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The Levin-McCain Stock Option Tax Hike: An Option Americans Can't Afford

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To some taxpayers, the term "stock option" may conjure up old-fashioned images of "fringe benefit" packages that only seem to apply to high-flying corporate executives. The reality is, options simply amount to one form of compensation in addition to, or in lieu of, an employee's salary – they provide the right to buy a given quantity of shares in company stock in the future, but locking in today's price.

In our modern, dynamic economy, stock options are increasingly important for millions of workers throughout the private sector, whether in manufacturing, services, or technology. Options give everyone a stake in the success of American business. But now a new tax threat is emerging to endanger this highly successful and flexible component of the American Dream.

For years reformers have tried to get companies that issue stock options to be more forthcoming about the cost of those options in their financial statements. Senate Bill 1940 – "The Ending the Double Standard for Stock Options Act" sponsored by Michigan Democrat Carl Levin, Arizona Republican John McCain, and three other Senators – masquerades as a post-Enron reform designed to ensure that options expenses are duly reported.

But S. 1940 is in fact a stealth tax increase, and a gigantic one. And it's an incentive to new forms of corruption by executives and auditors.

S. 1940 would increase Cisco's taxes by $1.16 billion based on last year's numbers. It would increase Oracle's taxes by $988 million. It would increase Sun Microsystems' taxes by $636 million. It would raise the taxes of any company that issues options, whether or not it's in the technology industry.

Worst of all, S. 1940 would hit innovative start-ups the hardest – they're the ones who have to issue options because they can't afford to compete for talent with cash compensation. And it is precisely those companies that are the engines of American growth and job creation. It's hard to imagine a more punitive tax policy for an economy struggling to come out of a recession.

S. 1940 works by addressing differences between how accounting rules and tax laws treat options. Currently, companies are not required to report options expenses at all under accounting rules set by the private Financial Accounting Standards Board. But under entirely separate tax laws set by Congress, they can nevertheless deduct options expenses.

The legislation resolves this supposed “double standard” by limiting a company’s tax deduction to whatever options expense it reports in its financial statements.

Today section 83(h) of the Internal Revenue Code allows companies to deduct from taxable income the difference between an option’s exercise price and the company’s stock price at the time the option is exercised – the option’s “intrinsic value.” For example, Cisco’s tax savings in Fiscal Year 2001 for options exercised on 133 million shares with a weighted-average exercise price of 7.43 was $1.755 billion.

Cisco deserves that deduction, because it issued stock to option-holders at 7.43 when the actual stock price was much higher. It’s not specifically disclosed, but a reasonable guess is that the total expense giving rise to this deduction was about $5.0 billion. That’s what it cost Cisco shareholders to honor the company’s options obligations to hard-working employees, and that’s the same amount for which those employees were liable for personal income taxes or capital gains taxes.

S. 1940 would change the Internal Revenue Code by limiting a company’s tax deduction to “the amount the taxpayer has treated as an expense for the purpose of ascertaining income, profit, or loss in a report or statement to shareholders...” On the surface it would seem that all a company would have to do to preserve today’s tax deductions would be to report as an expense whatever amount they are now deducting.
It would make the earnings they report to Wall Street each quarter look worse, but there would be no real difference in their actual cash earnings.

But here’s the dirty trick at the heart of S. 1940: companies can't do that – they can’t just make up accounting rules in order to get tax deductions. That’s what Enron did, and that’s what we’re supposed to be stopping!

Honest companies are bound by the strict rules of “Generally Accepted Accounting Principles” – or GAAP – set by the Financial Accounting Standards Board. And there's no way under GAAP that honest companies will get the deductions they are used to, and the deductions they deserve.

Under GAAP there are only two ways to report options expenses. One is the “intrinsic value method” given by Accounting Principles Board Opinion No. 25. Because an option issued with its exercise price set at the current stock price has no intrinsic value, the expense of issuing it is zero. When it is exercised the company makes no cash outlay, so that’s a zero expense, too. This is the method virtually all companies are already using today in order to justify reporting a zero options expense. And zero is not a very attractive tax deduction.

The only permissible alternative under GAAP is the “fair value method” given by Financial Accounting Standards Board Statement No. 123. Under this method, a company estimates the value of options when they are issued using a computerized option pricing model – such as the Black Scholes model – and then applies that value as an expense spread evenly over the option's life. Returning to Cisco as an example, Fiscal Year 2001 "fair value" option expenses would have been $1.7 billion. That's a lot less than the actual economic expense of $5.0 billion, and it gives rise to a commensurately smaller tax deduction: Cisco's tax savings would fall from $1.755 billion to $592 million – an effective tax increase of 1.163 billion dollars.

To put all these complicated accounting ideas in a nutshell, S. 1940 will raise taxes by limiting the deduction for options to the lower "fair value" when they are issued, rather than the higher "intrinsic value" when they are exercised. If it's not clear to you why options are worth more when they are exercised than when they are issued, just ask yourself this question: why do people want options in the first place? Of course, it is because they expect them to be worth more in the future when they will be exercised than they were in the past when they were issued.

What's more, switching the tax deduction to "fair value" at the time of issue creates incentives for corruption. The cost of exercise is an objective fact. But a purely theoretical model, on which even financial academics can't agree, calculates "fair value". It must be fed subjective forecasts from executives and auditors before it can come up with results. Considering the huge tax increase that companies would bear under S. 1940, executives would be tempted to jigger those subjective forecasts to produce the biggest deduction they could get away with declaring.

And finally, S. 1940 raises troubling Constitutional issues. By explicitly tying tax deductions to whatever accounting policies are set for companies by the Financial Accounting Standards Board, Congress would be delegating to the private FASB the power to write tax law at will. It is not proper for Congress to delegate that power.

The issue of disclosure requirements for corporate options expenses is a matter for further debate. There are many perspectives on this separate regulatory issue that require careful deliberation before moving forward. But legislating a massive corporate tax increase that would hit hardest America's most innovative and competitive companies – hidden under the guise of post-Enron financial reform – would be a tragic error and a great injustice. S. 1940 is a risky policy "option" that Congress (not to mention the nation's taxpayers) literally cannot afford to exercise.

About the Author

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