STATEMENT OF SENATOR CARL LEVIN (D-MICH)
BEFORE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
ON
EXECUTIVE STOCK OPTIONS:
SHOULD THE IRS AND STOCKHOLDERS BE GIVEN DIFFERENT INFORMATION?

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The subject of today's hearing is executive stock options. Stock options give employees the right to buy company stock at a set price for a specified period of time, typically ten years. Stock options are a key contributor to executive pay.

According to Forbes magazine, in 2006, the average pay of the chief executive officers (CEOs) of 500 of the largest U.S. companies was $15.2 million. Nearly half of that amount, 48%, came from exercised stock options that produced average gains of about $7.3 million. On the high end, one CEO cashed in stock options for $290 million, another for $270 million. Forbes also published a list of 30 CEOs in 2006, who each had at least $100 million in vested stock options that had yet to be exercised. J.P. Morgan once said that CEO pay should not exceed 20 times average worker pay. In the United States, in 1990, average CEO pay was 100 times average worker pay; in 2004, the figure was 300 times; today, it is nearly 400.

Stock options have been portrayed as a way to align corporate executives' interests with those of stockholders, because they produce income for an executive only if the company stock price rises. But stock options have also been associated with a litany of abuses ranging from dishonest accounting to tax dodging – from Enron, to the backdating scandal, to the Wyly brothers in Texas who, as our hearing showed last summer, tried to dodge U.S. taxes by sending $190 million in stock options to offshore shell companies they secretly controlled.

Today's hearing is looking at a stock option issue that does not involve allegations of wrongdoing. Rather, today's hearing focuses on a set of mismatched accounting and tax rules that are legal. These rules require companies to report one set of stock option compensation figures to investors and the public on their books, and a completely different set of figures to the Internal Revenue Service (IRS) on their tax returns. In most cases, the resulting tax deduction has far exceeded the expense shown on the company books.

When a company's compensation committee learns that stock options often produce a low compensation cost on the books, while generating a whopping tax deduction, it's a pretty tempting proposition for them to pay their executives with stock options instead of cash or stock. The problem is that the mismatch in stock option accounting and tax rules also shortchanges the Treasury to the tune of billions of dollars each year, while fueling the growing chasm between executive pay and average worker pay.

Accounting Battle. Calculating the cost of stock options may sound straightforward, but for years, companies and their accountants engaged the Financial Accounting Standards Board in an all-out, knock-down battle over how companies should record stock option compensation expenses on their books.

U.S. publicly traded corporations are required by law to follow Generally Accepted Accounting Principles (GAAP), issued by the Financial Accounting Standards Board (FASB), which is overseen by the Securities and Exchange Commission (SEC). For many years, GAAP allowed U.S. companies to issue stock options to employees and, unlike any other type of compensation, report a zero compensation expense on their books, so long as, on the grant date, the stock option's exercise price equaled the market price at which the stock could be sold.

Assigning a zero value to stock options that routinely produced millions of dollars in executive pay provoked deep disagreements within the accounting community. In 1993, FASB proposed assigning a "fair value" to stock options on the date they are granted to an employee, using a mathematical valuation tool such as the Black Scholes model, and then including a grant date expense on companies' financial statements. Critics responded that it was impossible accurately to estimate the value of executive stock options on their grant date. A bruising battle over stock option expensing followed, involving the accounting profession, corporate executives, FASB, the SEC, and Congress.

In the end, FASB issued a new accounting standard, Financial Accounting Standard (FAS) 123R, which was endorsed by the SEC and became mandatory for all publicly traded corporations in June 2005. In essence, FAS 123R requires all companies to record a compensation expense equal to the fair value on grant date of stock options provided to employees in exchange for their services.

The details of this accounting rule are complex, because they reflect an effort to accommodate varying viewpoints on the true cost of stock options. Companies are allowed to use a variety of mathematical models, for example, to calculate a stock option's fair value. Option grants that vest over time are expensed over the specified period so that, for example, a stock option which vests over four years results in 25% of the cost being expensed each year. If a stock option grant never vests, the rule allows any previously booked expense to be recovered. On the other hand, stock options that do vest must be fully expensed, even if never exercised, because the compensation was actually awarded. These and other provisions of this hard-fought accounting rule reflect painstaking judgements on how to show a stock option's true cost.

Opponents of the new accounting rule predicted that it would severely damage U.S. capital markets. They warned that stock option expensing would eliminate profits, discourage investment, depress stock prices, and stifle innovation. Last year, 2006, was the first year in which all U.S. publicly traded companies were required to expense stock options. Instead of tumbling, both the New York Stock Exchange and Nasdaq turned in strong performances, as did initial public offerings by new companies. The dire predictions were wrong.

Tax Treatment. In contrast to the battle raging over stock option accounting, relatively little attention was paid to the taxation of stock options. Section 83 of the tax code, first enacted in 1969, is the key statutory provision. It essentially provides that, when an employee exercises stock options, the employee must report as income the difference between what the employee paid to exercise the options and the market value of the stock received. The corporation can then take a mirror deduction for the same amount of income.

For example, suppose an executive had options to buy 1 million shares of company stock at $10 per share. Suppose, five years later, the executive exercised the options when the stock was selling at $30 per share. The executive's income would be $20 per share for a total of $20 million. The executive would declare $20 million as ordinary income, and in the same year, the company would take a corresponding tax deduction for $20 million. Although in 1993, Congress enacted a $1 million cap on the compensation that a corporation can deduct from its taxes, so taxpayers wouldn't be forced to subsidize millions of dollars in executive pay, an exception was made for stock options, allowing companies to deduct any amount of stock option compensation, without limit.

Book-Tax Differences. The stock option accounting and tax rules now in place are at odds with each other. Accounting rules require companies to expense stock options on the grant date. Tax rules require companies to deduct stock option expenses on the exercise date. Companies have to report grant date expenses to investors on their financial statements, and exercise date expenses on their tax returns. The financial statements report on all stock options granted during the year, while the tax returns report on all stock options exercised during the year. In short, company financial statements and tax returns report expenses for different groups of stock options, using dramatically different valuation methods, resulting in widely divergent stock option expenses for the same year.

Company Data. To test just how far these figures diverge, the Subcommittee contacted a number of companies to compare the stock option expenses they reported for accounting and tax purposes. The Subcommittee asked each company to identify stock options that had been exercised by one or more of its executives from 2002 to 2006. The Subcommittee then asked each company to identify the compensation expense they reported on their financial statements versus the compensation expense on their tax returns. In addition, we asked the companies' help in estimating what effect the new accounting rule would have had on their book expense if it had been in place when their stock options were granted. We very much appreciate the cooperation and assistance provided by the nine companies whose data is being disclosed today, including the three companies that were asked to testify.

The data showed that, under then existing accounting rules, the nine companies generally showed stock options as a zero expense on their books. The one exception was Occidental Petroleum which, in 2005, began voluntarily expensing its options and recorded an expense for a few options. When the Subcommittee asked the companies what their book expense would have been if the new FASB rule had been in effect, all nine calculated a book expense that remained dramatically lower than their tax deductions.

This chart, which is Exhibit 1, shows the book-tax differences, using the book expense calculated under the new FASB rule. It shows that the nine companies alone produced $1 billion more in tax deductions than the expense shown on their books, even using the tougher new accounting rule. Their tax deductions far exceeded their book expenses, not because the companies were doing anything wrong, but because the current stock option accounting and tax rules are so out of whack.

KB Home, for example, is a company that builds residential homes. Its stock price has more than quadrupled over the past 10 years. Over the same time period, it repeatedly granted stock options to its then CEO. Company records show that, over the past five years, KB Home gave him 5.5 million stock options of which he exercised more than 3 million.

With respect to those 3 million stock options, KB Home recorded a zero expense on its books. Had FAS 123R been in effect, KB Home calculated that it would have reported on its books a compensation expense of about $11.5 million. KB Home also disclosed that the same 3 million stock options enabled it to claim compensation expenses on its tax returns totaling about $143.7 million. In other words, KB Home claimed a $143 million tax deduction for expenses that on its books, under current accounting rules, would have totaled $11.5 million. That's a tax deduction 12 times bigger than the book expense.

Occidental Petroleum, the next company on the chart, disclosed a similar book-tax discrepancy. This company's stock price has also skyrocketed in recent years, dramatically increasing the value of the 16 million stock options granted to its CEO since 1993. Of the 12 million stock options the CEO actually exercised over the past five years, Occidental Petroleum claimed a $353 million tax deduction for a book expense that, under current accounting rules, would have totaled just $29 million. That's a book-tax difference of more than 1200%.

Similar book-tax discrepancies apply to the other companies we contacted. Cisco System's CEO exercised nearly 19 million stock options over the past five years, and provided the company with a $169 million tax deduction for a book expense which, under current accounting rules, would have totaled about $21 million. UnitedHealth's former CEO exercised over 9 million stock options in five years, providing the company with a $318 million tax deduction for a book expense which would have totaled about $46 million. Safeway's CEO exercised over 2 million stock options, providing the company with a $39 million tax deduction for a book expense which would have totaled about $6.5 million.

Altogether, these nine companies took stock option tax deductions totaling $1.2 billion, a figure five times larger than their combined stock option book expenses of $217 million. The resulting billion-dollar book-tax difference represents a huge tax deduction windfall for the companies simply because they issued lots of stock options to their CEOs. Tax rules that produce outsized tax deductions that are many times larger than the related stock option book expenses give companies an incentive to issue huge stock option grants, because they know the stock options will produce a relatively small hit to profits and a much larger tax deduction that can dramatically lower their taxes.

To gauge just how big the tax gap is for stock options, the Subcommittee asked the IRS to perform an analysis of its overall data on stock option book-tax differences. The new M-3 Schedule, which went into effect last year for large corporations, asked companies to identify differences in how they report corporate income to investors versus what they report to Uncle Sam. The resulting M-3 data applies mostly to 2004 tax returns.

The IRS found that stock option compensation expenses were one of the biggest factors in the difference between book and tax income reported by U.S. corporations. The data shows that, in 2004, stock option compensation expenses produced a book-tax gap of about $43 billion, which is about 30% of the entire book-tax difference reported for the period. That means, as a whole, corporations took deductions on their tax returns for stock option compensation expenses which were $43 billion greater than the stock option expenses shown on their financial statements for the same year. Those massive tax deductions enabled the corporations, as a whole, to legally reduce their taxes by billions of dollars, perhaps by as much as $15 billion.

When asked to look deeper into who benefitted from the stock option deductions, the IRS was able to determine that the entire $43 billion book-tax difference was attributable to about 3,200 corporations nationwide, of which about 250 corporations accounted for 82% of the total difference. In other words, a relatively small number of corporations was able to generate a $43 billion tax deduction by handing out substantial stock options to their executives.

There are other surprises in the data as well. One set of issues involves unexercised stock options which, under the new accounting rule, will produce an expense on the books but no tax deduction. Cisco told the Subcommittee, for example, that in addition to the 19 million exercised stock options mentioned a moment ago, their CEO holds about 8 million options that, due to a stock price drop, would likely expire without being exercised. Cisco calculated that, had FAS 123R been in effect, the company would have had to show a $139 million book expense for those options, but would never be able to claim a tax deduction for them since they would never be exercised. Apple pointed out that, in 2003, it allowed its CEO to trade 17.5 million in underwater stock options for 5 million shares of restricted stock. That trade meant the stock options would never be exercised and so would never produce a tax deduction. In both cases, under FAS 123R, it is possible that stock options would produce a reported book expense greater than a company's tax deduction. While the M-3 data suggests that, overall, accounting expenses lag far behind claimed tax deductions, the possible financial impact on an individual company of a large number of unexercised stock options is additional evidence that stock option accounting and tax rules are out of kilter.

Another set of issues has to do with how the corporate stock option tax deduction depends upon decisions made by individual corporate executives on whether and when to exercise their stock options. Normally, a corporation dispenses compensation to its employees and takes a tax deduction in the same year for the expense. With respect to stock options, however, corporations may have to wait years to see if, when, and how much of a deduction can be taken. UnitedHealth noted, for example, that it gave its former CEO 8 million stock options in 1999, of which, by 2006, only about 730,000 had been exercised. It does not know if or when it will get a tax deduction for the remaining 7 million options.

If the rules for stock option tax deductions were changed so that the annual deduction matched the expenses shown on a company's books in the same year, companies could take the deduction years earlier, without waiting for exercises, and it would allow companies to deduct stock options that vest but are never exercised. It would treat stock options in the same manner as every other form of corporate compensation by allowing a deduction in the same year that the compensation was granted.

Conclusion. The current differences between stock option accounting and tax rules make no sense. They require companies to show one stock option expense on their books and a completely different expense on their tax returns. They allow companies to take tax deductions that, overall, are many times larger than the stock option book expenses shown on their books, which not only shortchanges the Treasury, but also provides an accounting and tax windfall to companies doling out huge stock options, and creates an incentive for companies to keep right on doling out those options. The book-tax difference is fueling an ever deepening chasm between executive pay and the pay of average workers.

The stock option book-tax difference is a historical product of accounting and tax policies that have not been coordinated or integrated. Right now, stock options are the only compensation expense where companies are allowed to deduct much more on their tax returns than the expense shown on their books. In 2004, companies used the book-tax difference to claim $43 billion more in stock option deductions than the expenses shown on their books. We need to examine whether we can afford this multi-billion dollar loss to the Treasury, not only in light of the deep federal deficits, but also in light of evidence that this stock option book-tax difference is contributing to the growing gap between the pay of executives and the pay of average workers.

In past years, I've introduced legislation to require stock option tax deductions to match the stock option expenses shown on the company books. I hope the witnesses today will help us analyze the policy issues, and indicate whether they agree that federal tax policy should be brought into line with accounting policy, and provide that corporations deduct on their tax returns only the amount of stock option expenses shown on their books.

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