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## **Stock Options - Ending the Double Standard**

By Bill Krems, Of Counsel

Legislation was recently introduced Congress that would limit a company's income tax deduction on the exercise of stock options to the amount that is reflected as an expense in the company's financial statements. The Senate bill was introduced by Senators Levin, McCain, Fitzgerald, and Durbin, and the House bill was introduced by Representative Stark. The sponsors believe that differences in financial reporting and income tax treatment constitute an inappropriate double standard that should be ended. They believe that the financial reporting treatment for stock options is wrong and that an expense should be required for that purpose, although their proposal does not require any change in generally accepted accounting principles. The proposal would generally not apply to options qualified under the Internal Revenue Code as Incentive Stock Options, because a company would not be entitled to a tax deduction upon the exercise of an ISO.

Presently, a company may claim a tax deduction equal to the amount of income recognized by an employee at the time a non-ISO (nonqualified) stock option is exercised. This amount would be the value of the stock minus the exercise price. No expense recognition is currently mandated under generally accepted accounting principles for financial reporting purposes. The proposal would result in any permissible tax deduction being available in the year of option exercise, which could be many years after the year of the related financial statement expense.

The current tax treatment for nonqualified options is essentially revenue-neutral. The income taxable to the employee is the same amount deductible by the company. Under the proposal this would not be true, and additional tax revenue likely would be generated because the taxable income to the employee generally would be greater than the tax deduction to the company.

Even more problematic and controversial is the appropriate treatment of stock options for financial reporting purposes. The employee clearly receives something of value in the stock option grant, even though it may vest over a 3 to 5 year period and be exercisable at prices equal to or greater than the current stock price, and even if the option may never have actual value to the employee. However, it is undecided whether the company itself has an expense from the issuers of the option. There is no out-of-pocket compensation cost to issue new shares to the employee. Also, to the extent that stock options are treated as though exercised for financial reporting purposes, the options reduce the company's earnings per share on a "fully diluted" basis.

It is difficult to predict whether this recent proposal will be enacted. Although the proposal does not solve problems that the sponsors have identified, the legislative environment created by Enron may make Congress more sympathetic to this and other legislation affecting stock options.

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*The DGS Corporate Finance & Acquisitions Group is ready to assist you with any issue raised in this article. Please do not hesitate to contact any member of the group to discuss your specific legal needs.*

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