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Council of Institutional Investors wish may backfire

by Donald L. Luskin

The Council of Institutional Investors has weighed in on the Enron Corp. debate about integrity in financial reporting and management compensation, strongly throwing "its support behind efforts to get companies to include the cost of stock options as an expense on their income statements." The Council had better be careful what it wishes for.

A law pending in the congress -- Senate Bill 1940, "The Ending the Double Standard for Stock Options Act" sponsored by Carl Levin (D-Mich), John McCain (R-Ariz), and three other senators -- promises to do exactly what the Council wants. But it does something else at the same time: it's a stealth tax increase, and a gigantic one. And it's an open invitation to new forms of corruption by executives and auditors.

Under S.1940, every company that issues stock options would be hit with an enormous tax-hike -- but technology companies that use options extensively would be hit especially hard. S.1940 would increase Cisco Systems Inc's taxes by $1.1 billion based on last-year's numbers. It would increase Oracle Corp's taxes by $988 million. It would increase Sun Microsystems Inc's taxes by $636 million. Extracting that kind of money from American companies and shipping it off to Washington would abort today's nascent economic recovery, and turn Silicon Valley into Silicon Dust Bowl. Surely that's not what the Council of Institutional Investors wants -- but that's what this bill would do.

S.1940 hidden tax increase works by addressing a disconnect between accounting rules and tax laws. Companies are currently not required to report options expenses at all under generally accepted accounting principles set by the Financial Accounting Standards Board. But the tax laws set by Congress, companies can deduct options expenses. S.1940 resolves what it calls this "double standard" by limiting a company's tax deduction to whatever options expense it reports in its financial statements.

That means that any company that uses GAAP to report zero options expenses gets zero tax deduction. That's the gun that S.1940 holds to the head of corporate America to get companies to report their options expenses.

The problem is that, under GAAP, there's only one way to report options expenses other than zero -- and that's their "fair value" at the time they are issued. On the other hand, the tax laws allow companies to deduct a much higher amount -- the actual value of options at the time they are exercised.

Options are almost always worth more when and if they are eventually exercised than when they are first issued. If they weren't, why would anyone want options in the first place? And that's why S.1940 is a gigantic tax increase: it would require companies to deduct only the lower cost of options when they are first issued, not the higher cost of options exercised.

What's more, there' a subtle lose-lose deal for companies built in: the deduction of the fair value at issue can only be taken when and if the option is finally exercised. Then the company gets to deduct only the lower fair value -- but the employee who exercises the option will pay taxes on the higher exercise value, just as he does today.

Beyond the tax increase, switching the tax deduction to fair value at the time of issue creates incentives for corruption. The cost of exercise is a simple, objective fact. But "fair value" is calculated by a complex theoretical model, such as the Black Scholes options pricing model, which must be fed subjective forecasts from executives and auditors before it can come up with a result. Considering the huge tax increase that companies would bear under S.1940, executives would be tempted to pad those subjective forecasts to produce the biggest deduction they could get away with.

And what's worse, because S.1940 ties the tax deduction for options expenses to the way they are reported, there would be an incentive to change the reporting rules as a back-door means of changing the tax laws -- without any congressional say in the matter. Where in the U.S. Constitution does it say that the congress has the power to delegate tax-writing authority to the Financial Accounting Standards Board?

It's one thing for the Council of Institutional Investors to take a stand for greater transparency, integrity and shareholder empowerment in financial reporting and management compensation. But they should take just a strong a stand against S.1940. The destruction of shareholder value that would result from S.1940's massive hidden tax increase is too high a price to pay.

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