POLITICAL PULSE

Beware of Senators Bearing Tax Hikes

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Senate bill S.1940, the "Ending the Double Standard for Stock Options Act," is a Trojan horse. On the outside, this bill introduced a month ago by **Senator Carl Levin** (Dem: Michigan), with co-sponsorship by **John McCain** (Rep: Arizona) and three other senators appears to be about reporting transparency in the post-**Enron** world -- it seeks to motivate companies to include executive and employee stock option expenses in earnings reports by limiting corporate tax deductions to the amount that is expensed.

But on the inside, this Trojan horse contains an enormous hidden tax hike, structured in a strongly anti-supply-side way that would reduce incentives to invest and would systemically raise the cost of capital for American business. The tech industry advocates fighting it are just complaining about the purely optical hit to GAAP earnings that would result from having to expense options. What they are missing is that this is a *real* tax increase that would hurt *real* earnings -- not just GAAP optics.

Here's why. It's slightly technical, so please bear with me here.

Today section 83(h) of the Internal Revenue Code allows companies to deduct from taxable income the difference between the option's exercise price and the company's stock price at the time the option is exercised. That's the same basis on which the option holder pays personal income taxes on his gains. For example, **Cisco's** current and deferred tax deductions in fiscal 2001 for options exercised on 133 million shares with a weighted-average exercise price of 7.43 was $1.8 billion. It's not specifically disclosed, but a reasonable guess is that the total expense giving rise to this deduction was about $5.1 billion.

S.1940 would change all that by limiting a company's tax deduction to "the amount the taxpayer has treated as an expense for the purpose of ascertaining income, profit, or loss in a report or statement to shareholders..." On the surface it would seem that all a company would have to do to hang onto its tax deductions would be to report as an expense whatever amount they are now deducting -- it would be a bad hit to the optics of GAAP earnings, but the deduction would be preserved. But here's what's inside the Trojan horse: *companies can't do that* -- they can't just make up GAAP as they go along in order to get tax deductions. GAAP is very clear on how options expenses are to be reported -- and there's no way under GAAP that companies will get the deductions they are used to.

Under GAAP there are only two ways to report options expenses. One is the "intrinsic value method" given by **Accounting Principles Board** Opinion No. 25. Because an option issued with its exercise price set at the current stock price has no intrinsic value, the expense of issuing it is zero. When it is exercised the company makes no cash outlay, so that's a zero expense, too. This is the method virtually all companies are already using today in order to justify reporting zero options expense. And zero is not a very attractive tax deduction.

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The only permissible alternative under GAAP is the "fair value method" given by **Financial Accounting Standards Board** Statement No. 123. Under this method a company estimates the value of options when they are issued using the Black Scholes option pricing model, and then applies that value as an expense spread evenly over the option's life. Returning to Cisco as an example, fiscal 2001 option expenses would have been $1.7 billion. That's a lot less than the actual economic expense of $5.1 billion, and it gives rise to a commensurately smaller tax deduction: I estimate that Cisco's deduction would fall from $1.8 billion to $592 million -- *an effective tax increase of $1.16 billion dollars.* And there's nothing particularly unusual about Cisco -- most big technology companies would feel a similar effect.

The tax increase is progressive because it gets bigger and bigger the better a company's stock performs. When a company's stock soars, the real economic expense of delivering stock to option exercisers at below-market prices soars, too. Under S.1940 the tax deduction is fixed forever at the option's fair value at the time it was issued.

The only way out, if S.1940 is enacted, would be for the Financial Accounting Standards Board to issue new rules that would permit including the intrinsic value of exercised options in income statements. S.1940 effectively puts the FASB in the position of writing tax law.

That's what's inside the Trojan horse. A huge progressive tax increase. If S.1940 is enacted, this enormous tax increase would severely diminish real corporate earnings -- not just reported GAAP earnings. And the bigger the expected upside, the bigger the diminution. Companies would move at the margin to replace option-based compensation with cash compensation, and real earnings would fall even more. Stock prices would have to fall to equilibrate with lower earnings expectations. That would have the effect of raising the cost of capital to companies, which will discourage investment and risk-taking. And *that* would lower long-term growth prospects for the entire economy -- and those diminished growth prospects would require even further downward equilibration of stock prices.

It would hit every company that issues options -- from start-ups seeking venture capital funding to mature technology companies like Cisco, all the way up the food chain to giants like **General Electric**. It's the small, young companies at the bottom of the food chain who will suffer most, because they are most dependent on options for the acquisition of scarce intellectual capital -- and they have no other way to pay for it. Impairment in that part of the economy would have tragic consequences, because small companies are the engines of job formation and technology innovation in the economy.

You can be sure that technology industry lobbying organizations like **TechNet** and the **National Venture Capital Association** will be fighting S.1940 intensely. But at the same time, Old Economy companies that are relatively unreliant on options -- and are threatened by the technology revolution -- will be lobbying *for* S.1940 just as intensely. And they will be helped along by establishment voices like **Warren Buffett** -- and even **Alan Greenspan** -- who can be relied upon to keep speaking out against options.

On balance, I'd rate the chances that S.1940 will be enacted as quite small. Think of S.1940 as a far out-of-the-money option. It will probably expire worthless. But in the meantime, you're short it. Watch it closely. *We* will be. TM