Woman C.P.A.

Volume 32 | Issue 1 Article 2

1-1970

Stock Options for Small Business

Linda H. Kistler

STOCK OPTIONS FOR SMALL BUSINESS

The author examines stock options as a means of attracting talent to the small business and discusses means of determining fair market value for the stock used as an incentive.

Linda H. Kistler, CPA
Lowell, Massachusetts

Interest in tax-favored stock options continues unabated despite significant restrictions placed on options by the Revenue Act of 1964. The merits of stock option programs have been disputed since options evolved in the 1920s when Congress approved preferential tax treatment of capital gains.

Among the changes in tax law now before Congress is a section on the taxation of stock options. Basically, these substantive alterations would lessen the desirability of corporate stock option programs. However, since the House and Senate have not finalized any new legislation on the subject, it would be premature to comment on possible implications at this time. Further, changes affecting options may be allowed a transition period during which the regulations discussed here will remain effective.

Today's high personal and corporate tax rates stimulate development of comprehensive salary programs to attract and retain valuable personnel. Stock options, profit sharing plans, bonuses, pension plans, and other benefits have become nearly as important as basic monetary compensation.

Large corporations have included options in their salary programs for many years, but small businesses often were unable to satisfy certain requirements for tax-favored plans. The disutility of options for small, closely held companies appeared lessened by the Revenue Act of 1964, which amended many requirements for option plans. Superficially at least, small business appeared to benefit from the revisions.

The basic purpose of this paper is to examine statutory option requirements with a view to evaluating their utility and applicability for two types of small businesses—the well-established, closely held corporations and the new so-called "growth" enterprises which need to attract and motivate capable personnel and also to minimize cash outflow. Further, if options appear impractical, are there other alternatives to statutory options available to small companies?

Requirements for Qualified Options

Most corporations can satisfy many requirements for qualified stock options programs. Among these are the stipulation that a qualified option be issued pursuant to a written plan approved by a majority of stockholders within twelve months before or after its adoption. Options must be granted within ten years from the date the plan is approved or the date the plan is adopted, whichever is earlier. All options must be exercised not later than five years from the date of grant, and they are not transferrable except in case of death of the optionee. An optionee's employment must be continuous from the date of grant to within three months before exercise of the option. The option price of stock purchased must be equal to 100 per cent of fair market value at the date of grant. Stock purchased under options must be held more than three years from the date of acquisition of the stock in order to qualify for capital gains tax treatment on increases in value. A qualified stock option may not be exercised as long as an earlier option at a higher price remains outstanding.

LINDA H. KISTLER, CPA, is Assistant Professor of Economics and Management at Lowell Technological Institute, Lowell, Massachusetts.

While her husband earned two engineering degrees from Massachusetts Institute of Technology, Mrs. Kistler worked as a staff accountant for a Boston CPA firm, passing the CPA examination on her first try. She then returned to school and received her Bachelor of Science and M.S. in Business Administration degrees from Colorado State University.

She is a member of AICPA, AWSCPA, Massachusetts Society of CPAs, American Accounting Association, and American Association of University Professors.

For each of the above requirements, corporate size is not a relevant factor. The basic problem confronting small companies desiring to initiate stock option programs involves determination of a fair market value for the stock. Shares of closely held corporations seldom are traded; therefore, objective values on which to base stock option offers are difficult to ascertain.

Prior to 1964 the requirement that an option price be not less than 85 per cent of fair market value effectively eliminated the development of option programs by small corporations. Few experts could devise a safe, nonchallengeable value; and the penalty for improper valuation of an option was the immediate taxation, at ordinary rates, of all stock acquired. Even utilization of book values and price-earnings relationships were no guarantee that a value acceptable for tax purposes could be calculated.

The Revenue Act of 1964 eliminated the 85 per cent rule in an apparent effort to alleviate the valuation problem for small companies. The law also provided that in certain cases when shares are transferred by the exercise of an option which fails to qualify because there was a failure in an attempt, made in good faith, to set the option price at fair market value, such stock does not automatically require full taxation to the extent of the bargain received upon exercise of the option.

Under current law, if stock is transferred by the exercise of an option which fails to qualify because there was a failure in a good-faith attempt to set the option price at fair market value, then the option nonetheless will be considered to have met the 100 per cent of fair market value rule. However, alternative procedures for taxing shares thus acquired become effective. The optionee must include as compensation in his gross income for the taxable year in which the option is exercised an amount equal to the lesser of (a) 150 per cent of the difference between the option price and the fair market value of the stock at the date of grant of the option or (b) the difference between the option price and the fair market value of the stock at the date of exercise. The basis of stock acquired under these conditions is increased by the amount includible in gross income as compensation in the taxable year the exercise occurred. These provisions are set forth in Section 422 (c) of the Code.

An example may clarify the implications of Section 422 (c). Assume a closely held corporation grants an option entitling an employee to purchase 100 shares of company stock at $85 per share (a good faith estimate of the fair market value). Further, the option is exercised when the fair market value is ascertained to be $200 per share; and it is determined that the actual fair market value at the date of grant was $90 per share, not $85. The optionee must include $750 in his gross income for the year in which the option is exercised. This amount is the lesser of 150 per cent of the difference between option price and fair market value at the date of grant ($90 minus $85 x 150% x 100 shares), or the difference between option price and fair market value at date of exercise ($200 minus $85 x 100 shares). The basis for the stock acquired is $92.50 per share. The gain above $92.50 per share will be taxed at capital gains rates upon disposition of the stock provided that holding period requirements are satisfied.

Although the illustration clarifies to some extent the mechanics of the law, a small company remains confronted with the very real problem of ascertaining a fair market value for its stock utilizing a method that will satisfy the Commissioner of Internal Revenue. Whether there was a good-faith attempt to set the option price at not less than fair market value at the date of grant depends on the facts and circumstances surrounding each case. The option price may be determined by any reasonable valuation method so long as the minimum price under the terms of the option is not less than full fair market value of the stock. The Regulations (Paragraph 1.421-7(e)(2)) state that the valuation methods include those authorized under Estate Tax Regulations (Paragraph 20.2031-2).

The Commissioner will accept, as evidence of a good-faith attempt to establish fair market value for a stock not publicly traded, the average of the fair market values at the date of grant as set forth in the opinions of completely independent and well-qualified experts. It is assumed these experts would utilize a valuation method authorized under the Estate Tax Regulations.

A more complete illustration of the mechanics of the calculation may be useful at this point. Assume an employee is granted an option to purchase one share of his employer's stock for $200. At the time of grant, a panel of indepependent experts estimated this price to be the true fair market value of the stock. Later events, however, showed that a good-faith mistake in valuation had been made, that the correct value of the stock at the date of grant was $220, and that the fair market value at date of exercise was $210. Since the difference between the $200 option price and the $210 fair market value at the date of exercise, or $10, is less than 150 per cent of the $20 difference between the $200 option price and the $220 fair market value at date of grant, or $30 (150% x $20), the employee must report $10 of ordinary income in the year he exercised the option.

Acceptable procedures that a panel of independent experts might use for establishing fair market values for stock not actively traded are neither straightforward nor simple. Generally, the Internal Revenue Service bases the value of stock not actively traded on a number of factors including the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors. Among the other factors are goodwill, economic outlook, company position in the industry, and values of other companies engaged in similar businesses.

Determining a value for goodwill obviously is an important procedure in the valuation process. Rates for capitalizing goodwill depend upon the facts in each case, and determining a reasonable capitalization rate represents one of the most difficult problems in overall valuation. No standard tables of capitalization rates are now available. Among the most important factors to be considered in a particular case are the nature of the business, the risk involved, and the stability or irregularity of earnings.

Although there are various methods of evaluating goodwill, the Commissioner has most frequently applied a formula capitalizing earnings on the basis of a five year average of business activity. This formula computes average net earnings as one step. It then allows a set-off against earnings for a reasonable rate of return on net tangible assets (tangible assets minus current liabilities) as another step. The balance of net earnings is considered attributable to goodwill, and this amount is capitalized at a reasonable rate. The final value of the business is then fixed at the sum of goodwill plus the net worth (capital stock plus surplus accounts).

While a reasonable set of rates depends on the circumstances and facts in each case, the general tendency has been to use a rate of return of approximately 8 per cent on tangible assets and about 15 per cent as the rate for capitalizing income attributable to goodwill in the case of so-called nonhazardous businesses. The rates increase to 10 per cent and 20 per cent respectively for businesses classed as hazardous.

An acceptable method for valuing the stock of a closely held company is illustrated below. A value obtained in this manner may be used in a stock options program in which the optionor corporation's stock has no established fair market value. The method may be applied by independent experts hired to determine a fair market value for closely held stock; and complete documentation of the calculation should be retained in order to substantiate the option offering price to the Commissioner of Internal Revenue.

Earnings of the ABC Corporation during the past five years have averaged $16,000. The balance sheet reports net tangible assets of $120,000. Net worth consists of $100,000 common stock (1,000 shares) and $20,000 retained earnings. Assume that a 6 per cent return on tangible assets and a 20 per cent capitalization rate for intangibles are reasonable. Fair market value per share is calculated as follows:

Average earnings	$16,000
Less: Earnings attributable to net tangible assets (6% x $120,000)	7,200
Value of intangibles	$ 8,800
Capitalized value of goodwill ($8,800 ÷ 20%)	$ 44,000
Net worth before goodwill computation	120,000
Total value of corporation	$164,000

Fair market value per share of stock $\frac{\$164{,}000}{1{,}000} = \$164$ per share

Although the method illustrated does not guarantee acceptable fair market value for tax purposes, it has been an acceptable procedure in the past.

Other methods of evaluating a closely held company may be used. Irving J. Olson has written an informative and comprehensive paper on the valuation of closely held corporations;[1] interested readers should examine that article for further information on this subject.

Other Obstacles to Implementation

Even though an acceptable fair market value can be computed for closely held stock, a number of practical problems remain before a stock option program in a closely held corporation can be implemented. Normally, the penalty tax imposed on the optionee in the event of a good-faith undervaluation is relatively minor. Thus, independent experts may be inclined to place a relatively high value on stock as a precautionary measure and to avoid harsh penalties on the optionee.

Another problem confronts employees whose

[1] Irving J. Olson, "Valuation of a Closely Held Corporation," JOURNAL OF ACCOUNTANCY, August 1969.

optioned stock is closely held. No ready market exists for the sale of the stock, so an optionee cannot view it as additional compensation in lieu of cash. However, he may expect the company to offer shares to the public at some future date, and he could plan to hold the stock for that eventuality.

Financing the purchase of stock available under options is a problem faced by all optionees. Employees whose options involve shares of public corporations can obtain partial financing by pledging their stock. However, banks normally are reluctant to offer the same arrangement to optionees holding shares of closely held corporations with no established fair market value. If bank financing is difficult, some small companies will allow their employees to purchase optioned shares in instalments, which include a charge for interest.

Positive Factors for Options in Small Businesses

One of the basic purposes for establishing an options program in a small business is to give valued employees a proprietary interest in a company. An employee has a tangible incentive to help effect improvement in a company's position when he has a personal stake in the company's net worth. Further, if the company issues shares to the public, an employee can develop an investment of significant value.

Unquestionably, options can be a valuable tool for attracting and retaining managerial and technical talent who might otherwise be disinterested in working with a small company. Moreover, the opportunity for very large appreciation in stock values often can persuade talented employees to accept options (whose value multiplies as the firm prospers) in lieu of large salaries.

The financial history of Electronic Data Systems Corp., Dallas, Texas, is a case in point. The remarkable story of EDS and its owner, Ross Perot, are discussed in the November 1968 issue of *Fortune* magazine ("The Fastest Richest Texan Ever"). According to the article, Mr. Perot, 39, is one of Texas' richest citizens, ranking fourth behind H. L. Hunt, N. Bunker Hunt, and R. E. Smith. His $300-million fortune is based on his control of a computer software company he founded. Employees of EDS in 1968 held 1.5 million shares of stock worth over $50-million; and many of those shares had been bought at twenty cents a share, the book value of the stock prior to a public offering. Several young executives are multimillionaires and some programmers in their twenties are worth six figures. Today, the value of that stock has quadrupled. The example graphically illustrates the possibilities for gain when a small private company goes public and its employees hold shares of stock purchased at bargain prices. Deferral of cash outlays for compensation purposes can also affect favorably a small company's cash flow when funds are needed for internal growth.

Some Alternatives to Qualified Options

Given the problems associated with statutory options, what alternatives are available to small companies desiring to issue stock to employees? Several types of nonstatutory option plans can be developed to provide desired motivation for employees. Some plans also allow the issuing corporation to obtain substantial tax benefits. Among the nonstatutory option programs are restricted stock and deferred stock plans. Other alternatives include a cash reimbursement stock option plan in which the corporation pays all or a portion of the optionee's additional tax costs when the option is exercised. Shadow option plans or phantom option plans have been used in the past with some success. They derive their title from the fact that no stock is issued to the employee who receives a "theoretical" number of shares on which gain is later computed.

Discussion of possible alternatives to statutory plans is beyond the scope of this paper. However, it should be clear that small companies are not limited in their development of stock option programs. Although small corporations have a somewhat more difficult problem of valuation than corporations whose stocks are widely traded, the problem is not insurmountable. Those businesses which find a tax-qualified program too difficult to implement have alternative option programs available which may prove advantageous for their purposes.

Conclusion

Stock option programs which satisfy statutory requirements are more difficult to implement in small businesses because of the stock valuation problem. However, statutory option plans can be devised for small businesses which offer outstanding opportunities to both optionee and optionor. Nonstatutory programs may be easier to implement and may prove more advantageous in some circumstances. In any event, a stock option program can be developed for nearly every small corporation desiring to utilize the opportunities available. The service an accountant can perform for his client lies in devising the type of option plan that best fulfills the requirements of a particular business.