Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles

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NO TAX DEDUCTION
IF NO EXPENSE FOR STOCK OPTIONS –
PART II

Senators Carl Levin (D-Michigan), John McCain (R-Arizona), Peter G. Fitzgerald (R-Illinois), Richard J. Durbin (D-Illinois), and Mark Dayton (D-Minnesota) have introduced legislation to prevent companies from taking a tax deduction for the gain at exercise on employee stock options unless the company also takes an accounting charge for that gain.[1] Their rationale is that the tax deductibility of option gains that are not expensed is a loophole in the accounting rules that can lead to misinformation as exemplified by the Enron case. In particular, they are targeting the large tax deductions many companies have accrued recently that virtually exempt them from paying taxes for many years.

This legislation is similar to a bill that Senators Levin and McCain introduced in 1997, which also included the requirement that options be more broadly granted to employees below top management.[2] Companies generally take no charges for employee stock options under APB 25, the accounting standard used by the vast majority of companies. If the proposed legislation is adopted, companies could be taking an expense for their option gains that would be different than the expense they would take if they adopted SFAS No. 123, the most recent accounting standard adopted by the Financial Accounting Standards Board.[3]

The bill states that the tax deduction cannot be taken before the year of option exercise and limits the deduction to the value of the expense that has been accrued for the particular option through that year. Further, this legislation will become effective immediately upon enactment and will apply to outstanding stock options. The bill has been referred to the Senate Committee on Finance.

Not mentioned in the press releases accompanying the legislation is the fact that most stock option gains do not go untaxed. In fact, employees pay tax on non-qualified option gains at ordinary income rates, which are usually higher than the corresponding corporate tax rate. Thus, the revenue from taxes paid by employees on option gains more than compensates for that which the government loses due to companies deducting this gain. Also ignored is that option gains are already included in the calculation of diluted EPS, and therefore, not "hidden" from shareholders, as well as the fact that these gains are not a direct expense of the company but rather are borne by the market.

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1 S. 1940 introduced February 13, 2002.

2 See our May 7, 1997 letter. http://www.fwcook.com/970509.html

3 SFAS No. 123 requires companies to show the effect that the present value (on the grant date) of stock options has on earnings in either the income statement or a footnote to the financial statements.

It appears that this proposal is in response to the increased level of concern about accurate accounting standards and corporate governance resulting from the Enron bankruptcy and other recent issues. While the focus of this legislation is on tax, it will fuel the debate which has resurfaced on whether stock options should be expensed. That debate was presumably resolved back in 1995 when SFAS No. 123 was adopted but has been reopened by the International Accounting Standards Board.

We would prefer to see the accounting and tax issues of options discussed in sequence. Tax legislation should not be used as a lever to influence accounting standards. If there are open issues on stock option accounting, they should be resolved first, and then, based on the outcomes, this tax bill may be appropriately considered.

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Questions on this letter may be addressed to Beverly Aisenbrey or Michael Chavira in the New York Office (212) 986-6330. Copies of this letter and other published materials are available on our web site, WWW.FWCOOK.COM.