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**TAX FACTORS IN BALANCING THE INTERESTS OF  
INVESTOR - SHAREHOLDERS AND OFFICER - SHAREHOLDERS**

Edward J. Hawkins, Jr.

## STATEMENT OF PROBLEM

The simplest capital structure for a new company is a single class of voting common stock. This stock is issued to the individuals investing in the new company in direct proportion to the money or property contributed by each. Control of the company is then proportionate to the number of shares owned, and if the company grows, the increase is owned proportionately.

There are many situations, however, in which such a simple capital structure is unsatisfactory. One such situation may arise whenever substantially all of the capital of a new company is to be contributed by investors who are to play little or no part in daily management, and the daily management is to be supplied by corporate officers who are able to contribute very little money or property to the company's capital.<sup>1</sup> Under the simple capital structure just outlined, the officers, who risk their time and effort, would have substantially no share in the control of the company and substantially no share in equity growth. Accordingly, these men often will want the capital structure to be modified in such a way as to give them greater interests than their financial contributions.

In the present discussion we shall consider a number of the devices which have been developed to meet the situation just described. In particular, we shall consider elements in the capital structure designed to allocate control and equity ownership disproportionately to cash investments; employment contracts; devices for increasing the cash investment of the officers; and devices for decreasing the cash investment of the investors.

**ADJUSTING CAPITAL STRUCTURE TO GIVE OFFICERS  
DISPROPORTIONATE CONTROL AND EQUITY OWNERSHIP**

The first method of giving the officers a disproportionately large share in control and equity ownership is the issuance to the investors of debt, preferred stock, or common stock restricted as to voting rights. The use of debt has already been discussed, particularly in reference to the

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1. For simplicity, we shall refer to those who contribute money but little time as the investors and those who contribute time but little money as the officers.

frequently troublesome "thin capital" problem.<sup>2</sup> For present purposes, it should simply be added that to the extent that debt instruments are issued to an investor he is separated both from an interest in equity growth and from control. The separation from control is not complete, of course, since the investor will have the usual creditor's rights if there is a default on the debt. In addition, it is possible to write into debt instruments a variety of provisions giving the investor, in effect, a veto power over various decisions and even powers of affirmative control in certain circumstances.

Preferred stock gives the investor no direct interest in equity growth. Of course, if the company does grow and have large earnings, there will be an indirect benefit to the preferred shareholder since his interest will be better protected, and this added security may be reflected in an increase in the market value of his stock. The control of the corporation attached to the ownership of preferred stock can also be extensively limited. The preferred shareholders' right to vote can be limited to certain questions, and by issuing fewer shares in proportion to the dollars contributed, the proportionate voting strength of the preferred shareholders even on such questions can be reduced.

It should be noted, on the other hand, that preferred stock has most of the tax disadvantages of common stock without sharing in some of the tax advantages. Like common stock, there is danger of dividend treatment if the stock is redeemed by the company, and the company gets no deduction for dividends paid. Preferred stock does not qualify under section 1244 for ordinary loss treatment,<sup>3</sup> and a company which issues preferred stock does not qualify for the election under Subchapter S.<sup>4</sup>

Non-voting common stock is an alternative method of separating investment from control, while preserving to investors their full proportionate share in equity growth. Of course, the division need not be simply between a class of voting stock and a class of non-voting stock: voting power may be divided between the classes in various ways. One class may be entitled to vote only on certain questions, or it may have fewer shares (and hence fewer votes) per dollar of investment, or voting by classes may be required on certain questions. Of course, provisions of this type in the case of offerings in Ohio must be cleared with the Ohio Division of Securities, which will want to make sure that the securities are not being issued on unconscionable terms.<sup>5</sup>

2. See discussion pp. 205-09.

3. INT. REV. CODE OF 1954, § 1244(c)(1). (Hereinafter cited as §.)

4. § 1371(a)(4). § 306 also imposes additional handicaps on the use of preferred stock, but § 306(c)(2) makes these provisions inapplicable to preferred stock issued as part of the original capital structure. See discussion pp. 319-30.

5. OHIO REV. CODE § 1707.09. Variations in voting rights are dealt with in OHIO REV. CODE §§ 1701.44(A), .52.

The tax treatment of non-voting common stock is substantially the same as the treatment of voting common stock. Even the ordinary loss provisions of section 1244 are available.<sup>6</sup> One tax disadvantage, however, is that if the company makes use of more than one class of stock it is not qualified to make the election under Subchapter S.<sup>7</sup>

It is possible to use the devices just discussed in combinations. For example, the investors may be given both debt instruments and non-voting stock, the non-voting stock to become voting stock in the event of a default on the debt. Where the investor does receive a package of stock and securities in a greater face amount than his cash investment, however, he may have difficulty in establishing the proper allocation of basis among the items received. This would become significant when, for example, the debt instruments are repaid at face.<sup>8</sup>

Another consideration in analyzing the devices discussed above is that they are useful for other purposes than simply giving disproportionate advantages to the company's officers. From the investor's point of view, the acceptance of preferred stock or debt may make his interest substantially more secure. It also may assist his estate planning and charitable giving by permitting him to distribute economic interests where he would be unwilling to distribute operating control. The use of debt may also facilitate the subsequent repayment to the investor of some of his capital.

#### EMPLOYMENT CONTRACTS

In some cases, the objectives of the corporate officer can be substantially achieved by use of an employment contract, which would eliminate any need for complicating the company's capital structure. For example, such a contract can protect him from being discharged from his position and even perhaps from having his functions and area of operating control reduced. Furthermore, a provision in the contract for compensation which is to be measured by a percentage of the company's gross or net income can serve to increase his income in proportion to the success of the company in a manner analogous to the income participation through stock ownership.<sup>9</sup> There are great differences between stock

6. Assuming, of course, that the stock is issued for money or property and not for services. § 1244(c) (1) (D).

7. § 1371(a) (4). Another possible tax problem is that the Internal Revenue Service might argue that the non-voting stock is of lower market value, and hence that the capital structure involves an element of gift or compensation. Cf. Treas. Reg. § 1.351-1(b) (1). (Hereinafter cited as Reg.). For statistics indicating that, at least in publicly held companies, non-voting stock has substantially as high a market value as voting stock, see Comment, 4 STAN. L. REV. 575, 577, 585 (1952).

8. If the debt instruments and non-voting stock cannot be sold separately but constitute an indivisible "package" the thin capital problem would, of course, be aggravated.

9. For a high bracket officer, it may be more desirable to accumulate earnings in a corpora-

ownership and an employment contract. No employment contract creates a property interest which can be sold to others or left to one's children. However, careful draftsmanship can, if it is desired, minimize these differences. For example, death or retirement benefits can be included in addition to current compensation.

It should be noted that a percentage compensation arrangement has certain additional advantages. It will produce a low yield during the early low-income years so often experienced by new businesses, which puts a minimum strain on the company's finances. In later high-income years, on the other hand, the use of the percentage arrangement will help to protect the company against a contention that the compensation paid is unreasonably high and hence non-deductible.<sup>10</sup>

#### DEVICES FOR INCREASING INVESTMENT OF OFFICERS

The devices discussed so far have been designed to give the corporate officer a share in control and equity growth, disproportionate to his investment, from the time the company is first formed. A different solution would be to allow control to remain proportionate to investment, but to permit the officer to increase his investment on advantageous terms.

The best known device for permitting the corporate officer to increase his investment is the restricted stock option. A full discussion of restricted stock options as such is outside the scope of this article,<sup>11</sup> but it is relevant here to consider some particular problems which such options involve for small companies and the advantages and disadvantages of including such options in the steps taken at the time of incorporation.

The first of the problems which are particularly relevant to small corporations arises from the fact that minimum permissible restricted stock option prices are measured by a percentage of the fair market value of the stock at the time the option is granted.<sup>12</sup> The valuation of the stock of small closely-held companies is never easy, and it is especially difficult where the valuation must be so exact and where it will finally be tested only after the passage of several years has placed overtones of hindsight on the question. Accordingly, either the validity of the option may be rendered uncertain because of doubt as to whether the option

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tion of which he owns a percentage of the stock than to receive percentage compensation taxable as ordinary income. However, where the officer is in a lower tax bracket than the corporation, fully taxable compensation in the proper amount can produce more wealth after taxes for both officers and investors, since it is deductible by the corporation at a higher rate than it is taxed to the officer.

10. Reg. § 1.162-7(b)(2).

11. For a discussion of both restricted and non-restricted stock options, see Vesely, *Compensation Through the Use of Corporate Stock*, 29 U. CINC. L. REV. 52 (1960).

12. § 421(d)(1)(A).

price is high enough, or the option price may have to be set considerably higher than the law requires simply to provide a margin of safety.

A second problem is that a stock option interferes with the use of section 1244, a tax benefit provision relating to certain stock of small corporations. Not only is this benefit inapplicable to stock issued pursuant to an option "granted in whole or in part for services," but the very existence of the option disqualifies, for the purposes of section 1244, all other stock issued while the option is outstanding.<sup>13</sup>

A third difficulty with stock options is that although they permit the officer to share immediately in the equity growth of the company, his share in the control of the company is increased only as the option is exercised. Accordingly, except to the extent that he is protected by an employment contract, or the terms of the option itself, his interest may be subject to defeat by the investors at any time until he actually purchases the stock. For example, a common form of stock option can be exercised by the officer only if he is an employee, and hence the option can be terminated simply by firing the officer. More subtly, the directors can prevent the officer from exercising the option by holding his salary below the amount which he will need in order to pay the option price. Such attempts to defeat an option would seem more likely to occur in a small company where exercise of the option may substantially affect corporate control, than in large companies where the effect of stock on control is negligible in any event.

The suggestion that an officer's ability to exercise his option may depend on his salary level illustrates the fact that in the case of a small new company and a corporate officer without substantial financial means, a fourth major problem is paying the option price. Several factors make this problem especially difficult. The first is that the restricted stock option price must be substantially as high as the fair market value of the stock at the time the option is granted.<sup>14</sup> If the option is granted at the time of incorporation this value will presumably be the full amount paid per share by the investors. If the option is granted later, the valuation difficulties already mentioned tend to result in a price which is conservative in the sense of being too high, as a precaution against subsequent complete disqualification of the option.

A second factor is that if the officer must accumulate the option price from salary, he must first pay the ordinary income tax on the receipt of the salary. A third is that the option must be exercised within a limited period. No restricted stock option can run more than ten years, and if

13. This is the harsh position taken by the Treasury in Reg. § 1.1244(c)-1(c)(2), (e), (h).

14. The general rule is 85% fair market value, § 421(d)(1)(A), but an officer owning 10% of the company's stock when the option is granted must pay 110% of fair market value, § 421(d)(1)(C).

the officer owns more than ten per cent of the company's stock when the option is granted the period can be no longer than five years.<sup>15</sup>

A fourth factor is the difficulty of borrowing the purchase price if the officer is without personal means and can offer as collateral only stock in a small new corporation. It may be possible for the company itself to meet this part of the problem by selling the stock to the officer on an installment basis. However, such a program would have to be carefully drafted in order for it to qualify as an "exercise" of the option for tax purposes, but not to constitute a loan to a corporate officer which would give rise to personal liability for the directors.<sup>16</sup> In addition, the advantage to the investors of requiring the officers to contribute an equal amount per share to the company seems much diluted if the money paid not only comes ultimately from salaries paid to the officers by the company but also in the first instance comes from money loaned to the officers by the company.

It is not necessary, of course, to limit consideration to options which qualify as "restricted stock options." A company may deliberately make the option price much lower than the fair market value of the stock, and make the duration of the option longer than the five or ten years permitted by the Internal Revenue Code, thus eliminating some of the problems discussed above. The disadvantage of such a non-restricted stock option is that the difference between the fair market value of the stock and the option price is treated as ordinary income to the officer in the year the option is exercised.<sup>17</sup> However, this disadvantage may be outweighed by the longer period within which the option may be exercised. Also, if the value of the stock falls, which is not unlikely in the early years of a new company, the bargain element in the option may be relatively low, and the tax on this, plus the tax on the salary received to pay the lower option price, may be less than the tax on the salary needed to pay the high price under a restricted stock option. The company's cash position, on the other hand, is not injured by the low option price if the officer's situation is such that he could pay a higher price

15. § 421(d)(1)(C).

16. Compare OHIO REV. CODE § 1701.17, with OHIO REV. CODE § 1701.95. If the terms of the loan are too lenient, the Commissioner may contend that the stock was not in fact purchased when the option was exercised. Compare *National Clothing Co.*, 23 T.C. 944 (1955), *acq.*, 1956-1 CUM. BULL. 5, with *Patent Button Co. v. Commissioner*, 203 F.2d 479 (2d Cir. 1953).

Reg. § 1.421-1(e) defines "exercise," in effect, as the making of an irrevocable contract for the sale of stock. The definition would seem to permit a binding commitment by the officer to purchase stock at a specified later date. This would serve to extend the time limit for raising the purchase price, but it is doubtful whether either investor or officer would find such an irrevocable obligation acceptable for any very extended period.

17. Reg. § 1.421-6(d)(1). Income is realized on receipt of the option if its value is "readily ascertainable," but an option on a small company's stock would probably never qualify for this treatment under the Regulations. Reg. § 1.421-6(c).

only by drawing a correspondingly higher salary.<sup>18</sup> The company's cash position may even be improved, to the extent that granting the bargain price option enables it to secure the officer's services at a lower cash salary.

Still another possibility to consider is a non-restricted option on restricted stock. It is possible to subject the stock received pursuant to an option to restrictions which deprive the shares of any fair market value for a certain period of time. In such a case, the officer will not be taxed on the difference between the option price and the value of the stock without such restrictions, at least until the time years later when they expire, and perhaps not even then.<sup>19</sup>

It may be wiser for a small new company not to use options at all, but to issue stock directly for services. As discussed above in reference to bargain-price options, this may not hurt the company's cash position as much as it might appear, and it very effectively increases the officer's stock interest. The officer will, of course, be taxed on the value of the stock, but this value may be very low in the company's early years. Even this tax can be deferred, by the use of limitations on the stock.<sup>20</sup> The corporation probably will be able to deduct the same amount treated as income to the employee without paying out any cash except that necessary to pay the employees' own income tax.<sup>21</sup>

The assumption that the tax will be low on stock issued to the officer directly depends upon the company having losses or low earnings in its

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18. This statement should be qualified by noting that under Reg. § 1.421-6(e), the company's tax deduction for compensation paid is geared to the taxable income received by the officer from the exercise of a non-restricted option. Consequently, the less income to the officer, the lower the company's tax deductions. The situation is even more complex, of course, if the company pays the officer additional salary to cover tax he must pay on the salary paid to him to permit exercise of the option.

It should be noted that the general comparison between the tax impacts of restricted and non-restricted stock options assumes that the restricted option specifies a fixed price, an assumption which is made throughout this article. In fact, § 421 permits reduction of the option price in certain circumstances and also permits "variable price options." §§ 421(d)(1)(A)(ii), (e); Schlesinger, *Selected Problems in the Use of Restricted Stock Options*, 36 TAXES 709 (1958). Both alternatives, however, require measurements of fair market value which are likely to be quite impractical in the case of a small closely-held company.

19. The Regulations hold that the employee realizes taxable income when the restrictions expire. Reg. § 1.421-6(d)(2). This is contrary to a Tax Court holding that the expiration of restrictions is not a taxable event. Robert Lehman, 17 T.C. 652 (1951), *nonacq.*, T.I.R. 248, 4 P-H 1960 FED. TAX SERV. ¶ 54,967, *withdrawing acq.* 1952-1 CUM. BULL. 3.

The restriction used for illustrative purposes by the Regulations is a requirement that the employee resell the stock to the company at the price he paid for it if his employment terminates within two years after he acquires the stock, for any reason except his death. Presumably, restrictions should not be so severe as to permit the exercise of the option to be regarded as unreal. Cf. note 16 *supra*.

It is unfortunate that the term "restrictions" is used to refer to both options qualifying under § 421 and certain limitations on stock subject to nonqualifying options.

20. Reg. § 1.61-2(d)(5). Cf. notes 16 and 19 *supra*.

21. Although there have been expressions of doubt on this point, the Commissioner's last official position still seems to be I.T. 1197, I-1 CUM. BULL. 269 (1922), allowing the deduc-



early years. Some companies are more fortunate and enjoy a prompt and rapid growth. For these companies, restricted stock options, whereby the corporate officers pay no tax on the bargain element, are preferable to the direct issuance of stock, taxable at its ever increasing fair market value. Where this is a real possibility, therefore, the best solution may be a combination of stock options and an agreement to issue stock as compensation. If the company is immediately successful, the options can be used rather than the direct stock compensation. If the company encounters adversity, direct stock compensation can be used rather than the options. It is, however, difficult to set up so complex a plan at the very beginning of the corporation's life. In addition, the issuance of stock asserted to be worth five dollars in exchange for services at the same time that an option to purchase stock at one hundred dollars is outstanding may create a dilemma. If the officer receives stock for compensation and subsequently exercises the option as well, he may ultimately receive twice the percentage of control intended by the parties. Conversely, if the number of shares subject to the option is reduced each time shares are issued as compensation, the arrangement may be regarded as a disqualifying modification of the option, lowering the option price, in effect, from one hundred dollars in cash to five dollars in services.

A final problem relevant to our topic is whether stock options, if they are to be used, or a provision for issuing stock as compensation, should be included in the steps taken at the time of incorporation. There is no question, of course, that these points can be and should be part of the original understanding or contract between the investors and officers. It is also desirable in setting forth the number and par value of shares in the corporate charter to allow for the requirements of an option or compensation program.<sup>22</sup> Furthermore, the price paid for stock by the investors presumably sets the fair market value of the stock at that time, and hence restricted stock options can be issued then without the usual tremendous problem, discussed above, of valuing closely held stock.

However, two considerations weigh against issuing options at once. The first is that if the company goes through an initial period of adversity, the value of the stock may fall substantially and demonstrably, thus permitting lower option prices. Second, since no stock issued after the

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tion. Any other result would be inconsistent with the allowance of the deduction in reference to non-restricted options. Reg. § 1.421-6(e).

A possible disadvantage of issuing stock directly for services is that it would not qualify under § 1244, which does not cover stock issued for services. However, as has already been discussed, stock issued pursuant to options issued for services also do not qualify under § 1244.

22. Stock with a high par or stated value may present a problem when issued as compensation. The directors must find that the services rendered are worth the par value of the stock. If this is interpreted as a sale of the stock at a high price, it would seem inconsistent with a contention that the stock has a low fair market value.

option is granted will qualify under section 1244, as has already been discussed, the granting of the options should at least be delayed until all of the common stock originally subscribed for has been issued.<sup>23</sup>

#### DEVICES FOR DECREASING INVESTMENT OF INVESTORS

An alternative to increasing the investment of the officers is to decrease the investment of the investors. The three principal methods of doing this are the repayment of debt, the redemption of preferred or common stock, and the use of buy-sell agreements.

The great danger in repaying debt arises from the "thin capital" doctrine already discussed.<sup>24</sup> The debt may become due at an awkward time from the viewpoint of the company's finances, although failure to pay it may dangerously aggravate the thin capital problem.<sup>25</sup> Otherwise, the repayment of debt has a number of advantages to the investor, who can recover his money without tax to himself and without reducing his control or equity ownership.

Whether a redemption of some of the stock held by the investor will reduce his control and equity ownership depends upon the terms of the stock redeemed. The inflexibility of a debt repayment schedule can be avoided, perhaps at the price of rendering it less certain that the redemption will actually be undertaken. The real problems, however, relate to taxation. In the first place, there is at least a theoretical danger that the accumulation of the cash needed for the redemption will weaken the company's defenses against the accumulated earnings tax.<sup>26</sup> A more common problem is the possibility that the redemption price will be taxed as a dividend. The statute does expressly exempt certain stock redemptions from dividend treatment, but none of the statutory exceptions are intended to cover the case of the investor recouping part of his investment without a substantial reduction in his share of control.<sup>27</sup> On the other hand, of course, if the company has made the election to be taxed under Subchapter S, its earnings for all completed years during which the election was in effect will have already been taxed to the shareholders, and to this extent the danger of a redemption being treated as a taxable dividend will have been eliminated.<sup>28</sup>

23. Stock is legally issued when it is subscribed for and the subscription is accepted. It is not relevant whether or when certificates are issued. This is both the state law rule for Ohio corporations, OHIO REV. CODE § 1701.01(F), and the rule adopted by the Treasury Regulations dealing with the federal documentary stamp tax, Reg. § 43.4301-1(a).

24. See discussion pp. 205-09.

25. See discussion p. 207.

26. Cf. *Pelton Steel Castings Co. v. Commissioner*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958). *Contra*, *Mountain State Steel Foundries, Inc. v. Commissioner*, 60-2 U.S. Tax Cas. § 9797 (4th Cir. Nov. 7, 1960).

27. §§ 302(b), 303.

28. There are, however, some cases where redemption of the stock of a Subchapter S corpora-

Buy-sell agreements, the third method of reducing the investor's investment, can also serve a number of other objectives and can involve a wide range of problems. Space does not permit a full discussion here of this complex subject.<sup>29</sup> The importance of such agreements for the present discussion is that either the investor or the officer may be far more willing to agree to permit control to lie in the hands of the other, if, through such an agreement, assurance can be given that this control will not fall into the hands of widows, minor children, or strangers. Even more important, it gives the corporate officer with limited financial resources a real prospect of eventually taking over control of the business, a transfer which the investor is more inclined to agree to since it makes his interest more secure and liquid for estate planning purposes without reducing his control or his share in equity growth during his lifetime.

There are several reasons for including such an agreement in the steps taken at the time of incorporation. It is then mechanically easiest to put restrictions on stock certificates or in the corporate charter or by-laws. It is then easiest to integrate such an agreement with the general plan for the capital structure of the company and with any agreement designed to prevent transfers which would defeat an election under Subchapter S. It also would seem easier and fairer to negotiate the agreement while all parties are alive and well and entertaining the hope of being the survivor.

A disadvantage of drafting a buy-sell agreement at this time is that since the company is just starting out the parties may not be sure that it will be successful enough to justify the legal effort and expense involved. Even more important, the relationship between the parties, the competence of the management, and the character of the investors are often unknown and untested factors when the business begins, and they are very important factors in determining the type of contract to which one would wish to subject one's widow. On the other hand, these same objections pervade the entire area of allocating control and interests in equity growth. Indeed, while they add to the difficulties of the problem, these very uncertainties often make it especially important to secure a clear and early understanding as to the distribution of company control.

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tion may have ordinary income consequences. For example, the company might have undistributed earnings and profits from years in which the election was not in effect, plus earnings and profits for the current year. In addition, where a stock redemption comes within the collapsible corporation provisions, the gain will be taxed as ordinary income whether or not earnings and profits are present. In measuring gain, it should be noted that pursuant to § 1376 the basis of the stock will have been increased by undistributed earnings taxed to the stockholder and reduced by losses deducted by the stockholder.

29. For a discussion of buy-sell agreements see 2 O'NEAL, *CLOSE CORPORATIONS*, 2-80 (1958); Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 9, 83-98 (1959).