important is geography. Entrepreneurship flourishes where tacit knowledge can flow freely—thus the prevalence of concentrated entrepreneurship hubs in places like Silicon Valley, Boston, the Research Triangle in North Carolina, and Austin. Geographic concentration of entrepreneurship is often industry-specific, as with biotechnology

[82] Id. at 1487.

[83] Id. at 1487 ("Only the high-risk firms are likely to generate ex post losses, so these entrepreneurial firms should dominate the sample of firms with tax losses. … Second, by the theory, business losses should (mostly) show up on the tax return as noncorporate business losses.").

[84] Bankman, Structure of Silicon Valley Start-ups; Fleischer, Rational Exuberance.

[85] Poterba.

start-ups in San Diego, or natural foods and social networking start-ups in Boulder.

Cultural factors are important. The Silicon Valley entrepreneur is a revered figure in the United States. The number of undergraduates majoring in business has climbed in the last generation from 14 to 22 percent; at the same time, the numbers of those majoring in the humanities dropped from a total of 30 percent to less than 16 percent.[86] While the decline of Great Books from the curricula of U.S. universities may not be an altogether positive development, it does reflect a broad aspiration towards entrepreneurship and business success that exceeds most other countries. An open attitude towards change is important even among those who work for large firms. Amar Bhide has emphasized the role of innovative users in the infrastructure of entrepreneurship—the number of hours that U.S. employees have spent figuring out how to use Microsoft Outlook, for example, represents a significantly larger investment in the innovation than the underlying technological advance.[87]

Legal infrastructure. Other elements of the legal infrastructure appear to be more important than tax. Having strong intellectual property rights may be critical to entrepreneurship.[88] Bankruptcy law is important to entrepreneurship; the ability to get a fresh start if things don't turn out well may give founders the confidence to borrow money on their credit card to get the company going.[89] Employment law may be important; Ron Gilson has attributed Silicon Valley's success in part to the non-enforceability of non-compete clauses in California—thereby allowing the transfer of tacit knowledge from one firm to another.[90] Finally, securities law is often cited as a hindrance to entrepreneurship.[91]

Of all of the elements of the legal infrastructure, a change in ERISA has proven to be the most important change of all. In 1978, the

[86] William M. Chase, *The Decline of the English Department*, The American Scholar, Autumn 2009, available at http://www.theamericanscholar.org/the-decline-of-the-english-department/.

[87] Amar Bhide, The Venturesome Economy. Findings from economic research, including Litan, Saxenian, Bhide, Glaeser.

[88] Cites. Baumol. Others think a weak IP regime is better. Cites.

[89] Ayotte.

[90] Cite to Gilson.

[91] Sox cites.

Department of Labor (which oversees pension plans subject to ERISA) modified the prudent investor doctrine to allow trustees to invest in alternative asset classes like private equity and venture capital. The flood of investment capital into the sector in the 1980s created the venture capital industry we have today.

Against this backdrop, it is difficult to see how the nominal rate of tax on capital gains would greatly affect the rate of entrepreneurial entry. The strongest argument to the contrary, I think, is that because the empirical record is so thin, there is much we don't know about the relationship between taxes and entrepreneurship. Perhaps, one could argue, if the costs of setting the tax rate too high (a reduction in entrepreneurship) are so much worse than the costs of setting the tax rate too low (increased inequality) then we should err on the side of lower taxes. There might also be some merit in an approach that exempts the first $1 million (or even $5 million) of gains from tax. But even so, one would have to compare the relative effectiveness of a tax subsidy against other policy instruments, and there is little reason to think that a tax subsidy is the most effective means of pursuing the goal of a more venturesome economy.

Government subsidies might be more effective if targeted elsewhere. For example, suppose that the capital gains preference for founders' stock represents a tax expenditure of $10 billion a year, or one-tenth of the overall capital gains preference.[92] At a time when state support for higher education is disappearing, a federal subsidy for higher education would likely increase the supply of entrepreneurs. Access to higher education for poor and middle-income students depends in large part on federally-subsidized loans; $10 billion a year would provide full-tuition scholarships for about one million college students a year (about half of all students). Such subsidies would also free up university capital to cover the overhead costs associated with basic scientific research. Or we could focus more directly on the science end of the pipeline; $10 billion would triple the budget of the NSF.

[92] The tax expenditures for the capital gains preference and exclusion of capital gains at death combined are about $100 billion a year. See Joint Committee on Taxation, Estimates of Federal Tax Expenditures 2009-2013, at 35. There are no good estimates of how much of this amount is attributable to founders' stock and similar instruments.

Of course, given that any such subsidies would be implemented by imperfect political institutions with imperfect knowledge about innovation, I cannot dismiss the possibility that the founders' stock subsidy is more efficient than other unknown subsidies for entrepreneurial entry. In light of the absence of evidence of a first order effect, however, the entrepreneurial entry argument is better understood as an after-the-fact justification for an accidental tax break.

B. Lock-In Effect

The capital gains preference is most often understood among academics as an imperfect mechanism to reduce the lock-in effect caused by the realization doctrine. The usual arguments that politicians make—that capital gains are not really income, that the capital gains preference mitigates the double taxation of corporate earnings, incentivizes risk-taking, or avoids taxing inflationary gains—do not hold up well to analysis.[93]

One might expect the lock-in effect to be less problematic in the context of founders' stock. Because founders have both their human capital and much of their financial capital tied up in a single business, they should rationally seek to sell their stock and diversify their investment portfolio as soon as they are able. We might expect a small lock-in effect, then, allowing the optimal tax rate to reduce lock-in to be higher for founders than for portfolio investors.

A recent paper by economist Bill Gentry raises the possibility that, for many entrepreneurs, the tax advantage of deferral outweighs the non-tax advantage of diversification. Using household-level data, Gentry finds strikingly high levels of unrealized gains on entrepreneurial assets. Gentry's data set includes partnership and LLC interests in addition to founders' stock, but the data shows that entrepreneurs of all stripes tend to hold onto equity in their company for a long time. If this behavior is attributable to the lock-in effect of the realization doctrine, the economic consequences of the lock-in effect in the founder context could be particularly bad. As small businesses grow, founders might maintain control in ways that may not be economically efficient. In the context of venture-capital backed start-ups, the VCs often find ways to ensure a smooth transition to professional man-

[93] Cunningham & Schenk; Shaviro.

agement prior to or in conjunction with an IPO or acquisition of the company. Post-IPO, however, founders may retain large blocks of stock and interfere with managerial decisions in ways that are unhelpful.

But there are also reasons to think that the lock-in effect identified by Gentry is not tax-driven, at least to the extent his dataset includes founders of venture-backed companies.[94] Most successful exits of venture-backed companies are acquisitions. In many of these acquisitions, founders receive shares of the publicly-traded stock of the acquirer in a tax-free reorganization, allowing further deferral of unrealized gains. Sometimes these acquisitions are structured as taxable deals to allow the buyer a step-up in basis; in such deals the founders' tax penalty for selling is partially or completely offset by the acquirer's tax benefit for buying. In such circumstances, the founders are typically compensated for being forced to realize tax gains. For many successful start-up founders, in other words, there is no lock-in effect; they continue deferral upon a successful exit or receive substantial economic benefits to help offset the realization of built-in gains.

Moreover, for founders of successful companies that go public, or who wish to remain private, the ready availability of monetization techniques suggests that tax may not be what is causing the deadweight loss when founders hold onto stock in cases where it would be economically efficient for them to sell.[95] Founders can (and

[94] Gentry does not draw any conclusions with respect to founders' stock as such.

[95] Specifically, successful founders are not trapped by the problem of realizing gains; they can and often do exit through a tax-free reorganization, exchanging founders' stock for the publicly-traded stock of a company like Google, Yahoo, Microsoft, Cisco, or Intel, thereby further deferring their unrealized gains, possibly forever. If the startup itself goes public, the founders often enter into a variable prepaid forward or other self-help monetization techniques to reduce economic exposure without triggering a realization event. Even in taxable deals, the lock-in effect is muted. Founders often negotiate to share the tax benefit from the step up in basis the acquiring company receives, thereby shielding themselves from the capital gains realized on the sale of their founders' stock.

Successful founders can (and do) monetize their holdings without paying income tax by entering into derivative contracts or by selling the stock in a tax-free reorganization. While there is a great deal of wealth locked up in the equity of closely-held businesses, it's not clear that tax policy has much of a causal effect. Founders often have idiosyncratic, even irrational reasons for holding on to the equity in their company long after economic theory would suggest diversification as their optimal wealth management strategy. For founders of successful businesses who do want to

often do) enter into a variable prepaid forward contract to monetize their interest in the firm. A VPF is a derivative contract with a counterparty (an investment bank or institutional investor) that pays the founder some cash upfront in exchange for a variable number of shares in the future, the number of which depends on the valuation of the shares at that later point in the future. Founders can monetize a large portion of their interest without immediately realizing gains for tax purposes.[96]

There are tax-motivated reasons to hold on to founders' stock. The transaction fees associated with monetization techniques are costly. And holding equity in a closely-held firm is useful for estate tax planning purposes. By contributing founders' stock to a Grantor Retained Annuity Trust (GRAT) prior to IPO or exit, future estate tax obligations can be cut by half or even more.

In sum, the efficiency argument for taxing founders' stock at a low rate is weak. Existing empirical studies fail to establish a link between tax rates and entrepreneurial entry, and there are theoretical and practical reasons to believe that the effect is small. If the government must be in the business of subsidizing entrepreneurship, investment in math, science, and engineering education is more likely to have a positive effect.

V. REFORM OPTIONS

The normative case for reform is compelling. But fixing the problem is not easy, and the uncertain benefits of reform must somehow be weighed against the administrative costs, which are themselves uncer-

cash out, the relatively fixed transaction costs associated with entering into a monetization strategy make tax planning a more appealing option as the value of the firm increases. Founders in this position usually part with voting control of the firm as they hedge their economic exposure to the firm, holding on only to nominal ownership of the stock to prevent a realization event for tax purposes. Because the efficiency gains associated with lower capital gains rates occur from the shifting of control and economic ownership, not legal ownership, and because this shifting already occurs when it should under current law, it is doubtful that raising the tax rate would produce substantial efficiency losses.

Much of the lock-in that occurs is driven by the estate tax, not the income tax; holding or transferring stock of an illiquid closely-held firm can be advantageous for estate tax planning purposes.

[96] See constructive sale rules, Anschutz case.

tain and vary considerably depending on which reform is adopted. The crux of the problem is separating human capital from financial capital. The most straightforward solution is to make the distinction irrelevant by adopting a postpaid consumption tax, or by eliminating the capital gains preference. Before turning to issues of structural tax reform, however, I discuss why reform options within our current system would likely prove too difficult to administer.

A. Incremental Reform Options

Before turning to the normatively desirable solutions that involve structural changes to the tax code, I first outline the pros and cons of four incremental reform options, each of which is constrained by an income tax system with a capital gains preference and a realization doctrine.

1. The Closed Transaction Approach

The first approach is to put an end to the current practice of allowing founders to ignore the option value of the common stock they receive. Under this approach, anyone who makes a § 83(b) election with respect to stock without a readily ascertainable fair market value would be required to explicitly value both the liquidation and option value of the stock. The founders could use Black-Scholes or any other reasonable option valuation methodology to come up with the option value of the stock. A revenue procedure could provide a safe harbor for planning purposes. Such a valuation procedure need not be overly burdensome; with guidance as to reasonable assumptions for stock volatility, the other inputs to a basic valuation model are simple. As a further check against gamesmanship, the IRS could be permitted to use any valuation of the company within one year that is used for non-tax purposes (such as on a VC term sheet) to shift the presumption to the taxpayer to justify a lower valuation that was stated for tax purposes.

One can anticipate both conceptual and practical objections to this approach. At a conceptual level, an honest valuation of the common stock would effectively tax founders on the value of services they have yet to perform, which starts to resemble a tax on human endow-

ment. But recall that the § 83(b) election is optional; taxpayers who object to being taxed on their future services could use the default rule, § 83(a), treat the stock grant as an open transaction, defer their income and pay ordinary income when the income is later realized.

The more serious objections are administrative. While the initial rule would be simple enough to write, enforcement would be expensive, and some potential workarounds might invite aggressive tax planning and gamesmanship. For most taxpayers, the compliance costs would be significant only for those founders trying to be aggressive on valuation and opting out of the safe harbor of the revenue procedure.[97]

Two workarounds would need to be addressed, and neither is an easy move to counter. The first is the "capital contribution" strategy. Founders often make a non-cash capital contributions to the firm in the form of intellectual property and other intangibles like know-how, industry expertise, and other forms of intellectual capital. Under current law, only intangibles that are treated as property under state law can be counted as an "amount paid," with other contributions characterized simply as services or labor. But founders might get creative about what counts as property contributed to the company and the value of that property. A high valuation of that property could represent fair value for the stock received, turning what would otherwise be the bargain purchase of stock in exchange for services into an exchange of property.[98] While the IRS could look to case law and new regulations to guard against gamesmanship, limited resources available for enforcement would invite aggressive planning.

The second strategy might be called the "351 old-and-cold" strategy. This strategy turns on avoiding section 83 altogether. Founders could form a shell corporation a few weeks or months in advance of the funding event, receiving shares in the company as part of a § 351 transaction. The founders then retain those "old and cold" shares in the corporation rather than receiving new ones in exchange for ser-

[97] § 409A, by contrast, imposes significant compliance costs even on taxpayers who are not trying to be aggressive.

[98] As one practitioner explains, "The trick, within the bounds of reasonableness and good faith, is to argue that the founder's contribution is not 'services,' but intangible property, that is, a secret process or other proprietary information, because secret processes can be 'property' under the code." Bartlett.

vices. By retaining the old shares, the founders avoid a realization event at the point in time when the availability of venture funding increases the valuation of the common shares. This strategy involves some tax risk because of the step transaction doctrine, which would allow the IRS to collapse the two steps and treat the founders' receipt of common stock as part of the same deal as the venture financing.

The Treasury could counter this strategy by expanding the step transaction doctrine through regulation, or by treating entities formed for the purpose of avoiding tax as devoid of economic substance until the company receives outside financing. Such responses, however, would be difficult to design and expensive to enforce.

2. The Open Transaction Approach

In situations where property is difficult to value, the tax code often takes a wait-and-see approach. Under this approach, we would treat all gains by service providers as labor income, taxed at ordinary income rates at the time of realization; realization would be defined by statute to occur no earlier than the point at which the stock has a reasonably ascertainable fair market value.

Under this approach, if a service provider received or held stock with no readily ascertainable fair market value, a test would be administered to determine whether the service provider performed enough services to become a non-passive investor. (In Congressional testimony, legendary tax lawyer Jack Levin memorably referred to this sort of approach as sniffing the investors' armpits to see if they're sweaty.) If the taxpayer indeed performed enough services, her stock would be deemed disqualified for capital gains treatment. Then, when the stock was later sold, the gains would be ordinary income.

The conceptual basis for this approach would be grounded in the treatment of nonqualified stock options. Under section 83(e)(3), options without a readily ascertainable fair market value are not eligible for section 83 treatment and are instead treated as open transactions, with the amount of ordinary income to the service provider determined later in time when valuation is less subjective.

The chief problem with this approach is administrative; the determination of whether an investor is active or passive would be difficult. On the margins, founders and venture capitalists who could plausibly qualify as passive would abstain from the provision of useful services to the company to protect their tax status. Such a rule would arguably be overinclusive, as many active investors take board seats, meet with management, and otherwise contribute human capital as well as financial capital. Nowhere is this more obvious than with start-ups, where angel investors and venture capitalists are selected as much for these nonfinancial contributions as for their money. Discouraging investors from participating in management decisions would create an efficiency loss and—unless ERISA's VCOC rules were changed—could make it more difficult for pension funds to invest in venture capital funds, depriving the asset class of an important source of capital.

If the amount of activity were set so high—say, more than 500 hours per year per company—as to exclude venture capitalists, founders who start a company and turn day-to-day operations over to professional managers might be able to skirt the rule. Furthermore, founders might give up managerial roles too soon in response to the tax incentive, creating new agency costs as outside managers were brought in simply to help the founder get a lower tax rate.

The open transaction approach is also subject to the "§ 351 old-and-cold" strategy, as the universe of taxpayers subject to the rule would be limited to § 83.

3. The Qualified Capital Approach

A third approach, the "qualified capital" approach, could apply to investors and founders alike, avoiding much of the gamesmanship associated with section 83. Under this approach, which would apply to any investor or stockholder who provides a material amount of services to the company, one first measures the amount of financial capital and property contributed to the corporation—the "qualified capital"—and permits a reasonable return on that investment to qualify for capital gains treatment. Any return in excess of that amount would be treated as labor income. Given the riskiness of start-up investment,

one could impute a fairly high rate of return, like 10%, and still capture a large amount as ordinary income.

The main problem with this approach is the scope. Proposed Section 710 of the code, which would have treated carried interest as ordinary income, followed a "qualified capital" approach, treating anyone who holds a partnership interest in a partnership in which they engage in a material amount of investment services activity (defined broadly) as the holder of an ISPI. There was a tremendous amount of lobbying activity, not surprisingly, over the definition of an ISPI, and the contours of the definition remained vague.[99] Writing a definition of services in the start-up context would be equally challenging and would likely have to include venture capitalists and board members who hold equity. In our example, is Eduardo a founder or an investor? Eduardo invested $25,000 in NewCo, and provided some services, but Mark provided most of the labor. If we do treat Eduardo as an investor, and tax only Mark at a higher rate, that hardly seems like the right result.[100]

The effect of the qualified capital approach is to pick up both founders and active investors who achieve extraordinary returns—in effect, increasing the tax rate on entrepreneurial rents.[101] While taxing entrepreneurial rents at a higher rate than normal returns may be good policy, the importance of this change in policy arguably raises it to the level of a structural change to the tax code, which I discuss further below in part V.B.4.

4. The Cost-of-Capital Approach

An accrual-based approach is another option. Rather than wait until entrepreneurs realize income, we could impute an amount of wage income based on the amount of senior equity and debt invested in the firm. The idea is that entrepreneurs are financing their opera-

[99] Furthermore, the definition of "qualified capital" became complicated when stockholders reinvest previously-taxed capital in the firm without taking a distribution, which makes capital accounts harder to administer.

[100] I am indebted to Noel Cunningham for pointing this out.

[101] *[whether this is good or bad is unclear and a really complicated question – are these monopoly rents with negative externalities? rents resulting from creative destruction with short-term negative but long-term positive externalities?]*

tions with other people's money, and they could be taxed as if they'd actually borrowed the money themselves without paying interest.

In our example, we would treat Mark and Eduardo as each receiving a zero-interest, nonrecourse loan of $5 million, which they then turned around and invested in the firm. The forgone interest on this imputed loan—say, $5 million times an 5% interest rate, or $250,000 per year—would be treated as wage income, taxed at ordinary rates, and deemed invested in the company. Because the imputed interest income would be taxed as accrued, and not in advance based on talents, this approach would avoid the "enslaving the beachcomber" objections associated with endowment taxation.

The principal objections to this approach are again related to scope and administrability. The example of Mark and Eduardo involves one round of financing, and measuring the capital deemed borrowed would get complicated quickly as the firm raises more money, pays dividends, divides into two firms, or acquires other firms.

One might also object to the limited nature of this approach, which allows unlimited conversion on extraordinary returns to human capital. In our example, Mark and Eduardo would recognize $250,000 per year in ordinary income, but in those few unusual cases where founders make tens of millions or even billions on the sale of founders' stock, the effective tax rate on their return to human capital would still be quite low.[102] From a distributive justice standpoint, it is precisely these unusual cases that ought to concern us the most.

B. Structural Reform Options

This section outlines four approaches that are not constrained by our current tax structure of an income tax system with a capital gains preference. Each approach does not assume ideal conditions, however; I assume that we have imperfect information as to the value of stock, imperfect political institutions that would design legislation, imperfect administrative agencies applying the law, and taxpayers who act strategically to exploit these imperfections. This section, in other words,

[102] On the analogous question of how to tax carried interest, it was presumably this concern that led Congress to follow a qualified capital approach rather than a cost of capital approach.

imagines the real world but adds in the not implausible assumption that new forces—taxpayer revolt, or a desperate need for revenue to fund social programs—spurs Congress to consider structural changes to the tax system.

1. Eliminating the Capital Gains Preference

The capital gains preference is traditionally thought of as a method of encouraging investment generally, and in particular, investment in risky activities. The literature on the taxation of risk, however, shows that for portfolio investors, the income tax on capital gains mostly burdens the risk-free rate of return.[103] Portfolio investors have losses that partially offset gains and can often scale up their investments to (mostly) eliminate the effect of the income tax. Capital gains policy would benefit from focusing on those who are actually burdened by the tax on capital gains, including founders. As noted above in Part IV, the efficiency arguments for a capital gains preference are weak; eliminating the capital gains preference is thus an obvious partial solution to the tax treatment of Founders' stock.

Eliminating the capital gains preference would mitigate the problem of founders' stock, as well as solving numerous other difficult line-drawing problems in the code. This approach is not without weaknesses, however. Eliminating the capital gains preference would not eliminate the timing benefits associated with the founders' deferral of unrealized gains. Nor would it eliminate the "entrepreneurial risk subsidy"—the deferral associated with making an investment in a company you work for using pre-tax income.

Furthermore, as tax rates rise, founders would have an increased incentive to exploit the realization doctrine by monetizing their holdings while continuing to hold the stock for tax purposes. As noted above, founders often use variable prepaid forward contracts and other tax-deferral strategies to avoid capital gains taxes.

Finally, global competition would make it difficult for the U.S. to unilaterally raise the tax rate on capital gains. The increased globalization of the capital markets could make it difficult to impose a higher

[103] Domar-Musgrave etc.

tax on the capital income of U.S. residents, as it would motivate U.S. portfolio investors to invest overseas and defer gains abroad. More broadly, it would cut against the global trend of lowering taxes on capital income. The preference for capital gains has proven remarkably resilient to reform efforts, disappearing briefly after the 1986 tax reform only to re-emerge a few years later. For these reasons, a move to a consumption tax or dual-income tax might be both more effective and more politically feasible.

2. Reforming the Estate Tax

Before turning to alternative tax systems, a brief detour into the estate tax is warranted. The estate tax is often thought of as a backstop to the income tax, imposing a tax on the previously untaxed appreciation of assets bequeathed to heirs. Founders' stock, however, often slips right through the thicket of the estate tax with barely a scratch. Heirs who receive founders' stock take a stepped-up basis in the stock, eliminating any income tax on appreciation.[104] The founders' stock itself is part of the taxable estate, but planning techniques often reduce the value of the stock by half or more. Illiquidity and minority discounts can lower valuations substantially, particularly when coupled with advanced estate planning techniques. [*describe GRATs]*

A properly designed inheritance tax could address, at least in part, the distributive justice concerns associated with heirs achieving higher levels of status and consumption as a result of inherited entrepreneurial wealth. It would not address the consumption of low-taxed income by the entrepreneurs themselves. *[discuss why inheritance tax is better than estate tax]*

In light of these challenges, reforming the estate tax is something to be pursued for its own sake. Such reforms might have some beneficial effect on the non-taxation of Founders' stock, but would not, in my view, go far enough in addressing the undertaxation of founders. If the estate tax debate can be properly framed around the idea of imposing a tax on previously untaxed wealth rather than taxing income twice, it

[104] One possible change would be to retain the current design of the estate tax, but to eliminate the step-up in basis at death. A carryover basis approach would continue the deferral of income, but would at least tax heirs when they sell the stock.

seems to me that the political viability of an inheritance tax would be increased.

3. Adopting a Consumption Tax System

Conventional wisdom holds that an income tax is more progressive than a consumption tax. But tax scholars have long understood that consumption taxes can be progressive as well. One of the more challenging tasks is figuring out whether, in practice, a consumption tax would be more or less progressive than the status quo. While numerous scholars have compared an ideal income tax with an ideal consumption tax, relatively few have compared the non-ideal income tax with the non-ideal consumption tax we would likely have if it were adopted.[105]

A consumption tax system would help solve the distributive justice problem of founders paying a lower tax rate on consumed income. It would not address deferral. But from a distributive justice standpoint, some argue that it is consumed income, not earned income, which should constitute the tax base.[106] If Mark Zuckerberg is taxed at a low rate because he lives like a college student, that is less troubling from a distributive justice standpoint than if he is taxed at a low rate and lives like a king. Unequal consumption of resources is arguably more important, and more easily measured, than unequal wealth.

To achieve these goals, Congress would have to adopt a postpaid consumption (expenditure) tax rather than a prepaid (wage) system. In a postpaid system, like a VAT, the tax is imposed (or the economic burden felt) at the time of consumption. In a prepaid system, wages are taxed, but savings are exempt. The problem with a prepaid system is that founders' stock might be treated as savings rather than wages. *[discussion from blueprints – Bradford.]*

A consumption tax would also have the beneficial effect of eliminating the lock-in effect, whether on founders' stock or other assets with built-in gain. *[more]*

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[105] For some thoughtful discussions, see Weisbach, Bankman, Shaviro, McCaffery, others.

[106] McCaffery.

[brief summary of other pros and cons of consumption tax; founders' stock is obviously only one piece of the puzzle]

4. Adopting a Dual Income Tax System

A dual income tax system has two tax rate schedules, one for the capital income base and one for the labor income base. Capital income is taxed at a low, flat rate. Labor income is taxed at a higher (and increasingly progressive) rate. While this system sounds similar to the current U.S. system, a dual income tax has design elements that would arguably better achieve both efficiency and distributive goals than the current system.[107] In a dual income tax system the capital income base is very broad, which allows for lower tax rates and reduces the deadweight loss associated with tax planning. The Nordic countries of Denmark, Finland, Sweden and Norway have all adopted characteristics of the dual income tax system.

Edward Kleinbard has highlighted how a dual income tax puts the task of distinguishing between labor and capital income front and center.[108] The Nordic approach is to impute a statutory rate of return on business assets, with that amount capping the portion of income treated as capital income; any excess is deemed labor income. While applying a statutory rate of return is somewhat arbitrary and imperfect method of distinguishing between capital and labor income, it is also workable and likely no less accurate than the current U.S. system. As I have argued here and elsewhere, the current U.S. system gets this distinction wrong in a variety of contexts, including founders' stock, carried interest, publicly-traded partnerships, and the sale of an investment services partnership.

Importantly, applying an arbitrary but generous statutory rate would rarely treat the returns of portfolio investors as labor income. Because portfolio investors (by definition) hold a portfolio of business assets, diversification strategies tend to smooth out returns. A statutory rate of 10% per year, for example, would treat the vast majority of portfolio gains as capital income, while tainting an exceedingly small number of portfolio investors with labor income. Successful founders, however, would see most of their return treated as labor income.

[107] Kleinbard.
[108] Kleinbard.

This statutory rate approach would also capture investors who achieve abnormal returns, like successful private equity and venture capital investors, as receiving substantial amounts of labor income. The benefit of this approach is that it is no longer necessary to distinguish between founders and their investors; the drawback, if it is one, is that entrepreneurial rents would be taxed at a higher rate no matter who receives them; it does not target only founders. In my view, this only increases the attractiveness of a dual income tax system; abnormal returns are usually the effort of unique labor inputs and thus are appropriately taxed as labor income.[109]

[more]

The normative attractiveness of a dual income tax needs further study and debate, and the tax treatment of founders is only one element of what would be a significant change in U.S. tax policy. Given the administrative challenges of changing the status quo treatment of founders' stock within our current income tax system, however, a dual income tax, like a consumption tax, is a promising avenue to pursue.

VI. Conclusion

This Article has argued that the favorable tax treatment of founders' stock unjustly contributes to the increasing inequality in the United States, and that the efficiency case for subsidizing founders is weak. Addressing the problem within our existing income tax system would be administratively difficult, however. The goal of this Article is to draw attention to the tax treatment of founders' stock and to ensure that policymakers consider the issue as part of future fundamental tax reform efforts. In my view, the most promising solutions are a shift to a postpaid consumption tax (expenditure tax) or a dual income tax. While adoption of a consumption tax or dual income tax would obviously be driven primarily by broader concerns of efficiency and distributive justice, consideration of the tax treatment of founders will provide a useful focal point for the debate.

[109] Swensen.