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Employee Stock Options: Tax Treatment and Tax Issues

James M. Bickley, Government and Finance Division

May 7, 2008

Abstract. This report examines the tax treatment of various types of employee stock options recognized by the Internal Revenue Code and discusses some of the issues that have arisen because of the real and perceived tax benefits accorded them.

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Summary

The practice of granting a company's employees options to purchase the company's stock has become widespread among American businesses. Employee stock options have been praised as innovative compensation plans that help align the interests of the employees with those of the shareholders. They have also been condemned as schemes to enrich insiders and avoid company taxes.

The tax code recognizes two general types of employee options, "qualified" and nonqualified. Qualified (or "statutory") options include "incentive stock options," which are limited to $100,000 a year for any one employee, and "employee stock purchase plans," which are limited to $25,000 a year for any employee. Employee stock purchase plans must be offered to all full-time employees with at least two years of service; incentive stock options may be confined to officers and highly paid employees. Qualified options are not taxed to the employee when granted or exercised (under the regular tax); tax is imposed only when the stock is sold. If the stock is held one year from purchase and two years from the granting of the option, the gain is taxed as long-term capital gain. The employer is not allowed a deduction for these options. However, if the stock is not held the required time, the employee is taxed at ordinary income tax rates and the employer is allowed a deduction. The value of incentive stock options is included in minimum taxable income for the alternative minimum tax in the year of exercise; consequently, some taxpayers are liable for taxes on "phantom" gains from the exercise of incentive stock options. In the 110th Congress, identical bills H.R. 3861 and S. 2389 have been introduced to provide an abatement of any taxes still owed on "phantom" gains.

Nonqualified options may be granted in unlimited amounts; these are the options making the news as creating large fortunes for officers and employees. They are taxed when exercised and all restrictions on selling the stock have expired, based on the difference between the price paid for the stock and its market value at exercise. The company is allowed a deduction for the same amount in the year the employee includes it in income. They are subject to employment taxes also. Although taxes are postponed on nonqualified options until they are exercised, the deduction allowed the company is also postponed, so there is generally little if any tax advantage to these options.

On December 16, 2004, the Financial Accounting Standards Board issued new rules requiring companies to subtract the expense of options from their earnings. The Securities and Exchange Commission (SEC) applied these new rules to financial statements for large publicly traded companies beginning with their next fiscal year after June 15, 2005 (or December 15, 2005, for small companies). Currently, the SEC is investigating allegations that some companies backdated some of their stock options.

This report will be updated as issues develop and any new legislation is introduced.

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Background

The practice of granting a company's employees, officers, and directors options to purchase the company's stock has become widespread among American businesses.[1] According to Information Technology Associates, 15 to 20% of public companies offer stock options to employees as a part of their compensation package, and over 10 million employees receive them. During the technology company boom of the 1990s, they were especially important to start-up companies allowing them to avoid paying large cash salaries to attract talent.[2]

Employee stock options have been extolled as innovative compensation plans benefitting companies, stockholders, and employees.[3] They have been condemned as schemes to enrich insiders at the expense of ordinary stockholders and as tax avoidance devices.[4]

This report explains the tax treatment of various types of employee stock options recognized by the Internal Revenue Code, examines some of the issues that have arisen because of the real and perceived tax benefits accorded employee stock options, discusses the Financial Accounting Standards Board's (FASB) rule for expensing employee stock options, and describes the controversy over the backdating of stock options.

Definition

Employee stock options are contracts giving employees (including officers), and sometimes directors and other service providers, the right to buy the company's common stock at a specified exercise price after a specified vesting period. The exercise price is typically the market price of the stock when the option is granted (although it can be more or less, as discussed later under "Types of employee stock options"), the vesting period is usually two to four years, and the option is usually exercisable for a certain period, often five or 10 years. The value of the option when granted lies in the prospect that the market price of the company's stock will increase by the time the option is exercised. (If the price falls, the option will simply not be exercised; the contract does not obligate the employee to buy the stock.) Employee stock options typically cannot be transferred and so have no market value.

To illustrate, suppose that Ceecorp, Inc., is a publicly held corporation whose stock is selling for $10 a share on January 1, 2004. As a part of her compensation plan, Ceecorp's chief financial officer (CFO) was granted options on that date to buy 1,000 shares of stock for $10 a share any time over the next 10 years, subject to certain conditions. One condition was that she had to work for the company until she exercised her options. Another was that her right to the options vested over a period of four years, one-quarter each year. This meant that on January 1, 2005, she received an unrestricted right to buy 250 shares of stock for $10 a share, and so on each year until, on January 1, 2008, all of the options were fully vested and she could buy 1,000 shares if she chose.

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[1] The original author of this report was Jack H. Taylor, consultant in business taxation.

[2] John Doerr and Rick White, "Straight Talk About Stock Options," *The Washington Post,* March 12, 2002, p. A21.

[3] Ibid.

[4] Warren Buffett, "Stock Options and Common Sense," *The Washington Post,* April 9, 2002, p. A 19; Martin A. Sullivan, "Stock Options Take $50 Billion Bite Out of Corporate Taxes," *Tax Notes,* March 18, 2002, p. 1,396.

Suppose that Ceecorp's stock had risen to $30 a share on January 1, 2005, when the CFO became vested with the right to buy 250 shares, with no further restrictions on her ownership of the stock. She could pay the company $2,500 for the 250 shares, which were at that point worth $7,500, with an immediate gain of $5,000 (ignoring taxes for the moment) in either cash if she sold the stock or property if she held on to it. She could similarly exercise the other options as they became vested or wait for later stock price changes. The options would continue to be worth extra compensation for her as long as Ceecorp's stock was selling for more than $10 a share.

When she exercised her options, the company had to be prepared to sell her the stock at the below-market exercise price. So on January 1, 2005, if she chose to buy 250 shares of Ceecorp stock, the company had to either buy 250 shares of its own stock for $7,500 or issue 250 shares of new or treasury stock that it could have sold for $7,500. When it sold these shares to the CFO for $2,500, the economic reality was the same as if it had paid her $5,000 in cash: she received additional compensation of $5,000 and Ceecorp was out $5,000 that it would have still had if she had not exercised her options.

Advantages and Disadvantages of Stock Options

Paying for the services of employees or directors by the use of stock options has several advantages for the companies. Start-up companies often use the method because it does not involve the immediate cash outlays that paying salaries involves; in effect, a stock option is a promise of a future payment, contingent on increases in the value of the company's stock. It also makes the employees' pay dependent on the performance of the company's stock, giving them extra incentive to try to improve the company's (or at least the stock's) performance. Ownership of company stock is thought by many to assure that the company's employees, officers, and directors share the interests of the company's stockholders. Before June 15, 2005, accounting rules did not require stock options to be deducted from income in the companies' financial statements; consequently, net profits reported to shareholders were larger than they would have been if the same amounts were paid in cash.

Critics of the stock options, however, argue that the practice gives officers and directors a strong incentive to inflate stock prices and that there is no real evidence that it does improve performance. (Many of the leading users of stock options were among the companies suffering substantial stock losses in recent years.)

Receiving pay in the form of stock options can be advantageous to employees as well. Stock options can be worth far more than companies could afford to pay in direct compensation, particularly successful start-up companies. Some types of stock options receive favorable income tax treatment. Receiving pay in the form of stock options serves as a form of forced savings, since the money cannot be spent until the restrictions expire.

Of course, it is a risky form of pay, since the company's stock may go down instead of up. Some employees may not want to make the outlay required to buy the stock, especially if the stock is subject to restrictions and cannot be sold immediately. And some simply may not want to invest their pay in their employer's stock.

Types of Employee Stock Options

There are a number of variations on the general idea of an employee stock option. Some variations are due to the tax rules that govern them, and some are because of the intended use of the options by the companies granting them. This report focuses on the tax treatment of the options and the issues arising from the tax treatment; but one of the issues is whether the tax code has kept up with the proliferation of ways options can be designed.

The Internal Revenue (IR) Code recognizes two fundamental types of options. One is called "statutory" or "qualified" options because they are accorded favorable tax treatment if they meet the Code's strict qualifications (IR Code Section 421-424). Generally, the value of these options is not taxed to the employee nor deducted by the employer. The second is "nonqualified" options, which have no special tax criteria to meet, but are taxed to the employee as wage income when their value can be unambiguously established (which IRS says is when they are no longer at risk of forfeiture and can be freely transferred). They are deductible by the employer when the employee includes them in income (IR Code Section 83).

Some options have special features designed to do more than just compensate employees. Some, such as the employee stock purchase plans discussed below, are granted at less than the market price of the stock, to make it easier for recipients (particularly lower level employees) to buy stock. Nonqualified options are often used to reward management, and some are only exercisable if certain goals are met. "Premium" options are granted at a price higher than the current price of the stock; "performance-vested" options are not exercisable until a specific stock price is reached. "Indexed" options are repriced based on broad stock indices, to differentiate between the company's performance and the market's performance. There are other variations.[5]

Options are not the only way to use a company's stock to compensate employees. Direct grants of stock are always possible, and can be hedged with restrictions similar to those governing the exercise of options. "Stock appreciation rights" and "phantom stock" plans pay employees the cash equivalent of the increases in the company's stock without their actually owning any.[6]

These various plans have different tax consequences for companies and employees.

Qualified Stock Options

Two types of stock options qualify for the special tax treatment provided in IR Code Section 421: incentive stock options and employee stock purchase plans. Both types require that the recipient be an employee of the company (or its parent or subsidiary) from the time the option is granted until at least three months before the option is exercised. The option may cover stock in the company or its parent or subsidiary. Such options may not be transferrable except by bequest.

[5] Shane A. Johnson and Yisong S. Tian, "The Value and Incentive Effects of Nontraditional Executive Stock Option Plans," *Journal of Financial Economics*, vol. 57 (2000), pp. 3-34.

[6] See Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-29-02), April 2002, p. 26.

Incentive Stock Options

Incentive stock options (IR Code Section 422) must be granted in accordance with a written plan approved by the shareholders. The plan must designate the number of shares to be subject to the options and specify the classes of employees eligible to participate in the plan. The option price must be no less than the market value of the stock at the time of the grant, and it must require exercise within 10 years from the time it was granted. The market value of the stock for any incentive stock options exercisable in any year is limited to $100,000 for any individual. This is the limit on the amount that receives favorable tax treatment, not on the amount that may be granted; options for stock exceeding $100,000 in market value are treated as nonqualifying options. There are additional restrictions for options granted to persons owning more than 10% of the outstanding stock.

Employee Stock Purchase Plans

An employee stock purchase plan (IR Code Section 423) must also be a written plan approved by the shareholders, but this type of plan must generally cover all full-time employees with at least two years of service (or all except highly compensated employees). It must exclude any employee who owns (or would own after exercising the options) 5% or more of the company's stock. The option price must be at least 85% of the fair market value of the stock either when the option is granted or when it is exercised, whichever is less. The options must be exercised within a limited time (no more than five years). The plan must not allow any employee to accrue rights to purchase more than $25,000 in stock in any year.

Current Tax Treatment

Both types of qualified stock options receive some tax benefit under current law. The employee recognizes no income (for regular tax purposes) when the options are granted or when they are exercised. Taxes (under the regular tax) are not imposed until the stock purchased by the employee is sold. If the stock is sold after it has been held for at least two years from the date the option was granted *and* one year from the date it was exercised, the difference between the market price of the stock when the option was exercised and the price for which it was sold is taxed at long-term capital gains rates. If the option price was less than 100% of the fair market value of the stock when it was granted, the difference between the exercise price and the market price (the discount) is taxed as ordinary income (when the stock is sold).

Companies generally receive no deduction for qualified stock options, so the tax advantage accrues to the employee, not the employer. Companies that would not be taxable anyway, such as start-up companies not yet profitable, would care little if at all about the tax deduction and would be expected to use this method of compensation. Many companies that are taxable grant qualified stock options, however, so these options must have some advantage that outweighs the tax cost. In some cases, the companies no doubt find that rewarding their employees with qualified stock options is worth the cost; in other cases, perhaps, the officers and employees who receive the options exercise special influence over the companies' compensation policies.

If the stock is not held for the required two years from the granting of the option and one year from its exercise, special rules apply. The employee is taxed at ordinary income tax rates instead of capital gains rates on the difference between the price paid for the stock and its market value either when the option was exercised or when the stock was sold, whichever is less. The company is then allowed a deduction just as if the employee's taxable gain were ordinary compensation paid in the year the stock is sold.

To illustrate the tax treatment of incentive stock options, suppose that the Ceecorp's grants to the CFO described previously were under an incentive option plan approved by the shareholders. The CFO could postpone taxation of her $5,000 gain by holding the stock until at least January 1, 2006 (one year after she bought it and two years after the options were granted). Assuming the stock was still worth $30 a share, she could realize her gain at that point and be taxed at the lower capital gains rate instead of her regular tax rate.

Alternative Minimum Tax

Imposing the alternative minimum tax on qualified stock options reduces their tax advantage; for persons paying the AMT, the tax treatment is similar to the regular tax treatment of nonqualified options.[7] Although the minimum tax exemptions limit the minimum tax to relatively high-income taxpayers, it does impose some burden on the otherwise tax-favored option plans.

The minimum tax can make the receipt of qualified stock options an extremely complex problem. It is imposed in the year the options are exercised (and the stock is transferred without restrictions) at the AMT rates of 26 or 28%, and the basis of the stock then becomes, for AMT purposes, the market price of the stock. When the stock is sold, it will have two bases, one for the AMT and one for the regular tax. Double taxation will not result, because an alternative minimum tax credit will be available (if the employee is not again subject to the minimum tax) or an adjustment of minimum taxable income will be made (if he owes minimum tax again that year). Since taxpayers often will not know if they are subject to the minimum tax until the tax year is over, tax planning can be very difficult.

Under certain circumstances, it is possible for an individual to owe the AMT on the value of incentive stock options at the time that these options are exercised. But in the same year, a subsequent decline in the value of the stock after exercise would cause the individual to owe income taxes under the AMT on "phantom" gains. There was a credit for prior year minimum taxes in excess of regular taxes that accrues when the taxpayer returns to the regular tax system, but this credit was not refundable.[8]

On December 20, 2006, this "unfair" situation was solved for most taxpayers by passage of the Tax Relief Act and Health Care Act of 2006 (P.L. 109-432), which made the credit for prior years' minimum tax liability refundable. According to Sections 402 and 403 of this act,

> an individual's minimum tax credit allowable for any taxable year beginning before January 1, 2013, is not less than the "AMT refundable credit amount". The "AMT refundable credit amount" is the greater of (1) the lesser of $5,000 or the long-term unused minimum tax credit, or (2) 20 percent of the long-term unused minimum tax credit. The long-term unused minimum tax credit for any taxable year means the portion of the minimum tax credit attributable to the adjusted net minimum tax for taxable years before the 3rd taxable year

[7] For a description of the alternative minimum tax, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

[8] For an analysis of this issue, see CRS Report RS20874, *Taxes and Incentive Stock Options*, by Jane G. Gravelle.

> immediately preceding the taxable year (assuming the credits are used on a first-in, first-out basis).[9]

The Tax Increase Prevention Act of 2007 (P.L. 110-166) provided a one-year extension of AMT relief for non-refundable personal credits to offset AMT liability for tax year 2007 and increased the individual AMT exemption amount for taxable years beginning in 2007 to $66,250, in the case of married individuals filing a joint return and surviving spouses, and $44,350 in the case of other unmarried individuals.

Some taxpayers are still liable for taxes on "phantom" gains from the exercise on incentive stock options. Consequently, legislation has been introduced in the 110th Congress to provide an abatement of any taxes still owed on "phantom" gains. H.R. 3861 and S. 2389 are identical bills which would

> Amend the Internal Revenue Code to: (1) increase the alternative minimum tax (AMT) refundable credit amount for individuals who have long-term unused minimum tax credits from prior taxable years; and (2) abate any underpayment of tax attributable to the application of special AMT rules for the treatment of incentive stock options.[10]

Tax-Favored Treatment

Continuing the tax advantages that qualified stock options receive is not often raised as an issue in their tax treatment. It is often argued that giving favorable tax treatment to a limited amount of compensation in the form of options helps spread the use of options to rank-and-file workers. (Nonqualified options, which are not tax favored, are more likely to go to officers and highly paid employees.) Employee stock ownership plans are explicitly promoted as a means for workers to become owners of their companies. In addition, the cost to the government is at least partially offset by the lack of a tax deduction at the company level. There may be a corporate governance issue in why publicly held companies are willing to incur an unnecessary tax cost for the benefit of officers and employees. (The company could offer nonqualified stock options, which are deductible; in fact, many companies do offer both incentive and nonqualified options to the same employees.)

Payroll Taxes

Before 1995, qualified stock options were not considered wages for Federal Insurance Contribution Act (FICA) and Federal Unemployment Tax Act (FUTA) purposes. The Internal Revenue Service (IRS) issued a ruling in 1971 to this effect (Revenue Ruling 71-52). However, the Tax Court later ruled that they were wages for calculating the research tax credit,[11] and IRS acquiesced in that decision in 1997. Subsequently, IRS said that it would be required to impose employment taxes on the options also, and it made several attempts to impose the taxes in specific cases.[12]

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[9] Joint Committee on Taxation, *Technical Explanation of H.R. 6408, the "Tax Relief and Health Care Act of 2006," as Introduced in the House on December 7, 2006,* Dec. 7, 2006, pp. 83-84.

[10] The summary of S. 2389 as introduced in the Senate.

[11] Sun Microsystems, Inc., v. Commissioner, T. C. Memo. 1995-69.

[12] Sheryl Stratton, "Hearing on Stock Option Regs Should Be Livelier Than Most," *Tax Notes*, May 13, 2002, p. 968.

In November 2001, IRS announced a proposed regulation that would subject the value of qualified stock options (the difference between the exercise price and the market price) to FICA and FUTA taxes in the year the options are exercised. This new rule would have been effective January 1, 2003, and until that time IRS would not attempt to collect any taxes on the options. No change in income tax treatment was proposed, and income tax withholding would not have been required.[13]

The proposed regulation received a negative reaction in the public comments that IRS requested. Companies argued that the additional tax cost and the paperwork burden of a new accounting requirement would discourage the granting of options and make them less attractive to employees. The critics argued that Congress explicitly excluded the value of an exercised qualified stock option from income, and that something cannot be "wages" if it is not also "income."[14]

On June 25, 2002, the Treasury Department and the IRS announced an indefinite extension of their administrative moratorium on qualified stock options. Pam Olson, acting Assistant Secretary for Tax Policy, stated that

> Given the significant administrative changes that would be required of employers to implement the proposed withholding, it is clear that a delay in the effective date is necessary to provide employers with adequate time to make the required changes. In addition, Treasury and IRS need additional time to consider the many comments we received on the proposed regulations and to decide on an appropriate course of action. Consequently, employers will not be required to implement the changes for at least two years after the regulations have been issued in final form.[15]

On October 22, 2004, P.L. 108-357 (American Jobs Creation Act) was signed by the President, and this law included a provision (Title 11, Subtitle F), which excluded qualified stock options from FICA and FUTA taxes.

Nonqualified Stock Options

Employee options that do not qualify for tax-favored treatment are by far the most important (at least by value). Because there are no statutory limits on the amount of these options that can be offered, these are the options used to compensate corporate officers and highly paid employees. Unlike qualified options, these options can be offered to anyone "providing services" to the company, not just employees. Therefore, they can also be given to those who serve on the company's board of directors (or even to independent contractors). When news reports and policy analysts mention options, without other qualifications, they normally mean nonqualified options.

[13] Proposed Regulation REG-142686-01, *Internal Revenue Bulletin 2001-49*, p. 561.

[14] See Stratton, op. cit.

[15] U.S. Department of the Treasury, "Treasury and IRS Extend FICA and FUTA Tax Moratorium for Statutory Stock Options," press release, June 25, 2002, p. 1.

Tax Treatment

Nonqualified options fall under the general rules governing the transfer of property other than money in return for services (IR Code Section 83). Basically, the rule is that the recipient receives income equal to the fair market value of the property (less any amount paid for it) when he receives an unrestricted right to the property and its fair market value can be reasonably ascertained. Stock options without a "readily ascertainable market value" are specifically excepted by Section 83(e)(3). (Qualified stock options are also excluded.)

In the case of nonqualified options, IRS has ruled that options that are not tradeable (as is almost always true of these options) have no "readily ascertainable market value." Therefore, their fair market value cannot be established until they are exercised and any restrictions on the disposition of the stock have been lifted. At that time, the value of the options is equal to the difference between the exercise price and the stock's current market price.[16] (There is a provision in Section 83 (b) allowing the recipient of the options to elect to include their value in income in the year they are exercised, valuing them as if the stock were not restricted. However, no future deduction is allowed if the stock is later forfeited.)

Nonqualified stock options exercised by employees are subject to FICA and FUTA taxes and income tax withholding, just as cash wages are.

The company granting the options is allowed to deduct from income the same value of the options that the recipient includes in income, in the same year it is taxable to the recipient (Section 83(h)).

If the options granted by Ceecorp to its CFO in our previous example were nonqualified options, there would be three notable differences from the qualified options assumed before. One is that she would have been immediately taxable on the difference between what she paid for the stock and what it was worth in the year she acquired it, so she would have owed income and FICA taxes on $5,000 in 2005. The second was that Ceecorp could deduct the $5,000 as employee compensation on its own tax return (and would also owe FICA and FUTA taxes on it). And probably most important in the real world (although not in our example), there would have been no limit on the value of the options granted, so a highly compensated officer like a chief financial officer could receive potentially large amounts of additional compensation.

Are Nonqualified Options Tax Favored?

Nonqualified options are not taxed to the recipient when they are granted or when they become vested, so receiving compensation in this form postpones the payment of taxes from when they would have been due on an equivalent amount of cash wages. However, the reason for not taxing them is the uncertainty of their actual value; the tax rules follow the practical path of postponing tax until their value is realized, as is the case with capital gains. In addition, the company's deduction of the compensation is also postponed, being allowed only in the same year that the recipient reports the income realized. Since most of these options go to highly compensated individuals, whose marginal tax rates would often be higher than the company's, the government

[16] IR Reg. 1.83-7.

probably suffers little if any revenue loss. So it could be argued that the government should be indifferent to the issue.

The Issue of Tax Versus Book Income

The treatment of stock options under the generally accepted accounting rules that govern the way companies report to stockholders, creditors, and regulators is quite different from the tax accounting rules. Originally, the accounting rules were of very limited scope. Because employee options were normally priced equal to the market price of the company's stock when they were granted, they were said to have no value. The fact that they were intended to have value and therefore serve as compensation was not taken into account. As they became more popular, however, the accounting standards were modified to require some recognition of their effect on a company's income. Rule FAS 123 required companies to estimate the value of the options when they are granted (using an option pricing model) and show that amount, called the "fair value," as a cost over the years until the options are vested. In their published financial statements, the companies could either treat the estimated value of the options as a cost in calculating net income,[17] or they could use the traditional valuing of the options (i.e., zero) in calculating net income and show the effect of deducting the estimated value in a footnote. Most companies chose to use the footnote method, but in the early 2000s many large corporations shifted to the deduction method. These corporations included Boeing, Coca-Cola, General Electric, General Motors, and Winn-Dixie.[18] Financial corporations adopting the deduction method include Allstate Insurance, American Express, Bank of America, J.P. Morgan Chase, Merrill Lynch, Citigroup, Wachovia, and Prudential Financial.[19]

In the very simple example used so far, Ceecorp and its CFO, the traditional valuation of the options when granted would be: the stock is selling for $10 a share, the options allow the CFO to buy it at $10 a share, so the options' value is zero. Ceecorp, like almost all public corporations, would probably calculate its net profit on its financial statement using this valuation. Under FAS 123, however, it would also use an estimating model to determine a market value. The model would estimate the likelihood that the stock would go up in value over the life of the option and take other variables into account and establish what the option might be worth on the open market when granted (if it could be marketed). So, Ceecorp might estimate that the "fair value" of the options when granted was $16 each, for a total value of $16,000, and report in a footnote to its financial statement an additional compensation cost of $4,000 each year for the four years over which the options vested. It would not account for the actual cost of the options when exercised on its income statement.[20]

Several bills were introduced in Congress over the years to restrict the tax deduction for options because of the differences with the accounting treatment. The bills attempted to change the companies' accounting practices, to make the cost of stock options more apparent to stockholders and investors; but the device chosen in the bills is to restrict the tax deduction allowed to the

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[17] This method is commonly referred to as "expensing."

[18] Steve Burkholder, "FASB to Change Reporting of Shifts to Expensing of Employee Stock Options," *Daily Tax Report*, No. 153, Aug. 8, 2002, p. GG1.

[19] "Members to Expense Stock Options, Financial Services Forum Announces," *Daily Tax Report*, No. 157, Aug. 14, 2002, p. G1.

[20] It would account for the difference in its balance sheet. For a more complete discussion of the accounting issues, see CRS Report RS21392, *Stock Options: The Accounting Issue and Its Consequences*, by Bob Lyke and Gary Shorter.

amount "treated as an expense" on the companies' books of account. Without further changes in either the accounting rules or the tax law, however, this approach did not in fact conform the tax and book treatment. The book expense was based on the estimated value of the options when granted and is charged off over the vesting period of the options. The tax deduction, in contrast, was allowed only when the options are exercised, and would, under this approach, be limited to the smaller of the estimated or actual values. In addition, the amount deducted by the company would no longer necessarily equal the amount taxed to the individual.

Executive Compensation Limits

The tax deduction for compensation paid to the chief executive officer and certain other highly paid officers of a publicly held corporation is limited under IR Code Section 162(m) to $1,000,000 annually, with a number of exceptions. The most important exception is incentive compensation; with shareholder approval, compensation rewarding officers for performance is not subject to a deduction limit. Since stock options have value only if the stock performs well, compensation in the form of stock options is not subject to the executive compensation limits if they are granted in accordance with a plan approved by the shareholders and meet the other requirements of Section 162(m).

FASB Rule for Expensing Stock Options

On March 31, 2004, the Financial Accounting Standards Board (FASB) issued a new exposure draft that would treat all forms of share-based payments to employees, including employee stock options, the same as other forms of compensation by recognizing the related cost in the income statement. The expense of the award generally would be measured at fair value at the grant date.[21] On July 1, 2004, the Council of Institutional Investors (a group of 140 pension funds), voiced its concern about reports that FASB was considering delaying implementation of the planned standard on stock option compensation.[22] On July 14, 2004, the National Association of Manufacturers, the Business Roundtable, and the U.S. Chamber of Commerce issued a joint news release stating that FASB should engage in field testing of multiple stock option valuation models and delay finalizing any standard until such testing has occurred.[23] Alan Greenspan, Chairman of the Board of the Federal Reserve, endorsed FASB requiring the expensing of stock options. He stated: "Not expensing stock options may make individual firms look more profitable than they are."[24]

On December 16, 2004, the FASB issued new rules requiring companies to subtract the expense of options from their earnings.[25] These new rules would dramatically reduce the earnings of many

[21] Alison Bennett, "Baker Criticizes Stock Options Proposal; Announces Subcommittee Hearing in April," *Daily Tax Report*, no. 62, Apr. 1, 2004, p, GG-2.

[22] Sarah Teslik, Executive Director of Council of Institutional Investors, "Letter to Director of Financial Accounting Standards Board," July 1, 2004.

[23] Kurt Ritterpusch, "Options Bill Jurisdictional Issues Remain But Blunt Hopes to See Bill on Floor Soon," *Daily Tax Report*, no. 135, July 15, 2004, p. G-4.

[24] Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, "Letter Responding to Senators Levin, McCain on Stock Options Accounting," Oct. 1, 2004.

[25] Financial Accounting Standards Board, "FASB Issues Final Statement on Accounting for Share-Based Payment," *FASB News Release*, Dec. 16, 2004.

companies that currently show this expense in footnotes.[26] Initially these new rules would apply to financial statements beginning after June 15, 2005, for large publicly traded companies (or December 15, 2005 for small businesses) or the third quarter of 2005 for those large companies on a fiscal calendar year.[27] But, effective April 21, 2005, the Securities and Exchange Commission (SEC) postponed the stock option expensing standard until the beginning of companies' next fiscal year. Thus, companies with fiscal years on a calendar year basis will not have to comply with the expensing standard until the first quarter of 2006. The SEC gave three justifications for this postponement: reducing compliance costs, relieving companies from having to change their accounting systems in the middle of the fiscal year, and allowing auditors to conduct more consistent review procedures.[28] On March 29, 2005, the SEC stated that public companies may choose from a number of valuation methods to estimate the fair market value of their stock options.[29]

In response to the FASB requirement that the cost of stock options be included as an expense on financial statements, a survey found that some companies were reducing the amount of their stock option benefits or eliminating their stock option plans.[30] Another study found that 439 companies had pushed up vesting dates on their stock options to beat the December 31, 2005, deadline; consequently, these companies eliminated more than $4 billion in expenses, which would otherwise have shown up on income statements starting in 2006.[31]

The Securities and Exchange Commission continued to refine appropriate methodologies for the valuation of stock options.[32] On December 5, 2005, Alison Spivey, associate chief accountant with the SEC's Office of Chief Accountant, issued a warning regarding volatility assumptions for valuing stock options.[33] Some large U.S. companies reduced the cost of their stock options by making subjective changes in their methods used in valuing their stock options.[34] In estimating the value of their stock options, companies have to make assumptions about numerous factors including volatility or the magnitude and speed of share-price swings over the life of their options.[35] The cost of an option rises as its volatility increases. One study found that the volatility assumptions for 50 large companies with sales in excess of $20 billion declined by an average of 13% from 2003 to 2005.[36] On October 17, 2007, the SEC approved the Zions Bancorporation's auction process to value employee stock options. The SEC stated,

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[26] "FASB to Require Expensing of Options Starting Next Year," *The Wall Street Journal*, vol. 224, no. 119, Dec. 17, 2004, p. C3.

[27] Ibid.

[28] Securities and Exchange Commission, "Amendment to Rule 4-01(a) of Regulation S-X Regarding the Compliance Date for Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment," 70 *Federal Register* 20717, Apr. 21, 2005.

[29] 17 C.F.R. PART 211.

[30] Andrew Blackman, "Firms Reconsider Stock Discounts for Employees," *The Wall Street Journal*, vol. 246, no. 46, Sept. 6, 2005, p. D2.

[31] Ben White, "Pushing Fast-Forward on Options," *The Washington Post*, Dec. 19, 2005, p. D1.

[32] Steven Marcy, "SEC Continues to Refine Determination of Valuation, Volatility Assumption in Plans," *Daily Tax Report*, Dec. 14, 2005, p. G9.

[33] Ibid.

[34] Richard Waters, "Options Rule Used to Lift Earnings," *Financial Times*, Apr. 24, 2006, p. 18.

[35] Steven D. Jones, "Option Expensing Leaves Room for Tallying the Volatility Factor," *The Wall Street Journal*, May 2, 2006, p. C3.

[36] Ibid.

> Your Submissions represent significant progress towards the identification of a suitable market-based approach to valuing employee share-based payment awards. We remain committed to supporting the development of a variety of competing market-based objective measurement of the fair value of employee stock options, of which yours is an example. Of course, future auctions using the approach outlined in your Submissions must be evaluated by a company and its external auditors based upon the particular facts and circumstances to ensure that the result produces a reasonable estimate of fair value in accordance with Statement 123R.[37]

Backdating Stock Options

Professor Erik Lie, currently on the faculty of the University of Iowa, formulated the hypothesis that some companies backdated (retroactively selected), without disclosure, dates for granting options to times when prices of their stock were low.[38] He found that some companies exhibited a pattern of behavior of backdating stock options without disclosure.[39] Dr. Lie wrote an article titled "On the Timing of CED Stock Options Awards," which included an empirical analysis supporting his backdating hypothesis and sent a copy of this article to the SEC in 2004.[40] In May 2005, his article was published in a journal called *Management Science*. [41]

Dr. Lie indicates that "the board of directors of a company generally assigns the administration of the [stock option] grants of the stock option plan to the compensation committee."[42] Executives, however, may be able to influence the decisions of the committee because executives often propose parameters of stock option grants, executives often have close personal friendship with some committee members, and executives may influence the timing of compensation committee meetings.[43] Using a sample of almost 6,000 stock option grants to chief executive officers (CEOs) between 1981 and 1992, he conducted several statistical analyses and concluded "that the abnormal stock returns are negative before the award dates and positive afterward."[44] These findings were consistent with his hypothesis of backdating of stock options without disclosure. The publication of Dr. Lie's article led to SEC investigations of the timing of the granting of stock options by certain companies.

Dr. Lie's article did not mention any company by name, but his hypothesis of backdating of stock options without disclosure was tested for five corporations by authors Charles Forelle and James Bandler in an article in *The Wall Street Journal* on March 18, 2006.[45] These authors examined the timing of stock option grants for five corporations. In each case, stock options were granted on

[37] Conrad Hewitt, Chief Accountant, SEC, *Letter to James G. Livingston,* Vice President of Zions Bancorporation, Oct. 17, 2007.

[38] For a comprehensive analysis of the issue of backdating of stock options, see CRS Report RL33926, *Stock Options: The Backdating Issue*, by James M. Bickley and Gary Shorter.

[39] Steve Stecklow, "Options Study Becomes Required Reading," *The Wall Street Journal*, May 30, 2006, p. B1.

[40] Ibid.

[41] Erik Lie, "On the Timing of CEO Stock Option Awards," *Management Science*, vol. 51, no. 5, May 2005, pp. 802-812.

[42] Ibid., p. 803.

[43] Ibid.

[44] Ibid., p. 810.

[45] Charles Forelle and James Bandler, "The Perfect Payday; Some CEOs Reap Millions by Landing Stock Options When They Are Most Valuable; Luck—or Something Else?," *Wall Street Journal*, March 18, 2006, p. A1.

dates when prices were extremely low. The authors concluded that the odds of these dates "happening by chance was extraordinarily remote."[46] For example, one corporation CEO received six stock-option grants from 1995 to 2002, which occurred at dates when the stock price was unusually low.[47] The author found that the probability of these dates being selected by chance was around one in 300 billion.[48]

Backdating of stock options without disclosure has serious implications:

> Companies have a right to give executives lavish compensation if they choose to, but they can't mislead shareholders about it. Granting an option at a price below the current market value, while not illegal in itself, could result in false disclosure. That's because companies grant their options under a shareholder-approved "option plan" on file with the SEC. The plans typically say options will carry the stock price on the day the company awards them or the day before. If it turns out they carry some other price, the company could be in violation of its options plan, and potentially vulnerable to an allegation of securities fraud.
>
> It could even face accounting issues. Options priced below the stock's fair market value when they're awarded bring the recipient an instant paper gain. Under accounting rules, that's equivalent to extra pay and thus is a cost to the company. A company that failed to include such a cost in its books may have overstated its profits, and might need to restate past financial results.[49]

In addition, backdating without disclosure can have important negative tax implications for both the company and the recipient of the stock options:

> Backdating options can force companies to restate tax positions, which can result in an obligation to lose tax deductions and pay back taxes, penalties and interest. For tax purposes, corporations can generally deduct executive compensation. However, IRC Section 162(m) limits this deduction for public companies to $1 million per year per executive for compensation paid to the top five most highly compensated executive officers for proxy reporting purposes. If options are in the money when granted . . . then the compensation realized by the grantee upon exercise will count towards the $1 million IRS deduction cap. Thus the discounted options are ineligible as performance-based compensation under Section 162(m). Furthermore, discounted options would be treated as "non-qualified defined compensation" under Section 409A, resulting in taxation (and excise taxes) at the time of vesting, rather than exercise. Finally, for incentive stock options to qualify for favorable tax treatment, they must be granted at 100% of the underlying stock fair market value on the date of grant.[50]

On May 22, 2006, Charles Forelle and James Bankler wrote a second article in *The Wall Street Journal* concerning backdating of stock options without disclosure.[51] The authors identify five

[46] Ibid.

[47] Ibid.

[48] Ibid.

[49] Ibid.

[50] Orrick, "Stock Options Grant Timing: Is Your Company at Risk?", June 14, 2006, pp. 3-4. Available at http://orrick.com/publications/index.asp?action=article&articleID=682.

[51] Charles Forelle and James Bandler, "Matter of Timing: Five More Companies Show Questionable Options Pattern—Chip Industry's KLA-Tencor Among Firms with Grants before Stock-Price Jumps—A 20 Million-to-One Shot," May 22, 2006, p. A1.

more companies "with highly improbable patterns of options grants...."[52] The authors state that the SEC is investigating at least 20 companies for manipulation of options timing.[53]

Some companies that opposed the FASB proposal to require expensing of stock options are now under investigation by federal authorities for allegedly backdating the dates of the granting of stock options without disclosure.[54] "This turn of events," according to Randall A. Heron and Erik Lie, "casts the companies' arguments against expensing stock options in a different light and offers what some accounting-industry observers say is a vindication for FASB."[55]

In their article in the *Journal of Financial Economics* titled "Does Backdating Explain the Stock Price Patten Around Executive Stock Option Grants?," Professor Randall A. Heron and Professor Erik Lie examine the frequency of backdating of stock options since August 29, 2002, when the Sarbanes-Oxley Act (P.L. 107-204) mandated that the SEC change the reporting regulations for stock option grants.[56] Before the change, executives receiving stock options had up to 45 days after the end of the company's fiscal year to report them to the SEC.[57] After August 29, 2002, recipients of stock options must report them to the SEC within two business days of receiving the grant.[58] One day after receiving this information, the SEC makes it public, and now firms with corporate websites are required to post this information on the day after they disclose it to the SEC.[59] The authors state that

> if backdating produced the abnormal return patterns around executive option grants, we hypothesis that the new reporting requirements should substantially dampen the abnormal return patterns that previously had been intensifying over time.[60]

Heron and Lie utilized a large sample of stock option grants to CEOs between August 29, 2002, and November 30, 2004, and compared this sample with a large sample from January 1, 2000, to August 28, 2002.[61] The authors conclude that

> Overall, we find evidence suggesting that backdating is the major source of the abnormal stock return patterns around executive stock option grants. Our evidence further suggests that the new reporting requirements have greatly curbed backdating, but have not eliminated it. To eliminate backdating, it appears that the requirements need to be tightened further, such that grants have to be reported on the grant day or, at the latest, on the day thereafter. In addition, the SEC naturally has to enforce the requirements.[62]

[52] Ibid.

[53] Ibid.

[54] David Reilly, "FASB Appears in a New Light on Stock Options," *The Wall Street Journal*, Aug. 14, 2006, p. C1.

[55] Ibid.

[56] Randall A. Heron and Erik Lie, "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?," *Journal of Financial Economics*, vol. 83, no. 2, pp. 2-3. This article is available at http://www.biz.uiowa.edu/faculty/elie/GrantsJFE.pdf.

[57] Ibid., p. 3.

[58] Ibid.

[59] Ibid.

[60] Ibid., p. 3.

[61] Ibid., pp. 29-30.

[62] Ibid., p. 30.

Thus, the authors found that while the undisclosed backdating of stock options still occurs, it was far more prevalent before new reporting regulations were applicable on August 29, 2002.

On July 26, 2006, the SEC voted to adopt changes to the rules requiring disclosure of executive and director compensation and related matters.[63] These new rules include disclosure regarding option grants.[64]

The Securities and Exchange Commission, various state prosecutorial, and Department of Justice (DOJ) probes into backdating abuses are ongoing. In addition, many firms have mounted their own internal probes into possible abuses. About 200 companies have been under federal investigation and/or have restated earnings.[65] By November 2007, the SEC's investigation caseload had fallen from a peak of 160 to about 80, and the SEC had brought civil enforcement actions against seven companies and 26 former executives associated with 15 firms. And according to reports from the DOJ, there were at least 10 criminal filings against defendants for backdating.

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[63] U.S. Securities and Exchange Commission, "SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters." Press release #2006-123, July 26, 2006, 8 p. Available at http://www.sec.gov/news/press/2006/2006-123.htm.

[64] Ibid., p. 4.

[65] For a list and status of 140 of these companies (last updated Sept. 4, 2007), see the *Wall Street Journal* online site at http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html, visited May 7, 2008.