WRITTEN TESTIMONY OF THE ACTING COMMISSIONER OF INTERNAL REVENUE KEVIN BROWN BEFORE SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS PERMANENT SUBCOMMITTEE ON INVESTIGATIONS HEARING ON BOOK-TAX DIFFERENCES WITH EXECUTIVE STOCK OPTIONS

JUNE 5, 2007

Good morning Chairman Levin, Ranking Member Coleman and members of the Permanent Subcommittee on Investigations. I am pleased to appear before you to discuss executive stock options and the differences that arise between financial statements that are provided to shareholders and the public and the corporate tax returns filed by the company. I also appreciate Chairman Levin's and Senator Coleman's interest and their assistance, in not only this area, but also in other areas related to the enforcement of our Federal tax laws.

Background

There are two general types of employee options recognized in the tax code, "qualified" and "nonqualified". Qualified (or "statutory") options include "incentive stock options," which are limited to a total cap of $100,000 a year for any one employee, and "employee stock purchase plans," which are limited to $25,000 a year for any employee. Employee stock purchase plans must be offered to all full-time employees with at least two years of service; incentive stock options may be confined to officers and highly paid employees.

Under the Code, tax on qualified options is imposed on the executive employee only when the stock is sold, not when the options are granted or when the employee exercises the option. If the stock is held one year from purchase and two years from the granting of the option, the gain is taxed as long-term capital gain. The employer is not allowed a deduction for these options. However, if the stock is not held the required time, the employee is taxed at ordinary income tax rates and the employer is allowed a deduction.

In contrast to qualified options, nonqualified options (or non-statutory options) may be granted in unlimited amounts. Generally, it is these types of options that have given rise to significant corporate governance issues as key executives are provided substantial options that can be earned without regard to the relative performance of the employer in comparison to peer companies. For example, a key executive could be earning substantial income from the exercise of stock options while the return to shareholders either remains constant or even declines.

Nonqualified options are taxed when exercised. Tax is based on the difference between the purchase price for the stock and its fair market value at exercise. The company is allowed a deduction for the same amount in the year of exercise. The income is also subject to employment taxes.

Tax Administration and Corporate Governance

It is important to distinguish between tax administration and the oversight of corporate governance. The IRS is responsible for tax administration; our colleagues at the SEC focus on governance per se more directly than does the Service. Nevertheless, it is critical that we work together to the extent possible under existing law.

From a tax administration standpoint, unlike a financial accounting standpoint, we are generally unable to identify most executive compensation tax issues until a return is filed and an examination is started. Therefore, it is difficult for the IRS to address stock option issues before they have become known through the media or identified by others, such as institutional shareholders, research analysts, or the SEC, unless a return has already been filed and examined. We are generally precluded from sharing information derived from a tax return or audit with the SEC or other government agencies by IRC section 6103 except in limited, prescribed circumstances.

In addition, tax provisions that might be expected to have an impact on corporate governance may, for a number of reasons, not always have the impact that had been anticipated when they were drafted. For example, Section 162(m) is a relatively straightforward section of the Code that most publicly traded companies understand and are in compliance with. Compensation arrangements are commonly structured to allow executives to earn compensation in excess of the $1 million limit in the form of performance-based bonuses, which includes stock options. As a result, corporations subject to section 162(m) are generally entitled to deduct these performance-based bonuses.

Book-Tax Differences

Despite the fact that the IRS has ramped up efforts in the area of executive compensation in recent years, adjustments on executive and corporate returns as a result of executive compensation issues are relatively infrequent. Our examiners find relatively few indications of executive compensation non-compliance in return information they inspect and the returns they examine. This is an area where corporations can comply with the tax law without inordinate risk or expense and still manage to pay their executives handsomely.

One of the key transparency issues in corporate examinations is the differences between what corporations report to shareholders on their financial statements and what they report to the IRS for tax purposes. This is commonly called the book-tax difference.

One of the prime reasons for this difference is that the financial accounting and tax systems differ in terms of their goals; the goal of the tax system is to measure income and deductions fairly and accurately, in order to compute tax revenue; the goal of the financial accounting system is to provide financial data that are comparable between companies for the users of financial statements.

For financial accounting (book) purposes, beginning in 2005, stock options for most companies are valued as of the date of grant and that value is recognized as compensation expense over the period of services to which the grant relates. The valuation methods used to estimate the value of such stock options generally involve sophisticated mathematical models that estimate the expected economic outcome under the stock option utilizing numerous assumptions based on historical and other data.

This methodology reflects an important goal of financial accounting, which in this case is to match compensation expense to the appropriate period using a consistent method in order to yield results that facilitate comparison of different companies by users of financial statements.

In contrast, the primary goal of the tax system in this context is to accurately and efficiently measure compensation income and associated deductions to facilitate the collection of tax revenue. Accordingly, for tax purposes, compensation income of the employee exercising non-qualified stock options and the employer's corresponding deduction are measured based on the excess of the fair market value of the stock received by the employee upon exercise of the stock option, over the strike price. This method of measuring income for tax purposes provides an efficient and accurate measure for determining income and deductions with no prediction or estimate.

Reconciling the Book-Tax Differences

Public corporations with assets of over $10 million must file a schedule M-3 with the IRS that assists us with reconciling the differences between book and tax income. The M-3 is important to our enforcement efforts in that it provides greater transparency over the specific basis for the differences between financial statement income and expense and tax income and expense.

We use the M-3 to guide examiners to potential areas of non-compliance. Our examiners are instructed to pay attention to items on corporate schedules M-3 that are large, unusual or questionable.

The M-3 does not necessarily identify non-compliance, but it does give us an indication of areas that merit further analysis. For example, lines 2b and c ask the question: "Has the corporation's income statement been restated for the current year or any of the five income statement periods preceding?" If the corporation answers yes, it may prompt an examiner to raise additional questions and could lead potentially to the discovery that stock options have been backdated.

Stock option expense is one of the line items prescribed on Schedule M-3. Financial Accounting Standard (FAS) 123R requires recognition in financial statements of a measure of expense associated with payment for employee services with employer stock options. That measure of expense is based in part on stock value at grant date. For tax purposes the option becomes taxable at the exercise date.

Prior to the adoption of FAS 123R, companies were not usually required to recognize any stock option expense in financial statements**.** Thus, for companies that had not adopted FAS 123R prior to the tax years included in the 2004 aggregate Schedule M-3 data, all differences between book and tax income would have been permanent differences. Generally, for years after companies adopt FAS 123R, the differences between the book expense and the tax deduction for stock options are temporary in nature since the tax deduction comes at only one point in time, date of exercise, while the book expense is reported over time, according to a formula. Generally, public companies had to adopt FAS 123R for the first quarterly or annual reporting period that began the first fiscal year beginning after after June 15, 2005.

Latest Numbers

For Tax Year (TY) 2004, the IRS received M-3 Schedules from 31,298 companies. Of this total 3,203 identified a book-tax difference involving employee stock options. Of this total, just over 70 percent (2,278) were companies filing 10-Ks with the SEC. This represents approximately 51 percent of all companies that filed Schedule M-3 and 10-Ks for TY 2004.

For all the companies filing TY 2004 M-3s and reporting book-tax differences relating to stock options, the ***gross*** amount of book-tax difference by which taxable income was decreased was $47 billion. However, that amount does not include a $4 billion offset by companies that had begun expensing stock options in their books earlier than required by FAS 123R. So, the ***net*** amount of book-tax difference for stock options by which taxable income was decreased for TY 2004 was $43 billion.

Of the TY 2004 $43 billion net book-tax difference reducing taxable income, $40 billion was reported by 2,278 companies that also file 10-Ks with the SEC, while $3 billion was reported by companies that do not file 10-Ks with the SEC. Of this $43 billion net book-tax difference, nearly $20 billion, or 45 percent, involved the top 50 companies ranked by size of their stock option book-tax differences, that filed a 10K and which had book-tax differences related to options. Approximately $35 billion or 82 percent of the book-tax differences reported by all companies for stock options were reported by the top 250 companies.

In the 2004 aggregate Schedule M-3 data, book-tax difference related to stock option expense was the third largest book-tax difference. Only depreciation and the amount of book-tax differences related to Reportable Transactions were higher.

It is important to understand that stock options fluctuate in absolute and relative size from year to year because optionees exercise options when they perceive values are relatively high and do not exercise them when they perceive values are relatively low. The fact that stock option deductions are large does not necessarily indicate that there is anything amiss with the deductions. Since 2004 is the only year at this point for which we have aggregate Schedule M-3 data, it cannot be stated whether stock option deductions and book-tax differences for 2004 are generally high or low compared to other years. We would expect, however, that the differences between book expense and tax deductions related to stock options will more than likely decrease in total in any future years, and that the differences will be more temporary in nature due to the mandate to account for stock options in financial statements in accordance with FAS 123R.

We expect to have data for TY 2005 later this summer.

Tax Evasion or Avoidance

As I mentioned earlier, despite our ramped up efforts in the executive compensation arena, adjustments on executive and corporate returns as a result of executive compensation issues are still relatively infrequent in that compliance is relatively simple. One of the areas where we have spent considerable time in the past year has been on the backdating of stock options.

In general, corporate stock options are granted to employees with an exercise price equal to the market price of the stock on the date of grant. An employee benefits from an option if the market price of the stock on the day the option is exercised exceeds this exercise price. The practice of backdating options allows the use of hindsight to pick a date for the exercise price on which the market price was lower. By using the lower stock price the employee has increased realized gain on the option and makes it possible for the employee to benefit from corporate performance that occurred before the option was granted. While this practice does not guarantee income upon exercise, it increases the value of the option and makes it more likely the employee will be able to exercise the option at a time when the market price exceeds the exercise price (i.e., at a time when the option is "in the money").

As this simplified description of the practice suggests, backdated options that are in the money do not measure the performance of the company from the date of grant, and as a consequence, they may not be treated as performance-based compensation under section 162(m). Thus, for the company, the tax implications are that any deduction of compensation related to the backdated option would be subject to the $1 million limitation of section 162(m).

In addition, if an Incentive Stock Option (ISO) is backdated, the option will no longer qualify for preferential ISO treatment and will be reclassified as a nonqualified stock option. The difference between the exercise price and the sales price would be additional wages to the executive and must be included on the employee's Form W-2 in the year of exercise. The executive will lose favorable capital-gain treatment and may be subject to

alternative minimum tax as the result of the exercise. The corporation may be eligible for an additional wage deduction if the section 162(m) limitations are not triggered.

Internal Revenue Code §409A impacts virtually all companies that have nonqualified deferred compensation plans. Companies will need to revise their executive compensation arrangements to avoid the considerable penalties imposed for not complying with the strict new rules passed by Congress and signed into law in October 2004.

IRC Section 409A requires immediate inclusion of income and imposes an additional 20 percent tax and interest on the tax that would have been paid if the deferral amount had been taxable when first deferred if specified requirements for nonqualified deferred compensation are not met. A stock option having an exercise price that is less than the fair market value of the stock on the grant date constitutes deferred compensation for purposes of Section 409A. Section 409A applies to options granted after 2004 and options granted before 2005 that were not earned and vested as of December 31, 2004.

To provide relief to rank-and-file employees, the IRS issued legal guidance, Announcement 2007-18, which announced a compliance resolution program to allow employers to pay additional taxes generated by the exercise of certain discounted stock options and related appreciation rights in 2006 for their employees. The announcement was issued on February 8, 2007. The deadline for requesting relief under Announcement 2007-18 and the employer's intent to participate in the Program closed on February 28, 2007. Relief will be granted to 80 employers and over 13,500 employees upon completion of the requirements. The Program required the 80 employers to compute and pay the additional taxes and interest, associated with the exercised stock options, owed by these employees by June 30, 2007. As of May 30, 2007, the IRS has processed over $78.7 million dollars of payments from the employers. This represents no compromise on the actual tax liability incurred but merely allows employers to satisfy the obligations of affected employees.

In the past year, the IRS's focus on backdated stock options has intensified. Backdated Stock Options (BSO) issues receive the highest priority within the IRS' Large & Mid-Sized Business (LMSB) operating division. Currently, LMSB has identified over 180 companies with confirmed or potential backdating.

Company identification is accomplished through company press releases, SEC filings, and the normal audit process. The IRS has also identified a number of companies through its administration of the Compliance Resolution Program, which provided relief for rank and file employees who exercised "discounted options" and were not considered corporate "insiders."

We have also completed examinations in a number of cases under Notice 2003-47. This was a settlement initiative for executives and companies that participated in an abusive tax avoidance transaction involving the transfer of stock options or restricted stock to family controlled entities.

Under this scheme, executives, often facilitated by their corporate employers, transferred stock options to family controlled partnerships and other related entities typically created for the sole purpose of receiving the options and avoiding taxes on compensation income normally taxed to the executive. The tax objective was to avoid payment of income and employment taxes. In many cases the corporation deferred a legitimate deduction.

Thus far we have completed 156 examinations and assessed taxes, penalties and interest totaling over $211 million. This includes both taxpayers that elected to participate in the settlement initiative and those that did not. There are also 16 Notice 2003-47 cases that have not been resolved and are currently under examination by LMSB, 3 corporations and 13 individuals.

Additionally, the IRS' Small Business Self-Employed Division has established the Broker Initiative Project. One purpose of this project is to detect transfers of options to entities domiciled in offshore secrecy jurisdictions that are beneficially owned by U.S. persons. The examinations have not been underway long enough and have not involved enough brokerage firms to draw conclusions as to the extent to which stock options have been used to avoid or evade federal taxes.

Summary

Abuses in the areas of executive compensation are a concern from a tax administration perspective. IRS will continue to prioritize its efforts in the entire area of executive compensation. However, as I indicated, this is an area where we, in many instances, are unlikely to identify significant noncompliance through our traditional corporate audits.

Greater transparency will certainly assist us in identifying potential noncompliance in an area such as the granting of stock options. Our analysis of the schedule M-3 for TY 2005 should provide some additional information in this area in that most companies should be in compliance with FAS 123R.

But, based on what we have seen thus far, it is not that difficult for companies to compensate senior executives at whatever level they choose and remain fully compliant with the tax laws.

I appreciate the opportunity to be here this morning, and I look forward to any questions.