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ARTICLES

Laura W. Morgan **Private Attorney Access to Child Support Enforcement Tools: Recommendations of the Interstate Commission**

Leonard M. Friedman **Options: Valuation, Taxability, and Divorce**

Karen Steinhauser **Presenting the Expert Witness in Child Physical and Sexual Abuse Cases: Challenges and Opportunities**

Don E. Stott **A Mediator's View of Custody Litigation**

Marilyn Barrett **How a Woman Can Protect Herself and Her Children in Divorce**

DEPARTMENTS

Joseph W. Cunningham **IRS Proposed Regulation on Taxation of Divorce Related Redemptions**

Jay E. Fishman and William J. Morrison **Business Valuation Case and Commentary: Cellular Phone Companies Valued as of Date of Divorce**

FEATURES

Ron Brown **Fairshare Cases: Self-Representing Attorney, Reverse Piercing of Corporate Veil, Support Where Artificial Insemination, GAL/Mediator, Passport Restrictions**

Anju D. Jessani **Checklist: Decisions to be Made in Divorce Mediation**

INDEX

Options: Valuation, Taxability, and Divorce

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Over the past decade, options have been widely used as an incentive tool to lure an employee into a company and/or keep valuable employees from leaving. Employers love them because they are generally cashless compensation. I have many tax clients that have become far wealthier due to their annual option awards than their pension plans and/or their regular savings could ever make them. I had one client come to me for tax planning who had 100,000 options shares with an exercise (strike) price of 50 cents a share. These were awarded at a time when his employer was almost bankrupt. His regular salary had been between \$100,000 and \$120,000 per year. The stock in 2000 hit \$160 a share and the options were worth more than \$16 million. There was very little chance that he could have amassed this kind of wealth on his regular salary.

Soon after, my client's administrative assistant came to see me. She makes \$35,000 a year but had 15,000 options shares at 50 cents a share. Need I say more? That's \$2.4 million for the secretary!!!!

I have many examples of clients becoming wealthy due to options. Recently, I have also had many clients who were almost worth a lot due to their unvested options—only to witness their employer's stock price plummet and their options no longer in the money. This is especially true with very volatile high tech companies. Such

valuations need to be handled carefully because these stocks may have as much upside potential as downside risk.

The purpose of this article is to educate readers about options, how they are valued, their taxability, and their impact in divorce cases. Some important definitions include the following:

- *Option.* The right (not the obligation) to purchase shares of stock at a specified price.
- *Strike or exercise price.* The specified price at which one can buy the underlying stock.
- *Vested shares.* The number of shares allowed to be exercised at any given time.

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- *Short sale.* The act of selling a stock before it is bought—the stock must be bought back at a later date.
- *Spread value.* The difference between the option exercise price and the price of the stock.
- *Volatility.* A measurement of how much a stock goes up and down within short periods of time.
- *In the money.* The stock price exceeds the exercise price of the option.

WHY OPTIONS ARE SO VALUABLE

Options are valuable in several different ways. One of the most basic elements of value is that the holder theoretically holds stock that he or she doesn't have to pay for and therefore there is value in the leveraging of those shares. Figure 1 is an example of option holder vs. stockholder value and is based on the following assumptions: (1) the owner has a 5 year option to buy 1,000 shares of stock in ABC Corp. for \$10—a total exercise cost of \$10,000; (2) the \$10,000 of exercise cost is invested in risk free investments for 5 years at 5 percent; and (3) the stock price increases 12 percent a year through year 5.

By leveraging the investment through the options, the options holder realizes a greater value because he or she does not have to lay out cash upon grant of the option.

This scenario illustrates the potential value of merely one aspect of holding a long-term option.

Another benefit (for illustrative purposes only) is that a person who trades a stock on a regular basis can use the open market to hedge his or her option in the stock. The following example is based on two assumptions: (1) the owner has a five-year option to buy 1,000 shares of stock in ABC Corp. for \$10; and (2) through a series of good news, the stock goes up to \$20 (this is common with a volatile company) and the holder sells short 1,000 shares of stock and receives \$20,000. This is commonly called a hedge. At this point, the holder cannot lose any money, but has theoretically capped his or her profit on the options except as follows:

Exception: The company stock price recedes back to \$10 and the holder covers his or her short (buys back). The holder has just earned \$10,000 and still owns the option, which continues to have value. (Therefore, the option has "put" value upon hedging—a put is a bet that the stock will go down.)

This type of trading (hedging) is not always prohibited under an option agreement. When there is a high level executive, however, there is generally a restriction on shorting his or her employer's stock.

VALUING OPTIONS

There are over 100 variations and formulas on valuing options. The most widely used method of valuing options is the Black Scholes method. In

FIGURE 1: OPTION HOLDER VALUE VS. STOCKHOLDER VALUE

	OUTRIGHT PURCHASE	STOCK OPTION
Purchase of Stock	\$10,000	\$ 0
Purchase of Five Year T Note		10,000
Interest Earned on T Note for Five Years		2,763
Appreciation in the Stock at 12% Annually	7,623	7,623
Gross Value at End of Five Years	<u>\$17,623</u>	<u>\$20,386</u>
Effective Annual Rate of Return	<u>12.0%</u>	<u>15.3%</u>

1997, the creators of this method won the Nobel Prize in economics. The calculation is very complicated, but is simplified by the use of computers and various Internet sites and financial tools. The six basic components for the calculation are:

1. Stock price
2. Exercise or strike price of options
3. Risk free rate of return (T bills) commensurate with the duration of the option
4. Volatility of the stock
5. Dividend yield (if the company pays dividends)
6. Duration of the option

These components will yield a theoretical value of the options based on the Black Scholes model when input into a Black Scholes formula. A model can be found on the Internet at *www.numa.com*. This model has been tested against a calculator that a client of ours uses with his subscription to Bloomberg. (The client manages a \$250 million hedge fund that our firm audits.)

VOLATILITY AND TIME COMPONENTS

The volatility of a stock is its most complex component, but feasible to calculate if one has the right tools (as shown in Figure 2). Volatility is one of two value drivers of an option (the higher the volatility, the higher the value). Volatility is calculated by taking the periodic percentage changes in the historical stock prices and calculating the standard deviation of the changes. The length of the option is the other value driver (the longer the option, the more valuable it is).

CALL VALUE AND PUT VALUE

It is important to remember that a stock's option value works both ways. There is value to a call option when the bet is that the stock will go up, and there is value to the put option when the bet is that the value will go down. The employee option is always a hope that the stock will go up—unless the holder is a savvy investor who is hedging (shorting) and betting the stock will go up or down at specified timing cycles.

Put value calculations have been offered as an alternative way to measure marketability dis-

FIGURE 2: CALCULATING VOLATILITY

	30% Volatility	75% Volatility
1. Stock Price	\$20.00	\$20.00
2. Exercise or Strike Price of Options	\$22.00	\$22.00
3. Risk Free Rate of Return	5.00%	5.00%
4. Volatility of the Stock	30.00%	75.00%
5. Dividend Yield	0	0
6. Duration of the Option (in months)	36	36
Value of the Option	\$ 4.51	\$ 9.93
	36 Months	72 Months
1. Stock Price	\$20.00	\$20.00
2. Exercise or Strike Price of Options	\$22.00	\$22.00
3. Risk Free Rate of Return	5.00%	5.00%
4. Volatility of the Stock	30.00%	30.00%
5. Dividend Yield	0	0
6. Duration of the Option (in months)	36	72
Value of the Option	\$ 4.51	\$ 7.19

counts because marketability discounts are related to the potential negative value that may occur as a result of the amount of time it takes to sell an interest in a non-marketable company.

To illustrate, consider how the market has come down in the past year. The most volatile stocks came down the hardest (and fastest). The best example of this is owning stock in a company, such as Priceline.com. Let's say you owned stock in Priceline.com and a private company similar to Priceline.com. On May 1, 2000, Priceline was \$64 a share and on October 1, 2000, the stock was \$12 a share. If on May 1, 2000, you decided to sell your one percent interest in Priceline.com, you could call up your broker and execute this trade within hours, if not minutes (not losing much). With your private company ownership, it would no doubt take months if not a year to sell. There is a potential negative value to the lack of marketability. Studies have shown that marketable securities and restricted securities have a value difference due to the disparity in their respective marketability. In addition, what better way to measure potential down value than a put options calculation—at least that is what some experts believe.

THE TAXABILITY OF OPTIONS

There are two basic types of options granted to employees: (1) Incentive Stock Options (ISOs); and (2) Non Qualified Stock Options (NQs).

NQs are taxed at the time of exercise as wages subject to regular and state income taxes, as well as wages for Federal Insurance Contributions Act (FICA) and Medicare purposes. The top tax rate combined is 46 percent after taking into consideration the federal tax saving of the state tax deduction. This tax is applied whether the stock is held or sold at the time of exercise.

ISOs are more complicated because they are not taxed at the time of exercise for regular tax purposes, but are taxed for Alternative Minimum Tax (AMT) purposes. If they are sold within a year of exercise, they are taxed as ordinary income (wages) but are not taxed for FICA and Medicare purposes (combined top rate of approximately 45 percent). Therefore, if sold within the year, the spread value is taxed at ordinary rates as ordinary income and the incremental value from date of exercise is taxed as short-term capital gains. If sold after one year of exercise, the entire gain (sale price less option price) is taxed as long-term capital gains (20 percent federal vs. up to 40 percent federal on ordinary income).

The fly in the ointment for ISOs is the AMT. Even though the ISOs that are exercised and held are not taxed for regular tax purposes, they are subject to the AMT. Without getting too technical, in most cases in which there is a significant spread value at time of exercise (over \$75,000) there will be a tax to pay due to the AMT. The tax rate is either 26 percent or 28 percent depending on how much other income there is on the person's tax return. The amount of AMT that is attributed to the ISOs does get credited in the year the stock is sold. In reality, the big difference between the held ISO stock and the NQ is a 12 percent tax rate differential on the exercise spread value.

DIVORCE IMPLICATIONS

Without giving an opinion on which method works best and most equitably, obviously life would be easier if the options could be split with the spouse. As most of us know, however, options are not assignable to a spouse—nor can they be assigned through a Qualified Domestic Relations Order (QDRO).

Property Considerations

Some of the alternative ways that I have seen option splitting handled include the following:

- The value at a given time is split and the optioned spouse pays a lump sum settlement. This is generally done post tax. This occurs when the spouse does not want to ride with the risk of the stock. I have also seen some spouses make bad decisions. In one case, it cost the spouse over \$25 million. In some other cases, however, it turned out to be the correct move. Attorneys must be very careful to cover their hides in these cases.
- The non-optioned spouse has a quasi trust set up in which he or she controls the decision on his or her divided share of options. When the options are exercised and sold, the net after tax amount is given to the spouse controlling the decision by the optioned spouse under the terms of the agreement.
- The vested options are liquidated and the unvested portions are dealt with similar to the options described previously.

Alimony Considerations

There is a strong argument that annual awards of options can be considered as compensation for the purposes of determining alimony. This argument in all probability *fails* if the following conditions *do not* exist:

- The employee is a long time employee of the employer.
- The employee is granted options consistently year after year.
- The stock of the company has a track record of increasing.
- The company is and has been publicly traded for years.

Let's review the reasons for granting options to employees of public companies:

- It provides a reward for past service or coming on board.
- It provides an incentive to stay on and grow with the company through vesting.
- It is a basically cashless compensation for the employer.

Based on this, if the spouse with the options received grants for new options year after year and his or her employment is long term, then there is an argument that the value of the options granted are added to salary (on average) for the purposes of alimony.

The first argument we hear when we propose this is that there is double dipping because the options are valued at the time of complaint or later and then divided in some fashion. The counter to that argument is the following: Suppose a person is earning \$150,000 a year base salary and consistently received bonuses totaling anywhere from \$50,000 and \$75,000 a year. Suppose further that most of the after tax bonus is saved and invested. Therefore, for alimony purposes, the salary would be between \$200,000 and \$225,000. If the investments typically saved

through bonuses (because they were saved and weren't needed to maintain lifestyle) at the time of the complaint were worth \$500,000, that amount would be subject to division. In this case, what is the conceptual difference between receiving cash bonuses and saving the same amount and receiving annual awards of options? In a way, the options are forced savings and usually amount to a great deal of money. Therefore, shouldn't the value of the annual option awards be added to salary for the purposes of alimony?

. . . options are forced savings that should be added to salary for alimony purposes.

The second and more esoteric argument relates to how the option awards are valued. Again, I refer to the Black Scholes model because it is the most widely accepted measure of value. The counter to this argument, however, is that when using an options model, it assumes that the option is freely tradable and can be hedged to maximize the theoretical value. Although this is a valid argument in some respects, it does not counter the argument that these annual awards have value and that the Black Scholes model is the most widely accepted valuation model for option valuation.

SUMMARY

In conclusion, it is fairly safe to say that options will remain a popular compensation tool for many years to come. They will always be a subject of controversy when it comes to splitting them up and/or valuing them. In addition, adding the value of an annual options award to cash salary when setting alimony will continue to be controversial, as well. I invite you to email your comments to lfriedman@rrbb.com or contact me by phone at (908) 231-1000 Ext. 531.