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Facebook's Multi-Billion Dollar Tax Break

There has been a lot written recently about Facebook's multi-billion dollar tax break from the tax deduction for the cost of executive stock options and share awards. Stock awards such as these are taxed to executives as compensation based on their value at the time of exercise (options) or vesting (shares), and the employer gets a corresponding deduction for the compensation expense, even though no cash was expended. Facebook's phenomenal growth in value from its private company days (when most of these grants were made) makes the resulting deduction very large, particularly compared to its operating income. The publicity regarding this little understood section of the tax code will likely lead to calls for limiting or eliminating these deductions. In our opinion, this is treating the symptom, not the disease.

The fundamental problem is that in the eyes of the IRS, stock grants are treated as compensation by the employer rather than as an investment by the executive. In the example below we contrast tax treatment of a warrant issued by a company as a "sweetener" in a stock offering to a identical situation where a stock option is issued by the same company to an executive. In both instance we assume the option is priced at $10 (strike price), exercised at $20, and with the underlying share sold after one year at $24. For simplicity, we assume corporate tax of 35%, individual tax of 40% and capital gains of 20%.

Comparison of IRS Treatment: Investors vs. Employees

	Employer Treatment		Investor/Executive			IRS
	Compensation Deduction	Tax Impact	Ordinary Income	Capital Gains	Total Taxation	Net Taxation
Investor Model	$0	**$0.00**	$0	$14	**$2.80**	**$2.80**
Employee Model	$10	**($3.50)**	$10	$4	**$4.80**	**$1.30**

The company does not receive a deduction with warrants, and the warrant holder does not recognize any income. Upon exercise of the warrant (share purchase) the capital gains holding period begins. Upon sale of the share after completing the holding period for capital gains, their tax bill would be $2.80 per share (i.e., $14 gain x 20%). In contrast, under the current IRS employee model, the employer realizes a $10 tax deduction for compensation expense (the gain at exercise), the employee recognizes the same amount as ordinary income. Upon a later sale the employee qualifies for capital gains on the additional $4 gain. Thus the Treasury nets only $1.30 per share in revenue in the employee model compared to the investor model, where the IRS realizes $2.80 per share in revenue.

As we noted in an earlier blog entry treating corporate executives as shareholder/ investors for tax purposes would be beneficial to the Treasury by increasing revenue and simplifying taxation. More importantly, it would align tax policy with social and economic objectives of encouraging long-term stock ownership as a deterrent to excessive risk taking and of making corporate and individual taxation more transparent.

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