May 9, 1997

Proposed Bill -- No Tax Deduction if No Expense for Stock Options

Stock option grants limited to executives, senior management, or other narrowly defined employee groups would lose much of their current tax deductibility if the "Ending Double Standards for Stock Options Act" is passed. Introduced on April 15 by Senators Carl Levin (D-Mich.) and John McCain (R-Ariz.), the bill (S. 576) would not allow companies to take a tax deduction for the gain at exercise of an employee stock option unless:

- substantially all U.S.-based employees were eligible to receive options,
- no one individual received more than 20% of the total stock options granted during the year, and
- at least 50% of the option shares were granted to non-management employees.

The requirement to grant at least 50% of option shares to non-management employees is consistent with an earlier failed proposal to create a tax-advantaged stock option, the Performance Stock Option[1]. Management employees are not defined in this new bill.

The Levin/McCain bill, which would amend IRC §83(h), would limit the tax deduction for stock options to the amount recorded as an expense in the company's financial statements. This limitation is inconsistent with the new FAS 123 rules that require companies using that standard to expense stock options at "fair value" and require all other companies to use fair value to report in footnotes the pro forma impact on net income and earnings per share. Therefore, even companies adopting FAS 123 could be inherently limiting the deductible amount of their stock options to an amount which could be much lower than the actual gain. For example, if a company expenses the fair value of an option at 25% of the exercise price, then any realized gain above that 25% price appreciation would not be deductible unless the stock option plan meets the bill's exemption requirements.

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1 See our letter of July 13, 1993

Although S. 576 would only apply to stock options granted after its passage, an analysis of companies' current stock option grants provides insight into this bill's potential cost to companies. As shown on the Attachment, ten large companies[2] have current gains of more than $20 billion in employee stock options. If those gains were considered non-deductible as defined in S. 576, these companies would be collectively liable for more than $8 billion in additional taxes, assuming a 40% corporate tax rate. By contrast, the Congressional Budget Office estimates that the bill will generate only $933 million in tax revenue over ten years.

The cost to companies is even greater when one considers that the bill would also limit option gains to the amount expensed as compensation when determining a company's research tax credit, unless the exemption conditions were met.

The bill's introductory language erroneously states that stock options are the only item of compensation that is tax deductible without being an expense on a company's income statement. Under APB 25, any stock grants that have fixed-plan accounting will have a higher tax deduction than expense if stock price goes up. For example, any gain on restricted stock after grant or any gain in the value of deferred stock to be paid out in stock will be tax-deductible without being an expense. Senators Levin and McCain appear to be using tax legislation to influence accounting policy, something that we believe even the FASB and the accounting profession would not support.

Obviously, passage of this bill could have a dramatic effect on the future design and use of stock options. If companies wish to comply by granting options more broadly, plans will become much more dilutive than they are currently[3] and the use of large, mega-grants could be curtailed.

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General questions on this letter may be addressed to Beverly Aisenbrey in the New York Office (212) 986-6330. Copies of this letter and other published materials are available on our web site, WWW.FREDERICWCOOK.COM. Specific tax questions should be directed to tax counsel.

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[2] Ten large U.S. companies based on market capitalization

[3] See our February 13, 1997 letter

Attachment
5/9/97

CURRENT STOCK OPTION GAINS
AT LARGE COMPANIES*
($mil)

Company	Gain in Outstanding Options as of 12/31/96	Estimated Tax at 40% of Gain Assuming Entire Gain is Tax Deductible (mil)
Bristol-Myers Squibb	$1,429	$572
Citicorp	1,828	731
Coca-Cola	2,038	815
DuPont	1,053	421
Exxon	1,168	467
Johnson & Johnson	1,719	688
Merck	3,558	1,423
Microsoft	4,794	1,918
Pfizer	1,718	687
Philip Morris	1,044	418
Total	$20,349	$8,140

* Ten largest U.S. companies based on market capitalization for which 1996 annual reports were available on the date of this analysis; reflects options outstanding in annual report footnote and 12/31/96 stock price