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Taxing Founders' Stock

Victor Fleischer

ABSTRACT

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.

This Article argues that the preferential tax treatment of founders' stock is not normatively justified. The economic efficiency case for a tax preference for founders' stock is weak: Tax has a limited effect on entrepreneurial entry. Geographic, cultural, and business factors are far more important, as are nontax legal factors like bankruptcy, employment law, immigration policy, and securities law. Tax is a blunt policy instrument, and given the problems associated with direct government subsidies, the optimal level of government subsidy of entrepreneurship may be zero.

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.

AUTHOR

Victor Fleischer is Associate Professor of Law at the University of Colorado Law School and Visiting Professor of Law at NYU School of Law (Fall 2010).

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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 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]

1. The long-term capital gains rate is currently 15 percent. *See* I.R.C. § 1(h)(1)(C) (2006). Founders' stock sometimes qualifies for the special rate that applies to qualified small business stock (QSBS) under section 1202, which historically has allowed for exclusion of a percentage of gains measured from the ordinary income tax baseline, not taking deferral or inflation into account. The exclusion is available to both investors and founders. *See id.* § 1202(a)(1). Recent legislation temporarily excludes up to $10 million of gains from qualified small business stock. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 760, 124 Stat. 3323 (extending temporary 100 percent exclusion under I.R.C. § 1202 to January 1, 2012). For simplicity, I assume in this Article that the QSBS rules will remain in place but reference the long-term capital gains rate in the discussion. For analytic clarity, it is helpful to assume that any policy change would exempt the first $1 million (or $10 million) of gains from tax; the more controversial question is whether additional gains should be taxed and, if so, at what rate.
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* I.R.C. §§ 61, 83. Employees who receive incentive stock options, or ISOs, are taxed at capital gains rates in limited circumstances. *Id.* § 422(b).
4. The deferral of labor income and its conversion from ordinary 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 N.Y.U. L. REV. 1 (2008) (critiquing the 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.

This tax break for founders results from a valuation wedge created when a start-up receives outside financing. By capitalizing the company with two classes of stock, common and preferred, founders take the low-value common stock in exchange for their performance of future services and report only a nominal amount of ordinary income. In many cases, this planning strategy relies on a timing gambit available as an unintended consequence of a 1969 amendment to the U.S. tax code. The amendment, codified as section 83,[5] curbed the abusive deferral of income from restricted stock awards to corporate executives.[6] Under 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,[7] section 83 normally makes it impossible to both defer service income and convert that service income into capital gain. But section 83 also contains an election—the section 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.[8]

5. *See* I.R.C. § 83.
6. *See* S. REP. NO. 91-552, at 2151 (1969) ("The present tax 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 arrangements."); *see also id.* at 2152 ("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.").
7. 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 that 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 that 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 is subject to tax at ordinary rates like other forms of compensation. I.R.C. § 83.
8. The section 83(b) election was intended to provide flexibility, allowing employees to treat the stock award as compensation in the year it was received. *See* S. REP. NO. 91-552, at 2154 ("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. *See id.* 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. *See id.*

The section 83(b) election allows founders to take advantage of the valuation wedge created when investors buy stock to finance the company's operations.[9] If advised by competent counsel, founders routinely make the section 83(b) election, accelerating the ordinary-income portion of the tax hit to the point in time when 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.[10] By making the election, the founders transform their compensation for future services into capital gain on the appreciation of the stock. 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.[11] By contrast, an actual stock option would give rise to ordinary income.[12]

Founders' stock—not high executive salaries and bonuses—accounts for a significant part of the growing inequality of wealth in the United States.[13] 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 permanently exempt the first $10 million of gains from founders' stock and would tax additional gains at a 15 percent rate, as under current law.[14] Many academics agree with this approach. In a recent *Harvard Law Review* article, Ron Gilson and David Schizer argued that the favorable tax treatment of

9. The valuation wedge is created by issuing convertible preferred stock to the investors while the founders retain common stock. *See infra* Part I.A.
10. For the history of the garage where Bill Hewlett and Dave Packard started their company, see HP GARAGE, http://www.hp.com/hpinfo/abouthp/histnfacts/garage/brief.pdf (last visited Aug. 20, 2011).
11. Common stock of a firm with a large amount of debt or senior equity performs economically like a call option. Fisher Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 649 (1973).
12. Nonqualified stock options give rise to ordinary income when exercised. *See* I.R.C. § 83. ISOs can achieve tax results similar to founders' stock, subject to limitations. *See id.* § 422.
13. *See infra* Part I.B.
14. *See* OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2012 BUDGET OF THE U.S. GOVERNMENT 161, *available at* http://www.whitehouse.gov/files/documents/budget_2012.pdf ("[T]he Administration proposes to permanently extend the Act's provision eliminating all capital gains taxes on investments in small business stock in order to enhance the flow of capital to small businesses."); *Fact Sheet: White House Launches "Startup America" Initiative*, WHITEHOUSE.GOV, http://www.whitehouse.gov/startup-america-fact-sheet (last visited July 18, 2011).

founders' stock is a well-designed subsidy for entrepreneurship.[15] Their article was primarily descriptive, not normative: They argued that the founders' stock subsidy explains the use of convertible preferred stock by venture capitalists (VCs). Given this analytic focus, they chose not to consider whether the tax break for founders was normatively justified in the first place.[16] Instead, they argued that—assuming that a government subsidy of founders is justified—the indirect tax subsidy is likely more efficient than direct government grants, as VCs, rather than government bureaucrats, choose the targets of the subsidy. This Article takes a step back analytically and answers the question that Gilson and Schizer set aside: Should founders be taxed at a low rate?

While this Article focuses on the possible efficiency justification for taxing founders at a low rate, principles of distributive justice explain why we should care about the issue. 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[17] 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 2010 list, for example, includes no athletes, doctors, fund managers, investment bankers, lawyers, or movie stars—only founders and their heirs.[18]

The recurring fights about raising marginal ordinary income tax rates on the rich have little relevance for this privileged group of founders and heirs, as

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

16. *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.").

17. The Forbes 400 is a popular business magazine's annual list of the richest Americans. While hardly a perfect data set, it is often used in academic research as a useful proxy for the very top of the wealth scale. *See, e.g.*, Wojciech Kopczuk & Emmanuel Saez, *Top Wealth Shares in the United States, 1916–2000: Evidence From Estate Tax Returns*, 57 NAT'L TAX J. 445, 482 (2004).

18. The top ten 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 2010*, FORBES.COM, *available at* http://www.forbes.com/wealth/forbes-400/list (last visited Sept. 16, 2011).

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 could 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.

It is clear that founders are taxed differently than most other providers of human capital. This Article thus focuses on whether founders should be taxed differently than ordinary employees and executives. Founders and VCs argue that entrepreneurial wealth is different from all other forms of wealth.[19] Concerns about distributive justice and equality should be set aside, they argue, in light of the new jobs created by entrepreneurship. Successful new companies do not merely make founders rich; these new firms ignite the dynamic capitalism that enriches all of us.[20] This narrative appeals to our collective aspiration to a society marked by ambition, class mobility, creativity, imagination, and resourcefulness. The problem is that the story does not logically lead to the conclusion that founders should pay tax at a lower rate than other employees.[21]

In places like Austin, Boulder, Seattle, and Silicon Valley, it is 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.[22] The evidence instead suggests that tax policy has only a small marginal effect on entrepreneurial entry.[23]

19. For a similar argument, see David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 743–44 & n.70 (2008) ("[T]he more entrepreneurial the activity, the more likely the treatment will be capital . . . . [S]elf-created assets, including, significantly, patents under § 1235, get capital gains treatment. An inventor who puts in many hours of labor gets capital gains treatment when the invention is sold. A proprietor who raises capital to start a business and uses his expertise and labor to build the business receives capital gains when he sells the business. Similarly, founders of companies get capital gains treatment when they sell their shares, even if the gains are attributable to labor income. For example, most, if not all, of Bill Gates's fortune comes from his performing services for Microsoft, but the overwhelming majority of his earnings from Microsoft will be taxed as capital gains.").

20. *See generally* WILLIAM J. BAUMOL ET AL., GOOD CAPITALISM, BAD CAPITALISM, AND THE ECONOMICS OF GROWTH AND PROSPERITY (2007).

21. I am not making a claim about whether entrepreneurship should or should not be subsidized. If the government wants to subsidize entrepreneurship, however, tax policy does not appear to be the optimal instrument.

22. *See, e.g.*, James M. Poterba, *Capital Gains Tax Policy Toward Entrepreneurship*, 42 NAT'L TAX J. 375, 379 (1989) (finding "very little support" for the claim that entrepreneurial activity declined following the steep rise in the capital gains tax rate in 1986). For further discussion of the empirical evidence, see *infra* Part III.A.

23. *See infra* Part III.A.

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 kind of entrepreneurs who create growth businesses with positive externalities.[24] Tax policy did not lead Larry Ellison, Bill Gates, Steve Jobs, or Mark Zuckerberg to start companies. Economic theory and empirical studies show that tax policy is less important than geographic,[25] cultural, and environmental[26] factors. Moreover, tax policy is less important than other elements of the legal infrastructure, such as bankruptcy law,[27] Employee Retirement Income Security Act (ERISA),[28] employment law,[29] immigration law,[30] intellectual property law,[31] and securities law.[32]

The best normative justification for the status quo is what conservatives might call a tax version of the precautionary principle: In the absence of academic consensus or conclusive data proving that eliminating a tax subsidy would not harm the valuable activity in question, the burden of proof is on those who would eliminate the subsidy. This rationale for a lower tax rate is at odds, however, with the usual tax policy baseline that the most efficient tax

24. *See infra* Part III.A.
25. *See generally* ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1994).
26. *See* BAUMOL ET AL., *supra* note 20.
27. *See, e.g.*, Kenneth Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start*, 23 J.L. ECON. & ORG. 161, 179 (2006) ("In particular, social gains can be made from bankruptcy law that offers entrepreneurs an opportunity for a fresh start—a second chance to succeed that would otherwise be encumbered by debt obligations carried over from its previous failure.").
28. *See, e.g.*, Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. ECON. PERSP. 145, 148 (2001) (noting the importance of the Department of Labor's 1979 clarification of the "prudent man" rule to allow pension fund managers to invest in high-risk assets as part of a diversified portfolio).
29. *See, e.g.*, Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575, 578 (1999) ("I suggest here an alternative explanation for the two districts' differing efficiency at transferring knowledge between firms: differences in the districts' legal infrastructures, particularly the rules governing the enforceability of postemployment covenants not to compete.").
30. *See, e.g.*, ANNALEE SAXENIAN, THE NEW ARGONAUTS: REGIONAL ADVANTAGE IN A GLOBAL ECONOMY (2006) (describing foreign-born entrepreneurs who travel back and forth between Silicon Valley and their home countries).
31. *See, e.g.*, Brett M. Frischmann & Mark A. Lemley, *Spillovers*, 107 COLUM. L. REV. 257, 258 (2007) ("Spillovers do not always interfere with incentives to invest; in some cases, spillovers actually drive further innovation.").
32. *See, e.g.*, Ehud Kamar, Pinar Karaca-Mandic & Eric Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, 25 J.L. ECON. & ORG. 107 (2008) (using evidence of going-private decisions to show that the Sarbanes-Oxley Act of 2002 puts small firms at a disadvantage).

system is one with a broad base and lower rates. Still, if one takes the view that entrepreneurship is fragile, valuable, and more easily fractured by taxation than other desirable economic activities, a tax version of the precautionary principle is a plausible normative justification.

While I conclude that it would be normatively desirable to eliminate the tax subsidy and instead tax gains from founders' stock as labor income, I concede that 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),[33]
(2) treating all realized gains by nonpassive investors as labor income (the open-transaction approach),[34]
(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),[35] or
(4) imputing ordinary income to founders based on value of capital provided by investors, treating the investment capital as an imputed loan to the founders (the cost-of-capital approach).[36]

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 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,[37]
(6) reforming the estate tax,[38]
(7) adopting a consumption tax,[39] or

33. *See infra* Part IV.A.1.
34. *See infra* Part IV.A.2.
35. *See infra* Part IV.A.3.
36. *See infra* Part IV.A.4.
37. *See infra* Part IV.B.1.
38. *See infra* Part IV.B.2.

(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.[40]

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 two principal contributions to the academic literature. First, I challenge the accepted wisdom that taxing founders at a low rate is normatively justified on efficiency grounds.[41] Second, I establish that the tax treatment of founders' stock encapsulates a critical design flaw of our tax system.[42] An income tax system with a capital gains preference is unable to cleanly separate returns to human capital from returns to financial capital.[43] This structural design flaw creates dizzying administrative complexity and traps for the unwary, and it undermines the very goals of vertical equity and distributive justice that a

39. *See infra* Part IV.B.3.
40. *See infra* Part IV.B.4.
41. The tax treatment of founders' stock is not a well-designed subsidy for entrepreneurship. If the normative case for the tax break is weaker than Gilson and Schizer suggest, and if policymakers still wish to subsidize entrepreneurship, they may wish to do so by other methods. 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 National Institutes of Health, National Science Foundation, National Aeronautics and Space Administration, and National Oceanic and Atmospheric Administration. Given the challenges associated with having the government pick winners and losers, it is sounder government policy to focus subsidies on the technology and human capital inputs to entrepreneurship rather than the commercialization of technology.
42. 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. Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010). Entrepreneurs tend to be a more sympathetic group than other taxpayers I have written about, like private equity fund managers, publicly traded private equity firms, corporate executives, or sovereign wealth funds. *See* Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008) [hereinafter Fleischer, *Taxing Blackstone*] (publicly traded private equity firms); Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. 440 (2009) (sovereign wealth funds); Fleischer, *supra* note 4 (fund managers); David I. Walker & Victor Fleischer, *Book/Tax Conformity and Equity Compensation*, 62 TAX L. REV. 399 (2009) (corporate executives).
43. The difficulty of separating labor income from capital income has been explored in the consumption tax literature as one reason to favor a postpaid consumption tax rather than a wage tax. *See* David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599, 608 (2000) (discussing the challenge of policing the border between wages and capital as an important difference between yield-exempt and cash-flow consumption taxes).

progressive income tax purportedly addresses. This Article thus identifies an important new reason to consider fundamental tax reform.[44]

The remainder of this Article is organized as follows. Following this Introduction, Part I describes the tax treatment of founders' stock under current law and the scope of the subsidy. I motivate the Article by discussing how the founders' stock subsidy poses a challenge to both progressive and proportional tax ideals. Part II 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 tax subsidy or tax expenditure. Part II also clarifies the relevance of losses and substitute taxation. Part III 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 IV turns to possible solutions and questions of regulatory design.

I. THE TAX TREATMENT OF FOUNDERS' STOCK

A. Typical Use of Founders' Stock

Suppose two entrepreneurs, Mark and Eduardo,[45] form a new start-up, NewCo. Mark and Eduardo locate outside equity investors—venture

44. Founders' stock is a prism that changes how one views the classic tax policy debates about the capital gains preference, progressivity, the desirability of a consumption tax, and estate tax reform. 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. The tax treatment of founders may not convince loyal income tax supporters to favor a consumption tax. But the failure of the income tax to achieve progressivity here suggests the need for more fundamental rethinking. For those who are already skeptical of the equity and efficiency of the income tax, the tax treatment of founders taps one more nail into the coffin.

45. THE SOCIAL NETWORK (Columbia Pictures 2010). *The Social Network* describes the founding events of Facebook. While "NewCo," in my example, is only loosely modeled on Facebook, I use the characters "Mark" and "Eduardo" to illustrate that even among founders, there are varying levels of financial, intellectual, and labor contributions to the firm. In the movie, "Mark" contributes mostly intellectual capital and labor; "Eduardo" contributes mostly financial capital. This variation illustrates how difficult it is to distinguish not just among founders, but also between founders and VCs, who also contribute labor in addition to financial capital. *See infra* text accompanying note 165.

capitalists (VCs)—to finance the new venture.[46] 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 know-how, and an implicit promise of future services to the company. They also contribute what might be called intellectual capital—the idea for the new business and related intellectual property.

The VCs contribute $5 million to NewCo in exchange for stock. The VCs' primary contribution is money, but they also provide nonmonetary contributions: They take seats on the board of directors, obtain various control rights and negative covenants to ensure themselves a seat at the table, and in doing so 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 a limited liability company (LLC).[47] 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.[48] The equity investment of both the founders and the VCs therefore takes the form of stock rather than partnership interests.

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 nontax 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

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46. 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 M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. 1169, 1176–80 (describing venture lenders).

47. Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1738 (1994) (observing that most start-ups are organized as corporations); Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137, 137 (2004) ("A typical start-up is organized as a corporation under state law, which means that it is treated as a separate entity from its owners for tax purposes. If a start-up instead were organized as a partnership or limited liability company (LLC), it could elect pass-through treatment for tax purposes.").

48. Fleischer, *supra* note 47, at 139 ("Partnerships are, on paper, more tax-efficient than corporations. But various 'frictions'—nontax business costs such as transaction costs, information problems, reputational concerns, and adverse accounting treatment—currently prevent deal planners from using the theoretically tax-favorable form.").

the strategic-behavior risk that results from letting the founders build a company with someone else's money.[49] 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 start-up 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 stock and participate in residual profits if things go well.[50]

The use of convertible preferred stock also facilitates tax planning. Specifically, using a separate class of stock allows the founders to create a valuation wedge and to report a low (or nil) valuation on their common stock.[51] 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 one 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 perform.[52] If, as is typical, the stock is restricted and vests over a four-year period, the valuation of the founders' common shares would be lower at the outset, and 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.

49. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons From the American Experience*, 55 STAN. L. REV. 1067, 1081–83 (2003) ("The special character of venture capital contracting is shaped by the fact that investing in early stage, high technology companies presents these problems [of uncertainty, information asymmetry, and agency costs] in extreme form.").
50. Sometimes early-stage investors use convertible debt, which performs economically much like convertible preferred stock.
51. *See* Gilson & Schizer, *supra* note 15, at 898.
52. Section 83(a) requires the service provider to recognize the value of property received without regard to restrictions on transferability.

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 section 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 section 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 section 83(b) election and artificially accelerate the recognition of income to the very beginning of the company—a point in time when the Internal Revenue Service (IRS) is in no position to challenge the low valuation of the founders' common stock. In our example, Mark contributes $25,000 worth of software code and Eduardo contributes $25,000 cash. Each makes the section 83(b) election and 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. From that point forward, the founders are treated like other investors in the company, with gains and losses treated as capital, not ordinary.[53]

53. If the section 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) (1978).

In the founders' stock scenario, the section 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* DO MORE FASTER 269 (David Cohen & Brad Feld eds., 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 appre-ciate in value but recognize no income until there is a sale or other disposition of the stock.

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 or out-of-the-money call option on one-third of the assets of the firm.[54] Unlike an actual stock option, however, which would generate ordinary income to the service providers once exercised,[55] the founders convert the character of the income into capital gain by taking common stock with nominal liquidation value and then making the section 83(b) election.[56] 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.[57] 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.[58]

54. 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. 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 one-third each claim on the $3 million of assets remaining in the firm. The payout to each founder is equivalent to buying one-third of the assets of the firm ($2.66 million) for the strike price of $1.66 million, netting $1 million.
55. I.R.C. § 83(e)(3) (2006); Treas. Reg. § 1.83-7 (describing treatment of nonqualified options). The amount of ordinary income would be the value of the stock less any amount paid (that is, the strike price of the option).
56. The irony is that section 83 was intended to reduce tax-motivated structuring of executive compensation. *See supra* note 6. The section 83(b) election, which permits founders to elect to 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. I.R.C. § 83(b). With seasoned companies, the fact that the 83(b) election accelerates the recognition of ordinary income acts as a check against gamesmanship.
57. 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 be publicly traded or otherwise have a readily ascertainable fair market value. 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.
58. *See* 1 JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS AND REORGANIZATIONS 82 (2d ed. 1995). It is 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) (as amended in 2005) 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

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

But sometimes start-ups succeed. And when they do succeed, it is often in a winner-take-all fashion.[59] Massive gains can accrue when a founder, through some combination of luck, skill, and nerve, exploits the right opportunity at the right time. 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 is 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 would 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

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grant of an option does not constitute a transfer of property, and in certain circumstances under which the stock grant "may be in substance the same as the grant of an option," section 83 will not apply. Treas. Reg. § 1.83-3(a)(2) (as amended in 2005); *id.* § 1.83-3(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."); *id.* § 1.83-3(a)(6) (risk of loss); *id.* § 1.83-3(a)(7) ex. (5) (equating a stock grant to an at-the-money call option recharacterized as an option). 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. The IRS's practice of not challenging this structure, however, is consistent with its administrative practice in other similar situations, and the IRS practice of nonenforcement presumably gives sufficient comfort to practitioners who advise founders to report a zero value on the stock. 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 id.* § 1.83-3(a)(6).

59. *See* ROBERT FRANK, THE WINNER-TAKE-ALL SOCIETY: WHY THE FEW AT THE TOP GET SO MUCH MORE THAN THE REST OF US (1995).

exemption would be consistent with current law.[60] The focus of this Article, from both an economic and distributive justice standpoint, is how we tax extraordinary gains.

1. 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.[61] 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, that receives preferential tax treatment.

The low taxation of gains from founders' stock contributes to the broader trend of increasing inequality, particularly at the very top of the scale. Research by Piketty and Saez shows that the new rich are mostly entrepreneurs, asset managers, and CEOs, not individual investors.[62] According to Kopczuk and Saez, "among the top fractiles of the wealth distribution, only the very top (perhaps a group limited to just the hundred richest individuals in the country) has experienced sizeable gains since the mid-1980s."[63] Other groups of high wealth holders, by contrast, "actually did not experience much gains relative to the average wealth holder in the U.S. population."[64] A recent paper by Kaplan and Rauh estimates that the usual suspects—executives of financial and nonfinancial public companies, athletes, lawyers, and asset managers (venture capital, private equity, and hedge fund managers)—account for just 15 to 26.5 percent

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60. *See supra* note 1.
61. David Kamin, Note, *What Is a Progressive Tax Change? Unmasking Hidden Values in Distributional Debates*, 83 N.Y.U. L. REV. 241 (2008) (analyzing different measures of progressivity).
62. Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913–1998*, 118 Q. J. ECON. 1 (2003); Emmanuel Saez, *Striking It Richer: The Evolution of Top Incomes in the United States*, July 17, 2010, at 4, http://www.econ.berkeley.edu/~saez/saez-UStopincomes-2008.pdf ("The evidence suggests that top income earners today are not 'rentiers' deriving their incomes from past wealth but rather are 'working rich,' highly paid employees or new entrepreneurs who have not yet accumulated fortunes comparable to those accumulated during the Gilded Age. Such a pattern might not last for very long. The possible repeal of the federal tax on large estates in coming years would certainly accelerate the path toward the reconstitution of the great wealth concentration that existed in the U.S. economy before the Great Depression.").
63. Kopczuk & Saez, *supra* note 17, at 482.
64. *Id.*

of the individuals in the top 0.1 percent of income.[65] While they have no data on who comprises the rest, they speculate (consistent with the Kopczuk and Saez data) that they include founders and "independently wealthy" individuals—a group that would include heirs who receive founders' stock.[66] Inequality is therefore a problem that cannot be addressed solely by raising marginal ordinary income tax rates.[67] If the effective tax rate of the top 0.1 percent of the population is close to 15 percent, we ought to examine more closely both what this means for distributive justice and the most plausible justifications for the status quo.

2. Proportional Tax Ideals

Not everyone shares a commitment to progressivity.[68] 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.[69] Because the low taxation of founders' stock allows founders and their heirs to pay income tax at 15 percent 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.[70]

65. Steven N. Kaplan & Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes*, 23 REV. FIN. STUD. 1004, 1006 (2010).

66. *Id.* at 1006–07 ("We suspect that some of the missing individuals are trial lawyers, successful entrepreneurs, owners and executives of privately held companies, highly paid doctors, and independently wealthy individuals who have a high AGI [adjusted gross income].").

67. 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.

68. 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.

69. The optimal income tax literature produces a result where marginal tax rates fall at the very top of the income scale, but average tax rates rise through most of the income scale if one counts the demogrant as a negative tax. There is little reason to think that the behavioral assumptions of the optimal tax literature, which focuses on the labor–leisure tradeoff and the value of marginal additional labor inputs that might be deterred by tax, apply readily to the tax treatment of founders' stock, where the tax on capital income is low and flat, and where the labor effort takes place long before the income may or may not be realized.

70. 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 that a flat rate of 35 percent 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 percent tax at the grocery store, drugstore, or car dealership? Should the heir of a founder stand in a special Paris Hilton VIP line and pay no sales tax at all? Because a

3. Distributive Justice

The most plausible distributive justice case is a utilitarian argument grounded in the efficiency gains 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.[71] 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 is possible that those positive externalities associated with entrepreneurship make everyone better off. Even accounting for the social costs associated with increasing inequality, it is 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 want to know that a lower tax rate increases entrepreneurial entry, and it would be helpful to show that tax has positive first-order effects that 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

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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 other 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 role of the capital gains preference generally. Under the status quo, people are aware 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 under which 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.

71. Sarah B. Lawsky, *On the Edge: Declining Marginal Utility and Tax Policy*, 95 MINN. L. REV. 904, 915 (2011) ("[T]ax legal scholarship that incorporates a welfarist approach overwhelmingly assumes that individuals experience declining marginal utility of income.").

equal outcomes.[72] 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.[73] 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. And founders themselves routinely acknowledge that luck plays a role in their success.[74]

From a 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. 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.[75] 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

72. Anne L. Alstott, *Equal Opportunity and Inheritance Taxation*, 121 HARV. L. REV. 469, 477 (2007) ("The second core principle, termed the choice-chance principle, is an outgrowth of neutrality, and it holds that distributions of society's resources among individuals ought to reflect individual choices (after the initial distribution) but not 'pure' bad luck."); Miranda Perry Fleischer, *Equality of Opportunity and the Charitable Tax Subsidies*, 91 B.U. L. REV. 601, 636–62 (2011) (applying resource equality to charitable deduction); Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 564 (2010) [hereinafter Fleischer, *Theorizing the Charitable Tax Subsidies*] (explaining resource equality).

73. Alstott, *supra* note 72, at 477.

74. *See, e.g.*, Vivek Wadhwa et al., *The Anatomy of an Entrepreneur: Making of a Successful Entrepreneur*, KAUFFMAN FOUND. 10 (Nov. 2009), *available at* http://www.kauffman.org/uploadedFiles/making-of-a-successful-entrepreneur.pdf (reporting that 73 percent rate "good fortune" as extremely important, very important, or important; whereas only 9 percent rate as not at all important).

75. *See* Ola Bengtsson & David H. Hsu, *How Do Venture Capital Partners Match With Startup Founders?* 14 (Univ. of Pa. Wharton School Dep't of Mgmt., Working Paper No. 7, 2010), *available at* http://www-management.wharton.upenn.edu/hsu/inc/doc/papers/david-hsu-vc-matching.pdf (describing empirical findings on the importance of ethnicity and top university affiliation on VC and entrepreneur matching).

structured, consistently promote distributive justice in a meaningful way.[76] 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 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 an athlete, a doctor, a lawyer, or a venture capitalist 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 IV.

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 persuasive, Part III evaluates whether tax is an efficient policy instrument for delivering that government subsidy. Before turning to that question, however, Part II clarifies the nature of the tax subsidy.

II. DEFINING THE SUBSIDY

This Part briefly 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.[77] Some aspects of deferral of economic income from the appreciation of founders' stock are normatively justified by theoretical objections to taxing unrealized human capital.[78] 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.[79] I briefly discuss the tax treatment of losses, which I show to be a red herring absent an investment of after-tax cash.[80] I then clarify

76. Fleischer, *Theorizing the Charitable Tax Subsidies*, *supra* note 72.
77. *See infra* Part II.A.
78. *See infra* Part II.A.
79. *See infra* Part II.B.
80. *See infra* Part II.C.

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—that is, if the revenue lost on account of the subsidy is made up through higher taxes elsewhere in the structure, which in this case would be in the form of potentially smaller compensation deductions by the start-up.[81]

A. Deferral

Founders defer tax on their labor income, but the problem differs from the usual problems posed by deferral of executive compensation.[82] 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) underestimating 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.

1. Deferral of Forgone Earnings

Consider, first, the failure of the income tax to reach forgone earnings. In an ideal income tax,[83] 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.[84] 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.[85] In this way entrepreneurs are favored over wage earners who make an after-tax

81. *See infra* Part II.D.
82. The tax treatment of deferred compensation has been recently addressed by section 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.
83. I use "ideal" in the 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 tradeoffs.
84. William A. Klein, *Timing in Personal Taxation*, 6 J. LEGAL STUD. 461, 463–64 (1977).
85. *Id.* The Haig–Simons definition of income is derived from the names of two early scholars of the income tax. *See* ROBERT M. HAIG, THE FEDERAL INCOME TAX (1921); HENRY C. SIMONS, PERSONAL INCOME TAXATION (1938).

investment in the same business; this violates the premise of an ideal income tax system that treats income equally regardless of the source.

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 of forgone earnings, perhaps by imposing an interest surcharge on the tax when it is collected.[86] 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 William 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 that taxed the deferral of forgone earnings—if we somehow overcame the practical difficulties—would start to resemble an endowment tax by treating innate human capital as subject to tax.[87] Failing to tax innate human capital would favor those blessed with talent over those who must acquire it (through education or hard work) with after-tax dollars. Few scholars find the idea of taxing endowment attractive.[88]

86. 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.

87. *See* Klein, *supra* note 84. Louis Kaplow makes a similar point. *See* Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 VA. L. REV. 1477 (1994).

88. *See, e.g.*, David Hasen, *Liberalism and Ability Taxation*, 85 TEX. L. REV. 1057 (2007).

The first problem is valuation. It is difficult to measure endowment except as manifested through arms-length labor market transactions, which are absent if 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.[89]

The paradox is avoided if we choose consumption rather than income as our baseline.[90] 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 is not available for consumption.[91] 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 suggest that allowing entrepreneurs to defer the income from forgone market earnings is a plausible second-best solution.

The deferral of forgone 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.[92] It derives from the fact that entrepreneurs make a pre-tax labor investment in their own business.

2. 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.

89. Whether this objection is, in fact, worse than the burden of the income tax on employment decisions is a matter of debate. *See* Kirk J. Stark, *Enslaving the Beachcomber: Some Thoughts on the Liberty Objections to Endowment Taxation*, 18 CAN. J.L. & JURISPRUDENCE 47 (2005).
90. *See* Kaplow, *supra* note 87, at 1501–02.
91. 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.
92. *See* Fleischer, *supra* note 4.

Founders' stock is subject to a wide range of potential valuations. In our example, using a standard Black–Scholes calculator, assuming a current price for NewCo at $5 per share, a strike price of $5 per share, a risk-free interest rate of 1 percent, a time until expiration of four years, and a volatility of 50 percent, each founder receives common stock worth nearly $2 million each.[93] The fact that the shares would be worth less in the hands of another (because the shares incentivize the founders to work) and would be subject to a minority and illiquidity discount would appropriately bring the valuation down. But it is equally clear that a common share of NewCo would fetch more than a penny from an arms-length buyer. Many practitioners, however, would advise Mark and Eduardo to take the tax position that the stock was worth $50,000, or the value of the cash and property that they actually contributed to the company. The founders thus each benefit from the deferral of perhaps $1 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 tax authorities have recognized the impracticability of ex ante valuation: (1) the receipt of a stock option with no readily ascertainable fair market value,[94] and (2) the receipt of a partnership profits interest.[95] In each of these cases, the deferral benefit is simply accepted as a structural flaw of the tax system.[96]

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 section 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;[97] 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

93. Black–Scholes would not be an ideal valuation method for an illiquid option in a closely held firm.
94. *See* I.R.C. § 83(e)(3) (2006).
95. *See* Rev. Proc. 2001-43, 2001-34 I.R.B. 191; Rev. Proc. 93-27, 1993-24 I.R.B. 63.
96. *But see* David M. Schizer, *Realization as Subsidy*, 73 N.Y.U. L. REV. 1549, 1551–52 (1998) (evaluating effectiveness of the realization doctrine as a subsidy rather than a necessary evil).
97. *See* Fleischer, *supra* note 4.

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.

3. 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 after the receipt of the stock and recognition of income 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.[98] But practical considerations make it difficult to think about moving to a mark-to-model system for privately held property.[99]

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 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 founders' 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 founders' stock at a low rate represents a

98. Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 503 (2004).
99. Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355 (2004).

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 variations in tax rates should be based on progressivity, not source.[100] 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.[101]

With respect to founders' stock, the departure from Haig–Simons is threefold: (1) converting the (deferred) forgone market earnings from ordinary income into capital gain, (2) underestimating the value of the initial grant, which understates service income and overstates investment income, and (3) taxing gains from founders' stock as capital gain.

1. 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 proceeds 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

100. Lawrence Zelenak, *The Sometimes Taxation of the Returns to Risk-Bearing Under a Progressive Income Tax*, 59 SMU L. REV. 879, 904 (2006) (noting the inclusion of progressive tax rates in most ideal income tax models).

101. *See* STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2010–2014, at 41 (Comm. Print 2010) (estimating 2010 tax expenditure from capital gains and dividend preference at $77.7 billion and exclusion of capital gains at death at $25.4 billion).

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.[102]

2. 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, so the valuation gamesmanship represents a departure from an ideal income tax baseline.

3. 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. 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 under current law. In our example, assuming we had no capital gains preference, Mark and Eduardo could be taxed at a 35 percent 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 did not 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 section 83(b) election, Mark and Eduardo recognized income of $1 million

102. Of course, one might normatively justify a lower tax rate on the forgone market earnings in terms of subsidizing an activity with positive externalities. *See infra* Part III.

each under section 83(a) when their stock vested. Each would take a basis in the stock and take a capital loss of $1 million if things did not 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. The loss-limitation rules are relaxed for sales of stock in certain small business corporations, allowing many founders to offset up to $100,000 of ordinary income in the year the stock is sold.[103] In some cases, the asymmetry might tilt 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 up front 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 forgone wages whether things work out or not.[104] The founders' argument here is like that of a jockey complaining that while his share of the purse would be taxed, the government does not 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.

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.[105] Assuming that the employer and the employee have the same tax rate, there is no loss to the U.S. 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.[106] In the context of the tax

103. *See* I.R.C. § 1244 (2006).
104. Another useful way to frame the problem is to think of the tax on founders' stock as a tax on extraordinary returns 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.
105. I.R.C. § 83(h).
106. *See, e.g.*, Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money*,*"* 95 YALE L.J. 506, 519–24 (1986); Michael S. Knoll, *The Section 83(b) Election for Restricted Stock: A Joint*

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.[107]

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.[108] 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. In tax planning for a start-up, then, it is unsurprising that the concerns of the founders dominate the employer's concerns. While the understatement of the employer's deduction may, in 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[109]—start-ups become profitable fairly quickly and could benefit from larger compensation deductions. The Treasury loses money when Google co-founder 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 U.S. tax rate in 2009 was 22 percent, although its marginal U.S. rate

Tax Perspective, 59 SMU L. REV. 721 (2006); David I. Walker, *Is Equity Compensation Tax-Advantaged?*, 84 B.U. L. REV. 695 (2004); Chris William-Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers With Profit Shares: What Is It? Why Is It Bad?*, 75 U. CHI. L. REV. 1071 (2008); Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571 (2007).

107. Walker & Fleischer, *supra* note 42.

108. *See Executive Compensation and the Founder Discount*, NOAM WASSERMAN'S "FOUNDER FRUSTRATIONS" BLOG (Sept. 14, 2005), http://founderresearch.blogspot.com/2005/09/executive-compensation-and-founder.html (showing that founders of IT companies make about $30,000 less annual cash compensation than similarly situated nonfounders, but that average cash compensation for founders ranges from $160,000 for small companies to $190,000 for larger start-ups).

109. I am indebted to Ethan Yale for this observation.

was surely higher.[110]) The joint tax perspective provides some reassurance that the public fisc is partially protected in some cases, but it hardly makes the problem disappear.

While the joint tax perspective provides some solace that the founders' stock subsidy is smaller than it first appears, it does not assuage 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 determines where the economic burden of the tax falls.[111] 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, shifting the economic burden of the employer's lost tax deduction back to the executive. While the economic theory is clear, the implicit tax assumption fails in environments with high transaction costs—specifically, where information costs related to the value of tax assets are high and where agency costs related to deal structuring are substantial.[112]

To illustrate, consider the use of tax receivable agreements used in connection with some initial public offerings (IPOs). When a company goes public, restructuring may create a new tax asset in the hands of the public company, such as goodwill that can be amortized over fifteen years. The amortization creates a tax benefit to the public company and can be used to shelter operating income going forward. Selling founders often enter into an

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

111. Kyle D. Logue & Joel Slemrod, *Of Coase, Calabresi, and Optimal Tax Liability*, 63 TAX L. REV. 797, 798–99 (2010) ("Although this theorem is rarely stated formally, the informal version goes something like this: The incidence of a tax imposed on the sale or purchase of a good or service will be independent of the assignment of the legal obligation to remit the tax to the government.").

112. *Cf. id.*

agreement with the public company to shift the economic benefit of the reduction in taxes from the company back to the founders.[113]

These tax receivable agreements exist because public investors are perceived as being bad at pricing tax assets. When investors price a stock, they do 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.[114]

This tax receivable agreement example suggests that when founders take their compensation in the form of founders' stock, thereby depriving the company of a tax deduction it would have otherwise received for compensation paid and decreasing the size of the company's NOLs, the founders likely do not pay an implicit tax in the form of a reduced price at IPO. 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 in which 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' rate.

III. 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 promotion of social policy goals. If an activity generates positive externalities, for example, a lower tax rate on that activity could make everyone better off.

113. Jeffrey J. Rosen & Peter A. Furci, *Monetizing the Shield: Tax Receivable Agreements in Private Equity Deals*, 11 DEBEVOISE & PLIMPTON PRIVATE EQUITY REP., Fall 2010, at 9.

114. 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.

A. Entrepreneurial Entry

The economic literature supports the view that entrepreneurship creates positive externalities. In *Good Capitalism, Bad Capitalism*, Baumol, Litan, and Schramm make a persuasive case that entrepreneurship is a key component to a dynamic, growth-friendly economy.[115] 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.[116] 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.[117] 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.[118]

The need to subsidize entrepreneurship and encourage entrepreneurial entry is often cited as a reason for taxing capital gains at a lower rate.[119] 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 one skeptical that tax is of first-order importance; 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

115. BAUMOL ET AL., *supra* note 20, at 85–92.
116. *Id.*
117. *Id.* at 60–85.
118. SCOTT A. SHANE, ACADEMIC ENTREPRENEURSHIP: UNIVERSITY SPINOFFS AND WEALTH CREATION 21–22 (2004); Bruce A. Kirchhoff & Bruce D. Phillips, *The Effect of Firm Formation and Growth on Job Creation in the United States*, 3 J. BUS. VENTURING 261, 268 (1988).
119. William M. Gentry & R. Glenn Hubbard, *Tax Policy and Entrepreneurial Entry*, 90 AER PAPERS & PROCEEDINGS 283 (2000).

conducted anyway.[120] 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 percent.[121]

1. 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 is 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.[122] 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, Gentry and Hubbard provide a theoretical model and empirical support for the proposition that increasing the progressivity of the income tax discourages entrepreneurial entry.[123] 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. Moreover, as they concede, "whether such encouragement [of entrepreneurial entry] is efficient (that is, stimulating the most talented entrepreneurs)" is not yet known.[124]

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120. *Cf.* Max Chafkin, *In Norway, Start-Ups Say Ja to Socialism*, INC., Jan. 20, 2011, http://www.inc.com/magazine/20110201/in-norway-start-ups-say-ja-to-socialism.html.

121. A higher tax rate does not 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.

122. SCOTT A. SHANE, ILLUSIONS OF ENTREPRENEURSHIP (1988).

123. Gentry & Hubbard, *supra* note 119.

124. *Id.* at 283.

2. A Blunt Device

Second, as economist James Poterba has emphasized, cutting the capital gains rate is a relatively blunt device for subsidizing entrepreneurship.[125] 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.[126] 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.[127] 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.[128]

3. Knowledge of Institutional Detail and Tax Law

Third, the tax code is complicated, and economists may not always fully grasp how it applies in practice. The problem is even more acute in the field of entrepreneurship in which knowledge of the practices of venture capital contracting is 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.[129] But the model and empirical data in that article 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 "start-up firms almost invariably are noncorporate,"[130] and they use, as their measure of entrepreneurial firms,

125. Poterba, *supra* note 22.
126. *Id.*
127. *Id.* at 379.
128. *Id.*
129. Julie Berry Cullen & Roger H. Gordon, *Taxes and Entrepreneurial Risk-Taking: Theory and Evidence for the U.S.*, 91 J. PUB. ECON. 1479 (2007).
130. *Id.* at 1487.

firms with noncorporate business losses.[131] But the devil is in the institutional detail. The study tells us nothing about venture-capital-backed start-ups, which are almost always organized as corporations, not partnerships or LLCs.[132] Their measure of entrepreneurial firms 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 by questions that are often muddied by the institutional detail of venture capital contracting against the backdrop of a complicated tax code.

4. 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.[133] 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 does not exist yet, spends a lot of time thinking about whether their tax rate will be 20 percent or 40 percent when they sell their stock five or ten or twenty years down the road in the unlikely event they achieve a home run return.[134]

5. 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.[135] Geographic

131. *Id.* ("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.").
132. *See* Bankman, *supra* note 47; Fleischer, *supra* note 47.
133. *See* Poterba, *supra* note 22.
134. If one assumes that the first $1 million, or $10 million, of capital gains is exempt, it becomes even less likely that the entrepreneur makes this calculation.
135. *See* SAXENIAN, *supra* note 25; Gilson, *supra* note 29, at 577.

concentration of entrepreneurship is often industry specific, as with biotechnology start-ups in San Diego or natural-foods and social-networking start-ups in Boulder.

Cultural factors are also 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.[136] 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 of Outlook than the underlying technological advance.[137]

6. 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.[138] Bankruptcy law is important to entrepreneurship; the ability to get a fresh start if things do not turn out well may give founders the confidence to borrow money on their credit card to get the company going.[139]

136. William M. Chace, *The Decline of the English Department*, AM. SCHOLAR, Autumn 2009, http://www.theamericanscholar.org/the-decline-of-the-english-department.

137. AMAR BHIDE, THE VENTURESOME ECONOMY (2008); *see also* EDWARD GLAESER, TRIUMPH OF THE CITY: HOW OUR GREATEST INVENTION MAKES US RICHER, SMARTER, GREENER, HEALTHIER AND HAPPIER (2011); Edward L. Glaeser, *Entrepreneurship and the City* (Harvard Inst. of Econ. Research Discussion Paper No. 2140, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1001108.

138. *See* Harold Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. PAPERS & PROC. 347, 348 (1967); F. Scott Kieff, *Property Rights and Property Rules for Commercializing Inventions*, 85 MINN. L. REV. 697, 717 (2001); Edmund W. Kitch, *The Nature and Function of the Patent System*, 20 J.L. & ECON. 265, 276 (1977); Mark A. Lemley, *Property, Intellectual Property, and Free Riding*, 83 TEX. L. REV. 1031, 1033–46 (2005) (discussing the rise of intellectual property rights discussion in real property terms).

139. *See* John Armour & Douglas Cumming, *Bankruptcy Law and Entrepreneurship*, 10 AM. L. & ECON. REV. 303, 337 (2008) ("Controlling for a range of other legal, economic and social

Employment law may be important; Ron Gilson has attributed Silicon Valley's success in part to the nonenforceability of noncompete clauses in California—thereby allowing the transfer of tacit knowledge from one firm to another.[140] Finally, securities law is often cited as a hindrance to entrepreneurship.[141]

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 U.S. 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.[142] 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 do not 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 apply the tax precautionary principle[143] and err on the side of lower taxes. There might also be some merit in an approach that exempts the first $1 million (or $10 million) of gains from tax.

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.[144] The usual arguments that politicians make—that capital gains are not really income and that the capital gains preference mitigates the

factors that may affect national levels of entrepreneurship, we show that bankruptcy law has a pronounced effect on levels of entrepreneurship."); Ayotte, *supra* note 27.

140. *See* Gilson, *supra* note 29.

141. *See* Robert P. Bartlett III, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-Private Decisions*, 76 U. CHI. L. REV. 7, 33–38 (2009) (examining the impact of the Sarbanes-Oxley Act on small-cap and medium-cap companies); Kamar et al., *supra* note 32; Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. ON REG. 229, 274–75 (2009) (discussing complaints from small businesses).

142. *See* Gompers & Lerner, *supra* note 28.

143. *See supra* text accompanying notes 28–33.

144. *See* Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993).

double taxation of corporate earnings, incentivizes risk taking, or avoids taxing inflationary gains—do not hold up well to analysis.[145]

The lock-in effect may be less problematic in the context of founders' stock than in the context of portfolio investors. 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.[146] This urgent need for diversification allows the optimal tax rate to reduce lock-in to be higher for founders than for portfolio investors.

A recent article by economist Bill Gentry raises the possibility that, for many entrepreneurs, the tax advantage of deferral outweighs the nontax advantage of diversification.[147] Using household-level data, Gentry finds strikingly high levels of unrealized gains on entrepreneurial assets.[148] Gentry's dataset includes partnership and LLC interests in addition to founders' stock, but the data shows that entrepreneurs of all stripes tend to hold on to equity in their company for a long time.[149] 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 management prior to or in conjunction with an IPO or acquisition of the company. After an IPO, however, founders may retain large blocks of stock and interfere with managerial decisions in unhelpful ways.

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.[150] Most successful exits of venture-backed companies are acquisitions.[151] In many of these acquisitions, founders receive shares

145. *See id.*
146. *See* Sanjai Bhagat & Brian Bolton, *Bank Executive Compensation and Capital Requirements Reform* (working paper) (on file with the author).
147. *See* William Gentry, *Capital Gains Taxation and Entrepreneurship* (working paper) (on file with the author).
148. *See id.*
149. *See id.*
150. Gentry does not draw any conclusions with respect to founders' stock as such.
151. *See* Mark Heesen, *2010 Exit Mark Sets Stage for 2011*, NVCACCESS, Jan. 3, 2011, http://nvcaccess.nvca.org/index.php/topics/research-and-trends/165-2010-exit-mark-sets-stage-for-2011.html (noting 72 IPOs, only 45 from U.S.-based companies, compared to 420 acquisitions).

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 specifically to help offset the realization of built-in gains.

Moreover, the ready availability of monetization techniques suggests that tax may not be what is causing the deadweight loss when founders hold on to stock even though it would often be economically efficient for them to sell.[152] Founders can (and often do) enter into a variable prepaid forward (VPF) 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 up front in exchange for a variable number of shares in the future, the number of which depends on the valuation of the shares at

152. 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 Cisco, Google, Intel, Microsoft, or Yahoo, thereby further deferring their unrealized gains, possibly forever. If the start-up 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 is 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 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.

that later point in the future. Founders can monetize a large portion of their interest without immediately realizing gains for tax purposes.[153]

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.[154]

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.[155]

IV. 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 uncertain and vary considerably depending on which reform is adopted. The crux of the problem is separating human capital from financial capital. The most straightforward conceptual solution is to make the distinction irrelevant by adopting a postpaid consumption tax or a dual income tax. 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.

153. David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001) (discussing weak frictions associated with the constructive sale rule).
154. Leo L. Schmolka, *FLPs and GRATs: What to Do?*, 86 TAX NOTES 1473 (2000).
155. BAUMOL ET AL., *supra* note 20, at 270–72.

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 section 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 any 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. 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 nontax 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 endowment. But recall that the section 83(b) election is optional; taxpayers who object to being taxed on their future services could use the default rule, section 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 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.[156]

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 noncash capital contribution 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

156. Section 409A, by contrast, imposes significant compliance costs even on taxpayers who are not trying to be aggressive. I.R.C. § 409A (2006).

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.[157] 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 old-and-cold strategy. This strategy turns on avoiding section 83 altogether. Founders could form a corporation a few weeks or months in advance of the funding event, receiving shares in the company as part of a section 351 transaction. The founders then retain those old-and-cold shares in the corporation rather than receiving new ones in exchange for services. 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. Indeed, under current law, founders who start a company well in advance of getting outside financing need not make a section 83(b) election unless their shares are newly issued or subject to new vesting requirements. This old-and-cold 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 in which property is difficult to value, the tax code often takes a wait-and-see approach.[158] 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

157. 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, *supra* note 58, at 82.

158. *See, e.g.*, I.R.C. § 83(e)(3) (treating stock options as an open transaction).

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 nonpassive investor. (In congressional testimony, legendary tax lawyer Jack Levin memorably referred to this sort of approach as probing the investors' armpits to see if they're sweaty.[159]) 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.[160]

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, in which 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 could make it more difficult for pension funds

159. *See* Testimony of Jack S. Levin to the House Ways & Means Comm., Sept. 6, 2007, at 3, *available at* http://www.kirkland.com/files/Levin_Testimony_090607.pdf ("Or if an innovative entrepreneur like Bill Gates and his investor group start a company, is (or should) the entrepreneur's long-term capital gain on sale of the computer company's stock be converted into ordinary income because he had many sweaty armpit days? My point is that the Code does not make, and never has made, the absence or presence of activity and ingenuity—or even a bit of bodily dampness—the test for long-term capital gain, nor should we now legislatively adopt a test requiring IRS agents to poke around in Warren Buffett's or Bill Gates' dirty laundry searching for perspirational evidence.").

160. *See* I.R.C. § 83(e)(3).

to invest in venture capital funds, depriving the asset class of an important source of capital.[161]

If the amount of activity were set so high—say, more than five hundred 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 are brought in simply to help the founder get a lower tax rate.[162]

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 percent, 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 that engages in a material amount of investment services activity (defined broadly) as the holder of an investment services partnership interest (ISPI).[163] There was a tremendous amount of lobbying activity, not surprisingly, over the definition of an ISPI, and the contours of

161. Pension funds subject to ERISA often rely on a venture capital operating company (VCOC) exemption. The VCOC rules require an intermediary (like a VC fund) that accepts pension plan assets and seeks to qualify for the VCOC exemption to have 50 percent of its assets invested in venture capital investments and to have management rights in at least one or more of the portfolio companies in which it invests. *See* 29 C.F.R. § 2510.3-101(d) (1996).

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

163. *See* Carol Kulish Harvey, James B. Sowell & Deborah Fields, *I Spy an ISPI: Expansive Breadth of Carried Interest Proposals*, 128 TAX NOTES 526 (2010).

the definition remained vague.[164] 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.[165]

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.[166] While taxing entrepreneurial rents at a higher rate than normal returns may be good policy, the importance of this change in policy raises it to the level of a structural change to the tax code, which I discuss further below in Part IV.B.4.

4. The Cost-of-Capital Approach

An accrual-based approach is another option.[167] 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. Because entrepreneurs are financing their operations with other people's money, they could conceivably be taxed as if they had actually borrowed the money themselves, interest-free.

In our example, we would treat Mark and Eduardo as each receiving a zero-interest, nonrecourse loan of $2.5 million, which they then turned around and invested in the firm. The forgone interest on this imputed loan—for example, $2.5 million times a 5 percent interest rate, or $125,000 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.)

164. *See id.* at 528 & n.19. Furthermore, the definition of qualified capital becomes complicated when stockholders reinvest previously taxed capital in the firm without taking a distribution, which makes capital accounts harder to administer.
165. I am indebted to Noel Cunningham for pointing this out.
166. Entrepreneurial rents are economic rents derived from the creation of a new product or service not readily available elsewhere (or a new firm that creates a new product or service). Whether taxing entrepreneurial rents at a high rate is preferable depends on the extent to which we think of them as monopoly rents or returns to innovation.
167. *See* Fleischer, *supra* note 4 (discussing the cost-of-capital approach).

The principal objections to this approach are again related to scope and administrability. The example of Mark and Eduardo involves one round of financing. 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 $125,000 per year in ordinary income, but in those few unusual cases in which founders make tens of millions or more on the sale of founders' stock, the effective tax rate on their return to human capital would still be quite low.[168] From a distributive justice standpoint, it is precisely these unusual cases that ought to concern us the most.

B. Structural Reform Options

This Subpart outlines four approaches that are not constrained by our current tax structure of an income tax system with a capital gains preference. The approaches do 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 Subpart, in other words, imagines the real world but adds in the plausible assumption that new forces—perhaps taxpayer revolt or a desperate need for revenue to fund social entitlement programs—spur 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.[169] Portfolio investors have losses that partially offset gains and can often

168. 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.
169. *See, e.g.*, Zelenak, *supra* note 100.

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 III, 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.[170]

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

170. *See supra* text accompanying notes 152–153.

bequeathed to heirs.[171] Founders' stock, however, can slip 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. Absent planning techniques, the founders' stock itself would be counted as part of the estate, as measured by fair market value at the time of death. Planning techniques, however, can reduce the value of the stock by half or more, especially if the stock is placed in a family limited partnership or GRAT prior to an IPO, acquisition, or other valuation event.[172]

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.[173] It would not address the consumption of low-taxed income by the entrepreneurs themselves. 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 undertaxation of gains from founders' stock.

3. Adopting a Consumption Tax System

A consumption tax system would help solve the distributive justice problem of founders paying a lower tax rate on consumed income.[174] 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

171. *See* Miranda Perry Fleischer, *Charitable Contributions in an Ideal Estate Tax*, 60 TAX L. REV. 263, 318–19 (2007) ("[B]ecause of the realization requirement, many estates subject to the estate tax contain assets with considerable appreciation that has not been subject to the income tax during the decedent's life. Because heirs receive bequest property with a stepped-up basis under § 1014, the appreciation is never taxed under the income tax system. When valuing a decedent's estate, however, fair market values generally govern. This ensures that any unrealized appreciation in assets in a decedent's taxable estate is taxed at death.").

172. *See, e.g.,* Schmolka, *supra* note 154, at 1476 ("The GRAT produced a wealth transfer 78½ times that of an outright gift, over two years.").

173. Lily L. Batchelder, *What Should Society Expect From Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1 (2009).

174. *See* Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1437 (2006) ("Consider the individual who has substantial labor income that is incorrectly labeled as capital income . . . . A wage tax will not pick up this income. An ex post consumption tax, however, will tax this income to the extent it is really attributable to his labor. A consumption tax ignores the labels put on earnings because the tax is not imposed directly on earnings. Instead, the tax is imposed when the earnings are spent, and the source of the earnings is irrelevant. Therefore, to the extent that [the individual's] stock value reflects his labor income, it is taxed under a properly structured consumption tax.").

base.[175] If 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 value added tax, 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.[176]

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. In our current system, we rely on founders' urgent need to diversify to balance out the lock-in effect, and founders facing large unrealized gains engage in wasteful tax planning to avoid realization. A consumption tax would eliminate the need for monetization strategies, as founders could simply sell their stock and reinvest the proceeds in other assets.

The tax treatment of founders is obviously just one piece of the puzzle for policymakers considering adopting a consumption tax. While many think of a consumption tax as intrinsically more regressive than an income tax, taxing consumption may impose more of an economic burden on the very highest end of the income scale than an income tax does. This observation holds true if, as seems likely, a consumption tax is imposed in addition to, rather than in place of, an income tax.

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

175. *See* Edward J. McCaffery & James R. Hines, Jr., *The Last Best Hope for Progressivity in Tax*, 83 S. CAL. L. REV. 1031, 1039 (2010) ("A spending tax alone among feasible alternatives can collect significant tax revenue from the propertied, capitalist classes in a way that does not necessarily undercut their incentives to become propertied in the first place.").

176. *See* Weisbach, *supra* note 43, at 608.

efficiency and distributive goals than the current system.[177] In a dual income tax system the capital income base is very broad, allowing for lower tax rates and reducing the deadweight loss associated with tax planning. The Nordic countries of Denmark, Finland, Norway, and Sweden have all adopted characteristics of the dual income tax system.[178]

Edward Kleinbard has highlighted how a dual income tax puts the task of distinguishing between labor and capital income front and center.[179] 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.[180] While applying a statutory rate of return is a 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.[181]

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 percent 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.

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

177. Richard M. Bird & Eric M. Zolt, *Dual Income Taxation and Developing Countries*, 1 COLUM. J. TAX L. 174 (2010); Edward D. Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 NW. J. L. & SOC. POL'Y 41, 45–47 (2010) (describing possible equity and efficiency advantages of dual income tax).

178. *See generally* Annette Alstadsæter, *The Achilles Heel of the Dual Income Tax: The Norwegian Case*, 20 Finnish Econ. Papers 5 (2007); Sven-Olov Daunfeldt et al., *Do High Taxes Lock-in Capital Gains? Evidence From a Dual Income Tax System*, 145 PUB. CHOICE 25 (2010); Peter Birch Sorensen, *From the Global Income Tax to the Dual Income Tax: Recent Tax Reforms in the Nordic Countries*, 1 INT'L TAX & PUB. FIN. 57 (1994); Peter Birch Sorensen, *The Nordic Dual Income Tax: Principles, Practices, and Relevance for Canada*, 55 CAN. TAX J. 557, 562 (2007).

179. *See* Kleinbard, *supra* note 177.

180. *See* Alstadsæter, *supra* note 178, at 6.

181. *See* Fleischer, *Taxing Blackstone*, *supra* note 42; Fleischer, *supra* note 4.

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.[182]

The 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.

CONCLUSION

This Article argues that the favorable tax treatment of founders' stock contributes unjustly 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 solution is a shift to a postpaid consumption tax or, perhaps, to a dual income tax. While adoption of a consumption tax or a dual income tax would obviously be driven primarily by broader concerns of efficiency and distributive justice, the tax treatment of founders will provide a useful focal point for the debate.

182. *Cf.* DAVID F. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT: AN UNCONVENTIONAL APPROACH TO INSTITUTIONAL INVESTMENT (2000).