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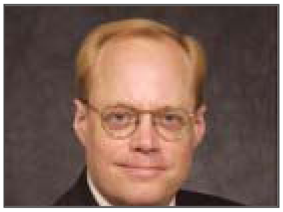

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Twitter IPO Tax Tips Worth Tweeting

The Twitter logo is seen on the floor of the NYSE on Nov. 6, 2013. Twitter launches its IPO on Nov. 7. (Image credit: Getty Images via @daylife)

The Twitter IPO news is exciting. Yet it also is opening an old wound. Many companies–even some that are not paying tax–get big tax write-offs for stock options that actually cost the company very little. Facebook got pilloried over the issue since it received tax benefits far beyond simple economics.

This time in advance of the Twitter opening, Sens. Carl Levin, D-Mich., and John McCain, R-Ariz., made a statement. Stock options like Twitters are a tax loophole, they said. Companies can report stock option compensation expenses one way on their financial statements and another on tax returns. That can mean a whopping tax deduction compared to a small charge on the corporate books.

As the Senators put it, on Twitter going public "the company will be able to take an estimated $154 million tax deduction for a stock option compensation expense which its own books show cost Twitter only $7 million." That's 20 times larger, say the Senators. Of course, it's not just Twitter.

But what about the lucky founders and employees who have Twitter stock or options to acquire it? As in the case of Facebook's Mark Zuckerberg, founders and some others–including Twitter employees–will make out pretty well on the Twitter IPO. And as with Zuckerberg, it naturally invites chatter over how options and restricted stock are taxed.

How is the spread between option price and market price taxed? There are different types of plans, but often immediately upon exercise as compensation income. That means up to 39.6% in federal tax and 13.3% in California tax. Employment taxes too. For Twitter, it is treated as paid in cash so yields correspondingly whopping tax deductions.

According to the AP, most of the founders and early leaders will benefit, and one will likely become a billionaire . Here's how much three key Twitter figures may be worth if Twitter's IPO hits the high end of its price range:

- Evan Williams, co-founder, CEO from 2008 to 2010. His 10.4% stake will be worth $1.4 billion.
- Jack Dorsey, co-founder and chairman, was CEO from 2006 to 2008. His 4.3% stake in the company will be worth about $586 million.
- Dick Costolo, CEO from 2010 to present, joined Twitter in 2009 as CEO. He owns a 1.4% stake, which will be worth about $192 million.

But will any Twitter founders get capital gain treatment for their options? It depends. Capital gain is taxed up to 20%, plus subject to the 3.8% Obamacare tax. Still, 23.8% is much better than 39.6%. If you buy stock in a company, hold and sell your investment more than a year later, you should qualify.

However, if you receive your stock from your employer with restrictions–say you must stay with the company for two years to keep it–special rules apply under Section 83 of the tax code. With restrictions on stock that will expire with time, the IRS waits to see what happens before taxing it. Yet some restrictions will never lapse, so the IRS values the property subject to those restrictions. See Ten Tax Tips For Stock Options.

But if you make an 83(b) election, you can include the value in your income earlier (disregarding the restrictions). It sounds counter-intuitive to ***elect*** to pay tax on something before it is required. Yet the idea is to try to pay tax at a low value, locking in capital gain treatment for future appreciation. See Option and Restricted Stock Basics, Part II.

How do you pull off this tax magic? You file an 83(b) election with the IRS within 30 days of receiving the restricted stock. Your election reports the value of what you received as compensation (which is hopefully small). Then, you attach a copy of the election to your tax return. See Code Sec. 83(b) Elections: The Good, the Bad, and the Ugly.

Some Twitter employees will likely exercise their options and if permitted, sell shares to cover taxes. But retaining some shares should mean they could continue to appreciate…or depreciate. Once shares are held for more than a year they should qualify for long term capital gain treatment on sale… assuming they go up.

Whatever happens to the corporate tax treatment of stock options–and my bet will be no change–holders of options and restricted stock will be watching and planning. There's no substitute for that–regardless of how many characters you use.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.