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Stock Options and the Levin-McCain Double Standard

By Alan Reynolds

Senator Carl Levin (D-MI) has revived a bill he introduced (as S.576) in 1997 when it died from lack of support. The last time the bill's key issue—tax deductibility of stock options—came up for a vote was in May 1994, when a Senate resolution rejected Senator Levin's position by 88 to 9. Today, as in 1997, Senator Levin's "Ending the Double Standards for Stock Options" bill (S.1940) is co-sponsored by John McCain (R-AZ) and a couple of other Senators.

On June 20,1997, Senator Joe Lieberman wrote to Treasury Secretary Rubin, "the McCain/Levin bill could have the double effect of asphyxiating individual drive and undermining innovation." Michael Mares of The American Institute of Certified Public Accounts (www.aicpa.org) put his finger on the fundamental flaw of the original Levin-McCain bill. He said it would destroy "the parity between the income inclusion and deduction that ensures income is taxed only once."

When Senators Levin and McCain refer to a "double standard," they mean accounting rules allow some unknown future expense–such as the future cost of pensions and options—to be *estimated.* Tax law, by contrast, necessarily operates on a higher standard: We do *not* base taxes on estimates. Taxes are due only when income is actually received, and deductions are allowed only when costs are actually incurred.

The Levin-McCain proposal would create a double standard. Employee taxes would be based on the *actual* income received from stock options. But employer deductions would be based on the *estimated* cost—years before the options are realized and their true value and cost become known.

Coherent tax policy maintains parity between costs and income. Wages and benefits are a deductible cost of doing business to the employer, but taxable income to the employee. Stock options are no different. If and when stock options generate income for an employee, the employee will then owe ordinary *income* tax (not capital gains tax) and the employer will then take a matching deduction.

Senator Levin claims the cost of stock options never shows up in the company's earnings. That is quite mistaken. Suppose options were granted when the stock was $10 a share, but executed years later when the stock was $50. To finance the required $40 per share payment to employees, the company will often purchase the required stock on the open market–a stock "buyback." Using earnings to buy back shares keeps the number of outstanding shares unchanged, but it obviously *does* result in lower reported earnings. The only alternative is to issue more shares—"dilution"—which also clearly reduces earnings *per share.* Does the cost of buybacks or dilution show up in company earnings? Of course it does.

Stock options are no free lunch for employers, but neither is this a zero-sum game. Critics sometimes claim that options hurt stockholders. That is paradoxical nonsense since options only have value to the extent that the stock goes *up.*

The immediate value of stock options is precisely zero at the time they are granted, which is why they are neither taxable income for employees nor a tax deduction for employers. The future value of options is, of course, as mysterious as the stock market itself. The Black-Scholes model purports to *estimate* the present value of future options, based on such vagaries as expected volatility of the stock, expected interest rates, and expected dividends. Such estimates are readily available in one of the

footnotes widely used to *explain,* not conceal, the complexities of corporate income statements.

Estimates of the future may be useful for accounting purposes, but not for taxes. Senators Levin and McCain would not dare to suggest that employees should be taxed today on the *estimated* future value of stock options that will not even be vested for five years. Yet they do propose that the employer's tax deduction be limited to what a Black-Scholes estimate thought the options *might* be worth some day, rather than what they actually turn out to be worth. This makes no sense.

A March 26 *Wall Street Journal* feature said, "In 2000, Enron issued stock options worth $155 million, according to a common method of valuing options." In the real world, however, all options Enron doled out in 2000 are *completely worthless.* The *Journal* reporters suggest that Enron should have subtracted the fanciful $155 million estimate from reported earnings, thus reducing reported earnings by a trivial 8 percent. Any analyst innocent enough to believe the estimates could easily make that simple calculation, and some did. But why bother?

The *Wall Street Journal* missed the real story, which is about *taxes* not accounting. If the Levin-McCain bill had been in effect, it would have *reduced* Enron's *taxable* income by $155 million in 2000. In this case, the $155 million Levin-McCain tax deduction for the estimated cost of options would have been 100 percent too large. In the case of highly successful companies, the Levin-McCain deduction would be much too small. In either case, basing the deduction on the estimated present value of future options would *always* be wrong.

Senator Levin claims Enron did not pay taxes in four of the past five years, including 2000, so giving Enron the gift of a meaningless $155 million deduction might not seem to matter. Unfortunately, the claim that Enron paid no taxes came from a one-page "study" from Citizens for Tax Justice (CTJ), which previously claimed Enron would get a big "windfall" if the alternative minimum tax (AMT) were repealed. But how could Enron possibly reap a windfall from repealing the minimum tax if it never paid any taxes?

Senator Levin was more cautious about the newer CTJ story than most journalists. He acknowledged that CTJ estimates are "not based on a review of the actual tax returns," while adding "Enron has yet to release its tax returns." The implication was that Enron must have been hiding the fact that it paid no taxes in recent years. Browsing through press releases at enron.com shows that Enron reported an "income tax expense" of $434 million in 2000. A company widely accused of exaggerating profits had no motive to exaggerate its tax expenses. Some of the $434 million may have gone to state and foreign governments (the company operated power plants and pipelines in at least 8 countries). But it is certainly *not* true that the company paid "no taxes." Besides, paying more taxes would scarcely have been the best way to avoid bankruptcy.

All of this suddenly fashionable agitation over stock options is curious, since the drop in stock prices over the past two years has put most options under water. Even mentioning the issue ought to be particularly embarrassing for Democrats, because they alone voted for the 1993 tax law that decreed that not more than $1 million of executive salary could be deducted as a business expense. Since then, deductions above $1 million have been permitted *only* for "performance-related compensation"–mainly stock options. Predictably, Brian Hall and Jeff Liebman later found the 1993 million dollar rule had "led firms to adjust the composition of their pay away from salary and toward performance-related pay." If legislators really want to reduce the share of executive pay coming from stock options, the most effective way to do that is to repeal the Clinton Administration's arbitrary cap on deductibility of large salaries.

The Levin-McCain double standard would base employer deductions on the *estimated* rather than actual costs of stock options, and do so in the year issued rather than many years later when the employees are vested to exercise the options *if* the stock price has increased. This was a totally indefensible proposal in 1997, and it still is.

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