

VALUATION OBSERVATIONS

*Some practical observations from a practicing
business appraiser.*

VLC

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INVISIBLE INCOME

Just because it's not taxable, and just because it's not cash in your pocket, doesn't mean it's not income. You may not be able to touch it, but it is real. It is income. Yes, unexercised stock options are taken into consideration when determining the obligor's income for purposes of child support.

ORC 3119.01 defines income for support purposes. We discussed that at length a few months ago. See *Valuation Observations Vol. 5, Nos. 11 and 12*. Some of the key words in this definition are "earned", "unearned", "from all sources", "whether or not ...taxable" and "potential cash flow from any source."

Excluded from the definition is "nonrecurring or unsustainable income or cash flow." Three years is the magic number in determining whether the income is "recurring."

The definition of income is expansive in order to ensure that the best interests of the children are protected. In fact, one of the purposes of the "potential cash flow" provision is to prevent a parent from avoiding child support obligations by shifting present income to a cash flow expected to be enjoyed at some future time, when the children have become emancipated. A choice to defer income will not justify deferring or avoiding child support.

The Court considered this very issue in *Murray v. Murray, 128 Ohio App.3d 662 (1999)* and found that the appreciation in the value of the unexercised stock options was to be included in gross income. The stock options were given every year and were an integral part of appellant's annual compensation. Twelve months after the grant, he could exercise an option and immediately realize the income, or he could decline to exercise the option and let the value ride. It is an investment choice. The nature of the stock options led the Court to conclude that the options, once they could be exercised, were a source of "potential cash flow from any source" to be included in the parent's gross income. And because appellant received the options every year, and could expect to receive them every year in the future, the court also found that the options were not a "nonrecurring or unsustainable cash flow item" within the meaning of the Code.

So how do you determine what the level of income is that flows from these stock options? The best way to account for this is to calculate the options' appreciation in value as determined on the grant and exercise dates of the options which fall into the income year at issue. By this method, the options are valued according to the underlying stock price on the date most important to the options' holder, the date the options may be exercised and income realized.

Say for example that options are granted on March 31 of each year. Options available to be exercised on March 31, 2005 were 400 options from 2004, 200 options from 2003, and 300 options from 2002 for a total of 900 options available to be exercised. The stock price less the option price was \$60.20 on March 31, 2005 and was \$40.90 on March 31, 2004. This provides an appreciation in value for the year 2005 of \$19.30 per option. Multiply this by the options available to arrive at the income to be imputed for 2005.

This method captures the immediate appreciation in value the stock has gained due to the option holder's choice not to exercise the options, with the expectation of a potential future increase in value. Additionally, this method of calculating the imputed income by the anniversary date of the options eliminates the gamesmanship of the obligee choosing a high market day in an attempt to increase the child support while the obligor uses a low market day in an attempt to lessen the child support burden.

Remember the purpose – it's all about the best interests of the child. Whenever an obligor chooses not to exercise his options, he is making an investment choice, and the Court has stated that he should not be allowed to benefit from such a choice by depriving his child of the inherent income in the stock options that could be unlocked.

If you would like additional information, or have a question, please do not hesitate to call.

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