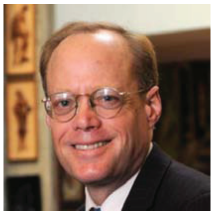
Forbes



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Theranos Founder Elizabeth Holmes May Have Lost $4.5 Billion, But Gets No Tax Deduction

It is hard not to be captivated by the numbers, now that Forbes revised its estimated net worth for Elizabeth Holmes from $4.5 billion down to zero. In 2015, Elizabeth Holmes topped the Forbes list of America's Richest Self-Made Women. Her astonishing $4.5 billion net worth was an *estimate*, though, one that Forbes said was based entirely on her 50% stake in Theranos. Her blood-testing company was a skyrocketing darling, but is now under investigation.

Holmes founded Theranos in 2003, planning to revolutionize the diagnostic test market. Theranos is still a private company, so valuation can be debated. Yet private investors purchased stakes in Theranos in 2014, at prices suggesting a $9 billion valuation. That would have made Holmes' 50% worth $4.5 billion. But that was then. You can read how Forbes reached its $4.5 billion to nothing estimated net worth.

Theranos could still succeed, of course, although it faces allegations that its tests are inaccurate, and is being investigated by federal agencies. Forbes suggests that Theranos' annual revenues may be less than $100 million, and that the VC investors would get money on a sale or liquidation before Holmes. But, even if Forbes' estimates are correct, is it likely that Ms. Holmes can write off her $4.5 billion loss? Not hardly.

First, consider that Holmes was a founder, so has probably paid very little for her shares. That means her tax basis is probably extremely small. Even if her stock turns out to be worthless, the stock would have to be *totally* worthless to deduct it. The fact that a company is in bankruptcy or that its stock is not trading does *not* make it worthless.

A taxpayer must generally prove that the security has *no* liquidating value, and that there is a *complete* lack of future potential value. That may be because of the occurrence of an identifiable event, such as the cessation of business or a sale of substantially all of the assets. Even if Holmes could do that, the worthless stock loss is only for the taxpayer's *basis*.

For example, suppose that Holmes had paid 10 cents a share. Say thereafter the stock soared to $100 a share, before returning to earth, and then tanking. Even if she could establish worthlessness–which she clearly cannot here–her maximum deduction would be 10 cents a share, her basis. Does that mean founders are in a hurry to have a high basis or to pay tax? Certainly not the latter.

In fact, founders and other insiders want to *avoid* paying taxes as long as they can. When the time comes for cashing in on their (hopefully big) gains, they want long term capital gain treatment. That's one reason founders and employees alike must consider taxes when they receive stock, restricted stock, or options.

Suppose your employer says if you remain with the company for 36 months, you will be awarded $50,000 worth of shares. You don't have to "pay" anything for the stock, but it is given to you in connection with performing services. You have no income until you receive the stock. Then, you have $50,000 of wage income, depending on how those shares have done in the meantime.

With restrictions that will lapse with time, the IRS waits to see what happens before taxing it. Yet with restrictions will never lapse, called "non-lapse" restrictions, the IRS values the property subject to those restrictions. The restricted property rules generally adopt a wait-and-see approach if restrictions will eventually lapse. Nevertheless, under an 83(b) election, you can choose to include the value of the property in your income earlier (in effect disregarding the restrictions).

The idea is to try to include it in income at a low value, locking in future capital gain treatment for future appreciation. Say you are offered stock by your employer at $5 per share, when the shares are worth $5, but you must remain with the company for two years to be able to sell them. You *already* have paid fair market value for the shares. That means filing an 83(b) election could report zero income. Yet by filing it, you convert what would be future ordinary income into capital gain. When you sell the shares more than a year later, you'll be glad you filed the election.

Theranos founder Elizabeth Holmes is probably not thinking about taxes. But if her stake goes way up again, you can bet that she will want to defer taxes and pay long term capital gain rates on any dispositions. Some things are universal.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.