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HOUSE WAYS AND MEANS SUBCOMMITTEE HOLDS HEARING ON EMPLOYEE STOCK OPTION PLANS

The House Ways and Means Committee Subcommittee on Oversight held a hearing on October 12 on employee stock option plans. The purposes of the hearing were to evaluate the effectiveness of current tax law on stock options (IRC §83, 422 and 423), to explore ways the laws could be "changed to strengthen incentives for employers to offer such plans", and to encourage broader participation and longer-term ownership by employees of stock in their employer.

The hearing was called by Representative Amory Houghton (R.NY), the subcommittee chair, who had earlier introduced legislation for "Universal Employee Stock Options,"[*] an improved form of employee stock purchase plans allowing pre-tax employee payroll deductions and a company tax deduction for the stock's fair market value at exercise. Another bill positively affecting key employee stock options ("Super Stock Options") had also been introduced by Representative John Boehner (R.OH). The thought is that both of these bills might be reintroduced into the next session of Congress in 2001 in a consolidated fashion. Obviously, input and support from the corporate compensation community will be sought.

Five organizations testified at the October 12 hearings: The National Association of Stock Plan Professionals ("NASPP"); Proxicom, Inc.; the American Benefits Council; the U.S. Chamber of Commerce; and our firm. The charts used in our testimony are attached. All witnesses favored the goal of improving the tax effectiveness of stock options for both employers and employees.

Under current tax laws affecting tax-qualified options (IRC §422 and 423), employee contributions are made with after-tax dollars and, if certain requirements are met, the employee does not incur tax on gains at exercise and may claim long-term capital gains treatment on gains at sale if minimum holding period requirements are met. The price for this favored treatment is the loss of a corporate tax deduction. Many regard these plans as financially inefficient for that reason. This has led to the growth of "non-qualified" stock option plans and also to the popularity of 401(k) plans which permit employee contributions with pre-tax dollars.

The focus of our firm's testimony was to alter the tax tradeoff between employers and employees that has existed since the Revenue Act of 1950. Specifically, in support of Congressman Houghton's bill, we testified that employee contributions to IRC §423 employee stock purchase

[*] Please refer to our letter dated August 16, 2000

plans ("ESPPs") should be permitted with pre-tax dollars within limits. Under both ESPPs and IRC §422 incentive stock options ("ISOs"), there should be no employee tax at exercise. Employees should be taxed only at sale of the stock, with ordinary income tax due based on the stock value at exercise, and capital gains tax on any excess gain realized. Corporations should be allowed a tax deduction *at exercise* for the same amount taxable as ordinary income to the employee *at sale*. There should be no alternate minimum tax or employment taxes imposed on amounts treated as ordinary income.

For ESPPs, we advocated forgoing the ability to grant options at 85% of market value and the "look-back" feature in exchange for pre-tax employee contributions and a corporate tax deduction at exercise. We believe the 85% pricing feature, while nice, is not necessary to encourage participation. And, like many, we believe the 85% "look back" feature is unfair to shareholders and encourages employees to "flip" the stock at exercise for current income.

ESPPs should retain the requirement that essentially all full-time U.S. employees would be eligible to participate, except that bargaining unit employees could be excluded, just like under 401(k) plans. For key employee option plans, we advocated dropping the $100,000 annual vesting limit currently in ISOs, and substituting a requirement that at least half the shares granted as tax-favored options each year would need to be granted to "non-highly compensated employees" as defined under IRC §414 (q). Non-qualified plans would continue to be available with their current tax treatment -- employees taxed on gains at exercise at ordinary tax rates, and employers allowed a tax deduction at the same time and for the same amount.

In summary, the tradeoff that has existed for the last 50 years in tax-qualified stock option and employee stock purchase plans, (i.e., no tax at exercise, long-term capital gains at sale and no corporate tax deduction), should be changed for the twenty-first century. First, employers should be encouraged to adopt tax-qualified plans by being able to deduct gains at exercise, now only available under non-qualified plans and through disqualifying dispositions under tax-qualified plans. Second, employees should be encouraged to participate in ESPPs by permitting payroll deductions with pre-tax dollars. And finally, employees should be encouraged to hold stock for the long run by deferring tax from option exercise to stock sale and by eliminating gains at exercise from being subject to employment taxes and the alternate minimum tax.

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