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Top Tax Tips From Zuckerberg's Facebook Bonanza

The revelation that Facebook's Mark Zuckerberg plans to exercise $5 billion worth of stock options before his IPO suggests his 2012 tax bill could be close to $2 billion! See Zuckerberg's 2012 personal income tax bill: $1.5B. If size matters, that will make Zuckerberg ***The Incredible Hulk of Taxpayers***. After all, the 400 wealthiest filers only averaged $48 million in federal income taxes in 2009.

Image via newsflash.org

As for Warren Buffett with his 17% tax rate? A mere piker, he paid less than $7 million in federal income and payroll taxes in 2010. Surely a $3 billion after-tax take-home is nothing to complain about.

Still, with Zuckerberg about to pay perhaps the ***largest single tax bill ever***, it naturally invites chatter over how options are taxed and Buffett-like questions of ordinary income versus capital gain. Zuckerberg owns many shares outright, and in 2005 received options to buy 120 million shares of Facebook for 6 cents a share. The shares are currently valued at more than $40 a share.

How is the spread between option price and market price taxed? Usually immediately upon exercise as compensation income. For Zuckerberg that means 35%, yielding $1.5 billion in federal tax and $500 million in California tax.

For Facebook, it is treated as paid in cash so yields correspondingly whopping tax deductions. Those deduction have become controversial, something Facebook's example fuels. "Due to the stock option loophole, Facebook may not pay any corporate income taxes on its profits for a generation," said Senator Carl Levin, the Michigan Democrat who proposes changing it.

Could Zuckerberg have gotten capital gain treatment for his options? Maybe in large part. If you receive stock (or other property) from your employer with restrictions (e.g., you must stay for two years to receive or keep it), special restricted property rules apply under Section 83 of the Internal Revenue Code.

With restrictions that will lapse 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 include something on your tax return ***before*** it is required. Yet the game here is to try to include it in income 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 property. Your election reports the value of what you received as compensation (which might be small or even zero). Then, you attach another copy of the election to your tax return. See Code Sec. 83(b) Elections: The Good, the Bad, and the Ugly.

According to filings, Zuckerberg plans to exercise all his options but only sell enough shares to cover taxes. Retaining the rest of the shares should mean they could continue to appreciate and that once held more than a year should qualify for long term capital gain treatment on sale.

For more, see:

Ten Tax Tips For Stock Options

Restricted Stock SNAFUs

Zuckerberg Remains the Undisputed Boss at Facebook

Personal Data's Value? Facebook Is Set to Find Out

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