November 13, 1997

LEGISLATION INTRODUCED
FOR NEW FORM OF EMPLOYEE STOCK OPTIONS

The Employee Stock Option Bill of 1997 was introduced in Congress on October 31 by Representative Amo Houghton (R.NY). The bill would create Employee Stock Options ("ESOs"), a new form of incentive stock option (ISO) under Internal Revenue Code Section 422. Like ISOs, there would be no tax due at exercise of an ESO. However, unlike ISOs:

1. The maximum annual vesting limit per individual for ESOs would be $200,000 (vs. $100,000 for ISOs),

2. The gain at exercise would not be taxed so long as the shares are held at least 2 years from the date of option grant **or** 1 year from option exercise

-- The ISO holding period is 2 years from grant **and** 1 year from exercise,

3. The gain at exercise would **not** be a tax preference item for purposes of the alternate minimum tax ("AMT").

This highly favorable tax treatment for ESOs will be available so long as at least half the ESO shares granted in any year go to "non-highly compensated employees." Thus, the purpose of providing this favorable tax treatment is to give companies an incentive to make broad-based grants to lower-level employees.

The disadvantage of ESOs for companies is the same one that exists for ISOs, namely the loss of corporate tax deductions for option gains at exercise when required holding periods are met. The recent lowering of long-term capital gains tax rates in relation to ordinary income rates makes ISOs relatively more attractive to employees than they were previously. In addition, ESOs will be more attractive than ISOs because of no AMT at exercise. Thus, if the ESO bill passes, companies currently granting ISOs at lower levels likely would switch to ESOs. Further, companies currently granting nonqualified stock options could decide that the tax advantages of ESOs to employees are worth forgoing the tax deduction.

We would urge all compensation professionals to become familiar with the bill and encourage their companies to support its passage. Even if many decide not to use ESOs, the ability to grant them will be a valuable additional compensation tool for those companies that do.

Note: The Houghton bill for ESOs should **not** be confused with the Levin-McCain "Ending Double Standards for Stock Options Act". The Houghton bill provides tax benefits to employees and no disadvantages for companies other than those inherent in ISOs today. The Levin-McCain bill provides no benefits to employees and severe disadvantages for companies.

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Questions on this letter may be addressed to Fred Cook at (212) 986-6330, or to any member of our firm. We invite persons interested in reviewing other publications by our firm to visit our web site at http:\\www.fredericwcook.com

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Footnote1

HR 2788

Footnote2

Defined under IRC §414(q), currently a salary cut off of about $80,000

Footnote3

See our letter of August 22, 1997

Footnote4

See our letter of May 9, 1997