

Avoiding a Trap for the Unwary: Gains from Secondary Sales Treated as Compensation

Founders and other employees of private companies commonly employ sales of stock in the secondary market as a means of accessing cash prior to an offering or exit. Such sales are typically structured as a direct purchase of stock by a third-party investor or as a stock buyback by the company. Many founders face an unwelcome surprise when a portion of the sale proceeds are treated as compensation for services subject to tax as ordinary income as opposed to capital gains.

The possibility that sale proceeds will be treated as compensation arises whenever the purchase price per share in a secondary transaction exceeds other indications of fair market value of the common stock being sold, such as the company's option price or a recent 409A valuation. The theory is that the company, in allowing the founder to sell common stock for a price greater than its fair market value, is providing a benefit to the founder which is compensatory in nature.

Ultimately, the issue of whether proceeds from a secondary sale are deemed to be compensation depends on a variety of facts and circumstances. The following are a few of the key factors at play:

- **Who are the sellers?** Are the sellers in the secondary transaction limited to current and former employees or a subset of employees (e.g., key employees)? Are nonemployee stockholders also permitted to participate? Does the seller hold the shares outright or in a trust vehicle? If the sellers include nonemployee stockholders, are all participants selling at the same price or permitted to negotiate their own sales price without company involvement?
- **Who is the buyer?** Is the buyer an unrelated third party or is the purchase being made directly or indirectly by the company or a person with a prior economic relationship with the company?
- **Does the purchase price exceed the fair market value of the shares?** Determining the fair market value of a company's common stock is not a straightforward analysis. While a 409A valuation is not determinative, there may be a risk of recharacterization if the share price exceeds the latest 409A value.
- **Can the parties attribute any excess purchase price over other indicators of fair market value to something other than compensation?**
- **Intent of the parties.** In the event of an audit, relevant considerations may include the overall intent of the parties and the purpose of the secondary sale, the terms of the contract, and the respective tax reporting positions of the parties involved, among other factors.

The issue of how to treat proceeds from a secondary sale also affects the company. The amount treated as compensation to the founder is deductible by the company and subject to wage and FICA withholding as well as the employer's share of FICA and unemployment taxes. The company and the founder should be consistent in how they report the proceeds from a secondary sale and should seek to agree in advance on what position to take.

In the case of a stock buyback by a company, the parties should also consider whether amounts paid may be deemed to be a taxable dividend. A company's repurchase of stock may also have an impact on whether its shares are eligible to be treated as Qualified Small Business Stock (QSBS).

The bottom line is that the tax treatment of a secondary sale can be very complicated. If you are a founder who is considering a secondary sale of stock, you should consult in advance with your professional advisors and your company's advisors to determine the likely tax treatment and to explore any planning opportunities.

Patterson Belknap has a multi-disciplinary team of lawyers who are focused on the legal needs of founders and entrepreneurs. A description of the full range of our services and attorney contacts can be found [here](#). Please visit the [Founder Focus Resource Center](#) for more content on broad range of topics of interest to founders and their professional advisors.

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