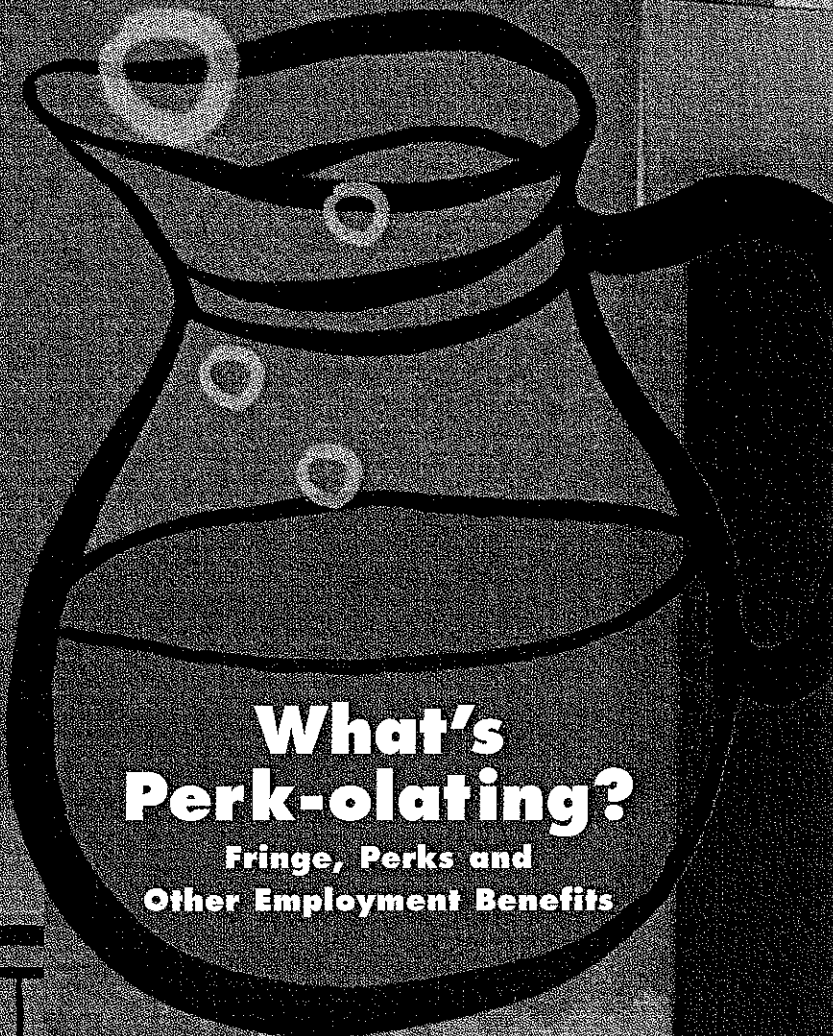
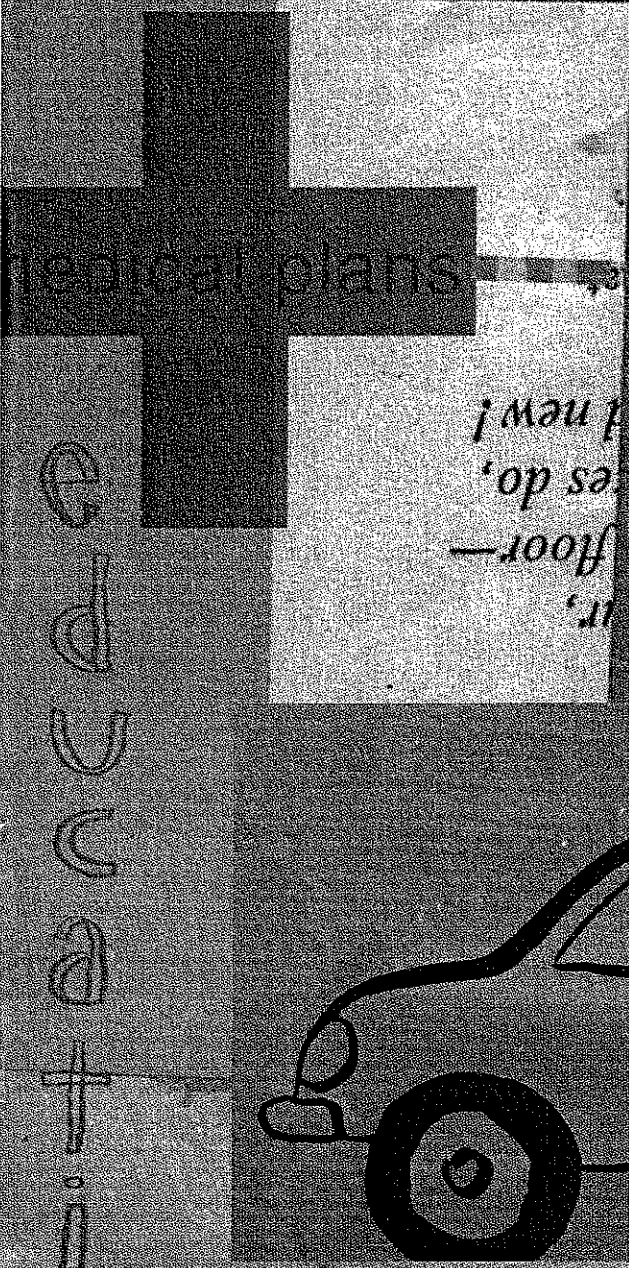


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What's Perk-olating?

Fringe, Perks and
Other Employment Benefits

benefits

Putting a Price Tag on Perks

Valuing employee benefits

BY JOHN E. BARRETT, JR.

Employee benefits generally are provided for two distinct and separate groups. The first is owner employees who generally receive both recorded and unrecorded owner's perquisites from the business. These benefits are subject to the financial status of the business and often are tax motivated. The second group of recipients is nonowner employees who receive benefits as part of a compensation package. These benefits continue to be provided even if the business declines. The company provides these benefits in an effort to attract and retain qualified personnel.

Marital dissolution cases often require a benefits package analysis, which may include health insurance, life and disability coverage, automobile usage, child-care assistance, accumulated vacation and sick days, stock options, and severance packages, among others. Some benefits enhance a spouse's ability to provide alimony or child support, whereas others increase the marital estate. Both spouses are likely to be affected by the tax consequences of these benefits.

Owner-employee perquisites

In addition to wages and bonuses, an owner employee often receives cash and noncash benefits. Some perks are for personal expenses, whereas others

are ordinary and necessary business expenses. Business perks that are personal in nature should be added back to the normalized income stream of the business. Ordinary and necessary business expenses represent additional income or compensation to the owner employee. Failure to identify these perquisites may prevent the nonbusiness spouse from receiving an appropriate property settlement or sufficient alimony and child support.

Common owner employee perquisites include company automobiles and related costs; health, life, disability, and other insurance; country club and association dues; personal nonbusiness travel and entertainment expenses; unreported income; interest-free loans from the business; divorce-related legal fees paid by the business; excessive compensation; and excessive rent on an owner's property leased to the business.

Perquisites of a personal nature affect the value of a business. Valuation of a closely held business for marital dissolution purposes generally requires a determination of fair market value. Revenue Ruling 59-60 defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to

sell, both parties having reasonable knowledge of relevant facts.”

Identifying perquisites of a personal nature (nonbusiness expenses or unnecessary business expenses, such as excessive compensation) is important in normalizing the earnings stream of a closely held business. A normalized income stream is a key component of the income approach to valuing a business on a control basis.

Ordinary and necessary business-expense perquisites are not added back to the normalized economic benefit stream when valuing the business. Rather, these are viewed as expenses a hypothetical investor would have to provide, in addition to reasonable compensation, to retain a replacement for the owner employee with the capabilities to manage the business. These perquisites, however, increase the total earnings and net disposable income of the owner employee, which, in turn, affects his or her ability to pay alimony or child support.

Cases involving owner employees with a controlling interest in the business generally require perquisites that are personal in nature to be identified and added back to the business income stream. This adjustment or normalization increases the income stream of the business, which, in turn, increases the value of the business. Many owner employees contend that an income stream used to value the business may be the same as the one used to calculate maintenance and support. This is called the double-dip or double-counting issue.

When the business's value is charged to one party, the income stream used to calculate income available for alimony and support could be the same as the income used to value the business. As the income essentially is counted twice, this results in the double dip. Courts have taken different positions on this matter. *Brookout*, 833 P.2d 800 (Colo. App. 1991); *Huff*, 834 P.2d 244 (Colo.

1992); *Zells*, 572 N.E. 2d 944 (Ill. 1992); *D'Oro v. D'oro*, 187 N.J. Super. 377, 454 A.2d 915 (1982), *aff'd*, 1993 N.J. Super. 385, 474 A.2d 1070 (1984).



One possible solution is to remove the business earnings from alimony or support calculations. The business earnings already have been included in the value of a marital asset—the business. Under this approach only the reasonable compensation (including ordinary and necessary business expense perquisites) is included as income for alimony and support payments. For a detailed discussion, see Brown, Ronald. *Valuing Professional Practices and Licenses*, 3rd. Ed. Chapter 39 (Aspen Publishers, Inc., 1999.)



The nonowner employee

In determining the nonowner employee's net disposable income, consider both wages and employee benefits. Some benefits are taxable and thus will appear on a W-2 form, others will not. Although the W-2 may not reflect total compensation, screen it for benefits, such as automobile usage, medical and dental coverage, and disability and life insurance coverage, to name a few.

These benefits can be useful in negotiating a settlement or presenting alimony and child support-related information to the court. For example, assume a nonowner employ-

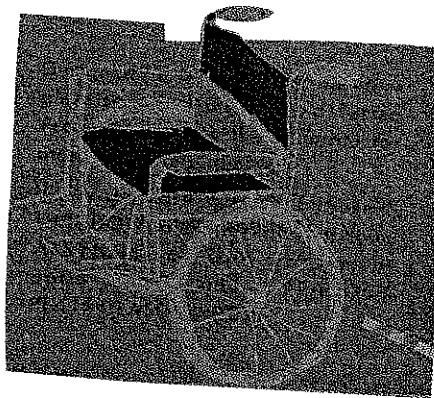
ee is receiving employer-paid health and dental care. The nonowner employee spouse could agree to continue health and dental coverage for a nonworking spouse and children. The employer could charge the employee only for the soon-to-be-ex-spouse's coverage. The nonowner employee also may use employer-provided group term-life insurance to meet the life insurance demands of a nonworking spouse. Often the biggest problem in this area occurs when the tax ramifications of I.R.C. § 71 (alimony), regarding third-party payments, are not addressed in the divorce decree.

Other nonowner employee benefits, such as stock options, may be included in marital property. Increasingly, corporate employees receive incentive stock options or nonqualified stock options as part of their compensation. Nonqualified stock options are more common. They provide tax advantages to the employer and are taxable to the employee at the time they are exercised. Courts have reached different conclusions about whether to include or exclude the value of stock options in the marital estate. See *Murray v. Murray*, 1999 WL 55673 (Ohio App. 12 Dist. 1999); *Peterson v. Peterson*, 1999 WL 988800 (Ohio App. 1999); *Davidson v. Davidson*, No. S-96-951, 1998 WL 271334 (Supreme Court of Nebraska, May 22, 1998); *Brandon v. Brandon*, No. 01-A-01-985-CV-00235, April 29, 1999 (Tennessee Court of Appeals).

Stock options are derivative securities; that is, they are securities that derive their value from an underlying asset, stock). A stock option provides the holder, in our case an employee, with the right to buy or sell a specified quantity of a particular stock at a fixed price at or before the expiration date of the option. Keep in mind that a stock option is a right, not an obligation. The option holder may exercise the option or allow it to expire. The value of a stock option is deter-

mined by a number of variables relating to the underlying stock, the terms of the stock option, and the financial markets.

Variables relating to the underlying stock include current value, price fluctuations, and dividends paid. The greater the price fluctuation of the underlying stock, the more valuable the stock options. The option holder's risk is limited to the price of the stock option. Greater volatility could result in substantial price increases in the underlying stock, while the risk has been fixed. Variables relating to the stock option include the strike price and expiration of the stock option. Variables relating to financial markets include the no-risk interest rate corresponding to the life of the stock option.



The intrinsic value of a stock option is the value of the optional stock minus the exercise price. The problem with the intrinsic value of stock options is that this is not how the financial markets value stock options. This is attributable to the time value of a stock option, which is derived from the chance that the underlying stock price might increase, making the stock option worth more.

Option pricing theory includes several models for estimating the

value of stock options. Some of the better known models include the Black-Scholes Model, the Binomial Model, and the Shelton Model. The Black-Scholes Model is often referred to in court cases. The American Institute of Certified Public Accountants, through SFAS 123, requires the application of the Black-Scholes Model to value options. For more information on valuing stock options, see *Shannon Pratt's Valuing a Business*, 4th ed., McGraw-Hill, 2000.

Both owner and nonowner employees receive employee benefits. These benefits can have a direct impact on net disposable income and the determination of marital property. The types and nature of employee benefits and their impact will vary from case to case. Once identified, a value should be placed on each benefit. Although valuing some benefits is fairly straightforward, valuing others, such as stock options, is complex and may require an expert. ■

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