The New Stock Option: Problems of the Smaller Company

V. Henry Rothschild 2nd
THE NEW STOCK OPTION: PROBLEMS OF THE SMALLER COMPANY†

V. HENRY ROTHSCILD 2ND* 

I. INTRODUCTION

FOR the first time in over thirty years Standard Oil Company (New Jersey) has adopted a formal bonus plan for executives—a replacement in part of its stock option program. One of the first companies to adopt a stock option program following the enactment in 1950 of the first tax legislation relating to stock options, Jersey Standard had adopted a second such program in 1959 when the shares authorized for the first program were about to be exhausted. The new Standard Oil Bonus Plan was presented to supplement a 1964 stock option plan "of materially reduced proportions," "in view," the Company explained to its stockholders, "of the recent tax law amendments that have severely reduced the incentives formerly associated with stock options."

The new stock option, created by the Revenue Act of 1964, undoubtedly has more limitations than the pre-1964 restricted stock option. The view, as to consequent more limited usefulness as an incentive, by Jersey Standard has been echoed in other quarters. As we shall see in

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2. The first plan was formulated by the Board of Directors on March 29, 1951. Standard Oil Company (New Jersey), Proxy Statement for Annual Stockholders' Meeting, June 8, 1951, pp. 5-7. It was upheld against stockholder attack in the New Jersey courts. Eliasberg v. Standard Oil Co., 23 N.J. Super. 431, 92 A.2d 362 (Ch. 1952), aff'd per curiam, 12 N.J. 467, 97 A.2d 437 (1953).


8. For Executives, Cash is the Sweetest Deal, Bus. Week, Sept. 5, 1964, p. 10S: "Now that the tax law has robbed stock options of some of their luster, many companies are rewriting their compensation schemes—with a stress on hard cash." Patton, Executive Compensation by 1970, 42 Harv. Bus. Rev. 137, 139 (1964): "With the three-year 'holding'
this article, however, the limitations imposed by the 1964 tax legislation do not appear so severe as to eliminate or even substantially reduce proper use of the stock option. And, contrary to the forebodings of commentators, the fact of the matter is that there has been a continued and extensive use of the option since enactment of the 1964 tax legislation. Leading companies have been readopting stock option plans. By October 1, 1964, the number of stock option plans adopted or expanded to increase authorized shares for stock option programs by companies with securities listed on the New York Stock Exchange was actually greater than the number of such plans adopted or expanded during either of the two full preceding years. Here are the figures based on data furnished by the Exchange:

<table>
<thead>
<tr>
<th>Year</th>
<th>New Plans</th>
<th>Amendments to Plans¹⁰</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964 (Oct. 1)</td>
<td>129¹¹</td>
<td>12</td>
<td>141</td>
</tr>
<tr>
<td>1963</td>
<td>59</td>
<td>40</td>
<td>99</td>
</tr>
<tr>
<td>1962</td>
<td>94</td>
<td>37</td>
<td>131</td>
</tr>
</tbody>
</table>

Continued vigorous stock option activity likewise appears from replies received during July and August 1964 by the Executive Compensation Service of the American Management Association from 344 companies, representing what was considered by the AMA as a cross section of 6,000 subscribing listed, unlisted and closely-held companies. All but one of

period for capital-gains treatment of stock options, for instance, and the so-called first-in-first-out clause governing the exercise of options, the value of this entrepreneurial incentive has been reduced rather significantly.” See Stanton, Cash Comeback: Stock Options Begin to Lose Favor in Wake of Tax Law Revision, Wall Street Journal, Aug. 10, 1964, p. 1, col. 6.


For a thorough analysis and splendid materials concerning the new stock option, see 7-3rd T.M. Stock Options (Statutory)—Qualifications (BNA Tax Management Portfolio 1964).

9. Among such companies are American Metal Climax, Inc., The Dow Chemical Co., General Dynamics Corp., International Telephone & Telegraph Corp., Owens-Corning Fiberglas Corp., The Proctor & Gamble Co., United States Steel Corp.

10. This column includes amendments to add additional shares, to extend a plan for an additional period of time, and to reduce option prices.

11. This figure includes 26 plans submitted for stockholder approval to effect a change from a restricted to a qualified stock option plan.
the responding companies, which comprised over one-half of the 659 to which the questionnaire was sent, evidenced a general intention of continuing their stock option plans. Fifty-eight had already adopted new plans and 128 had revised earlier plans to conform to the 1964 tax law, 63 by submission to stockholders. Such activity scarcely bears out dire predictions as to the dim future of the new stock option.

The new stock option created by the Revenue Act of 1964 takes the form of either a “qualified stock option” or an option issued under an “employee stock purchase plan” (sometimes termed a “stock purchase option”). The pre-1964 restricted stock option is recognized by the Revenue Act of 1964 but, with minor exceptions, only for options granted prior to January 1, 1964.

This article will concentrate on a few of the problems presented by the new stock option as they appear today, with emphasis on its utility for smaller and closely-held companies. The discussion is necessarily subject to review in terms of the final treasury regulations.

II. MAJOR CHANGES

The new stock option was intended to meet a demand for reform so strong that it had led to a presidential message proposing tax treatment that would have virtually eliminated options as an employee incentive. Familiarity with the criticism which led to this demand is necessary to understand and utilize the new option, interpret the legislation which created it, and help obviate stockholder criticism of option programs and additional legislative or administrative curtailment.

Six major changes reflected in the new stock option can be traced to major criticism of the pre-1964 stock option. Most of this criticism was voiced in testimony before congressional committees, particularly before the Ways and Means Committee of the House of Representatives. The major changes and the criticism that led to their adoption may be summarized as follows:

12. The figures are from a forthcoming study to be published by the American Management Association as part of its Executive Compensation Service.
16. See Appendix, I(B) infra.
17. President Kennedy’s Tax Message of Jan. 24, 1963, H.R. Doc. No. 43, 88th Cong., 1st Sess. 21 (1963), recommended that “the spread between the option price and the value of the stock at the date the option is exercised be taxed at ordinary income tax rates at the time the option is exercised.”
18. An attempt was made by the writer to evaluate most of the criticism; see Hearings on H.R. S363 Before the Senate Committee on Finance, 88th Cong., 1st Sess. 2243-47 (1953).
1. **Sale of option stock:** Option stock is sold rather than retained as contemplated by tax legislation. It is sold either for quick profits or to finance purchases of other option shares, and the executive may thus be making no real cash investment and is not retaining the shares purchased as anticipated.

**Resulting change:** This criticism has led to perhaps the single most important tax change—the requirement that for the prescribed tax treatment an employee must hold stock acquired by exercise of a qualified stock option for three years after the date of transfer of stock upon exercise,\(^\text{19}\) instead of (a) six months from such date and (b) two years from the date of the option grant, as in the case of restricted stock options.\(^\text{20}\) While the old holding period rather than the new three-year period is applicable to options under employee stock purchase plans,\(^\text{21}\) the non-discrimination requirements for such plans, together with the relatively short term of the option and the ceiling on the amount of option stock with this form of option,\(^\text{22}\) will serve to discourage its use as a substitute for restricted stock options for executives.

2. **Reducing option price:** Perhaps as great or even greater criticism of the pre-1964 tax law was that it permitted the option price to be reset at a lower figure, either directly under given circumstances\(^\text{23}\) or indirectly through use of the so-called variable-price option, which permitted the option price to depend on market value of the stock when the option was exercised rather than when the option was granted.\(^\text{24}\) Critics contended that by permitting the option price to be reset at a lower figure after the option had been granted, the option operated as an incentive in reverse.

**Resulting change:** Provisions permitting the option price to be reset, either directly or indirectly through the variable-price option, have been confined to the "grandfather" or pre-1964 form of stock option, except for the limited variable price permitted for stock purchase options.\(^\text{25}\)

Even more important than the elimination of the price resetting clauses, which many companies in the past declined to adopt as a matter of policy, is the new requirement, in the case of qualified stock options,

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\(^{19}\) Int. Rev. Code of 1954, § 422(a)(1).


\(^{22}\) See text accompanying notes 79-82 infra.


\(^{24}\) Int. Rev. Code of 1954, § 423(c)(2).

of prior exercise of pre-existing restricted or qualified stock options carrying a higher option price.\footnote{26}

3. \textit{Dilution}: Critics argued that options "dilute" existing stock.

\textit{Resulting change:} This criticism opens up an especially difficult technical and controversial set of problems. Without meeting these problems directly, the 1964 legislation, with the criticism in mind, included requirements for stockholder approval within twelve months of the adoption of the plan, a ten-year term for the plan, and a requirement that the option price be no less than full fair market value at the date of grant in the case of a qualified stock option.\footnote{27} The 85 per cent discount is still permitted for stock purchase options,\footnote{28} but the employee stock purchase plans under which such options can be granted are viewed more as capital-raising plans, rather than employee incentives, and the discount is thus equivalent to what the company would otherwise have to pay to underwriters.\footnote{29}

4. \textit{Compensatory nature of options}: Option profits should be taxed at ordinary income tax rates since they involve compensation rather than capital gain.

\textit{Resulting change:} It was primarily to meet this point that the term of the new option was reduced from ten to five years.\footnote{30} Elimination of the variable price and the permissible discount from market value were also intended to decrease any compensatory element in qualified stock options.

5. \textit{Improper benefit of large stockholders}: Prior law permitted participation in option plans by large stockholders, and such stockholders do not need this employee incentive.

\textit{Resulting change:} The new stock option is limited to employees owning not more than 5 per cent in vote or value of stock, with a maximum of 10 per cent in the case of qualified stock options.\footnote{31}

6. \textit{Fair market value problem}: The problem of determining fair market value deprives smaller companies of the use of options.

\textit{Resulting change:} A qualified stock option will be entitled to tax

\footnote{26} See text accompanying notes 39-44 infra.
\footnote{27} Int. Rev. Code of 1954, § 422(b)(1), (2), (4). Stockholder approval had originally been proposed for the restricted stock option. See H.R. 6712, 89th Cong., 2d Sess., § 137 (1948).
\footnote{28} Int. Rev. Code of 1954, § 423(b)(6).
\footnote{31} Int. Rev. Code of 1954, §§ 422(b)(7), 423(b)(3).
benefits if an attempt was made "in good faith" to determine fair mar-
ket value upon the basis of which an option price of 100 per cent of
such value was fixed.  

III. QUALIFIED STOCK OPTIONS: SOME GENERAL PROBLEMS  

A. Effect of New Holding Period  

Undoubtedly, the required three-year holding period for qualified
stock options materially increases the investment risk of an employee
seeking the tax benefit of a qualified stock option. In addition, it makes
financing the purchasing of option stock through sales of the stock more
difficult.  

On the other hand, the new holding period is not so onerous a require-
ment as at first appears for the following reasons:
1. As with the previous holding period requirement, the new re-
quirement does not prevent borrowing on the stock as collateral or the
sale of other stock.
2. The reduction in tax rates effected by the 1964 Revenue Act
somewhat lessens the differential between ordinary income and capital
gain rates, and while this differential is still far from negligible, the
penalty for not observing the holding period requirements is not quite
so onerous as before.
3. If the holding period is not observed, the tax at ordinary income
rates is not on the profit from the sale of the option stock but upon the
spread at the time of exercise of the option. If the profit on sale should
be less than the spread, then the amount subject to ordinary income
tax is the profit, and if there is no profit on the sale, no amount will be
subject to ordinary income tax.  

4. The new averaging provisions added to the Code by the 1964
Act lessen the penalty for failing to observe the holding period. By
permitting the spread-back of income for tax purposes, the 1964 Revenue
Act prevents application of steeply progressive rates which might other-
wise have been applicable.

34. For a discussion of the problems involved, see Rothschild, Financing: Stock Pur-
35. Int. Rev. Code of 1954, § 425(c)(1)(C). "Disposition" does not include "a mere
pledge or hypothecation." However a disposition does include a gift of any kind other than
5. Finally, as in the case of the pre-1964 stock option, the holding period requirement is inapplicable in case of death.  

B. Exercising of Pre-existing Options

The requirement, in the case of a qualified stock option, for prior exercise of a pre-existing option on stock of the same class carrying a higher price presents a number of practical and technical problems.

1. The option itself must contain the prior-exercise requirement, at least, unless there are in fact, no prior outstanding qualified or restricted options.  

2. The requirement applies by its terms only if the preexisting option was a qualified or restricted stock option. A qualified stock option can apparently be exercised if the pre-existing option is a stock purchase option or a non-statutory stock option, whether or not carrying a higher price.  

3. A qualified option can be exercised if the preexisting option is a restricted stock option granted before January 1, 1964 which has not yet become exercisable. Subject to this exception, the requirement applies to all options, whether or not exercisable at the time the qualified stock option is to be exercised.

A number of companies have had a practice of granting options annually, with each annual set of options exercisable only after a period of time. If one annual set of options should, when exercisable, carry a higher price than a later annual set of options, and the first set is not yet exercisable, the second set cannot be exercised and conceivably could lapse before it could be exercised. To avoid this problem without permitting exercise of the lower-priced options first, the 1964 legislation permits acceleration of the exercise date of qualified or other options without such acceleration being deemed a modification. Apart from permitting acceleration of the exercise of options, the 1964 legislation apparently permitted a pre-1964 restricted option to be cancelled during 1964 and a new option at a lower price to be granted.

4. The requirement of prior exercise of a pre-existing outstanding

43. See Int. Rev. Code of 1954, § 422(c)(2)(A). For the elaborate reasoning in support of this position, see Cox, supra note 8, at 299-300.
option applies even if the preexisting option is to purchase stock of a different class, irrespective of price.44

5. The requirement apparently does not apply to a contemporaneously granted option carrying a higher price. For example, assuming a fair market value for its stock of 100 dollars a share, a company might grant an employee an option to purchase 100 shares at 100 dollars, a second 100 shares at 105 dollars and a third 100 shares at 110 dollars. If all three options were granted at the same time, they apparently could be exercised in any order without prejudice to qualification of any option for tax benefits.

C. Payment for Option Stock

A number of stock option plans have permitted payment for stock in installments following exercise of the option, a method of financing which avoids bank loans and may make unnecessary the sale of other stock for option financing purposes.45 In connection with the new stock option, the Treasury Department has taken the position that if the option price is equal to no more than fair market value when the option is granted and the employee who exercises an option is permitted to pay any part of the purchase price over a period of more than one year from the date of exercise, the option will not be a qualified stock option unless the employee is required to pay at least 4 per cent interest on the unpaid balance of the option price.

The position of the Treasury Department derives from section 483 of the Code, attributing unstated interest under given circumstances in the case of the purchase of property in installments.46 The treasury position, however, depends not on section 483,47 but upon the premise that a note or other obligation to pay for property over a period of time is not the equivalent of a current payment of cash, and that the employee accordingly has not paid the full market value required for a qualified stock option. In theory, the same position could have been taken to disqualify a pre-1964 option if the minimum statutory percentage of market value was to be paid over a period of time.

To avoid requiring full payment on exercise or charging 4 per cent simple interest, the company could presumably increase the purchase

45. See Rothschild, supra note 34.
47. Section 483 may be held inapplicable to the sale by a company of its own stock. See the exception in Int. Rev. Code of 1954, § 483(f)(3); Cox, supra note 8, at 298-99. But cf. Rubenfeld, supra note 8, at 141.
price to reflect the additional value of installment payments, but then it might still be liable for taxes on unstated interest under section 483.

D. Requirements of a Stockholder-Approved Plan

A number of questions arise as a result of the new requirement that a qualified option must be granted under a plan that has been or is later approved by stockholders.48

With respect to the class of stockholders that must approve the plan, the Treasury Department has taken the position that only stockholders entitled by applicable law to vote on this question need approve the plan.49 It has also taken the position that the percentage vote required by the company’s by-laws or other local law requirement will suffice.50

Other questions remaining open as a result of the requirement of a stockholder-approved plan include:

1. Eligible Employees: Under the requirement that a qualified option must be granted under a plan that designates the employees or class of employees eligible to receive qualified stock options,51 the Treasury Department, in accordance with legislative intention,52 has taken the position that a designation of “key employees” is sufficient and that, with a permissible class designation such as “key employees,” the plan itself need not otherwise designate specific employees but may leave selection to the board of directors or a committee. In the case of an employee stock purchase plan, employees owning more than 5 per cent of the stock in vote or value must specifically be made ineligible by the terms of the plan.53

2. Aggregate Number of Shares: Under the Code requirement that the plan designate “the aggregate number of shares which may be issued” under qualified options,54 the Treasury Department has taken the position that the plan may provide for an increase in shares as the result of stock dividends, reclassification and the like.55 A number of questions are still open—among them the question of whether, on a merger or consolidation, pre-existing options can be assumed outside the provisions of the plan.

50. Ibid.
3. Amendment of the Plan: No change may be made in the provisions of the plan relating to eligible employees or aggregate number of shares without again seeking stockholder approval. Apparently other provisions of the plan may be amended by the board of directors without new stockholder approval. However, it may be open to question as a corporate, if not a tax, matter whether basic provisions of the plan such as the consideration for options, their term, the time when they may be exercised and, surely, the term of the plan itself, can be changed by the board of directors after the plan has been approved by stockholders.

E. Modification of Option Agreements

Prior to the 1964 Revenue Act, any change in the terms of an option, subject to a few stated exceptions, was specifically defined as a "modification" if it gave the employee additional benefits; any modification, as so defined, and any extension or renewal of an option, made it necessary that the option price be set in terms of the market value at the time of the modification, extension or renewal, or at the time of grant, whichever was higher. While the statutory provisions relating to modification have been retained for stock purchase options (except for the price reset clause), as well as for restricted options, they are inapplicable to qualified stock options; the only pertinent provision applicable to qualified stock options is one stating that a modification, extension or a renewal of an option will be considered the grant of a new option. The latter provision would prevent amending a qualified option without increasing the option price if, at the time of the amendment, the market value of the option stock is higher than when the option was granted.

A qualified option can be amended if at the time of amendment the market value is lower than at the time the option was granted, and the amendment can reduce the option price, but the option cannot be exercised at the higher price during the original term of the option.

As we have noted, a special rule apparently permitted cancellation of an option prior to January 1, 1965, even though, through the grant of a new option at a lower price, the option price may in effect be reduced,

56. See ibid.
60. See text accompanying note 43 supra.
provided the option price is not less than market value at the time the new option is granted.

F. Continuous Employment

For tax-favored treatment, continuous employment is required from the date of grant of the option until three months prior to its exercise,\(^{61}\) instead of the previous requirement of employment only at the time of the grant and either at exercise or within three months prior to exercise.\(^{62}\) The change in the employment requirement raises questions as to the effect of intervening military or government service, and the extent to which a company-granted leave of absence will prevent termination of employment disqualifying the option. Based on legislative history,\(^{63}\) the Treasury Department has taken the position that military leave or sick leave will not disqualify the option, but the factual situation may, at least theoretically, be subject to review.\(^{64}\)

IV. Special Problems of the Small Company

For the smaller company unable to afford large salaries, a substantial pension program, or other forms of supplemental compensation popular today, the stock option may provide one of the very few practical methods of attracting and retaining effective management. It is particularly in a company which is at the threshold of a new enterprise or the development of a new product, or which has had substantial reverses and faces an uncertain future, that the stock option, valueless in terms of the present but offering great hopes if management is successful in developing the future, finds its most effective and justifiable use. Yet it is in the small company with unlisted stock that the most serious problems of using the stock option have been posed.

A. The Problem of Fair Market Value

Chief among the roadblocks to use of the option in the smaller company has been that of determining fair market value for the purpose of the option price. In the case of the pre-1964 restricted stock option, Congress, recognizing the problem, granted some leeway for undervaluation before disqualifying the option from favorable tax treatment; 5 per cent undervaluation would result in no disqualification for capital gain treat-

\(^{63}\) See Senate Report, supra note 52, at 92.
ment and 15 per cent undervaluation would result in only limited dis-
qualification for such treatment.\textsuperscript{65}

1. Fair Market Value for Qualified Option

A different legislative approach was used in the case of the new quali-
ified stock option. No amount of undervaluation will disqualify an option
which otherwise meets the legislative tests, provided an attempt was made
"in good faith" to fix the option price at no less than fair market value
at the time the option was granted. A \textit{bona fide} undervaluation will not
"disqualify" the option but results in taxing to the employees as compen-
sation the lesser of (1) 150\% of the spread, at the time the option was
granted, between the option price and the market value of the option
stock, as ultimately determined, or (2) 100\% of the spread at the time of
exercise between the option price and market value at that time.\textsuperscript{66} The
tax penalty will, as heretofore, result in increasing the cost basis of the
stock in the hands of the employee.\textsuperscript{67}

In accordance with the legislative history of the provision, appraisals
will meet the good faith test provided that there are at least two apprai-
sals, that the appraisers are "well qualified" and that they are "com-
pletely independent."\textsuperscript{68}

Valuation of fair market value of closely-held stock being an inexact
science at best, two or more appraisers may well arrive at different market
values. Fixing the option price at the average of two or more appraisals
should meet the good faith test.\textsuperscript{69} Appraisers can presumably qualify
either from experience in appraising the stock of closely-held or smaller
companies generally, or through experience with the stock of the particu-
lar company as in the case of a brokerage firm. However, a broker special-
izing in or handling the company's stock could conceivably be held lack-
ing in the requisite "complete independence." Certainly, the appraiser
should have no connection, by representation on the board of the com-
pany, or by relationship or otherwise with the company's management
or employees to whom the options are to be granted.

As with the pre-1964 options, conformance with reasonably proximate

\textsuperscript{65} See Int. Rev. Code of 1954, ch. 736, § 421(b), 68A Stat. 143, in effect taxing as
compensation fair market value less option price at date of grant or amount realized on
disposition less option price, whichever is less.
\textsuperscript{66} Int. Rev. Code of 1954, § 422(c)(1).
\textsuperscript{67} See ibid.
\textsuperscript{69} Committee Report, supra note 68.
valuations accepted by the Treasury Department for estate or gift tax purposes, appropriately updated, if necessary, should surely be deemed a good faith attempt to fix market value.

These tests do not differ markedly from those used in the past in fixing the option price for pre-1964 options. Thus, for the purpose of options granted by Ford Motor Company in 1953, before its stock was listed on the New York Stock Exchange, the fair market value of the stock was fixed by appraisals. A price of 21 dollars a share so fixed does not appear to have been questioned, although there was a public offering less than three years later at 64.50 dollars a share.

Indeed, on analysis, the newly qualified stock option seems less advantageous for the smaller company than the old restricted stock option for the following reasons:

1. In the case of the new option, an undervaluation below fair market value in any amount at all results in a tax of the difference at ordinary income tax rates, whereas in the case of the restricted stock option, a leeway of up to 5 per cent was permitted without such a result.

2. Good faith in fixing fair market value for the purpose of a new stock option does not preclude application of the tax penalty upon the employee. It is only when the option price is more than 15 per cent below fair market value, both at the time of grant and at the time of exercise, that the new stock option may possibly benefit the employee more than the pre-1964 restricted stock option.

3. Most important of all, a company which makes an error of more than 15 per cent in a good faith attempt to fix market value for the purpose of the new stock option may be held to have lost the tax deduction which it could formerly have taken for the error. For example, assume the grant of an option for 100 shares at 70 dollars a share, the 70 dollar price having been fixed in good faith as fair market value at the time of grant. Assume further that the fair market value of the stock at both the time of grant and at the time of exercise is ultimately determined to have been 100 dollars a share. In the case of an option granted before 1964, the company could claim 30 dollars a share, or 3,000 dollars, as a tax deduction for compensation, since the option would not have been considered a restricted stock option. Apparently, the company would not have this tax deduction under the 1964 Revenue Act, since the erroneous bona fide valuation may not, as a matter of construction, disqualify the option as a qualified stock option, and a company is denied any tax deduction in respect of a qualified stock option.\footnote{70}{Int. Rev. Code of 1954, § 421(a)(2).}
2. Fair Market Value for Stock Purchase Options

The new provisions relating to a good faith attempt to fix fair market value do not apply to options granted under employee stock purchase plans. The penalty for undervaluation imposed by prior law applies to such stock purchase options, with the 15 per cent discount from fair market value permitted under employee stock purchase plans\(^7\) paralleling that for restricted stock options.\(^7\) Undervaluation of more than 15 per cent of fair market value at the time of grant or exercise will result in disqualification of the option, with the consequence that under applicable case law, the penalty, generally speaking, will be treatment as ordinary income of the spread between option price and fair market value at the time of exercise.\(^7\)

B. Restrictions on Disposition of Qualified Option Stock

A prohibition, limited in point of time, against sale of stock acquired on exercise of a qualified stock option should be given consideration in the case of options granted by closely-held or smaller companies. As a business matter, such a prohibition is usually consistent with the objectives of majority stockholders of smaller companies, who will not favor sales by employees to the public.

The prohibition can also help obviate fair market value problems. If the restriction against sale is held to have a "significant effect" on the value of the stock, the employee will realize no taxable income until the restriction lapses, with the amount taxable based on the spread between option price and market value on exercise or on lapse of the restriction, whichever is less. This result follows from Treasury Regulations in connection with non-restricted stock options\(^7\) which have not been changed as the result of the 1964 legislation.

A three-year period during which the stock cannot be sold imposes no more stringent a requirement than that needed to entitle a qualified stock option to tax benefits and should be deemed to have a "significant effect" on the value of the option stock.\(^7\) A similar result can ensue from a requirement that, upon termination of employment, the stock be resold to the company at a price derived from the type of formula used by service companies and based on factors such as book value, earnings, etc.

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For safety of capital gain treatment on such a resale, however, the stock should have been paid for by the employee at the time of exercise of the option or, in any event, prior to resale to the company. 70

Other restrictions upon the stock acquired by exercise of a qualified stock option might be a requirement precluding sale of the stock until after a period of employment or until attainment of profit objectives.

When restrictions are imposed on stock which have a "significant effect" on its value, the company's tax deduction will follow, in time and amount, the tax upon the employee as compensation. 77 Thus, the company will have a tax deduction only when the restrictions upon the stock lapse and the amount of the deduction will be the spread between option price and market value on exercise or on lapse of the restriction, whichever is less.

C. Financing Problems

The problems of financing exercise of an option to purchase stock are more serious for the employee of a company whose stock is not actively traded than for the employee whose listed stock can readily be disposed of, for the stock of such a company will generally not be as readily accepted as collateral for a loan. As against this consideration, however, bank borrowing with the stock as collateral or for the purpose of purchasing stock is not subject to Regulation U of the Federal Reserve Bank, which, in the case of stock listed on a national securities exchange, currently prohibits such loans for an amount in excess of 30 per cent of the fair market value of the stock to be purchased.

In the past, it has often been contemplated, in the case of smaller companies, that stock will be purchased and paid for by the employee chiefly through use of dividends on the stock or bonuses, or both. Without a down payment, it may be open to question whether an obligation to pay for stock in this manner constitutes exercise of the option, particularly when the company has an obligation to repurchase the stock on termination of employment. 78 Moreover, taxable interest may perhaps be imputed to the company if less than a specific rate of interest (currently 4 per cent) is charged on the unpaid balance. 70

D. Utility of Employee Stock Purchase Plans

If sufficient employees are to be offered stock, options granted under an employee stock purchase plan call for consideration by the closely-
held company. As previously mentioned, the option price can be as low as 85 per cent of fair market value, with tax consequences the same as heretofore in the case of restricted stock options. The option price can be made to depend on the lesser of fair market value when the option is granted and when the option is exercised. The option term can be as long as five years if the option price is fixed in terms of fair market value when the option is exercised. The holding period is only six months after the option is exercised and two years from the date of grant. The stock purchase option can be exercised although the option price may be lower than the option price of pre-existing and outstanding options, there being no requirement in this regard similar to that for qualified options.

The disadvantages of a stock purchase option arise primarily from the number of employees to whom it must be offered. All employees with two or more years of service must be included, except for temporary employees defined as those whose customary employment is twenty hours or less a week and for seasonal employees defined as those whose customary employment is five months a year or less. As with pension plans, officers, supervisory and highly-paid employees may be omitted.

The discrimination rules which require offering the plan to all employees, with the sole exceptions above mentioned, likewise apply to the administration of the plan. A uniform relationship to compensation is permitted, but the formula cannot eliminate or reduce shares for lower paid employees, as by excluding the first 4,800 dollars of compensation. Rules as to inclusion or exclusion of bonuses, overtime and the like may follow similar rules relating to compensation considered for pension purposes.

A further important limitation on stock purchase options is that such an option cannot be made exercisable in respect of stock having a market value of more than 25,000 dollars a year. For the purpose of this limitation, a stock is taken at its fair market value at the time of grant, present-

80. See text accompanying note 71 supra.
82. Int. Rev. Code of 1954, § 423(b)(7). Otherwise the term must not exceed 27 months. Ibid.
86. See discussion in 2 Washington & Rothschild, op. cit. supra note 73, at 677-78.
ing to the smaller company the valuation problems that have heretofore been discussed. 88

It should be observed that there is no requirement that employees of all subsidiary and affiliated companies be included in an employee stock purchase plan, raising the possibility of a plan confined to employees of a single corporation in an affiliated group. Such a solution may present problems in the case of employees rendering services to more than one company in the group.

E. Substantial Stockholders

For stockholders of smaller companies, the new limitation of statutory tax treatment to employees holding less than 5 per cent of the stock of their company (5 per cent to 10 per cent in the case of qualified stock options, depending on the amount of equity capital) 89 has added significance. The combined voting power or value of all classes of stock owned by the employee is counted. The rules of attribution of stock ownership apply as heretofore. 90 Stock subject to the option and to all forms of pre-existing option, statutory or non-statutory, is likewise counted. Stock is apparently counted though under option not yet exercisable. 91 For the purpose of determining the total stock outstanding, however, stock subject to option is apparently not counted.92

For the additional percentage over 5 per cent permitted in the case of qualified options, equity capital is, in substance, defined as the adjusted basis of assets less indebtedness to persons other than shareholders. 93 In the case of a group of corporations, provision is made to count the equity capital of all in the group after eliminating the effect of intercorporate ownership and transactions. 94

In the case of a qualified option, the option qualifies pro tanto to the extent of the permissible percentage and, if it can qualify in part, is not wholly disqualified. 95 Thus, in the case of such an option granted to a 4 per cent stockholder which would bring his percentage of stock ownership to 5½ per cent in a situation in which only 5 per cent is permitted, the option can still qualify for statutory tax treatment to the extent,

88. See text accompanying notes 65-70 supra.
94. Ibid.
generally speaking, of option shares equivalent to 1 per cent of the combined voting power or value of all classes of stock.

V. SUMMARY AND CONCLUSION

The new stock option is more restrictive than the pre-1964 stock option chiefly (a) in its holding period of three years from the date of purchase, (b) in precluding reduction of the option price and requiring exercise of prior options carrying a higher price, and (c) in its term of five instead of ten years. However, these and other limitations do not impair the basic usefulness of the option in proper cases, and the evidence to date points to continued vigorous use of option plans.

This is not to say that the option practice of the past should or will be followed. Excessive and indiscriminate use of options has evoked vocal and vigorous opposition on the part of stockholders and, to an increasing extent, a critical viewpoint in financial circles. This opposition in itself is tending to serve as a deterrent. Moreover, the stock option is increasingly recognized as an expensive measure entailing as it does the company's loss of any tax deduction.

As a result, forward-looking companies have begun to study and put into effect more suitable, more attractive and more effective arrangements for executives, including stock bonus, stock unit, profit-sharing, dividend equivalent and other plans, sometimes supplemented by modest stock option programs. Attention is also being given to non-statutory stock programs.

In the unlisted and closely-held company, the problem of fair market value for its stock has not been solved and the new stock option will probably not prove of much greater utility than its predecessor. For such a company, stock plans that have evolved in the past entailing restrictions on disposition of stock will probably continue to be found appropriate.

APPENDIX

SUMMARY OF SUBSTANTIVE CHANGES RELATING TO STOCK OPTIONS MADE BY THE REVENUE ACT OF 1964

I. The Restricted Stock Option [§ 424].* Generally speaking, prior rules apply:
   A. If granted before January 1, 1964 [§ 424(b)].
   B. If granted on or after January 1, 1964, and
      1. Pursuant to a binding written contract executed before January 1, 1964 [§ 424(c)(3)(A)], or

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* Bracketed sections refer to the Int. Rev. Code of 1954 unless otherwise noted.
2. Under a written plan approved before January 1, 1964 if (as of both that date and date of grant of option):
   a. The plan meets the non-discrimination and coverage requirements for an employee stock purchase plan (viz., all employees are covered with relatively minor exceptions, see III(D) and III(E) below), or
   b. The plan was not in its administration discriminatory in favor of officers, supervisory or highly paid employees [§ 424(c)(3)(B)].

II. The New “Qualified” Stock Option [§ 422].

A. What the option itself must provide.
   1. Option term—five [§ 422(b)(3)] instead of ten years.
   2. Option price—100% of fair market value [§ 422(b)(4)] instead of (a) 95% to 100%, or (b) 85% to 95%.
      a. Requirement of good faith determination of fair market value [§ 422(c)(1)].
      b. Penalty for undervaluation results in taxable compensation upon exercise of option equal to lesser of
         (i) 150% of spread on date of grant, and
         (ii) 100% of spread on date of exercise with corresponding increase in cost basis [§ 422(c)(1)].
   3. Prior exercise of “outstanding” qualified or restricted options [§ 422(b)(5)].
      a. Restricted stock options granted before January 1, 1964 are “outstanding” only when exercisable [§ 422(c)(2)].
      b. Rule inapplicable if prior options all cover stock of the same class as new option with option price no higher [§ 422(c)(6)].
   4. Non-transferability rules as heretofore [§ 422(b)(6)].
   5. Prohibited provisions.
      a. Variable price [§ 424(c)(2)].
      b. Reduction of option price (with exception for anti-dilution clause) [§ 425(h)(2)(B)].

B. Requirements for qualification apart from terms of option.
   1. Stockholder approval within 12 months before or after plan is adopted [§ 422(b)(1)].
   2. Requirements of a plan [§ 422(b)(1)].
      a. Designation of aggregate number of shares.
      b. Designation of employees or class of employees.
      c. Possible requirement of prior or subsequent adoption by board.
   3. Term of plan—ten years from earlier of (i) adoption by board or (ii) stockholder approval [§ 422(b)(2)].
4. Requirement of a "reason connected with employment" as heretofore [§ 422(b)].

5. Ineligible stockholder-employees [§ 422(b)(7)].
   a. Holder of over 5% of stock in vote or value as against prior specific requirements for over 10% stockholders (five-year term and 110% of fair market value).
   b. Holder of up to 10% is eligible if capital is $1 million, with proportionate percentage adjustment downwards with increase in capital to $2 million [§ 422(b)(7)].
   c. Rules of attribution as heretofore [§ 422(c)(3)(B)].
   d. Inclusion of all option stock to disqualify [§ 422(c)(3)(C)].

C. Requirements on employee for prescribed tax treatment.
   1. Holding period of three years from date of exercise, instead of six months from exercise and two years from date of option grant [§ 422(a)(1)].
   2. Continued employment from option grant to three months from termination, instead of requirement of employment only on grant and on exercise or three months prior to exercise [§ 422(a)(2)].
   3. Waivers following death [§ 421(c)(1)(A)].

D. Tax Treatment.
   1. Of employee [§ 421(a)(1)].
      a. If option price is fixed in good faith at less than fair market value, see II(A)2(b) [§ 422(c)(1)].
      b. If holding period is not observed [§ 421(b)]. Effect of loss on sale [§ 422(c)(4)].
   2. Of company [§ 421(a)(2), (a)(3)].

III. Employee Stock Purchase Plans [§ 423].

A. Eligibility confined to employees [§423(b)(1)].

B. Requirement of stockholder approval of a plan similar to that for a qualified stock option (see II(B)1) but no specific requirement of designation of number of shares or eligible employees [§ 423(b)(2)].

C. Ineligible stockholder employees [§ 423(b)(3)].
   1. Flat 5% instead of over 5% as with qualified options, see II(B)5(a).
   2. No adjustment if capital is less than $2 million as with qualified options, see II(B)5(b).
   3. Inclusion of all option stock to disqualify.

D. Requirement of inclusion of all employees [§ 423(b)(4)].
   1. With two or more years of service.
   2. Who are not temporary or seasonal employees, i.e., customarily
employed twenty hours or less a week or five months or less a
year.
3. Who are not officers, supervisory or highly paid employees.
E. Absence of discrimination in plan provisions against lower-paid em-
ployees [§ 423(b)(5)].
F. Purchase price of at least \(85\%\) of market [§ 423(b)(6)]:
1. On grant of option, or
2. On exercise of option.
G. Term of option [§ 423(b)(7)].
1. Five years if purchase price is based on market value on exer-
cise.
2. Otherwise, 27 months.
H. Limitation of amount of stock to \(\$25,000\) of fair market value dur-
ing each calendar year (valued on grant of option) [§ 423(b)(8)].
I. Non-transferability requirements as heretofore [§ 423(b)(9)].
J. Requirements on employee for prescribed tax treatment.
1. Holding period of two years from option grant plus six months
   from option exercise as with restricted stock options [§ 423
   (a)(1)].
2. Continued employment from option grant to three months prior
to date of exercise [§ 423(a)(2)].
1. Of employee.
   a. When option price is 100\% of fair market value—profit on
   sale at capital gain rates [§ 421(a)(1)].
   b. When option price is less than 100\% of fair market value—
discount from fair market value is compensation taxable on
   sale or death [§ 423(c)].
2. Of company—no deduction [§ 421(a)(2) and (3)].

IV. Transitional Rules Applicable to 1964.
A. A qualified stock option can be granted in 1964 without stockholder
approval and without a plan (and, necessarily, without the require-
ment that the option be granted within ten years of adoption of a
B. During 1964, either a restricted stock option or any other form of
option, whether or not statutory, can be changed into a qualified
stock option and a lower price thereby retained if the option price
was 100\% of fair market value at the time the option was granted,
or is increased to 100\% of fair market value at that time, irrespec-
tive of market value at the time of the change. Revenue Act of
1964, § 221(e)(3)(B) (1964 U.S. Code Cong. & Ad. News 280);
cf. [§ 425(h)(3)(B)].
C. A restricted stock option carrying a high option price can be cancelled in 1964 and a new qualified stock option carrying a lower option price can be issued at the same time or at any other time during 1964 \[\text{§ 422(c)(2)(A)}\]. Such a cancellation will probably not be permitted after 1964 without adverse tax consequences.

V. Reporting Requirements.

Beginning in 1965, new reporting requirements are imposed on companies that have granted stock options \[\text{§ 6039}\].

A. The company must file an information return showing all stock transferred by the company pursuant to a restricted or qualified stock option exercised during the preceding year.


2. The reporting requirement as to exercise does not apply to exercise of the new form of option granted under an employee stock purchase plan.

B. The company must also report the first transfer of stock from the employee (or other person who exercised the option) if the stock was originally acquired pursuant to exercise of either a restricted stock option carrying an option price of less than 95%, or of a stock purchase option carrying an option price of less than 100%, of fair market value when the option was granted.

1. This reporting requirement applies to the first transfer of each share under such an option. \[\text{§ 6039(a) (last sentence)}\].

2. The requirement applies only to an option which would produce ordinary income as the result of the option price, and is thus inapplicable to a qualified stock option and to a restricted stock option carrying an option price equal to at least 95% of fair market value at the time of grant.

C. The reporting company must give the employee a written statement before January 31 of the reporting year. \[\text{§ 6039(b)}\].

D. The company's treatment of the option governs for purposes of the reporting requirements \[\text{§ 6039(a) (second sentence)}\].

E. For each failure to file a report the penalty is $10 with a maximum of $25,000 a year \[\text{§ 6652(a)}\].