THE CONTINUING INUTILITY OF EMPLOYEE STOCK OPTIONS IN CLOSELY HELD BUSINESSES*

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Small businessmen had a right to expect that the 1964 amendments to the Internal Revenue Code would substantially improve the utility of employee stock options to corporations whose stock is not widely traded. Such an expectation would have been based on recognition of the handicap under which such corporations operated in competing for top managerial talent with publicly held concerns that regularly employed tax-favored stock options as a compensation medium. This handicap to closely held businesses resulted in large part from their difficulty in accurately valuing their stock for purposes of setting an option price that complied with the Code's pre-1964 requirements.

As enacted, the 1964 amendments substantially ameliorated the employee's adverse tax consequences where the employer inadvertently failed to meet the Code's option price requirements and seemed thereby to have improved the availability of tax-favored options to closely held businesses. However, analysis of other provisions of the new law yields the conclusion that Congress has not materially improved the utility of stock options to small firms. Such improvement as there has been in the small business's relative position is largely the indirect result of substantial reduction in the attractiveness of options that may henceforth be offered by publicly held companies.

This article will review briefly the changes made in the stock option provisions by the 1964 amendments[1] and will discuss the factors bearing on the present utility of tax-favored options in small

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1. The most comprehensive review of the new stock option provisions is Baker, *Employee Stock Option Plans Under the Revenue Act of 1964*, 20 TAX L. REV. 77 (1964). For another consideration of the effect of the new law on small businesses, see Rothschild, *The New Stock Option: Problems of the Smaller Company*, 33 FORDHAM L. REV. 393 (1965).

This discussion of the 1964 amendments is for the most part limited to the subject of "qualified" stock options created pursuant to INT. REV. CODE OF 1954, §422. However, the amendments also created another new type of option in §423, which sets forth the requirements of "employee stock purchase plans." Plans of this variety are similar to restricted stock option programs except that (1) all businesses. In addition to the continuing problems of achieving safe compliance with the Internal Revenue Code, there are numerous practical considerations suggesting that stock options are seldom appropriate in the close corporation context.

BACKGROUND AND SUBSTANCE OF THE 1964 AMENDMENTS

Corporations found at an early date that giving stock options to employees was a valuable means of creating incentive for improved employee performance. However, the pre-1964 restricted stock option, having been created by Congress in 1950 and endowed with favorable tax attributes, rapidly developed into a commonly accepted compensation device under which incentive was only a secondary consideration. The primary motive in the adoption of restricted stock option plans, it seems clear, was usually the desire to gain for highly paid personnel the tax relief accompanying such plans and a chance to participate on a favorable basis in the generally upward trend of the stock market.[2]

The 1964 amendments to the Internal Revenue Code did away with restricted stock options except to the extent that outstanding

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employees meeting certain minimum service requirements must be allowed to participate and (2) the price provisions of the option and its duration must adhere to stringent new requirements. In addition, the 1964 amendments perpetuated the old restricted option provisions in §424 in order that preexisting options of this kind would not be affected by the changes in the law. Small businesses are not likely to be interested in these aspects of the present law on stock options.

2. Even this conclusion may not be cynical enough since there are several bases for concluding that deception of shareholders and the public was an important objective of many stock option programs: (1) disclosure of management salaries did not take into account gains accrued through the possession and exercise of options, and such disclosure as was required was not easily interpreted or translatable into dollar amounts. See, *e.g.*, SEC Form S-1, Items 17-18; SEC Reg. X-14, Schedule 14A, Items 7, 11, 17 C.F.R. §240.14a-11 (1964). (2) Because remuneration by the option route occurred through the dilution of the shareholders' equity, the expense did not appear in income statements (although it was reflected in earnings-per-share figures once the options were exercised). (3) Because no tax deduction was allowed for compensation accomplished through the option route, the net cost to the corporation of providing a particular after-tax return to a given employee was apt to be greater (except in the case of executives in the highest tax brackets) than if cash were paid. *Cf.* text accompanying notes 53-54 *infra*. For a more complete discussion of the objections to the use of stock options, see *Hearings on the Tax Recommendations of the President Contained in His Message of Jan. 24, 1963, Before the House Committee on Ways and Means*, 88th Cong., 1st Sess. 480-97 (Comm. Print 1963) [hereinafter cited as "President's 1963 Tax Message"]. Criticism by shareholders of the use of options was less vigorous than it might have been because of the concurrent benefits accruing to them from the appreciation in the value of the company's stock.

options granted under the old law may continue to qualify for advantageous tax treatment.[3] In the place of the restricted option, Congress introduced the "qualified" option,[4] which is similar to the restricted option in many respects but which is characterized by stricter requirements. A review of the characteristics of the two types of options is helpful in appraising the extent of the handicap under which small businesses operated in this area prior to 1964 and in appreciating the extent to which their relative position was affected by the 1964 legislation.

Restricted Stock Options

Basically, the Internal Revenue Code prior to the 1964 amendments[5] permitted the optionee under a restricted stock option to omit reporting any gain when he acquired stock at a bargain price through the exercise of the option. The Code then taxed the optionee, who was required to be an employee, at long-term capital gain rates on the gain realized when he eventually sold the stock after satisfying certain holding period requirements.[6] By way of further generosity, the tax law excused from the income tax any gain that was not realized by sale of the stock prior to the death of the optionee.[7] These substantial benefits could be obtained only if the option program met the statutory requirements of restricted status.

The foregoing benefits continue to be available under qualified stock option plans established under the 1964 amendments, which made changes only in the requirements to be met in qualifying for favorable tax treatment and, in some cases, the consequences of departing from such requirements. The narrower requirements applicable to qualified stock option plans have the effect of somewhat curtailing the utility of stock options as a supplementary compensation device and of reemphasizing their incentive aspect. The major change

3. INT. REV. CODE OF 1954, §424. The grant of new restricted options after Dec. 31, 1963, pursuant to preexisting arrangements is permitted by INT. REV. CODE OF 1954, §424 (c) (3).

4. INT. REV. CODE OF 1954, §422.

5. INT. REV. CODE OF 1954, ch. 1, §421, 68A Stat. 142 (1954). Most of the provisions of old §421 are carried over in INT. REV. CODE OF 1954, §424.

6. However, where the option price was less than 95% but not less than 85% of the market price of the stock on the date the option was granted, the employee was taxed at ordinary income rates on his gain up to the difference between the option price and such market value. Similar provision is now made in INT. REV. CODE OF 1954, §424 (c) (1).

7. INT. REV. CODE OF 1954, §1014. Again there was a partial exception where the option price was between 85% and 95% of the market value of the stock when the option was granted. Under such circumstances, a tax was imposed at ordinary income rates on the gain up to the difference between the option price and such market value. Similar provision is now made in INT. REV. CODE OF 1954, §424 (c) (1).

is an increase from six months to three years in the period of time that the employee must hold the stock acquired under the option in order to be entitled to capital gain treatment on its sale.[8] Also, the life of the option may be no more than five years, whereas ten-year options were previously allowed.[9] From the point of view of the small business, however, the most important change probably lies in the area of the consequences of a failure to meet the requirement that the option price bear a particular relationship to the fair market value of the stock at the time the option is granted. This area is more fully discussed below.

Requirements of Qualified Status

A qualified stock option program under the 1964 amendments must meet a variety of statutory requirements in order to obtain beneficial tax treatment for the participating employees. Many of these requirements are entirely new or differ substantially from the requirements previously applicable to restricted options. The program must be embodied in a plan setting forth the aggregate number of shares that may be issued under options and identifying the employees, or the class of employees, eligible to participate in the program.[10] This plan must be approved by the shareholders of the employer corporation within a year before or after its adoption[11] and

8. INT. REV. CODE OF 1954, §422 (a) (1); Proposed Treas. Reg. §1.422-1 (a), 29 Fed. Reg. 18069 (1964). See note 14 *infra*. Previously the employee was required to hold the stock until at least two years after the option was granted. The three-year rule makes this additional rule superfluous. The lengthening of the holding period was to assure that employees will acquire a longer-lasting stake in the business and to inhibit rapid sale of the stock for the purpose of raising capital for the exercise of new options. H.R. REP. No. 749, 88th Cong., 1st Sess. 64 (1963). *Cf.* President's 1963 Tax Message 488-91.

9. INT. REV. CODE OF 1954, §422 (b) (3); Proposed Treas. Reg. §1.422-2 (d), 29 Fed. Reg. 18071 (1964). The purpose of this change was to hasten the acquisition of a proprietary interest in the business. This was deemed desirable because employees tended to delay exercise as long as possible in order to avoid making a capital outlay and because appreciation through the long-term rise in stock prices could not be distinguished from gains attributable to management performance. H.R. REP. No. 749, 88th Cong., 1st Sess. 64 (1963).

10. INT. REV. CODE OF 1954, §422 (b) (1); Proposed Treas. Reg. §1.422-2 (b) (3), 29 Fed. Reg. 18070 (1964). This is a new requirement. Under the Proposed Regulations the designation of "key employees" as recipients is acceptable. See also H.R. REP. No. 1149, 88th Cong., 2d Sess. 39 (1964); S. REP. No. 830, 88th Cong., 2d Sess. 92 (1964).

11. INT. REV. CODE OF 1954, §422 (b) (1); Proposed Treas. Reg. §1.422-2 (b) (1), (2), 29 Fed. Reg. 18070 (1964). This new requirement of shareholder approval was apparently intended to guarantee to shareholders a direct control over the use of options, which have often been objected to on the ground of unfairness to shareholders. See note 2 *supra*. A substantial number of companies would have

must not have a duration of more than ten years after its adoption or, if earlier, the date of shareholder approval.[12]

To be a qualified stock option, an option granted under the plan must not be exercisable after five years from the date of grant.[13] It must be nontransferable except upon death and must be exercisable only by the grantee during his lifetime.[14] In order to prevent the downward revision of the option price by the granting of new options in place of the old,[15] the option is required to provide that it is not exercisable so long as there is outstanding any other qualified stock option (or a surviving restricted option) previously granted;[16] it is expressly provided that an option is deemed to be outstanding until it is exercised in full or expires by lapse of time.[17] The exercise price of a qualified option must not be less than the fair market value of the stock at the time the option is granted.[18] However, as discussed

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to submit the plan to shareholders anyway. See, *e.g.*, MODEL BUS. CORP. ACT ANN. §18A (1960); New York Stock Exchange Company Manual A — 118-20 (1956).

12. INT. REV. CODE OF 1954, §422 (b) (2); Proposed Treas. Reg. §1.422-2 (c), 29 Fed. Reg. 18071 (1964). Previously there was no limit on the duration of the option program.

13. See note 9 *supra* and accompanying text.

14. INT. REV. CODE OF 1954, §422 (b) (6); Proposed Treas. Reg. §1.422-2 (g), 29 Fed. Reg. 18072-73 (1964). This is similar to the old provision. If the employee dies, his estate and heirs are relieved from the three-year holding period requirement (see note 8 *supra* and accompanying text) and the requirement that exercise occur not more than three months after the termination of employment. (See note 19 *infra* and accompanying text.) INT. REV. CODE OF 1954, §421 (c) (1) (A); Proposed Treas. Reg. §1.421-8 (c), 29 Fed. Reg. 18066-68 (1964).

15. Prior law permitted the resetting of the option price at a lower figure where a substantial decline in the value of the optioned stock could be demonstrated. INT. REV. CODE OF 1954, ch. 1, §421 (e), 68A Stat. 145 (1954). In addition, new options providing a lower option price could be granted and exercised while the old options remained outstanding. See Rev. Rul. 59-55, 1959-1 CUM. BULL. 94; Rev. Rul. 61-219, 1961-2 CUM. BULL. 107. It was considered objectionable that employees could profit even though the market value of the company's shares declined after options were first granted. H. R. REP. No. 749, 88th Cong., 1st Sess. 68 (1963). See also President's 1963 Tax Message 483-84.

16. INT. REV. CODE OF 1954, §422 (b) (5); Proposed Treas. Reg. §1.422-2 (f), 29 Fed. Reg. 18071-72 (1964). See note 15 *supra*. INT. REV. CODE OF 1954, §422 (c) (6), and §1.422-2 (f) (1) (ii) of the Proposed Regulations provide that this requirement will not apply if the new option provides for the same or a higher option price. This will permit the issuance of new options if it should appear that the option price provided in the outstanding options was less than the stock's fair market value at the time of the grant.

17. INT. REV. CODE OF 1954, §422 (c) (2); Proposed Treas. Reg. §1.422-2 (f) (3), 29 Fed. Reg. 18072 (1964). Cancellation of outstanding options is thus ineffectual. However, restricted options were permitted to be cancelled before the end of 1964 in order that options granted under the old law would not prevent utilization of the new provisions.

18. INT. REV. CODE OF 1954, §422 (b) (4); Proposed Treas. Reg. §1.422-2 (e), 29 Fed. Reg. 18071 (1964).

below, a good faith undervaluation will not disqualify the option altogether.

If the option is granted under a proper plan and meets the requirements set forth above, the grantee of the option will be in a position to obtain favorable tax treatment on the exercise of the option and on the eventual sale of the shares acquired under it. To be entitled to favorable treatment, however, the individual exercising the option must have been an employee of the employer corporation during the entire period from the date of grant up to three months prior to his exercise of the option.[19] If this condition is met and if the fair market value of the optioned stock was correctly estimated at the time the option was granted, the employee will not be taxed on the bargain received at the time of exercise.[20] If the stock acquired under the option is held for at least three years,[21] the total gain upon its sale will be taxed at capital gains rates. If the stock is sold before the end of the three-year holding period, the employee is treated as having received, during the year in which the disposition was made, ordinary income equal to the excess of the market value at the time of exercise over the option price.[22] Of course, a capital gains tax (at long-term rates if the shares were held more than six months) would also be payable on any excess of the sale price of the shares over their market value when they were acquired, and the employer would be entitled to a deduction for an amount equal to the amount taxed to the employee as ordinary income.[23]

THE PROBLEM OF FAIR MARKET VALUE

Prior to 1964 Amendments

Prior to the adoption of the 1964 amendments, the main obstacle to a small business's adoption of a restricted stock option plan was the requirement that the option price be not less than 85 per cent of the fair market value of the stock on the date the option was granted. Because stock of a closely held enterprise is not regularly traded, there was no ascertainable market value on which to predicate

19. INT. REV. CODE OF 1954, §422 (a) (2); Proposed Treas. Reg. §1.421-7 (h) (2), 29 Fed. Reg. 18065 (1964). Under prior law it was not necessary to be continuously employed during this period but only at the date of grant and at some time within three months prior to exercise. See also note 14 *supra*.

20. INT. REV. CODE OF 1954, §421 (a) (1); Proposed Treas. Reg. §1.421-8 (a), 29 Fed. Reg. 18066 (1964).

21. See note 8 *supra* and accompanying text.

22. INT. REV. CODE OF 1954, §421 (b); Proposed Treas. Reg. §1.421-8 (b), 29 Fed. Reg. 18066 (1964).

23. INT. REV. CODE OF 1954, §§162, 421 (b); Proposed Treas. Reg. §§1.421-6 (f), 8 (b) (1), 29 Fed. Reg. 18064, 18066 (1964).

an option price.[24] Experts gave a great deal of thought to possible methods of evaluating the equity in a close corporation, but they discovered no adequate means of arriving at a safe estimate of value.[25] The penalty for failing to achieve restricted status was the immediate taxation of the employee at ordinary income rates on the full extent of the bargain received in exercising the option.

The refusal of the Internal Revenue Service to issue rulings with respect to restricted status or the accuracy of valuations foreclosed one means of escape from the uncertainty resulting from the valuation problem.[26] In addition, a provision for retroactive increase of the exercise price could not be introduced to protect the optionee against an underestimate of the stock's value.[27] Having the stock appraised by experts might have been helpful in the event of a contest with the Revenue Service but would have been far from conclusive, particularly since it was the stock's market value rather than its intrinsic value that governed the option price. Moreover, the valuation of the stock of a closely held company is exceedingly diffi-

24. The handicap to small enterprises was widely noted. Among others, Dean Griswold recognized the anomaly that stock options are apt to be unavailable where they would be most justified:

"Because of the limits to 95% or 85% of market value — in some cases, 110% — a curious consequence develops. It is in small and closely held companies that the stock option device may have its clearest justification. It is in such companies, perhaps in need of better management, that an outsider can be brought in and given the real incentive through a stock option of sharing in the improvement of the company. It is in such companies, too, that the efforts of an individual can have some impact on the value of the stock.

"Yet it is in just these smaller companies that determination of the fair market value of the stock at any particular date is most troublesome and uncertain." Griswold, *Are Options Getting Out of Hand?*, Harv. Bus. Rev., Nov.-Dec. 1960, pp. 49, 51; reprinted in Corp. Practice Commentator, May 1961, pp. 52, 56. See also Moore, *Stock Options for Directors in Small Corporations*, 11 CLEV.-MAR. L. REV. 396 (1962); Wallace, *Should We Continue to Encourage the Use of Restricted Stock Options?*, 39 TAXES 785 (1961); Schlesinger, *Selected Problems in the Use of Restricted Stock Options*, 36 TAXES 709 (1958).

25. See, *e.g.*, Schlesinger, *The Utility and Feasibility of Stock Options in Close Corporations*, in TAXATION OF DEFERRED EMPLOYEE AND EXECUTIVE COMPENSATION 580 (Sellin ed. 1960); Cox, *Stock Arrangements for Executives*, N.Y.U. 16TH INST. ON FED. TAX 105 (1958); Lentz, *Restricted Stock Options — Problems of the Executive*, N.Y.U. 14TH INST. ON FED. TAX 1053 (1956); Bergen, *Restricted Stock Options for Executives of Closely Held Corporations*, N.Y.U. 11TH INST. ON FED. TAX 145 (1953). See note 41 *infra* for a discussion of some suggestions for solving the problem.

26. Rev. Rul. 59-243, 1959-2 CUM. BULL. 123, amplified in Rev. Rul. 60-242, 1960-2 CUM. BULL. 158. Presumably these rulings will be equally applicable under the new law.

27. Rev. Rul. 59-243, 1959-2 CUM. BULL. 123, amplified in Rev. Rul. 60-242, 1960-2 CUM. BULL. 158. Under these rulings it was required that the option price be fixed or determinable at the time the option was granted.

cult, and expert appraisers are apt to differ widely in their conclusions.[28]

Penalty Tax on Employee Where Undervaluation Occurs

The 1964 amendments to the Code changed the requirement that the option price be at least 85 per cent of the stock's value on the date the option is granted to a requirement that the option price be at least equal to such value.[29] However, in an apparent attempt to mitigate the penalty against the employees of a business that is unable to determine the fair market value of its stock with certainty, Congress provided that a good faith error in determining the option price would not automatically require the taxation of the employee to the full extent of the bargain received on the exercise of the option. Under the new law, where a good faith undervaluation has occurred, the employee, on the exercise of his option, will be taxed as if he had received income equal to one and one-half times the amount of the underestimate of market value.[30] If his actual gain on the exercise of the option is less than one and one-half times the amount of the undervaluation, the actual gain will be the measure of his tax.

> *Example*: An employee exercises an option to purchase 100 shares at $100 each, and it is subsequently found that the fair market value of the shares at the time the option was granted was $125 but that the $100 figure had been arrived at in good faith. If the shares are currently worth $160, he will be taxed on $3,750 of ordinary income (1½ X $25 X 100). If the shares are worth only $130, he will be taxed as having received $3,000 of compensation ($30 X 100).

28. One case has been heard of in which two investment banking houses and a respected research company were called in to evaluate the company's common stock on the basis of the price obtainable in a public offering. They reached results of $4, $7.50, and $12 per share, respectively. The option price was then set at around $16 per share, and no trouble was encountered. A few months after the options were granted, another investment banking house approached the company to suggest "going public" at a price in excess of $30 per share. One of the reasons for turning down this suggestion was the probable effect on the outstanding stock options. See also the reference to the experience of Ford Motor Company in Rothschild, *supra* note 1, at 405.

29. INT. REV. CODE OF 1954, §422(b)(4); Proposed Treas. Reg. §1.422-2(e)(1), 29 Fed. Reg. 18071 (1964).

30. INT. REV. CODE OF 1954, §422(c)(1). Reliance on appraisals would be sufficient to establish good faith in setting the price. H.R. REP. No. 749, 88th Cong., 1st Sess. A68 (1963) (suggesting use of "an average of the fair market values set forth in the opinions of completely independent and well-qualified experts"). See also Proposed Treas. Reg. §1.422-2(e)(2)(ii), 29 Fed. Reg. 18071 (1964), which adopts the quoted language from the House Committee Report.

The employee's basis in the shares for capital gains purposes is increased by the amount taxed to him as ordinary income under the penalty tax provisions.[31]

Employer's Deduction in the Event of Undervaluation

Under the rules relating to restricted stock options, the employer was entitled to a deduction for any amounts taxed as ordinary income to an employee on his exercise of the option as a result of the employer's failure to comply with the option price requirement.[32] The 1964 amendments appear to deny the employer a similar deduction in every case where the employee is taxed under the penalty tax provisions outlined above.[33] This denial of the deduction results from the provision in section 422(c)(1) that a good faith undervaluation of the stock in setting the option price does not, as formerly, disqualify the option altogether but merely requires the imposition of the penalty tax.

The denial of a deduction under circumstances analogous to those under which it was previously permitted greatly increases the aggregate of the adverse tax consequences to the employer and employee of a failure to meet the option price requirement. It is hard to believe that this result was actually intended by Congress since there is no specific indication in the legislative history that the denial of the deduction was deliberate[34] and the congressional reports clearly reflect the belief that the penalty tax alone would be sufficient to encourage compliance with the option price requirement.[35] More-

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31. INT. REV. CODE OF 1954, §422(c)(1); Proposed Treas. Reg. §1.422-2(e)(2)(i), 29 Fed. Reg. 18071 (1964).

32. Treas. Reg. §1.421-6(f) (1959), as amended, T.D. 6540, 1961-1 CUM. BULL. 161.

33. INT. REV. CODE OF 1954, §§421(a)(2), 422(c)(1). The Proposed Regulations confirm this reading. Proposed Treas. Reg. §§1.421-6(a), (f), 1.422-1(b)(3) (Example 6), 29 Fed. Reg. 18064, 18070 (1964).

34. The impression that the result was inadvertent is based in part on the assumption that Congress was in fact attempting to improve the competitive position of small businesses vis-à-vis companies with widely traded stock. No such intention is expressed in the legislative history, but it seems fair to infer it from the specific effort made to ameliorate the employee's adverse consequences where the option price requirement is not met. The extensive literature documenting the hardship to the closely held firm (see note 24 *supra*) surely did not escape congressional notice. Moreover, most of the criticism of options centered on their use in the largest firms. See President's 1963 Tax Message 459-97. Such of the criticism as concerned small companies (*id.* at 492-93) was obviated by the new rules prohibiting substantial shareholders from participating in the program. INT. REV. CODE OF 1954, §422(b)(7). See note 52 *infra* and accompanying text.

35. S. REP. No. 830, 88th Cong., 2d Sess. 91 (1964); H.R. REP. No. 749, 88th Cong., 1st Sess. 66 (1963).

over, it is difficult to think of other situations in which the tax law denies the employer a deduction on grounds other than unreasonableness while taxing the employee on the receipt of compensation.[36] The denial of the employer's deduction in the 1964 amendments may well have been a legislative drafting blunder resulting from a combination of (1) the carryover *in haec verba* of language in section 421 (a) (2) clarifying that no deduction would be permitted where the option achieved restricted (now qualified) status, and (2) the introduction of section 422 (c) (1) preserving qualified status merely as a device for preserving favorable tax treatment of the option while exacting the penalty tax.

The anomaly created by Congress in denying the employer a deduction where the penalty tax applies is particularly apparent when it is recognized that in many cases the employer and employee will bear a lesser aggregate tax burden if the noncompliance was the result of bad faith rather than of mere inability to make an accurate appraisal. In the example set forth above, two situations were hypothesized, involving market values of $160 and $130 at the time the option was exercised. Since good faith in setting the option price was assumed, the employer would not have been entitled to a deduction in either case. If, however, the employer should have established its own bad faith, it would have been allowed a deduction equal to the amount taxable to the employee in each instance – $6,000 and $3,000 (the excess of market value over the option price), respectively. Note that the savings accruing to the employer through the deduction (assuming a 48 per cent tax rate) would be $2,880 and $1,440 in the respective situations, whereas there would be an increased tax cost to the employee only in the first case. This increased cost would

36. INT. REV. CODE OF 1954, §424 (c) (1), carries over provisions of prior law which have the effect of denying the employer a deduction where the employee is taxed on an amount of ordinary income as a result of the employer's setting of an option price between 85% and 95% of fair market value at the time of grant. See notes 6 and 7 *supra*. (INT. REV. CODE OF 1954, §423 (c), has a similar effect.) This fact might be regarded as persuasive that there was an intent to deny the deduction as well in the case of an undervaluation in setting the exercise price of a qualified option. However, under the restricted option provisions, there is no penalty whatsoever to the employee where the option price falls in the 85-95% range, although a delayed tax is ultimately exacted on the amount of the original "spread" at ordinary income rates upon the stock's eventual sale or the employee's death. The new penalty tax rules, which are applicable only to qualified options, were introduced to mitigate the serious tax penalty that attached where the minimum (*i.e.*, 85%) price requirement was not met. No reason appears why the employer should lose the deduction that was allowed under those penalty provisions which Congress intended to ameliorate.

For an unsuccessful attempt under other circumstances to deny an employer a deduction when the employee became taxable on the receipt of compensation, see Mississippi River Fuel Corp. v. United States, 314 F.2d 953 (Ct. Cl. 1963).

be the difference between a tax payable currently on $2,250 at ordinary income rates and a capital gains tax on that amount levied when the stock acquired under the option is finally sold.

Because bad faith in setting the option price would entitle the employer to a deduction by disqualifying the option, an employer that takes a purely selfish view of the transaction will in each case refuse to assert that it acted in good faith. The employee's interest will generally be best served by establishing that the price was arrived at in good faith, although in some cases — where the penalty tax is measured by the employee's actual gain — it will make no difference how the price was set. In most cases it will be within the employer's power to elect whether or not to contend that the option price was established in good faith.[37] Thus, there appears to be a significant alternative to the kind of tax treatment that prevailed prior to the 1964 amendments, although the old treatment is in every case more advantageous from the employer's point of view. Nevertheless, the new penalty tax provisions reduce the substantial tax burden on the employee that resulted under prior law from a minor miscalculation of the option price. Employers will often be willing to forego a deduction in order to preserve the favorable tax treatment of the employee.

The strange result that seems to flow from the Code amendments in 1964 — namely, that an employer may receive more advantageous tax treatment if it acted in bad faith than if it merely made an honest miscalculation — would probably have justified the Commissioner in promulgating proposed Regulations allowing an employer to deduct the amount of a good faith undervaluation on which a penalty tax is predicated; the proposed Regulations might also have allowed a deduction for the full amount treated as taxable to the employee where his actual bargain on exercise is less than one and one-half times the amount of the undervaluation.[38] It seems extremely unlikely

37. Theoretically, the employee might assert the employer's good faith while the employer argued that it had in fact acted in bad faith. In this way, each might enjoy the most favorable tax treatment, although one or both of them would undoubtedly be required to litigate the question. *Cf. Estate of Lauson Stone*, 19 T.C. 872 (1953), *aff'd*, 210 F.2d 33 (3d Cir. 1954) (employer's claim of a deduction in another type of situation involving stock options did not determine the tax treatment of the employee).

38. The Commissioner's position in adopting such rules would have to be that the taxpayer ought to have the option of not pleading good faith if such a plea would result in a greater tax. However, it is only in the latter situation mentioned in the text that the tax treatment would coincide with the treatment where bad faith in the valuation effort is established. In the other case, the deduction would be limited to the amount of the undervaluation, which is the portion of the employee's gain that is most clearly compensatory. In the example set forth earlier in the text, the employer would be entitled to deductions of $2,500 and $3,000 in the respective situations postulated.

that the Commissioner's final Regulations will change the handling of these matters in the proposed Regulations.[39] For this reason, it is difficult to conclude that the 1964 amendments benefited small business as much as small businessmen had a right to expect.

PRACTICAL FACTORS AFFECTING THE UTILITY OF QUALIFIED OPTIONS IN SMALL BUSINESSES

The penalty tax imposed on the employee for the employer's undervaluation of the shares subject to option would not be a serious problem if there were any assurance that the amount of the undervaluation would be only minor. However, the difficulty of reaching even an approximate market value is in many cases so great that the penalty could be quite serious. For example, an employee exercising an option to acquire 100 shares of stock at $50 each would be faced with a tax on $7,500 of ordinary income if the market value at the time the option was granted were subsequently found to be twice the option price.[40] Such an employee would have received no cash with which to pay the tax imposed and might find it necessary, and exceedingly difficult, to liquidate his holdings in order to obtain cash to meet the tax liability. The seriousness of the risk to the employee is sufficient that, in the absence of some objective evidence of actual market value, closely held companies will be forced to place an unreasonably high value on their stock in setting an option price.

Likelihood of Overvaluation of Optioned Shares

From time to time in the life of most small businesses events occur that provide evidence of the current market value of the company's shares. For example, a valuation of a minority interest in the company for purposes of the federal estate tax or the sale by the corporation or a shareholder of a minority interest would probably provide a reliable indication of market value. The frequency of such events depends largely on the width of the stock's distribution and fortuitous factors, and prices set on the basis of them are not guaranteed freedom from attack. In the typical small business there will usually be no reliable objective evidence of fair market value on which an option price can be predicated.

39. See Proposed Treas. Reg. §§1.421-6 (a), (f), 1.422-1 (b) (3) (Example 6), 29 Fed. Reg. 18064, 18070 (1964).

40. The 1964 amendments to the Code introduced averaging provisions which permit taxpayers with large fluctuations in income from year to year to pay tax at a lower rate in the years of peak earnings. INT. REV. CODE OF 1954, §§1301-05. These provisions would be available to an employee who became taxable under the penalty tax provisions discussed here.

Since there is no known method of obtaining an advance indication from the Internal Revenue Service as to the accuracy of a valuation of closely held stock,[41] the small employer's sole protection generally lies in thoroughly documenting the case for the value chosen and in attaching to the stock the highest value that might conservatively be deemed reasonable. If this is done and if subsequent events do not reveal an egregious error, it is unlikely that a penalty tax will be imposed since the penalty provisions seem to have been inserted in the Code primarily for the purpose of compelling closely held businesses to adopt conservative valuations and of alleviating the Internal Revenue Service's task of strictly policing valuations in every case. Nevertheless, where the stock subject to option appreciates rapidly, as it is hoped it will, the likelihood of Revenue Service second-guessing is increased.

To the extent that the option price selected exceeds the stock's actual value as a result of an overly conservative judgment in setting the price, the option program will be of reduced value to the employees. Indeed, the five-year life of the option may not be a sufficient period for the actual value to catch up with the option price established. Moreover, because a new option providing a lower option price cannot be exercised until previously outstanding options have expired or been exercised, an overvaluation cannot be effectively corrected by the granting of new options.[42] Because the company whose stock is publicly traded has no problem in valuing its shares, it is able to assure its employees that they will receive the full measure of benefit from a qualified stock option plan. Small businesses will not ordinarily be able to give such an assurance and will consequently remain handicapped in competing with large companies for managerial and other talent.

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41. Some suggestions have been made, but they have generally failed to provide an adequate solution. One writer has suggested that a stock bonus be given the employee concurrently with the option so that the value of the stock could be tested immediately upon the employer's claim of a deduction for the fair market value of the stock. Cox, *supra* note 25, at 127. However, because the bonus is also income to the employee, the Revenue Service might assert a high value that would destroy the value of the option. Also, it is not clear how acquiescence in the valuation of the bonus would bind the Revenue Service for other purposes.

Use of restrictions on transferability to depress the market value of the optioned stock has also been suggested as a means of creating a margin of safety. Rothschild, *supra* note 1, at 406-07; Bergen, *supra* note 25, at 151-58. This expedient would yield utterly unpredictable tax results and, very likely a lawsuit if relied upon as a solution to valuation problems. See note 51 *infra* and accompanying text.

42. INT. REV. CODE OF 1954 §§422(b)(5), (c)(6); Proposed Treas. Reg. §1.422-2(f)(1), 29 Fed. Reg. 18071-72 (1964). On the other hand, an undervaluation

Absence of Market for Acquired Shares

Even if the small corporation should effectively overcome the problem of valuing its stock, perhaps by obtaining a bona fide offer for a minority interest, the qualified stock option would probably be less useful to it as compensation technique than it would be to a publicly held company. One problem would be the absence of a market for stock that the employees might obtain under the option. While many employees in large companies have been satisfied to retain the stock obtained through the exercise of an option, others have regularly disposed of it after the passing of the six-month holding period required by the Code for restricted options.[43] Without an existing market, disposition would be extremely difficult unless other shareholders or the corporation would be willing and able to purchase the stock. Redemption of the stock by the employer corporation might be the best method of permitting the employee to cash in on the option, but new problems might be raised if the redemption price could not be justified; the tax would be at ordinary income rates to the extent that the redemption price exceeded fair value. Also, requests for redemption might come at times when the cash supply of the business was reduced or otherwise committed.

The importance of a market for disposing of stock obtained under an option may be greater in a small business than in a large one. Stock in a closely held enterprise is often an unsatisfactory investment because of the uncertain dividend policies of the controlling shareholders. Also, the long-term prospects of the business may not be such that an equity interest is a good speculation, and, in any event, a degree of diversification of investments is normally advisable. For these reasons, large-scale use of options as a compensation medium requires some assurance that the shares will be readily disposable after the holding period has expired. If the purpose is merely to give employees a permanent stake in the business, a market for the shares will not be essential, and use of the plan will probably be on a smaller scale since employees may be less interested in committing a large portion of their personal assets.

Difficulty of Financing Exercise of Options[44]

The 1964 amendments to the Code, by increasing the minimum holding period from six months to three years and the minimum

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could be corrected by granting a new option at a higher price upon the occurrence of an event which reveals the true market value.

43. See note 8 *supra.*

44. The most thorough discussion of this problem, as it existed under the old law, is Rothschild, *Financing Stock Purchases by Executives*, Harv. Bus. Rev.,

option price from 85 per cent to 100 per cent of market value, increased the duration and the amount of the investment required to take advantage of stock options. In addition, shortening the permitted life of the option has somewhat reduced the possibility that market value will be sufficiently in excess of the exercise price that exercise of the option can be easily financed. The financing problems thus created are multiplied in the case of employees of a firm whose stock is not actively traded. It might also be noted that the option's shorter life under the new law also lessens the likelihood that an active market for such a firm's stock will have developed by the time it is desired to exercise the option.

Employees of publicly held corporations can ordinarily obtain partial financing for exercise of a stock option by pledging the shares acquired. While under Federal Reserve margin rules no more than 30 per cent of the market value of listed shares can be obtained in this manner,[45] larger amounts can probably be borrowed to purchase stock that is actively traded in the over-the-counter market. However, banks will normally be unwilling to accept as collateral shares having no established market or value. Bank financing might be obtainable if the corporation or another shareholder was willing and able to undertake to repurchase the shares from the pledgee if the loan should not be repaid, but such an arrangement might be unsatisfactory because of the strain on the employer's credit resources.

If bank financing of exercise of the option cannot be obtained at a reasonable cost, the corporation might allow payment for the stock to be made in installments. This is a common arrangement and the one most likely to be employed by small firms. The employee must have a fixed obligation to pay for the stock,[46] and substantial interest must be payable on this obligation.[47] In addition, care must be taken that state laws or charter provisions governing payment for shares[48]

Mar.-Apr. 1957, p. 136. Emphasis is placed on the undesirability of self-financing through the sale of shares acquired under old options to provide funds for the exercise of new ones. *Id.* at 137-39.

45. Regulation U, 12 C.F.R. §221.4 (1963).

46. Proposed Treas. Reg. §1.421-7(f), 29 Fed. Reg. 18065 (1964); Rev. Rul. 54-467, 1954-2 CUM. BULL. 207.

47. INT. REV. CODE OF 1954, §483, which was added to the Code in the 1964 amendments, would identify "unstated" interest if the rate paid by the employee was less than an amount prescribed by the Commissioner, currently 4%. Temporary Treas. Reg. §19.3-1(b), T.D. 6720, 1964-1 CUM. BULL. 622. Allocation of some of the purchase price to interest might have the effect of disqualifying the option by reducing the effective option price below the fair market value of the stock on the date of grant. Query whether the good faith requirement could be claimed to have been met under these circumstances.

48. See generally MODEL BUS. CORP. ACT ANN. §§16, 18, 23 (1960).

and loans to employees[49] are not violated. Use of this form of financing will increase the cost of the plan to the employer unless the interest charge is commensurate with what the firm could earn by otherwise employing its capital. The amount of funds that might be tied up in this manner might be considerable, and there is undoubtedly a practical limit on the amount of use that can be made of this financing technique in any business. The necessity for relying exclusively on installment sales as a means of financing the exercise of stock options is another aspect of the handicap under which small firms operate in this area.

Effect on Control Arrangements

Another drawback to a stock option arrangement in a closely held enterprise might be the disruptive effect that dispersion of stock among employees might have upon existing control arrangements.[50] Within the context of the close corporation, creation of new minority stock interests may bring about some obligation to declare dividends and perhaps to give the new shareholders a voice on the board of directors. The use of nonvoting shares as the subject of the option might solve some problems but would not guarantee that an unmanageable dissident minority would not arise.

To achieve a degree of control over the dispersion of the stock or the identity of subsequent purchasers, the employer may impose restrictions on the transferability of the stock acquired under options. The most suitable such restriction is usually a simple right of first refusal in favor of the corporation or the controlling shareholders in the event of a proposed sale.[51]

Ineligibility of Certain Shareholder-Employees

Qualified stock options may not be used to benefit employees who are also substantial shareholders of the employer corporation.[52] In

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49. See generally MODEL BUS. CORP. ACT ANN. §4 (f) (1960).

50. For a discussion of the danger that employees, upon becoming shareholders, might at some time attempt to interfere with management, see O'NEAL & DERWIN, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES: "SQUEEZE-OUTS" IN SMALL ENTERPRISES §2.14 (1961).

51. Such a restriction would not affect the value of the shares. Restrictions on alienability or providing an artificial repurchase price would render the stock's fair market value unascertainable and would greatly complicate the tax situation. See note 41 *supra*.

52. INT. REV. CODE OF 1954, §§422 (b) (7), (c) (3); Proposed Treas. Reg. §1.422-2 (h), 29 Fed. Reg. 18073-74 (1964). Prior law permitted 10% shareholders to participate if the option price was at least 110% of fair market value and the option had a duration of no more than five years. One objection to the restricted

companies having a "net capital" of $1 million or less, shareholder-employees having more than 10 per cent of the stock (by voting power or value) may not participate. In larger companies the percentage limitation is reduced so that in companies with net capital of $2 million or more the holding of more than 5 per cent of the stock disqualifies an employee from enjoying tax benefits. The maximum shareholdings for a beneficiary of a qualified option in a company with net capital between $1 million and $2 million is determined by prorating the additional 5 per cent allowed to the smallest companies. Thus, a shareholder-employee in a company with $1,600,000 of equity could qualify for favorable tax treatment if he owned no more than 7 per cent of the stock.

Under these provisions, large businesses and small businesses are subjected to different requirements, which, while making a concession to smaller companies, nevertheless remain potentially discriminatory against them. It is apparent that an officer of a publicly held business, whose shareholdings in his employer may be many times the value of the employer's stock held by his small business counterpart, will not usually be barred by the 5 per cent requirement from participating in a qualified option program. On the other hand, a relatively small investment in a small business can deprive an employee of this class of tax benefits.

Economic Drawbacks of Stock Options

The main justification for using stock options in a small business is probably the competitive necessity for offering a benefit comparable to those offered by larger firms. In the absence of such competitive pressure, stock options have very little to recommend them in a small business context, not only because of the considerations reviewed above but also because an option is seldom an economically sound compensation medium. This is particularly true in the light of the recent major reductions in individual tax rates in the higher brackets.

The primary drawback of options is quite simply their cost relative to compensation paid in cash. This cost is not always recognized because it is met through dilution of the equity of other shareholders and does not appear in the income statement, but it is nevertheless real. Moreover, because no tax deduction is allowed for compensa-

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option provisions was the large capital gain sometimes reaped by controlling shareholders of a closely held company. See President's 1963 Tax Message 492-93.

INT. REV. CODE OF 1954, §422(c)(3)(C), provides that, in determining the extent of an employee's shareholdings for purposes of applying the eligibility rules, he shall be treated as owning all shares that he has a right to purchase under outstanding options of any kind, including the option to be granted. This provision further narrows the class of eligible employees.

tion paid in this manner, the cost is multiplied substantially.[53] A corporation could pay out in deductible cash compensation $192.31 for each $100 in remuneration granted via the option route at the same net cost to itself (assuming a 48 per cent tax rate). The net after-tax benefit to the employee of the respective types of compensation will, of course, vary with the tax rate applicable to the cash payment and the timing of the disposition of stock acquired by option. However, even if we assume the most beneficial tax results of employing the qualified option – namely, that the employee holds the stock until death and thereby avoids all tax on his gain – it still appears that the corporation would achieve a better net result by paying cash compensation to all employees whose incremental current income would be taxed at a rate less than 52 per cent. Since only the amount in excess of $52,000 of a married taxpayer's taxable income is taxed at so high a rate, the significance of the above observation is clear. If it is assumed that the optioned stock will be sold, and the gain taxed, after the three-year holding period expires, the marginal tax bracket is substantially higher.[54]

The only possible countervailing economic advantage of stock options is the contingent nature of the gain to the employee. Since the value of the option accrues only as the employer's stock appreciates, the corporation is not out of pocket until the performance of its stock has justified the payment. Of course, similar results could be accomplished by means of well-designed profit-sharing arrangements with individual employees[55] or through a "phantom" stock plan for selected key men.[56] Nevertheless, a real and substantial equity interest in a small corporation, originally created in the form of a qualified option, may have an intangible incentive value that cannot be duplicated by a cash program.

CONCLUSION

Situations can be visualized in which the qualified stock option would serve the purposes of a small business admirably. Indeed, it is precisely in the smaller business that the exceptional endeavors of one or a few key men in management positions are most likely to be reflected in the value of the stock, and many examples of the suc-

53. For a review of cost considerations under the old law and rates, see President's 1963 Tax Message 484-87.

54. One writer concludes that the dividing line under these circumstances is 61%, which rate is applicable only to married taxpayers with taxable income in excess of $100,000. Baker, *Employee Stock Option Plans Under the Revenue Act of 1964*, 20 TAX L. REV. 77, 121 n.174 (1964).

55. See HAVIGHURST, DEFERRED COMPENSATION FOR KEY EMPLOYEES ch. 8 (1964).

56. See *id.* at 334-42.

cessful use of stock options in small but growing companies can be cited. Nevertheless, numerous considerations suggest that the qualified stock option cannot easily be adapted to the needs of the ordinary closely held corporation. These considerations lead to the conclusion that Congress might have better served the interests of small business by eliminating the stock option device entirely than by slightly increasing its availability to the closely held business.[57] If the big company's advantages were to be reduced by deleting tax-favored stock options from the Internal Revenue Code, the competition for capable employees would center more in the areas of cash and deferred compensation, where the small business operates under fewer and less artificial handicaps.

57. President Kennedy's 1963 tax reform proposals would have substantially done away with the tax benefits of stock options by taxing the employee at ordinary income rates on the full extent of his gain measured at the time of exercise. The effective rate would have been reduced by averaging provisions, and the burden of the tax would have been eased by provision for payment in installments over a period of years. See President's 1963 Tax Message 25, 147-48, 460-61.