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POLITICAL PULSE

Triple Witching Hour for the Stock Options Tax-Hike

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In the super-charged anti-business atmosphere of Washington, the dreaded Levin-McCain stock options bill -- S.1940 -- is at-the-money.

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Exactly four months ago I wrote a client report warning about the gigantic corporate tax-hike implicit in Senate Bill 1940, the "Ending the Double Standard for Stock Options Act," sponsored by **Michigan Democrat Senator Carl Levin** and **Arizona Republican John McCain** (see "Beware of Senators Bearing Tax Hikes" March 15, 2002). S.1940 would increase **Cisco's** taxes by $1.1 billion based on last-year's numbers. It would increase **Oracle's** taxes by $988 million. It would increase **Sun Microsystems'** taxes by $636 million. It's not just a matter of the optics of reported GAAP earnings, though that's all that's at stake in *other* proposals that simply call for expensing options on income statements. S.1940 pretends to be about expensing, but *the way it operates impacts the extent to which stock options are tax deductible* to the companies that issue them. So we're talking about *real cash*, sucked out of these and hundreds of other companies and sent straight to Washington, DC.

I wrote four months ago, "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."

I *still* don't think the tax-hike provisions of S.1940 will pass. But that far-out-of-the-money option is now *at*-the-money. It's high noon for the Levin-McCain stock options tax hike.

Don't be complacent about this. **Texas Republican Senator Phil Gramm** told the *New York Times* on Thursday, "In the environment we are in, virtually anything can pass." **Ohio Republican Representative Michael Oxley** called it a "feeding frenzy" and said, "Summary executions would get about 85 votes in the **Senate** right now."

Thankfully, so far Levin and McCain remain thwarted at least in terms of using options expenses to sneak in a corporate tax hike. Indeed, even without the tax hike element unique to S.1940, expensing of stock options is still a third rail that most politicians are unwilling to touch. On Thursday, an effort by McCain to attach an options expensing amendment to other corporate accountability legislation was turned back by parliamentary procedures controlled by none other than **Senate Majority Leader Tom Daschle**.

Now, Levin is pushing a watered-down amendment -- with no tax-hike implications -- that would require the proposed **Public Company Accounting Oversight Board** to conduct a review of how new rules for stock options expensing could be devised. Daschle told the *New York Times* that "Senator Levin has exactly the right proposal with regard to stock options."

Daschle told the *Wall Street Journal* that "We shouldn't be dictating to an independent board right out of the box," and that Levin's order for a review "is right on the mark." But this still sets a dangerous precedent, putting the new PCAOB on an immediate policy-making collision course with the **Financial Accounting Standards Board**.

Levin told the *Times* that Gramm is leading the efforts to block his amendment -- and at this point, it may take a lame duck like Gramm to do it. Historically efforts to legislate options expensing have been blocked most powerfully by **Connecticut Democratic Senator Joe Lieberman** -- who styles himself as a "pro-business Democrat," and who mobilized the Senate in 1993 to block a law similar to what Levin is now proposing.

But Lieberman is anything but a lame duck, and now he apparently fears that his pro-business stance may come to haunt him. According to the *New York Times* on Sunday, "In light of the corporate scandals, Mr. Lieberman said he had modified his views on stock options. He said he could now support Senator John McCain's proposal to prohibit top executives from selling stock they bought with options as long as they worked for the company. He could even support requiring companies to record options given to top executives as operating expenses, if a way could be found to do that and protect options awarded to lower-level employees."

Granting that the S.1940 corporate tax-hike element is safely out of the picture, there are still real dangers. The McCain proposal that Lieberman speaks of -- to require executives not to sell stock acquired through options -- is just another tax hike. Current alternative minimum tax rules virtually force options exercisers to sell their stock -- at least some of it to pay the tax bill if the stock goes up, and *all of it* to minimize taxes if the stock goes down. The answer for executives? Wait till the last minute to exercise, and then get the hell out of Dodge.

And Lieberman's idea of giving accounting preferences to options awarded to non-executives opens up a whole new frontier of legislated social engineering. Typically government awards *tax* loopholes to things it wishes to encourage, but this seeks to award *accounting* loopholes!

Perhaps the best solution of all would be if many companies would follow in the footsteps of **Coca Cola**, which announced over the weekend that they would voluntarily adopt alternate accounting rules that provide for options expensing (**Boeing** and **Winn Dixie** are the only other major public companies that currently use these rules). Voluntary compliance with existing alternate rules could forestall wrong-headed *new* rules, and help portray corporate America as cleaning up its own mess, as well. But as we've written in the past, investors will be shocked when they see the huge scope of options expenses that have been hidden all these years (see "Stock Options Expense: The Big Truth" May 15, 2002).

Bottom line: the stock market is probably safe from the multi-billion dollar stealth tax-hike of S.1940. But there are still the substantial risks I wrote about on Friday -- the greatest of all being the creation of a legislated environment in which no one wants to take the risk of being a public company CEO any more (see "Killing Capitalism in Order to Save It" July 12, 2002).

We need to watch carefully now, hoping that the "feeding frenzy" in the Senate gets choked off by the **House** in the coming weeks. If it does, then with stock market valuations at 6-year lows, we could be looking at a major buying opportunity. If it doesn't, then we could be looking at lengthy a new era of lower valuations.

While we wait and see, we remain comfortable with our relatively unaggressive Model Positions in equities -- a small long position in the S&P 500, and a small short position in the NASDAQ 100 (against a long position in long-term Treasuries).