Tax Court Characterizes Technology Executive's Merger Proceeds as Ordinary Income

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On October 30th, the U.S. Tax Court ruled that a key executive of a technology company acquired by Google for $93 million was required to report a large portion of his merger consideration as ordinary compensation income. Perhaps even more than the substantive tax principle it stands for, the case is a reminder that self-help is not the preferred way of addressing disagreements between taxpayers and employers regarding tax reporting positions. The salient facts of the case, *Brinkley v. Commissioner*,[1] as well as its key takeaways, are summarized below.

Brian Brinkley ("Brinkley") was a co-founder of Zave Networks, Inc. ("Zave"). After serving in an independent contractor capacity for Zave for a number of years, Brinkley became a salaried employee in 2010. A portion of his compensation was in the form of restricted stock grants. His initial stake in Zave amounted to 9.8% of the company. Brinkley made elections under Section 83(b) of the Code with respect to all stock grants that were not vested.

As is common with early-stage companies, subsequent infusions of capital by outside investors served to dilute Brinkley's ownership stake in Zave. Brinkley threatened to leave the company if his interest fell below 3%, and Zave issued to him additional stock grants to facilitate his 3% interest. However, by the fall of 2011, Brinkley's Zave stake had fallen below 1%.

Also in 2011, Google, Inc. ("Google") began negotiations to acquire 100% of Zave. Brinkley was not involved in the negotiations, but Google did require as part of the negotiation that Brinkley turn over all his intellectual property and become a Google employee in the event of an acquisition. In connection with the Google negotiations, Zave management explained to Brinkley that his equity interest was worth approximately $800,000. Brinkley "disagreed" with this assertion, in light of his expectation to share in at least 3% of the deal proceeds (i.e., a minimum of $2.79 million). Acceding to Brinkley's request, Zave then drafted a letter agreement that required Zave to pay Brinkley, upon consummation of the transaction, an amount equal to 3.3% of the $93 million deal consideration less any amounts paid directly to Brinkley for his stock. The letter agreement used the term "compensation" to describe this obligation.

Brinkley did not accept the initial offer. Moreover, he was told by his tax advisors that the proposed arrangement would likely result in ordinary income. Following further negotiations, Zave and Brinkley came to an agreement whereby Zave would pay Brinkley "as consideration $3,100,000 of the $93,000,000 purchase price offered by Google in exchange for "(i) all of * * * [petitioner's] shares, warrants and options of * * * [Zave stock] and (ii) * * * [petitioner's] execution of a Key Employee Offer Letter and Proprietary Information and Inventions Assignment Agreement with Google as required in the Merger Agreement." The agreement further provided that any payments were subject to all applicable tax withholdings. Brinkley eventually reviewed drafts of the merger agreement but did not consult the schedules and did not consult with his tax advisors. He signed a shareholders' consent agreeing to Zave's entering into the merger agreement. The schedules to that agreement in fact identified Brinkley as a deferred compensation recipient.

Following the transaction, Zave prepared spreadsheets indicating that Brinkley's stock was worth $787,671 and that he was to receive $1,879,779 in deferred compensation. As a result of the tax withholdings, Brinkley became aware of the way in which his former employer was treating the proceeds. He then had his [under-informed] tax advisors send a letter to Zave demanding a correction of the tax reporting position. Zave did not

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respond to the demand, so Brinkley engaged in self-help by reporting a long-term capital gain of $2,476,455 and reporting the withheld taxes as "estimated tax payments" on his 2011 federal tax return. He also included with the return a copy of his letter agreement with Zale as well as an explanation of the "mischaracterization" effected by Zave.

The court clarified that in attempting to characterize the entirety of his consideration as long-term capital gains, Brinkley "chose to ignore a lot of relevant information," most notably, the actual value of his stock and the intended treatment of the balance of his consideration by the two parties to the merger. Brinkley argued that his letter agreement with Zave amounted to a higher share price (relative to other Zave shares) being paid for his stock in the Google transaction. In the words of the court, "His expressed desire for a 3% share of the company does not establish that his stock was equal in value to, or sold for, $3,027,515." According to the court, the terms of the letter agreement made clear that the bulk of the consideration paid to Brinkley was in respect of his signing a new employment agreement and the assignment of intellectual property to Google. Specifically, the letter agreement between Brinkley and Zave "strongly suggests that petitioner's signing of the employment and assignment agreement was an imperative condition to receive the merger-based income."

Brinkley was assessed a 20% accuracy-related penalty under Section 6662 as a result of his "substantial understatement of income tax." Furthermore, he was unsuccessful in arguing that the understatement was a result of "reasonable cause and good faith."[3] The court's ruling on this point was based on the fact that Brinkley "chose to keep from his advisers essential facts, such as the amount of stock he owned and the stock's determined value in comparison to the amount he was receiving." Finally, and perhaps most importantly, the court asserted that misrepresenting information on federal tax forms does not show a good faith effort to properly compute a tax liability.

The *Brinkley* case underscores the hazards of trying to use a tax return to "undo" (in the words of the court) what a taxpayer feels is a mistaken tax reporting position taken by another party. This obfuscation, when detected, is not well received and may undermine a taxpayer's litigating position. In Brinkley's case, these measures included fabricating the estimated taxes paid for 2011. Another key takeaway from the case is that where a founder receives consideration that is in respect of past or future services, the amounts will be taxed as ordinary compensation income. Moreover, in the absence of compelling facts, a court will not simply disregard stock valuations and ownership percentages and treat certain executives as having received a higher per-share value for their equity. In these circumstances, additional consideration is likely to be treated as disguised compensation.

Endnotes

[1] T.C., No. 7367-13, T.C. Memo. 2014-227, 10/30/14.
[3] This is a defense to the accuracy-related penalty of Section 6662. See Section 6664(c).

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