



## Deductibility of Stock Options — Levin/McCain Stock Option Act

### Issue

Legislation introduced by Senators Levin (D-Mi.) and McCain (R-Az.) amends two provisions of the Internal Revenue Code relating to stock options. First, it limits an employer's tax deduction of employee wages resulting from the exercise of stock options to the amount expensed in determining net income for financial statement purposes. Second, for purposes of determining the R&D tax credit, wages from stock option exercises are limited in the same manner as the deduction.

### Background

Levin introduced related legislation in 1993, the "Corporate Executives' Stock Option Accountability Act." That bill would have required SEC registrants to expense the fair value of stock options in financial statements. The SEC was to issue regulations defining fair value. The bill targeted "lavish" executive compensation which harmed "American competitiveness." The first bill sought only to change SEC disclosure requirements and did not change tax law.

Fueled by a failed attempt in 1993 and by articles in the Wall Street Journal and Business Week touting "soaring" executive pay, Senators Levin and McCain introduced in 1997 the "Ending Double Standards for Stock Options Act." In introducing the second bill, Levin said the issue was no longer an "accounting issue." According to Levin, "the accounting authorities, the experts, have decided how this should be handled as an accounting matter. This is now a tax loophole matter." As such the bill limited the tax deduction for stock option compensation to the amount expensed in the financial statements. As in 1993 he targeted only executive pay, so the bill had an exception for broad-based option programs. Companies which offered options to a broad base of employees (as defined in the bill) would continue to deduct the full amount of option exercises for both executive pay and non-executive pay. The bill applied to all options granted after enactment.

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### Background (cont.)

Failing again and reenergized by Enron, Senators Levin and McCain introduced in 2002 a modified version of the “Ending Double Standards for Stock Options Act.” This bill is similar to the 1997 version, but the exception for a broad-based stock option program has been eliminated. In introducing this bill, Levin accused Enron of inflating earnings by keeping stock options off the company books. He later states that “most companies treat stock options the same way Enron did” and so puts an implied taint on any company who issues options, but fails to expense them in their financial statements. Thus, excessive executive pay is no longer the target, but the mere issuance of options is now problematic. The new bill continues to promote the “tax loophole” posture, and limits the tax deduction for stock option compensation to the amount expensed in the financial statements. Whereas the 1997 bill applied only to option grants after enactment, this bill applies to all option exercises after enactment. This denies companies a deduction for options granted as much as 10 years ago, but for which no expense was taken in the financial statements.

Senators Levin and McCain also have introduced legislation (S. 182) to require the Financial Accounting Standards Board (FASB) to review the appropriate stock option accounting treatment within one year.

### Policy Considerations

The true objective of this bill remains unclear. It claims to be closing a tax loophole. If it were a tax loophole, who is the victim? Government revenue is likely not lowered by reason of stock options. A deduction is permitted as in any transfer of property for the performance of services. The recipient recognizes the value of the property received in gross income and pays taxes on that income, often at a higher rate than that at which the company is able to claim a deduction. Thus, the government is likely in a net positive position with respect to revenue after permitting this deduction. Is Senator Levin suggesting that the recipient should pay tax on the amount received, while the payer gets no corresponding deduction? That would put the government in an illogical, unfair and untenable position of “double dipping” on tax revenue.



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### **Policy Considerations (cont.)**

To avoid an earnings charge, the initial corporate response may well be to limit stock option programs. Executives will generally get the compensation (including options) that the market for such talent demands, and thus the group penalized by this bill will be the non-executive employees who today receive options as part of their compensation. Notably, many high tech companies, and others as well, grant stock options to their entire employee population. The final loss will likely be to the government in lower income tax, Medicare tax and Social Security tax revenue.

Despite stating otherwise, Senator Levin appears to be attempting to modify accounting practice. The FASB agreed years ago that it would not require stock option expense to be determined under the Black-Scholes method. Does Levin not like that conclusion, and now is trying to force a change to accounting rules using tax law? If this bill attempts to do so, via a backdoor denial of a legitimate tax deduction, this true purpose of the bill should be seen, be acknowledged and be appropriately defeated. The name of the bill itself refers to a “double standard” of accounting for options. In fact, stock options are only one of many areas in which tax accounting and financial accounting diverge. If the elimination of divergent accounting practices is the true object of the bill, attacking only stock options falls far short of that goal.

Policy considerations are hard to define when the underlying agenda is unclear. Also unclear is what this bill has to do with the unfortunate situation emanating from the Enron downfall. However, what is clear is the potential damage to American competitiveness and to Treasury tax revenue if options are curtailed as a result of the passage of this bill.

### **Recommendation**

The SVTDG opposes the Levin/McCain bill (S. 182). The group acknowledges the current concerns in accounting practices associated with Enron, and the need to address those concerns. However, the SVTDG believes the Levin/McCain bill is not relevant and responsive to this need, and will produce widespread serious and detrimental consequences if passed.