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Googling Ordinary vs. Capital Consideration

By Robert W. Wood • Wood LLP

For individuals, the allure of long-term capital gain treatment can be palpable. This is even true in high-tax states such as California, where there is no rate preference for capital gain. California will take its 13.3 percent on all income no matter what, yet that may even increase the need for federal tax savings. At the federal level, gone are the halcyon days of 15 percent. However, even in the current rate pinch, where capital gain can trigger 20-percent tax plus a 3.8-percent investment tax, 23.8 percent is better than 39.6 percent.

Of course, reaping those savings can be difficult, particularly in less traditional sales or situations where one is selling mixed assets and rights. Take the case of Brian Brinkley, who sold his interest in Zave Networks to Google. His arguments were not silly, but they were not compelling either, at least not to the IRS and Tax Court.

Google's Omnipresence

In *B.K. Brinkley* [TC Memo 2014-227], Brinkley was a founder and employee of Zave Networks, Inc. Each time investors infused capital into Zave, Brinkley's interest was diluted. That is common and even expected, but Brinkley bristled at it nevertheless. He even threatened to leave the company if his interest ever fell below three percent.

In yet another cash infusion in 2008, Zave agreed to issue stock grants to facilitate Brinkley's minimum three-percent request. Nonetheless, by fall 2011, Brinkley's equity had fallen to 0.8 percent. In merger negotiations that same year, Google agreed to pay $93 million for Zave, and Brinkley was told he still owned 0.8 percent.

Brinkley disagreed and said he was entitled to receive three percent of the Google cash. Trying to buy peace, Brinkley and Zave signed an agreement that would allow them to grab the brass ring the Google deal represented. The agreement required Zave to pay Brinkley $3 million of the $93 million purchase price in exchange for

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all of Brinkley's Zave stock and his execution of an employment and assignment agreement with Google.

The agreement also said that Brinkley would "not be entitled to the Consideration, except for any amount you would be entitled to receive in exchange for your shares ... in the absence of this Agreement, if you do not comply with the terms of the merger agreement." Brinkley received a copy of the merger agreement, but not the schedules that identified him as a deferred-compensation recipient. Still, he was required to sign a consent to the merger agreement, agreeing to be bound by its terms.

Brinkley also executed an employment and assignment agreement, calling for a Google salary of $250,000 and a $2.5 million bonus for staying with Google for three years. He would receive another bonus for 25 percent of his salary, Google stock and other benefits.

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Brinkley also had to assign his interests in Zave-related intellectual property to Google.

After the merger closed, Brinkley received a paycheck that represented his pay in excess of his 0.8-percent stock ownership. Zave characterized it as deferred compensation from the merger closing. Because of the tax withholding on this amount, Brinkley became aware that Zave was treating this amount as ordinary income.

Ordinary or Capital?

Brinkley's attorney sent Zave a letter outlining his opinion that the transaction was capital in nature, claiming that Zave had mischaracterized it as ordinary. The letter stated that Zave's failure to comply with Brinkley's demand to recast the transaction would result in Brinkley filing suit against Zave for breach of contract. Brinkley never received any response from Zave regarding the demand letter, but he also did not file suit.

Eventually, Zave sent Brinkley a Form W-2 consistent with its ordinary income treatment. Nevertheless, Brinkley filed his federal income tax return showing the full amount he received from the merger as a payment in exchange for his Zave stock. It qualified for long-term capital gain treatment, the return claimed.

The IRS replied that it was ordinary, and Brinkley went to Tax Court. The Tax Court had a relatively easy time in agreeing with the IRS that all of Brinkley's consideration was ordinary, beyond the 0.8 percent of the Zave stock he truly owned. The court noted that the deal between Zave and Google was pretty clear, and yet Brinkley did not make himself aware of all of the deal terms between the two companies.

Mixed Role?

Those agreements revealed that whatever Brinkley *thought* about his role, the documents stated that Brinkley would receive both deferred compensation and capital gain income. Only the latter was from his 0.8 percent of the Zave shares. The former was from his execution of the employment and assignment agreement.

It was true that Brinkley testified that he did not know about these terms, but as a shareholder, he had consented to be bound by them. Brinkley relied on his side contract

with Zave, but the court found it significant that that side deal did expressly incorporate the merger agreement. Brinkley should have acquainted himself with the deal, which made it clear he was getting deferred compensation, not extra value for his shares.

Brinkley argued that he had negotiated a higher share price than other shareholders, and that was why he received the $3 million. It was all consideration for the sale of his Zave stock, he claimed. Yet to the Tax Court, there was no reason why Zave would pay more for Brinkley's stock than its determined value.

The mere fact that Brinkley had repeatedly expressed *desire* for a three-percent share did not mean that he actually owned it or that what he did own was worth $3 million. Besides, said the court, the side agreement Brinkley made with Zave was silent as to a *specific* amount paid for his stock.

Instead, it provided that to receive the merger-based income from Zave, Brinkley had to fulfill two requirements. He had to sell his stock. But he also had to sign the employment and assignment agreement. Brinkley contended that he gave up only one asset of any value, and that was his Zave stock. However, Zave obviously considered his employment and the documents he signed to have considerable value too.

IP Too

The court even found that Brinkley had undermined his own position when he testified that, if he had dissented, the merger would most likely not have gone through. Notably, that would presumably not been because of his stock ownership, but because he had to sign over all his interests in intellectual property and sign on with Google.

Brinkley argued that none of the income in issue was given to him for assigning his interests in Zave-related intellectual property to Google, noting how well compensated he was with wages, bonuses and other benefits upon becoming a Google employee. Still, the court found that his prior or future compensation did not preclude him from having been paid, in part, for his signing of the employment and assignment agreement.

The court thought it was clear that Brinkley *had* to sign the employment and assignment agreement in order to receive the merger-based income. That was the deal. The court even thought that Brinkley had not done enough to fix the situation himself once he knew that he and Zave saw the tax situation quite differently.

After all, why didn't Brinkley attempt to cure Zave's alleged breach? He could have required Zave to reissue a corrected Form W-2, the court noted. He also could have pursued legal recourse against Zave. That threatened lawsuit, even if unsuccessful, might have helped.

Lasting Lessons

The court suggested that Brinkley wanted to have his cake and eat it too. Thus, he seemingly made a decision to accept all the money and his new position at Google without causing a stir about receiving deferred compensation. He then used his income tax return in an attempt to regain his desired preferential tax treatment. But he had previously abandoned that desired tax treatment by not challenging Zave.

To the Tax Court, Brinkley did not do enough to show that he was being paid more for his shares. He also failed to prove that he was paid for anything else that was capital in nature. Not when the underlying documents—whether or not Brinkley had them all—made it clear that he was just being paid compensation.