

**SOLVING STOCK OPTION COMPENSATION:  
WHY BOOK-TAX CONFORMITY  
MAY NOT BE THE ANSWER**

I.	INTRODUCTION .....	176
II.	THE DUAL REPORTING SYSTEM.....	178
	A. <i>Financial Accounting vs. Tax Accounting</i> .....	179
	1. Financial Accounting .....	180
	2. Tax Accounting.....	181
	B. <i>Judicial Endorsement</i> .....	182
	C. <i>The Book-Tax Gap</i> .....	183
III.	EMPLOYEE STOCK OPTIONS .....	185
	A. <i>Background</i> .....	185
	B. <i>Reducing Agency Costs</i> .....	187
	1. Aligning Interests .....	187
	2. Reducing Risk .....	188
	3. Attraction and Retention.....	188
IV.	ACCOUNTING FOR EMPLOYEE STOCK OPTIONS.....	189
	A. <i>Tax Accounting for Employee Stock Options</i> .....	189
	1. Tax Treatment: Qualified vs. Non-Qualified.....	189
	2. I.R.C. § 162(m) .....	192
	B. <i>Financial Accounting for Employee Stock Options</i> .....	194
	1. The Intrinsic Value Method .....	195
	2. The Long Road to Fair Value .....	195
V.	STOCK OPTION CONFORMITY?.....	198
	A. <i>The Stock Option Gap</i> .....	198
	B. <i>The Stock Option Act</i> .....	200
	1. Theoretical and Practical Obstacles.....	201
	2. SFAS 123R and the Narrowing Gap.....	205
VI.	CONCLUSION.....	206

## I. INTRODUCTION

Wall Street analysts once heralded employee stock options as a driving force behind organizational growth and development.<sup>1</sup> However, these sentiments quickly changed once the state of blissful ignorance accompanying capital markets throughout the 1990s abruptly ended amidst discoveries of widespread corporate accounting fraud with implications reaching numerous U.S. firms.<sup>2</sup> Though subsequent investigations uncovered no specific wrongdoing with respect to stock option compensation,<sup>3</sup> public suspicion arose when reports surfaced detailing accounts of various embattled CEOs and top executives who walked away with hundreds of millions of dollars in option-related pay.<sup>4</sup> Concerns heightened when closer examinations exposed employee stock options as a source of windfalls<sup>5</sup> not only for the executives themselves, but also for the underlying corporations.<sup>6</sup>

As the public would soon learn, the interplay of tax and accounting rules governing employee stock options allowed many U.S. firms to legally report billions of dollars in profits to investors while at the same time paying virtually no corresponding income tax to the Internal Revenue Service (“I.R.S.”).<sup>7</sup> This shocking revelation drew attention to a fact which until this point generally went unrecognized outside academic circles: U.S. corporations operate under a dual reporting system—that is, they are bound to follow one set of

---

1. See Matthew A. Melone, *Are Compensatory Stock Options Worth Reforming?*, 38 GONZ. L. REV. 535, 536 (2003) (describing stock options as the “fuel” driving the new economy).

2. See Joann M. Weiner, *Taxing Stock Options is an Option*, 115 TAX NOTES 53, 53 (2007), available in TAX NOTES TODAY, 2007 Lexis TNT 64-40 [hereinafter *Taxing Stock Options*].

3. It should be noted however, that in the summer of 2006, the SEC began investigating a number of firms who allegedly engaged in unlawful stock option backdating. See David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 562 (2007).

4. For example, in 2000, the year before Enron’s collapse, its former Chairman Ken Lay netted \$123 million from exercised stock options. See Jerry Hirsch, *Energy Execs Gain Millions in Stock Sales*, L.A. TIMES, June 13, 2001, at A1.

5. A windfall is defined as “[a]n unanticipated benefit, usually in the form of a profit and not caused by the recipient.” BLACK’S LAW DICTIONARY 1631 (8th ed. 2004).

6. See *Taxing Stock Options*, supra note 2, at 53 (discussing the shock reverberating through the investment community when it was discovered that compensatory stock options enabled companies to report billions in profits while paying little to no income tax); Jim Jubak, *How Stock Options Turn into an Accounting Trick*, THE STREET, Mar. 6, 2002, <http://www.Thestreet.com/funds/jubak/10011828.html> (describing stock option accounting as “the 800-pound gorilla lurking in every discussion of accounting reform taking place”).

7. See *infra* Part II.

rules when reporting financial or “book” profits to the public and an entirely different set of rules when reporting taxable income to the I.R.S.<sup>8</sup> Accordingly, even full compliance with tax and accounting rules may generate financial reports which bare little resemblance to tax reports prepared for the same transactions.<sup>9</sup> In fact, the dual reporting system often presents corporate entities with unique incentives to use accounting gamesmanship to inflate financial profits while simultaneously reducing their tax liabilities.<sup>10</sup> The net effect of this practice is the “book-tax” gap,<sup>11</sup> and according to multiple sources, this gap has expanded significantly over the past two decades.<sup>12</sup>

Tracking the expansion of the “book-tax” gap, however, is another well-documented corporate phenomenon—the increased prevalence of stock option compensation among high-level executives.<sup>13</sup> Although recent regulatory developments have curbed much of their former appeal, stock options remain a significant component of executive pay at most U.S. firms today.<sup>14</sup> This worries some members of Congress who contend

8. See *Taxing Stock Options*, *supra* note 2, at 53.

9. See *Executive Stock Options: Should the IRS and Stockholders Be Given Different Information?: Hearing Before the Subcomm. on Investigations*, 110th Cong. (2007) [hereinafter *Stock Option Hearing*] (statement of Mihir A. Desai, Associate Professor of Finance, Harvard Business School).

10. Gil B. Manzon, Jr. and George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175, 181-82 (2002) [hereinafter *Reporting Measures*] (“[M]anagers of firms may have incentives to make choices that increase income reported to shareholders while at the same time making choices that minimize reported taxable income.”)

11. The book-tax gap is the “excess of reporting financial accounting income over taxable income . . .” See Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal* 3 (N.Y. Univ. Law & Econ. Research Paper Series, Working Paper No. 07-38, 2007), available at <http://ssrn.com/abstract=1017073>.

12. U.S. Dep’t of the Treasury, *The Problem of Corporate Tax Shelters: Discussion and Legislative Proposal* 3 (1999), available at <http://www.treas.gov/press/releases/reports/ctswhite.pdf> (reporting growth in the ratio of reported book to tax income which it attributed to increased tax shelter activity); Joann M. Weiner, *Closing the Other Tax Gap: The Book-Tax Income Gap*, 115 Tax Notes 849, 851 (2007), available at TAX NOTES TODAY, 207 LEXIS TNT 104-46 [hereinafter *The Other Gap*] (“[I]n 1990, U.S. corporations reported 8 percent more book income than taxable income. By 2000, corporations reported 50 percent more income on their books than on their tax returns, and in 2003, book income was nearly twice as high as tax income.”).

13. See *The Other Gap*, *supra* note 12, at 855 (noting that in 2005 exercised stock options made up 73% of the typical CEO’s total compensation compared with only 42% of total compensation in 1994); see also *Stock Option Hearing*, *supra* note 9, at 2 (statement of Sen. Norm Coleman, Ranking Minority Member, S. Subcomm. on Investigations) (noting that whereas in 1992, among S&P 500 companies, only \$11 billion in executive stock options were issued, by 2000, those same companies issued over \$119 billion in stock option compensation).

14. In 2006, exercised stock options accounted for 48% of the total compensation received by CEOs at America’s 500 largest companies. See Scott DeCarlo, *Big Paychecks*,

that the current option-related tax laws are antiquated, misaligned, and foster uncertainty, distrust, and confusion among corporate management and the investment community.<sup>15</sup> While Congress offers complete book-tax conformity as a potential solution,<sup>16</sup> this Comment contends that the benefits of implementing such a change are substantially outweighed by the latent costs.

This Comment will critically evaluate that congressional effort and its attempt to amend the tax laws that govern executive stock options. Discussion of both tax and accounting consequences will be necessary to make sound predictions about the implications of future legislative changes. Part II, therefore, provides a general overview of the dual reporting system and highlights its different objectives and rationales. Part III will then relate some background information on stock option compensation as well as the theoretical underpinnings which encourage its use in the corporate management context. Part IV details the different tax and accounting treatment of compensatory stock options and how these differences combined to fuel recent option growth. Part V illustrates how corporate compensation committees took advantage of those differences, using options to both inflate reported financial earnings and shelter taxable income—albeit legally—from tax authorities. The remainder of this Comment demonstrates why the recently proposed legislative measure aimed at aligning the tax and accounting treatment of option-based pay is unsound in both practice and theory as well as unnecessary in light of recent reforms.

## II. THE DUAL REPORTING SYSTEM

U.S. firms are required to maintain two different sets of financial statements: one for reporting “book income”<sup>17</sup> to

---

FORBES, May 3, 2007, available at [http://www.forbes.com/2007/05/03/ceo-executive-compensation-lead-07ceo-cx\\_sd\\_0503ceo\\_compensationintro.html](http://www.forbes.com/2007/05/03/ceo-executive-compensation-lead-07ceo-cx_sd_0503ceo_compensationintro.html).

15. Statement of Senator Carl Levin (D-Mich.) on Introducing the Ending Corporate Tax Favors for Stock Options Act, <http://levin.senate.gov/newsroom/release.cfm?id=284486> (Sept. 28, 2007) (noting that the book-tax disparities created as a result of stock option compensation “breed confusion, distrust, and schemes to maximize the differences”).

16. See *Stock Option Hearing*, *supra* note 9, at 17 (statement of Mihir A. Desai, Associate Professor of Finance, Harvard Business School) (“[A]ligning the tax treatment [of stock options] with . . . accounting rules could preserve the benefits of incentive compensation, reduce current distortions to that choice, and result in a simpler income reporting system.”).

17. “Book income” is the “income of a corporation as reported on its financial statements.” THE DOW JONES-IRWIN BUSINESS AND INVESTMENT ALMANAC 537 (1989).

investors and the public and another for reporting “tax income”<sup>18</sup> to the I.R.S.<sup>19</sup> The different measurements largely relate to the *timing* of how certain transactions are treated.<sup>20</sup> Whereas tax accounting places emphasis on the *actual receipt* of payments and proceeds, financial accounting takes a more liberal approach by using *estimates* and *probabilities* to measure profits and expenses when earned, regardless of actual receipt.<sup>21</sup> Although corporations are compelled to incur substantial costs in keeping and reconciling two sets of books,<sup>22</sup> the dual reporting system is often justified upon the recognition that financial and tax accounting serve two separate and distinct functions which therefore necessitate different methodologies.<sup>23</sup>

#### A. *Financial Accounting vs. Tax Accounting*

Financial accounting is primarily focused on providing current and prospective investors with a clear picture of a company’s financial health.<sup>24</sup> The need to supply these parties with the best possible information to measure firm performance demands that greater emphasis be placed on consistency over time within individual firms rather than accounting method uniformity across firms.<sup>25</sup> It is argued that allowing such discretion enhances the quality of information that managers can provide to shareholders.<sup>26</sup>

---

18. “Taxable income” is defined as “[g]ross income minus all allowable deductions and exemptions.” BLACK’S LAW DICTIONARY 768 (8th ed. 2004).

19. Celia Whitaker, *How to Build a Bridge: Eliminating the Book Tax Accounting Gap*, 59 TAX LAW. 981, 982 (2006).

20. See Mihir A. Desai, *The Degradation of Reported Corporate Profits*, SSRN, July 27, 2005, <http://ssrn.com/abstract=758144> [hereinafter *Degradation of Profits*].

21. See *id.*

22. John McClelland and Lillian Mills, *Weighing Benefits and Risks of Taxing Book Income*, 114 TAX NOTES 779, 779 (2007), available in TAX NOTES TODAY, 2007 LEXIS TNT 35-61.

23. *Degradation of Profits*, *supra* note 20, at 7 (“[F]irms presumably have come to value the opportunity to characterize their profits in distinct ways to the capital markets and tax authorities.”); *Thor Power Tool Co. v. Comm’r*, 439 U.S. 522, 542-43 (1979) (asserting that, given their different goals, “any presumptive equivalency between tax and financial accounting would be unacceptable”); see Whitaker, *supra* note 19, at 986 (noting that throughout the twentieth century Congress intentionally enacted Internal Revenue Code measures which deviated from economic income “on the assumption that such tax preferences or tax expenditures would stimulate economic activity or other socially useful behaviors . . .”).

24. See Whitaker, *supra* note 19, at 987 (“[T]he target audience needs full information about the corporation’s assets, all existing claims on those assets, and ongoing activities that will generate future cash flow.”).

25. See *Reporting Measures*, *supra* note 10, at 178.

26. *Id.* at 179; see also McClelland & Mills, *supra* note 22, at 780 (“As a result of that discretion, managers of firms within the same industry can recognize different

The principal concern of federal income taxation, on the other hand, is raising revenue to fund government expenditures.<sup>27</sup> In order to most effectively monitor compliance and collection of tax revenues, the I.R.S. permits far fewer accounting method options for determining taxable income than those that are allowed when reporting financial income.<sup>28</sup> As a result, unlike financial reporting standards, much of the Internal Revenue Code requires uniformity in accounting for income and expenses across firms.<sup>29</sup>

### 1. Financial Accounting

The rules regulating financial reporting began to take shape following the Great Depression.<sup>30</sup> The Securities and Exchange Act of 1934 created the Securities and Exchange Commission (“SEC”)<sup>31</sup> and granted it the authority to prescribe and monitor financial reporting standards for publicly-traded firms.<sup>32</sup> The SEC, however, has generally delegated its standard-setting authority to the private sector “under the assumption that business and accounting experts are better equipped than the federal government to assess U.S. business transactions.”<sup>33</sup> Since its creation in 1973, the Financial Accounting Standards Board (“FASB”) has been the designated private organization responsible for establishing accounting guidelines.<sup>34</sup>

The FASB requires all publicly-traded U.S. corporations to prepare the financial statements they release to the public pursuant to Generally Accepted Accounting Principles

---

amounts of revenue or expense to provide more complete information on their firms’ unique circumstances to their respective shareholders.”).

27. *Reporting Measures*, *supra* note 10, at 180. (“The primary objective of the Code is to provide a framework for the efficient and equitable determination of tax liabilities and the subsequent collection of revenue to fund governmental operations.”).

28. *See id.*; *see also* McClelland & Mills, *supra* note 22, at 780 (“For example, tax law does not allow some expenses to be deducted when they are estimated for financial accounting, such as reserves for warranty claims and bad debts.”).

29. *See Reporting Measures*, *supra* note 10, at 178.

30. George J. Benston, *Corporate Accounting Before and After Enron*, in *AFTER ENRON: LESSONS FOR PUBLIC POLICY 57* (William A. Niskanen ed., 2005).

31. The SEC is “[t]he five-member federal agency that regulates the issuance and trading of securities to protect investors against fraudulent or unfair practices.” *BLACK’S LAW DICTIONARY* 1384 (8th ed. 2004).

32. Securities and Exchange Act of 1934, ch. 404, 48 Stat. 894 (codified as amended at 15 U.S.C. § 78m(b)(1) (2006)).

33. *See Whitaker*, *supra* note 19, at 987.

34. Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, 28 Fed. Reg. 2261 (Dec. 20, 1973). Prior to the formation of the FASB, the Committee on Accounting Practice (1939-1959) and the Accounting Principles Board (1959-1973) maintained the standard-setting responsibility. *See McClelland & Mills*, *supra* note 22, at 780.

(“GAAP”).<sup>35</sup> GAAP is “a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice . . . and . . . provide a standard by which to measure financial presentations.”<sup>36</sup> To put it simply, GAAP comprises all of the accounting guidelines established by the FASB and governed by the SEC.

## 2. Tax Accounting

According to the Internal Revenue Code, taxable income is to be computed “under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.”<sup>37</sup> Though this provision seems to impose consistency in tax and financial reporting, the U.S. Treasury Department (“Treasury”) has in fact observed that no standardized method of accounting can be adopted for all taxpayers.<sup>38</sup> Rather, taxpayers are advised to use any method that is best suited to their needs as long as that method “clearly reflects income.”<sup>39</sup> While Treasury regulations indicate that use of GAAP will “generally” be regarded as clearly reflecting income,<sup>40</sup> the I.R.S. has stopped short of declaring it to be a controlling or even preferred standard.<sup>41</sup> GAAP conformity is actually just one of four standards which have emerged that both the I.R.S. and courts may use to determine whether a taxpayer’s accounting method clearly reflects income.<sup>42</sup>

35. See Whitaker, *supra* note 19, at 982.

36. The Meaning of “Present Fairly in Conformity with Generally Accepted Accounting Principles,” Statement on Auditing Standards No. 69, ¶ 2 (Am. Inst. of Certified Pub. Accountants 1992), *reprinted in* Am. Inst. of Certified Pub. Accountants, CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES AU § 411 (2007).

37. I.R.C. § 446(a) (2007).

38. Treas. Reg. § 1.446-1(a)(2) (as amended in 2006) (“It is recognized that no uniform method of accounting can be prescribed for all taxpayers.”).

39. *Id.*; see also *Huntington Sec. Corp. v. Busey*, 112 F.2d 368, 370 (6th Cir. 1940) (interpreting “clearly” to mean “plainly, honestly, straightforwardly, and frankly, but . . . not . . . ‘accurately’ which, in its ordinary use, means precisely, exactly, correctly, without error or defect”).

40. Treas. Reg. § 1.446-1(c)(1)(ii)(C) (as amended in 2006).

41. Whitaker, *supra* note 19, at 985 n.22 (“In 1990, the Service declared that it does not consider GAAP conformity a ‘controlling standard’ because to do so would impose a uniform accounting method (the accrual method) on all taxpayers in contravention of recognized tax policy and explicit regulations.”) (citing I.R.S. Tech. Adv. Mem. 1991-13-003 (Mar. 29, 1991)).

42. See *id.* at 989 n.44 (“The four standards are (1) year-to-year accounting consistency, (2) GAAP conformity, (3) ‘substantially identical’ results using the taxpayer’s asserted method and the Service’s chosen method, and (4) whether the method results in a matching of income and expenses.”) (citing I.R.S. Tech. Adv. Mem. 1991-13-003 (Mar. 29, 1991)).

### B. *Judicial Endorsement*

While the judiciary has historically only played a minor role in tax law,<sup>43</sup> the U.S. Supreme Court's 1979 opinion in *Thor Power Tool Company v. Commissioner* explicitly recognized and approved of the use of different corporate accounting methods for tax and financial purposes.<sup>44</sup> In *Thor Power*, the Court addressed the validity of a corporate taxpayer's attempt to use write-downs for excess inventory<sup>45</sup> and future bad debt reserves<sup>46</sup> for both financial and income tax purposes.<sup>47</sup> Though these write-downs were permissible under GAAP, nothing in the Internal Revenue Code or Treasury Regulations permitted an equivalent income tax deduction.<sup>48</sup>

The Court rejected the taxpayer's assertion that GAAP conformity created a presumption of validity for its corresponding income tax deduction, instead holding that "in light of the vastly different objectives that financial and tax accounting have . . . any presumptive equivalency between financial and tax accounting would be unacceptable."<sup>49</sup>

The Court continued by noting that the principal duty of the financial accountant is "to provide useful information to management, shareholders, creditors, and others properly interested . . . [and] to protect these parties from being misled."<sup>50</sup> Conversely, the Court declared that the I.R.S.'s primary goal is "the equitable collection of revenue" and "protect[ion] [of] the public fisc."<sup>51</sup> These distinct objectives, the Court observed, are reflected in many examples of differences in treatment:

Where the tax law requires that a deduction be deferred until 'all the events' have occurred that will make it fixed and certain, . . . accounting principles typically require that a loss be accrued as soon as it can reasonably be estimated. Conversely, where the tax law requires that a

43. *See id.* at 988.

44. *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 542-43 (1979) (holding that the different goals of tax and financial accounting require the use of separate methodologies).

45. "Excess inventory" is inventory which is "held in excess of any reasonably foreseeable future demand." *Id.* at 527.

46. A "bad-debt reserve" is a "reserve to cover losses on uncollectible accounts-receivable." BLACK'S LAW DICTIONARY 1334 (8th ed. 2004).

47. *Thor Power*, 439 U.S. at 524.

48. *Id.* at 535-36.

49. *Id.* at 538-39, 542-43.

50. *Id.* at 542.

51. *Id.*

liability be recognized currently under ‘claim of right,’ ‘ability to pay,’ and ‘control’ rationales, accounting principles may defer accrual until a later year so that revenues and expenses may be better matched. Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty.<sup>52</sup>

Finally, the Court warned that with the implementation of book-tax conformity, “a firm . . . could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable.”<sup>53</sup>

Although various lower courts have distinguished the *Thor Power* opinion on its facts, the Supreme Court’s broad endorsement of the dual reporting system has never been challenged.<sup>54</sup> Additionally, both the Internal Revenue Code and the regulations that guide it lend textual support to the *Thor Power* holding.<sup>55</sup> For instance, I.R.C. § 446(b) gives tax authorities broad discretion in determining whether a given accounting method “clearly reflects income”<sup>56</sup> and a 1990 I.R.S. Technical Advice Memoranda unequivocally rejects GAAP as a “controlling standard.”<sup>57</sup>

### C. *The Book-Tax Gap*

As a result of the different rules guiding tax and financial accounting, corporate managers are naturally driven to make decisions which both increase reported income to shareholders while at the same time minimizing taxable income reported to the I.R.S.<sup>58</sup> As discussed above, this practice often results in corporate tax deductions which do not match corporate “book”

52. *Id.* at 543 (citing *United States v. Anderson*, 289 U.S. 422, 441 (1926)).

53. *Thor Power Tool Co. v. Comm’r*, 439 U.S. 541, 544 (1979).

54. *See Whitaker, supra* note 19, at 988 (citing *St. James Sugar Coop. v. United States*, 643 F.2d 1219, 1225 (5th Cir. 1981); *Kollman Instrument Corp. v. Comm’r*, 870 F.2d 89, 92 (2d Cir. 1989)).

55. *Id.* at 989.

56. *See* Treas. Reg. § 1.446-1(c)(2)(ii) (“The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter . . . if, in the opinion of the Commissioner, income is clearly reflected by the use of such method.”).

57. *See supra* note 42.

58. *See Reporting Measures, supra* note 10, at 181-82.

expenses for the same period.<sup>59</sup> Such differences create what is known as the “book-tax” gap.<sup>60</sup>

In 1964, the IRS began requiring corporate taxpayers to account for any differences in book and taxable income on a special form attached to their federal tax return, known as Schedule M-1.<sup>61</sup> Firms simply entered their net book income reported to shareholders on the first line of the M-1, and then their net tax income, as reported to the IRS, on the tenth line of the M-1.<sup>62</sup> In between those two figures, companies entered transactions which reconciled the two numbers,<sup>63</sup> usually with multiple pages of supporting documentation.<sup>64</sup>

Though this enabled tax authorities to measure the size of book-tax differences,<sup>65</sup> “the M-1’s vague instructions made interpretation of the reconciliation difficult.”<sup>66</sup> The lack of standardization in the attached supporting documents, for instance, made year-to-year and inter-firm corporate comparisons difficult.<sup>67</sup> In addition to these difficulties, “some companies began with worldwide book income, others with U.S. book income, and many chose an indeterminate starting point.”<sup>68</sup> Consequently, the M-1 failed to provide the I.R.S. with a clear understanding of the practices responsible for fueling the growing book-tax gap.<sup>69</sup> Yet, despite its major deficiencies, until recently, it remained the sole means of gathering any relevant data.

59. See discussion *infra* Part V.

60. See discussion *infra* Part V.

61. See McClelland & Mills, *supra* note 22, at 781.

62. See *The Other Gap*, *supra* note 12, at 850-51.

63. *Id.* In the accounting context, “reconciliation” is “[an] adjustment of accounts so that they agree, especially by allowing for outstanding items.” BLACK’S LAW DICTIONARY (8th ed. 2004).

64. See McClelland & Mills, *supra* note 22, at 781 (“Although Schedule M-1 contains only 10 lines, corporations typically attached multiple pages of additional detailed schedules”).

65. See *id.* at 781.

66. *Id.*; see also *The Other Gap*, *supra* note 12, at 851 (“[T]he schedule provided no information regarding whether the [book-tax] differences were permanent or temporary.”).

67. See McClelland & Mills, *supra* note 22, at 781.

68. *Id.* at 781. According to economist Joann M. Weiner, “[s]chedule M-1 was effectively trying to reconcile the differences between an apple and an orange.” *The Other Gap*, *supra* note 12, at 851.

69. See *The Other Gap*, *supra* note 12, at 853 (“Schedule M-1 provided tax authorities few clues on why a corporation’s taxable income was often so much lower than its financial income.”).

In order to facilitate greater transparency in corporate tax reporting, in 2004, the I.R.S. introduced the Schedule M-3.<sup>70</sup> The new M-3 required an extensive level of detail<sup>71</sup> and standardization which, for the first time, gave tax authorities some answers about the growing gap.<sup>72</sup> For example, the information gleaned from the M-3 data revealed that for 2004, employee stock option compensation accounted for nearly 30% of the total book-tax gap.<sup>73</sup> In other words, stock option compensation allowed U.S. corporations to take tax deductions that were 30%, or \$43 billion, greater than the amount those same corporations reported on their financial statements for the year 2004.<sup>74</sup> Despite these startling figures, the findings were quite foreseeable given the disparate tax and accounting treatment of employee stock options.

### III. EMPLOYEE STOCK OPTIONS

#### A. Background

A stock option “allows a corporate employee to buy shares of corporate stock at a fixed price or within a fixed period.”<sup>75</sup> Thus, when a corporation issues employee stock options, the benefiting employee maintains the right to purchase shares of his or her employer’s stock at a pre-determined “strike”, or exercise price.<sup>76</sup> The exercise price is typically set “*at the money*”, or, in other words, at the market price that the stock is trading at on the grant date.<sup>77</sup> When the option’s exercise price is below the market price of the stock, however, the option is considered to be

70. John H. Ledbetter & Lucinda L. Van Alst, *The New Schedule M-3—An In-Depth Look*, TAXES, Nov. 2004, at 35.

71. *Id.* at 36 (noting that whereas the old M-1 identified only eight book-tax differences, the M-3 identifies sixty-seven).

72. *The Other Gap*, *supra* note 12, at 855.

73. *Id.* at 856.

74. *See Stock Option Hearing*, *supra* note 9, at 5 (statement of Sen. Carl Levin, Chairman, S. Subcomm. on Investigations).

75. BLACK’S LAW DICTIONARY (8th ed. 2004).

76. Brian J. Hall & Jeffrey Liebman, *The Taxation of Executive Compensation*, in TAX POL’Y & ECON. 2000, at 5 (MIT Press, Vol. 14, 2000).

77. The “grant date” is “[t]he date at which an employer and an employee reach a mutual understanding of the key terms and conditions of a[n] . . . award . . . [and the] employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer’s equity shares.” FINANCIAL ACCOUNTING STANDARDS BOARD (“FSAB”), STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123: SHARE-BASED PAYMENT 273 (rev. Dec. 2004), available at <http://www.fasb.org/pdf/fas123r.pdf> [hereinafter SFAS 123R]; see also Hall & Liebman, *supra* note 76, at 7.

“*in-the-money*”; conversely, if its exercise price is greater than the stock’s current market price, the option is “*out-of-the-money*”.<sup>78</sup>

Generally, an employee may not exercise his or her options and obtain the underlying company stock immediately, but, rather, must wait for a specified period until the option “vests”, or becomes owned by the employee, over time.<sup>79</sup> This vesting period generally ranges from three to five years; however, once vested, an option remains exercisable until expiration.<sup>80</sup> In most cases, the option will expire exactly ten years after the date of the grant.<sup>81</sup> Additionally, unlike actual stock, stock options do not typically impart their holders with voting or dividend rights.<sup>82</sup>

Before proceeding further, it is important to draw a distinction between the employee stock options, discussed above, and exchange-traded stock options. Whereas the former are used solely as an incentive compensation tool by corporations, the latter can be characterized purely as an investment vehicle.<sup>83</sup> As such, traded options are sold on an open exchange market available to all investors, are fully transferable, and, once acquired, are immediately exercisable.<sup>84</sup> Employee stock options on the other hand, are not openly traded on an exchange market.<sup>85</sup> Rather, they are typically granted only to company employees,<sup>86</sup> are completely non-transferable, and as discussed above, are subject to strict vesting requirements prior to being exercisable.<sup>87</sup> These fundamental differences in design and structure highlight the underlying purpose of employee stock options. The following subsection will provide some additional conceptual footing which will further clarify how options can

---

78. Hall & Liebman, *supra* note 76, at 7.

79. *See id.* at 5-7.

80. *See id.* at 7.

81. *See id.* An employee who leaves the company will generally forfeit all unvested options and will have only a limited period (such as 90 days) to exercise any already-vested options. SFAS 123R, *supra* note 77, at 164.

82. Hall & Liebman, *supra* note 76, at 7.

83. BARRON’S FINANCE AND INVESTMENT HANDBOOK 844 (John Downes & Jordan Elliot Goodman eds., 6th ed. 2003) (defining “traded options” as “a popular investment medium, offering an opportunity . . . to speculate in stocks with relatively little investment”).

84. *See* CONG. BUDGET OFFICE, ACCOUNTING FOR EMPLOYEE STOCK OPTIONS 5 (2004) available at <http://www.cbo.gov/ftpdocs/53xx/doc5334/04-02-stockoptions.pdf>.

85. *See id.*

86. Certain types of employee stock options may be granted to external consultants and directors. *See infra* text accompanying note 121. *See* Cong. Budget Office, *supra* note 82.

87. *See supra* text accompanying notes 79-80.

function as an efficient compensation tool in the employment context.

### B. *Reducing Agency Costs*

Stock option compensation has long been viewed as a potential means of reducing the agency costs inherent in the shareholder-management relationship.<sup>88</sup> Agency costs arise whenever any principal hires an agent to perform services which are difficult or costly to oversee.<sup>89</sup> The corporate management context serves as a classic example of the principal-agent problem.<sup>90</sup> Shareholder-principals, presumed to be owners of a firm, cede virtually complete control of both its day-to-day operations and long-term policy-making to management-agents.<sup>91</sup> Yet, despite the substantial authority managers wield, they typically own only a small fraction of the firm relative to its shareholders.<sup>92</sup> When ownership and control are separated in such a way, the interests of shareholders and management naturally diverge, resulting in agency costs.<sup>93</sup>

#### 1. *Aligning Interests*

First, management may be prone to “shirking.”<sup>94</sup> That is, “[a]ll else (e.g., pay) being equal . . . [the manager] would generally desire to give less effort, to the detriment of the . . . [shareholder].”<sup>95</sup> For instance, a manager who is paid strictly in cash has little incentive to actively promote corporate growth when he or she ultimately reaps no reward for their efforts.<sup>96</sup> However, given the opportunity to benefit from that growth, the manager will maximize his efforts to maximize his reward, and, as such, is less prone to “shirking.”<sup>97</sup> Managers who are

88. See Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1620, 1623 (2005).

89. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure* 5 (Soc. Sci. Research Network, Working Paper No. 94043, 1976), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=94043](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=94043).

90. Bainbridge, *supra* note 88, at 1620.

91. *See id.*

92. *See id.*

93. *See id.*

94. *Id.* at 1620-21.

95. Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 887 (2007).

96. *See id.* at 889 (analogizing an executive paid in cash to an unsecured creditor, “which is subject only to insolvency risk but does not participate in corporate growth to any extent”).

97. *See id.*

compensated with stock options stand to realize greater rewards as the stock price of the underlying firm increases.<sup>98</sup> In this regard, option compensation is believed to naturally align the interests of management and shareholders, both of whom now seek and benefit from higher value per share.<sup>99</sup>

## 2. Reducing Risk

Unlike shareholders who can more easily spread their own risk by investing in other firms, managers make an undiversified and firm-specific human capital investment.<sup>100</sup> The threat of irreversible damage to this investment often makes managers more risk-averse regarding firm-specific ventures than shareholders might prefer.<sup>101</sup> Option-based pay, however, helps balance this problem by allowing managers to realize the full benefit of any share increase above the exercise price, yet, unlike shareholders, experience no consequences when the share price decreases below the exercise price.<sup>102</sup> According to at least one commentator, this arrangement “should, in theory, counteract the effect of executive risk-averseness.”<sup>103</sup>

## 3. Attraction and Retention

For younger companies with low earnings and revenues, option compensation can be a powerful tool.<sup>104</sup> Without cash to attract top corporate talent, stock options allow these firms to use their own equity as an incentive, which in many cases, is their only available currency of value.<sup>105</sup> However, even for companies with available cash, a manager’s firm-specific interest is likely limited to his or her tenure, while shareholders’ interests are often far more lasting.<sup>106</sup> Managers therefore may place much greater importance on short-term earnings than they do on building long-term value for shareholders.<sup>107</sup>

---

98. See THE ETHICS OF EXECUTIVE COMPENSATION 35 (Robert W. Kolb ed., Blackwell Publishing) (2006).

99. See *id.* at 34-35.

100. See Polsky, *supra* note 95, at 889.

101. *Id.* (“If the firm does very poorly, managers will lose their job and status, and their reputation and future income-producing capacity could be adversely affected.”).

102. See *id.* at 890.

103. *Id.*

104. See Aswath Damodaran, *Employee Stock Options (ESOPs) and Restricted Stock: Valuation Effects and Consequences* 4 (Sept. 2005) (unpublished article, on file with The Houston Business and Tax Law Journal).

105. *Id.*

106. See Bainbridge, *supra* note 88, at 1621.

107. See *id.*

Stock option compensation, however, can help retain high-level managers by shifting focus away from short-term earnings and towards long-term value. As discussed above, option contracts typically impose a specified waiting or “vesting” period prior to becoming exercisable.<sup>108</sup> An employee who quits or is fired forfeits all of her unvested options.<sup>109</sup> Thus, the option-holding manager will generally have strong incentives to remain with the firm throughout the vesting period, and, in the process, will work to create long-term value from which both parties will benefit.

#### IV. ACCOUNTING FOR EMPLOYEE STOCK OPTIONS

##### A. *Tax Accounting for Employee Stock Options*

While compensatory stock options are, in theory, important tools for enhancing shareholder value, well-intentioned but misguided tax policies have reduced much of their overall efficacy. Tax considerations have in fact encouraged firms to alter the structure and design of their compensation plans in ways that heavily favor managerial interests—primarily by granting executives too many options, too often.<sup>110</sup> Aside from producing dramatic and unprecedented growth in executive pay,<sup>111</sup> this increased reliance on option compensation has resulted in a considerable expansion of the book-tax gap.<sup>112</sup>

##### 1. Tax Treatment: Qualified vs. Non-Qualified

For tax purposes, employee stock options are classified as either qualified or non-qualified.<sup>113</sup> Qualified stock options, often referred to as incentive stock options (“ISOs”), are typically

108. See Hall & Liebman, *supra* note 76, at 5-7; *supra* text accompanying notes 77-79.

109. See *supra* note 81.

110. See LUCIAN BEBCHUCK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 138 (Harvard University Press 2004) (citing a Salomon Smith Barney determining that “firms in the S&P 500 that heavily used options to compensate both executives and employees underperformed the index”).

111. See *id.* at 1 (noting that whereas in 1991 the average CEO earned 140 times that of the average worker, by 2003 that number had ballooned to around 500).

112. See *supra* note 12 and accompanying text.

113. CNNMoney.com, *Money101 Lesson 10: Stock Options Top Things to Know*, <http://money.cnn.com/magazines/moneymag/money101/lesson10> (last visited Oct. 21, 2008). Qualified options are named as such because under the Internal Revenue Code, they satisfy the requirements, or “qualify”, for favorable income tax treatment. See I.R.C. § 422(c)(1) (2000).

granted only to executives and are restricted to a value of \$100,000 per year for any one employee.<sup>114</sup> Additionally, ISOs must be held for at least two years following the grant date, and the underlying stock may not be sold for at least one additional year after being exercised.<sup>115</sup> Though meeting the requirements to qualify as an ISO offers favorable tax treatment for the employee-recipient,<sup>116</sup> the “*quid pro quo*” of that treatment is the inability of the employer to claim a corporate income tax deduction upon grant or exercise.<sup>117</sup> As a result, while ISOs are commonly used by “cash-poor”<sup>118</sup> start-ups who do not yet have taxable profits to offset, on the whole, they only account for around 5% of all compensatory stock options.<sup>119</sup>

All options which do not qualify as ISOs under I.R.C. § 422 are by default deemed non-statutory or non-qualified stock options (“NQSOs”).<sup>120</sup> NQSOs may be granted to all company employees as well as to outside consultants and directors.<sup>121</sup> Though the holder of an NQSO does not receive the same preferable tax treatment as the ISO recipient,<sup>122</sup> companies tend

---

114. See I.R.C. § 422(d) (2000); see also Staff of Joint Comm. on Taxation, 110th Cong., *Present Law and Background Relating to Executive Compensation*, Rep. No. JCX-39-06, at 36 (Sept. 5, 2006), available at <http://www.house.gov/jct/x-39-06.pdf> [hereinafter *Present Law and Background*] (“To the extent that the aggregate fair market value of stock with respect to which incentive stock options are exercisable for the first time by any individual during any calendar year . . . exceeds \$100,000, such options are treated as nonqualified options.”). This \$100,000 limit is based on the market value of the underlying stock on the date of grant. Kenneth L. Levine, *Final Incentive Stock Option Regulations Issued by Internal Revenue Service*, Murtha Cullina LLP, [http://www.murthalaw.com/\\_documents/Publication%5CPublication126.pdf](http://www.murthalaw.com/_documents/Publication%5CPublication126.pdf) (last visited Oct. 21, 2008).

115. I.R.C. § 422(a)(1).

116. See Melone, *supra* note 1, at 541-43. Tax is imposed on the ISO holder only when he or she disposes of the stock acquired through the exercise of the option, not when the option is granted or exercised. Levine, *supra* note 119. Additionally, when the stock is sold, it is taxed at favorable capital gains rates. *Id.*

117. Melone, *supra* note 1, at 546; see I.R.C. § 421(a) (2) (2004).

118. A “cash-poor” firm is one that is “financially sound but ha[s] little readily available cash.” MSN Encarta Dictionary, <http://encarta.msn.com/cash-poor.html> (last visited Feb. 23, 2008).

119. See Linda Markus Daniels, *Stock Options: Have they Lost their Luster?*, Local Tech Wire, Sept. 26, 2007, [http://localtechwire.com/business/local\\_tech\\_wire/opinion/story/1862429/](http://localtechwire.com/business/local_tech_wire/opinion/story/1862429/).

120. Such options are “non-statutory” in the sense that, unlike incentive stock options, they are not defined under the Internal Revenue Code. Melvin Aaron Eisenberg, *CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS* 644 (9th ed., Foundational Press 2005).

121. JAMES M. BICKLEY, CONGRESSIONAL RESEARCH SERVICE, REPORT NO. RL 31458, *EMPLOYEE STOCK OPTIONS: TAX TREATMENT AND TAX ISSUES* CRS-8 (2006).

122. See I.R.C. § 83(a) (2004). Upon exercise of a NQSO, the employee-recipient must pay, as ordinary personal income tax, the difference between the grant price and the price at which the option is exercised, the rationale being that it is on the exercise date

to favor NQSOs because, unlike ISOs, they may be granted in unlimited amounts<sup>123</sup> and confer favorable tax benefits for the issuing company itself.<sup>124</sup>

Under I.R.C. § 83(h), when an employer transfers “property” to an employee for the performance of services, the employer is allowed a compensation tax deduction equal to the amount which is included by the employee as taxable gross income under I.R.C. § 83(a).<sup>125</sup> However, the option itself is not treated as “property” within the meaning of the Internal Revenue Code unless it has a “readily ascertainable fair market value”<sup>126</sup> which in the case of NQSOs, does not occur until the options are exercised and the underlying stock is received.<sup>127</sup> The employee’s income tax inclusion is, therefore, deferred until the year in which his or her options are exercised because at such time “property” is received within the meaning of the I.R.C. § 83(a).<sup>128</sup> As a result, the employer also defers its “matching” tax deduction until the year in which the employee exercises the options.<sup>129</sup>

Although NQSOs are clearly tax-advantaged relative to ISOs with respect to deductibility under I.R.C. § 83, another Internal Revenue Code provision, added by Congress in the early 1990s, made NQSOs arguably more tax-advantaged than any other form

---

that the recipient “realizes” the benefit associate with his or her options. If the employee chooses to hold the underlying stock after exercise, any subsequent gains or losses will be subject to capital gains tax. Richard R. Upton, *Review of Stock-Based Compensation Arrangements*, PATTERSON BELKNAP WEBB & TYLER LLP, June 2000, <http://www.pbwt.com/resources/alerts/detail.aspx?id=ec2bca3d-5163-4015-90f9-266eb35d48e4>.

123. As such, NQSOs are the options “making the news as creating large fortunes for officers and employees.” JAMES M. BICKLEY, CONGRESSIONAL RESEARCH SERVICE, REPORT NO. RL 31458, EMPLOYEE STOCK OPTIONS: TAX TREATMENT AND TAX ISSUES CRS-8 (2006).

Unless otherwise noted, throughout the remainder of this Comment, all references to “stock options” refer to NQSOs.

124. Upton, *supra* note 122.

125. See I.R.C. § 83(h) (2004).

126. Treas. Reg. § 1.83-7(a) (2003). An option has a “readily ascertainable fair market value” when it is either actively traded on an established market, or if not so traded, is transferable immediately and fully exercisable, subject to no restrictions affecting its fair market value, and the option privilege has a readily ascertainable fair market value. Treas. Reg. § 1.83-7(b).

127. Treas. Reg. § 1.83-7(a). A NQSO only has a “readily ascertainable value” in accordance with I.R.C. § 83(a) when the NQSO holder’s rights are “transferable” and not “subject to substantial risk of forfeiture.” I.R.C. § 83(a). The regulations make clear when rights in “property” are conditioned upon the performance of services (such as a vesting schedule) and when a “substantial risk of forfeiture” exists. Treas. Reg. § 1.83-3(c)(1) (2005).

128. See Treas. Reg. § 1.83-7(a); I.R.C. § 83(a).

129. I.R.C. § 83(h) (“Such deduction shall be allowed for the taxable year of such person in which . . . such amount is included in the gross income of the person who performed such services.”).

of executive compensation.<sup>130</sup> Ironically, this legislation was enacted in response to increasing concerns about exorbitantly high executive pay and the burden it placed on the Internal Revenue Code.<sup>131</sup> Ironically, this particular legislation—which Senator Chuck Grassley recently described as “ha[ving] more holes than Swiss cheese”<sup>132</sup>—ultimately led to substantial increases in option compensation, unprecedented growth in executive pay, and rapid expansion of the “book-tax” gap.<sup>133</sup>

## 2. I.R.C. § 162(m)

Many of the concerns over rising executive compensation were borne from studies indicating American executives received too much pay “both in comparison to . . . lower-level employees and [similarly-positioned] overseas executives.”<sup>134</sup> These concerns eventually prompted the addition of I.R.C. § 162(m) to the Internal Revenue Code.<sup>135</sup> In an attempt to discourage excessive executive compensation, the law placed a \$1 million annual ceiling on the tax-deductibility of compensation paid to any publicly-traded corporation’s chief executive officer (“CEO”) and its next four highest paid executives.<sup>136</sup>

However, under I.R.C. § 162(m), pay which is determined to be “performance-based” is not subject to the limitation and remains fully deductible regardless of the amount.<sup>137</sup> In order to

130. See *infra* Part IV.A.2.

131. See Charles M. Elson, *A Board-Based Solution to Overpaid CEOs*, WALL ST. J., Sept. 27, 1993, at A22 (quoting former President Bill Clinton’s contention that “the tax code should no longer subsidize excessive pay of chief executives”).

132. *Executive Compensation: Backdating to the Future/Oversight of Current Issues Regarding Executive Compensation Including Backdating of Stock Options; and Tax Treatment of Executive Compensation, Retirement and Benefits: Hearing Before the S. Comm. on Fin.*, 110th Cong. (2006)(closing statement of Sen. Chuck Grassley, Chairman, S. Comm. on Fin.) (referring to I.R.C. § 162(m)).

133. See *Stock Option Hearing*, *supra* note 9 (statement of Senator Carl Levin, Chairman, S. Subcomm. on Investigations) (“In the United States, in 1990, average CEO pay [in large corporations] was 100 times average worker pay; in 2004, the figure was 300 times; today, it is nearly 400 [times].”).

134. Steven Basalm & David Ryan, *Limiting Executive Compensation: The Case of CEOs Hired After the Imposition of 162(m) 3* (unpublished article, on file with The Houston Business and Tax Law Journal).

135. I.R.C. § 162(m) (2004). Section 162(m) was passed into law as part of the Omnibus Budget Reconciliation Act of 1993. Pub. L. No. 103-66 § 13211, 107 Stat. 312, 608-10 (1993).

136. See I.R.C. § 162(m)(1)-(3); see also H.R. REP. NO. 103-11, at 646 (1993) (“Recently, the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced if the deduction for compensation . . . paid to the top executives of publicly held corporations is limited to \$1 million per year.”).

137. I.R.C. § 162(m)(4)(C) (2007).

qualify as “performance-based,” the treasury regulations indicate that the compensation should be payable “solely on account of the attainment of one or more preestablished,[sic] objective performance goals.”<sup>138</sup> These goals, including the “terms under which the remuneration is to be paid”, must be determined by the firm’s compensation committee, disclosed to shareholders, approved by a majority vote, and ultimately certified by the firm’s compensation committee upon completion.<sup>139</sup>

Naturally then, traditional salary or cash compensation does not qualify as performance-based as it is not conditioned upon the achievement of any preestablished goals.<sup>140</sup> However, the same is not true for stock option compensation. The treasury regulations make it clear that compensation which is “based solely on an increase in the value of the stock after the date of the grant or award” will be considered “performance-based.”<sup>141</sup> In other words, any increase in stock price after the option grant is “performance-related.”<sup>142</sup> Therefore, assuming the minimal requirements for shareholder approval are satisfied,<sup>143</sup> stock options granted “*at-the-money*” automatically qualify under this exception without regard for whether any of the pre-established performance goals are actually met.<sup>144</sup> On the other hand, options granted “*in-the-money*” do not qualify as “performance-based” and are still subject to the limitations of I.R.C. § 162(m).<sup>145</sup> Not surprisingly, however, less than 5% of all options granted to employees are done so *in-the-money*.<sup>146</sup>

While the framers of I.R.C. § 162(m) correctly predicted that the *cash-based* salaries of corporate executives would converge around the \$1 million dollar mark,<sup>147</sup> what ultimately resulted

138. Treas. Reg. § 1.162-27(e)(2)(i) (2007).

139. I.R.C. § 162(m)(4)(C)(i)-(iii) (2007).

140. See Basalm & Ryan, *supra* note 134, at 4.

141. Treas. Reg. § 1.162-27(e)(2)(vi) (2007).

142. See *id.*

143. I.R.C. § 162(m)(4)(C)(ii) (2007).

144. See Treas. Reg. § 1.162-27(e)(2)(vi)(A) (2007); see *Present Law and Background*, *supra* note 114, at 4-5.

145. See H.R. REP. NO. 103-111, at 648-49 (1993) (“[I]f a stock option is granted to an executive with an exercise price that is less than the current fair market value of the stock at the time of grant, then the executive would have the right to receive compensation on the exercise of the option even if the stock price decreases or stays the same. Thus, stock options that are granted with an exercise price that is less than the fair market value of the stock at the time of grant do not meet the requirements for performance-based compensation.”).

146. See Hall and Liebman, *supra* note 76, at 7.

147. See Kenneth R. Ferris & James S. Wallace, *IRC Section 162(m) and the Law of Unintended Consequences* 20 (November 2006) (unpublished article on file with author) available at <http://ssrn.com/abstract=942667>.

was an unexpected shift away from salary-based compensation towards performance-based pay, namely, stock options granted *at-the-money*.<sup>148</sup> According to former SEC Chairman Harvey Pitt, “[w]hat [§ 162(m)] did was create incentives to find other forms of compensation so people could get over the \$1 million threshold without running afoul of the code.”<sup>149</sup>

Therefore, in contrast to what its legislative proponents envisioned, I.R.C. § 162(m) neither slowed the growth of executive compensation nor tightened the relationship between firm performance and pay.<sup>150</sup> Rather, when coupled with the option-related accounting rules discussed below, it had the unintended consequence of triggering the rapid expansion of both executive earnings and the book-tax gap to historically high levels.<sup>151</sup>

### B. *Financial Accounting for Employee Stock Options*

Since 1993, the accounting community has engaged in a highly contentious debate regarding how stock options should be expensed on corporate books.<sup>152</sup> This debate is largely a result of the inherent difficulties of measuring the value of an equity instrument with various restrictions and for which no market exists.<sup>153</sup> Nonetheless, despite widespread criticism for its inability to accurately account for the true economic cost of options, companies have utilized the *intrinsic value* method throughout most of this period.<sup>154</sup> However, increased oversight of financial reporting standards prompted a mandatory change in

148. See *id.* at 4 (noting that in 1992, prior to the implementation of I.R.C. § 162(m), 1 million corporate employees retained stock options, but by 2002 the number had increased to 10 million); see Hall & Liebman, *supra* note 76, at 7 (“About 95 percent of options are granted *at the money*, or at *fair market value* . . .”).

149. Brian Grow & Eamon Javers, *Executive Pay Practices Under Scrutiny*, BUSINESSWEEK, Sep. 5, 2006, [http://www.businessweek.com/investor/content/sep2006/pi20060906\\_497396.htm?campaign\\_id=rss\\_null](http://www.businessweek.com/investor/content/sep2006/pi20060906_497396.htm?campaign_id=rss_null).

150. See Hall & Liebman, *supra* note 76, at 32-36. Prior to 1993, executive compensation was entirely tax-deductible. *Id.* at 8. By placing constraints on compensatory tax deductions, I.R.C. § 162(m) was intended to “tie top executives’ soaring pay packages more closely to a company’s performance.” Grow & Jarvis, *supra* note 149.

151. Cf. Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence CEO Compensation* 23 (Nat’l Bureau of Econ. Research, Working Paper No. 7842, 2000) (concluding that I.R.C. § 162(m) has had “relatively little impact on overall compensation”).

152. See Yi Feng & Yisong S. Tian, *Option Expensing & Executive Compensation 1* (March 12, 2007) (unpublished article, on file with the author) *available at* <http://ssrn.com/abstract=970662>.

153. See *supra* text accompanying note 86-87.

154. See Feng & Tian, *supra* note 152, at 5-6.

late 2005 to *fair value* reporting, a method which is believed to more accurately reflect stock option costs.<sup>155</sup>

### 1. The Intrinsic Value Method

The Accounting Principles Board<sup>156</sup> first addressed the issue in 1972 with its release of Opinion 25 (“APB 25”).<sup>157</sup> APB 25 endorsed the *intrinsic value* method, which stipulates that the cost of a stock option, or its financial book expense, is equal to the option’s intrinsic value on the day it is granted.<sup>158</sup> Intrinsic value is measured as the difference between the option’s exercise price and the market price of the underlying stock.<sup>159</sup> Therefore, options which are granted *at-the-money* have zero intrinsic value, and, under APB 25, need not be recognized as an expense on corporate income statements.<sup>160</sup> Naturally, the ability to “pay” executives millions of dollars without including the cost as an expense against earnings, motivated firms to issue options as if they were “free”,<sup>161</sup> a practice that is evident in light of the significant increases in the size and frequency of option grants to executives in recent decades.<sup>162</sup>

### 2. The Long Road to Fair Value

In response to the growing concerns about compensation practices which created millions of dollars in pay yet nothing in terms of book expenses, in 1993, the FASB issued an exposure draft proposing the use of the *fair value* method for expensing options.<sup>163</sup>

155. SFAS 123R; *supra* note 77, at iii-iv,vi.

156. *See supra* note 34.

157. *See* ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, Opinion of the Accounting Principles Board No. 25, ¶ 10 (Am. Inst. of Certified Pub. Accountants 1972).

158. *See* Tim V. Eaton & Brian R. Prucyk, *No Longer an “Option”*, 199 J. Acct. issue 4, 63 at 63 (2005).

159. *Id.*

160. Feng & Tian, *supra* note 152, at 5.

161. *See* Lawrence D. Brown & Yen-Jung Lee, *The Impact of SFAS 123R on Changes in Option-Based Compensation 3* (May 2007) (unpublished article, on file with author). It should be noted that there is some debate regarding the actual costs associated with issuing compensatory stock options outside of the accounting context. For an excellent discussion, *see* Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 89-90 (2003).

162. *See Taxing Stock Options*, *supra* note 2, at 56 (noting a finding by Professor Steven Balsam that whereas in 1994 the typical CEO received \$682,589 in option profits, by 2004 the option profits for the typical CEO had risen to \$5,180,820).

163. ACCOUNTING FOR STOCK-BASED COMPENSATION, Proposed Statement of Financial Accounting Standards: Exposure Draft ¶ 7, 13-15 (Fin. Accounting Standards Bd. 1993).

Under this methodology, stock options are assigned an estimated *fair value*<sup>164</sup> on their grant date using a mathematical valuation tool such as the Black-Scholes option-pricing model.<sup>165</sup> Black-Scholes takes into account a number of factors in determining the option's projected value.<sup>166</sup> This value is then expensed on the company's financial statements over the option's vesting period.<sup>167</sup> Thus, unlike APB 25's *intrinsic value* method which produces no book expense for most stock options, using the *fair value* method significantly increases an option's cost and corresponding book expense, and can potentially result in large reductions in reported income and earnings.<sup>168</sup>

As expected, this FASB proposal was met with fierce opposition and lobbying from the corporate world which worried about the drastic effect fair value expensing would have on corporate profits.<sup>169</sup> Some companies claimed that Black-Scholes, a model originally designed to measure tradable options, could not reliably estimate the fair value of compensatory options.<sup>170</sup>

164. "Fair market value" is defined as "[t]he price that a seller is willing to accept and a buyer is willing to pay on the open market and in an arm's-length transaction . . . ." BLACK'S LAW DICTIONARY 634, 1586-87. (8th ed. 2004).

165. See Norbert Michel & Paul Garwood, *Expensing Employee Stock Options: Lifting the Fog*, THE HERITAGE FOUNDATION, Center for Data Analysis Report No. 02-06, Oct. 18, 2002, available at <http://www.heritage.org/Research/Regulation/cda02-06.cfm>. Released in 1973, the Black-Scholes model was considered the first reliable pricing model for valuing stock options. See *id.* ("The main reason that APB No. 25 did not require option expensing was that a reasonable method of valuing the options did not exist. In 1973, a model that still serves as one of the most widely used methods for valuing traded stock options—the Black-Scholes model—was published" in the *Journal of Political Economy*). See generally Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973).

166. See SHARE-BASED PAYMENT, Statement of Financial Accounting Standards No. 123, ¶ 19 (Fin. Accounting Standards Bd. 1995) ("The fair value of a stock option . . . shall be estimated using an option-pricing model (for example, the Black-Scholes or a binomial model) that takes into account as of the grant date the exercise price and expected life of the option, the current price of the underlying stock and its expected volatility, expected dividends on the stock . . . , and the risk-free interest rate for the expected term of the option.").

167. See Feng & Tian, *supra* note 152, at 5. An employee stock option that vests over a period of 4 years for example, results in 25% of that cost being expensed each year.

168. See *id.* at 5-6; see also *Taxing Stock Options*, *supra* note 2, at 60. ("For example, in 2002 Microsoft reported that if it had measured its stock-based compensation costs according to FAS 123 rather than APB 25, its pretax income would have fallen by \$ 3.6 billion, or more than 30 percent.")

169. See Feng & Tian, *supra* note 152, at 1.

170. See Nicholas G. Apostolou & D. Larry Crumbley, *Accounting for Stock Options: The Controversy Continues*, THE CPA J. ONLINE, (May 2001), <http://www.nyscpea.org/cpajournal/2001/0500/features/f053401.htm> (alluding to a 1999 PeopleSoft 10-K filing which raised concerns that fundamental differences between traded and compensatory stock options, such as the latter's vesting requirements and liquidity restrictions, significantly affect the Black-Scholes input variables and make it an unreliable valuation tool outside the context of traded stock options); see also *infra* Part V.B.1.

Other, mostly younger high-tech firms with low profits and earnings voiced concerns that the added compensation expense would cripple their stock price and put them at a significant disadvantage to larger, more established companies that could more easily absorb the additional stock option expense.<sup>171</sup>

Ultimately, the FASB compromised by issuing Statement of Financial Accounting Standards 123 (“SFAS 123”) in 1995.<sup>172</sup> The rule specifies that while companies *should* apply the fair value method to expense their option grants, companies maintain the discretion to choose to continue applying APB 25’s intrinsic value method as long as they disclose in footnotes the options’ fair value expense.<sup>173</sup> Not surprisingly, most firms chose to continue to utilize APB 25 and merely disclose their stock option costs in footnotes rather than on their actual income statements.<sup>174</sup>

However, several years later, many investors began to raise questions about whether the current accounting of stock options truly reflected their actual cost.<sup>175</sup>

In an effort to signal “transparency and good corporate governance” to investors and the public, more U.S. companies began to voluntarily adopt *fair value* option expensing.<sup>176</sup> By December 2004, with the SEC’s full endorsement and the political climate now in their favor,<sup>177</sup> the FASB issued Statement of Financial Accounting Standard No. 123R, *Share-Based Payment*, (“SFAS 123R”) mandating all publicly-traded firms to expense the grant-date fair value of employee stock options on their income statements.<sup>178</sup> Effective for annual

---

171. Nicholas G. Apostolou & D. Larry Crumbley, *Accounting for Stock Options: Update on the Continuing Conflict*, THE CPA J. ONLINE, (Aug. 2005), <http://www.nysscpa.org/cpajournal/2005/805/essentials/p30.htm>.

172. ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd. 1995).

173. See *id.* at ¶ 45.

174. See Feng & Tian, *supra* note 152, at 6.

175. See Brown & Lee, *supra* note 161, at 1-2.

176. See Feng & Tian, *supra* note 152, at 6 (noting that in the 6 month period following July of 2002, the number of publicly-traded firms voluntarily expensing options at fair value grew from 11 to 170); see Benjamin A. Templin, *Expensing Isn’t the Only Option: Alternatives to the FASB’s Stock Option Expensing Proposal*, 30 J. CORP. L. 357, 366 (2005) (“[B]y February 2004, companies that represented forty-one percent of the market capitalization of S&P 500 index had elected fair-value accounting instead of intrinsic value.”).

177. See *Stock Option Hearing*, *supra* note 9, at 171 (statement of Senator Carl Levin, Chairman, S. Subcomm. on Investigations).

178. SFAS 123R, *supra* note 77, at iii-iv.

periods beginning after June 15, 2005, all firms are required to be in compliance with SFAS 123R.<sup>179</sup>

Because of the inherent difficulty in measuring an option's true cost on its grant date, SFAS 123R allows companies to use a variety of mathematical models in calculating fair value.<sup>180</sup> Companies also enjoy some discretion in determining the parameters and numerical inputs to be used in calculating these values.<sup>181</sup> "Because these estimated values are not subsequently adjusted, initial valuation is especially important".<sup>182</sup>

Despite the post-2005 GAAP shift to mandatory fair value expensing, the compensatory option costs a company reports on its financial statements may still differ from the amount it reports to the I.R.S. These book-tax differences, which will be further explored in the following section, have the potential to be rather significant.<sup>183</sup>

## V. STOCK OPTION CONFORMITY?

### A. *The Stock Option Gap*

The Internal Revenue Code allows a corporation to defer taking a tax deduction for the options it issues until the date at which those options are exercised.<sup>184</sup> Because this tax deduction is associated with the option's *intrinsic value* at the *exercise date*, it can vary significantly from the amount expensed as compensation in the company's financial statements, as GAAP requires that this amount be linked to the option's *fair value* at the *grant date*.<sup>185</sup> To better illustrate:

---

179. See *id.* at 25-26.

180. *Id.* at 41.

181. See Paulette A. Ratliff, *Reporting Employee Stock Option Expenses: Is the Debate Over?*, THE CPA JOURNAL ONLINE, Nov. 2005, <http://www.nyssscpa.org/cpajournal/2005/1105/essentials/p38.htm>.

182. *Id.* Once an option vests, even if left unexercised, it must be fully expensed and its cost is not recoverable. See *Present Law and Background*, *supra* note 114, at 39. For options that do not vest however, any previous book expense is recoverable. *Id.*

183. See *Stock Option Hearing*, *supra* note 9, at 1 (statement of Senator Carl Levin, Chairman, S. Subcomm. on Investigations). After conducting an investigation into the compensation practices at nine major U.S. firms between 2002 and 2006, the Subcommittee found that even if expensed at fair value throughout the four year period, those nine companies alone would have reported \$1 billion more in option expenses to the I.R.S. than they reported to investors on their financial statements. *Id.*

184. See *supra* text accompanying note 129.

185. See *Stock Option Hearing*, *supra* note 9, at 7-8 (testimony of John W. White, Director, Division of Corporate Finance, SEC); see also SFAS 123R, *supra* note 77.

[S]uppose a company gave an executive [non qualified] options to buy 1 million shares of the 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.<sup>186</sup>

To comply with current GAAP standards, the company would record on its financial books a compensation expense equal to the option's fair value at grant.<sup>187</sup>

Determining the actual fair value expense involves a complex calculation of various firm-specific factors.<sup>188</sup> However, due to their illiquidity and risk of forfeiture, employee stock options are generally valued at 20% to 50% of the firm's current stock price.<sup>189</sup> Assuming here that the options are valued at 50% of the stock's current price of \$10, fair value would equal \$5 per option. The company would record a \$5 million expense for financial purposes or \$1 million per year over the five year vesting period. When the executive exercises those options at the end of the five-year term, the company is able to take a tax deduction equal to the intrinsic value of the exercised options.<sup>190</sup> Again, that value in this scenario is \$20 million.

Thus, in circumstances such as those illustrated in this example, where the price of the company's stock rises to a value exceeding that of the option's fair value at the grant date, the company is afforded a very favorable tax deduction relative to the compensation expense reported to investors on its financial books.<sup>191</sup> The \$15 million difference between the expense recorded on the company's financial statement and deduction recorded on its tax statement is now part of the book-tax gap.

In reality, the gap created by many U.S. corporations can often be much larger than the \$15 million gap created by the

---

186. *Stock Option Hearing*, *supra* note 9, at 3 (statement of Senator Carl Levin, Chairman, S. Subcomm. on Investigations).

187. *See* SFAS 123R, *supra* note 77.

188. *See supra* note 166 and accompanying text.

189. David Harper, *ESOs: Accounting for Employee Stock Options*, Investopedia.com, <http://www.investopedia.com/features/esofeso1.asp> (last visited Dec. 21, 2008) (explaining accounting for employee stock options).

190. *See supra* note 129.

191. *See Stock Option Hearing*, *supra* note 9, at 8 (statement of John W. White, Director, Division of Corporate Finance, SEC).

above hypothetical.<sup>192</sup> In June 2007, the Senate Permanent Subcommittee on Investigations released data that it collected from several U.S. firms from 2002-2006.<sup>193</sup> Their findings were quite revealing. For instance, during that period, the CEO of Cisco Systems exercised around 19 million stock options, which gave the company a tax deduction of \$169 million.<sup>194</sup> Although Cisco granted those options prior to SFAS 123R, had the mandatory expensing standard been in place, their corresponding book expense would have totaled a mere \$21 million, a difference of nearly \$150 million.<sup>195</sup>

While a rising stock market can produce this type of windfall, in a declining market, the interplay of tax and accounting rules can potentially have opposite adverse effects for a corporation.<sup>196</sup> The data collected from Cisco also reveals that its CEO still holds an additional 8 million options which, due to declines in the company's stock price, are currently *out-of-the-money* and will, therefore, likely expire unexercised.<sup>197</sup> Under the new accounting standard, those options would have produced a book expense of \$139 million when granted.<sup>198</sup> Assuming they ultimately do expire unexercised, Cisco would receive no tax deduction.<sup>199</sup> According to Senator Levin, the potential adverse financial impact of such a scenario "is additional evidence that stock option accounting and tax rules are out of kilter."<sup>200</sup>

### B. *The Stock Option Act*

In September 2007, Senator Levin introduced legislation ("Stock Option Act") aimed at tightening the book-tax gap and reducing executive pay.<sup>201</sup> By limiting the allowable size of any option-based corporate tax deduction to the amount expensed for financial purposes, the Stock Option Act would effectively align the tax treatment of employee stock options with that of current

---

192. For instance, in 2000, Cisco claimed a \$2.5 billion tax deduction as a result of exercised stock options, "almost entirely offsetting its operating income of \$2.67 billion that year and effectively paying little in taxes." Damodaran, *supra* note 104, at 27.

193. See *Stock Option Hearing*, *supra* note 9, at 3 (statement of Senator Carl Levin, Chairman, S. Subcomm. on Investigations).

194. *Id.* at 4.

195. *Id.*

196. See *id.* at 5.

197. *Id.*

198. *Id.*

199. See *Stock Option Hearing*, *supra* note 9, at 5 (statement of Senator Carl Levin, Chairman, S. Subcomm. on Investigations).

200. *Id.*

201. Ending Corporate Tax Favors for Stock Options Act, S. 2116, 110th Cong. (2007) [hereinafter *Stock Option Act*].

accounting standards.<sup>202</sup> Thus, rather than waiting for executives to exercise their options, under the proposed legislation, firms would immediately take a tax deduction equal to the options' book expense value.<sup>203</sup>

Recall that, currently, the Internal Revenue Code does not allow an employer to take a tax deduction until the time at which its employee has paid income tax on the "property" received.<sup>204</sup> The proposed Stock Option Act would amend I.R.C. § 83(h) to require that any tax deduction relating to employee stock options "not exceed" the corresponding book expense.<sup>205</sup> Further, it would require the deduction to occur in the same period that the book expense is recognized,<sup>206</sup> which for accounting purposes takes place in the year of the grant. As a result, rather than the deduction matching the executive's inclusion at exercise, it would instead match the option's projected book value at grant. Presumably then, the employer would receive a tax deduction some 3 to 10 years prior to the executive's including and paying of income tax on the intrinsic value of the exercised options.<sup>207</sup>

### 1. Theoretical and Practical Obstacles

Implementing such a change, in which the employer takes a tax deduction based on an estimated calculation of unrealized value, is a stark deviation from the longstanding book-tax principles established by the Supreme Court.<sup>208</sup> As observed in *Thor Power*, whereas financial accounting is amenable to probabilities and approximate estimations, the Internal Revenue Code, "with its mandate to preserve the revenue, can give no quarter to uncertainty."<sup>209</sup> Under this framework, the *Thor Power* Court indicated that "the tax law requires that a deduction be deferred until 'all the events' have occurred that

---

202. *Id.* at 3. ("In the case of compensation . . . paid with stock options, the deduction . . . shall not exceed the amount the taxpayer has treated as an expense . . . for the purpose of ascertaining income, profit, or loss in a report or statement to shareholders . . .").

203. *Id.*; Fin. Accounting Standards Bd., Statement of Financial Accounting Series iii, (Fin. Accounting Found., No. 123, rev. 2004).

204. See *supra* note 128-29 and text accompanying.

205. See *Stock Option Act*, *supra* note 201, at 2-3.

206. *Id.*

207. Ronnie Sircar & Wei Xiong, *A General Framework for Evaluating Executive Stock Options*, J. of Econ. Dynamics & Control 2317, 2322 (2007) (citing calculated average vesting period, and expiration of stock options). Assume here an average vesting time of 3-5 years and a 10 year expiration period.

208. See *supra* Part II.B.

209. *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 543, 99 S. Ct. 773, 786 (1979).

## 202 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. IX

will make it fixed and certain.”<sup>210</sup> The actual value of a stock option clearly is not “fixed and certain” on the grant date. Thus, in disallowing a tax deduction until the time at which the option’s value is in fact “fixed and certain,” the Internal Revenue Code’s current treatment of employee stock options presently reflects congruence with the *Thor Power* decision.<sup>211</sup>

Senator Levin describes I.R.C. § 83’s current “wait-and-see”<sup>212</sup> approach to corporate stock option tax deductions as outdated, in as much as the provision was enacted prior to any consensus on how to determine the grant-date value of stock options.<sup>213</sup> While the enactment of I.R.C. § 83 did pre-date the availability of any reliable option-pricing tool,<sup>214</sup> experts have fervently debated the accuracy of the models which have since developed.<sup>215</sup> Much of the disagreement centered around the fact that the modified pricing models used to estimate fair value for employee stock options<sup>216</sup> rely on the application of variables that require subjective—and perhaps speculative—assumptions which are largely within a firm’s discretion.<sup>217</sup> Consequently, opponents argue that even “[m]inor variation or errors in these assumptions can yield drastically different results.”<sup>218</sup> In response to these concerns, the FASB asserts that this uncertainty is no different than that which exists for various other “items in accounting that necessitate the use of estimates . . .”<sup>219</sup> Indeed, for a system which “is hospitable to estimates [and] probabilities”<sup>220</sup> such uncertainty is acceptable.

---

210. *Id.*

211. *See id.*

212. The approach is described as “wait-and-see” because it defers tax payment until a definite value is calculable.

213. *Stock Option Hearing, supra* note 9, at 6 (statement of Senator Carl Levin, Chairman, S. Subcomm. on Investigations).

214. *See supra* note 165.

215. *See supra* Part IV.B.2. As noted above, this debate stymied regulatory efforts to enforce mandatory fair value option expensing for nearly two decades. *Id.*

216. *See* Feng & Tian, *supra* note 152, at 6. Recall that option-pricing models were originally developed to measure tradable options. *See supra* note 170 and text accompanying.

217. *See supra* text accompanying note 188.

218. Templin, *supra* note 176, at 385 (citing Letter from John F. Gifford, CEO, Maxim Integrated Products, Inc., to FASB, Letter of Comment on Proposed Statement No. 123., Ltr. No: 66, 1-2 (Jan. 30, 2003) available at <http://www.fasb.org/oc/1102-001/14393.pdf>).

219. SFAS 123R, *supra* note 77, at 171-72. The FASB lists “loan loss reserves, . . . deferred tax assets, and pensions” as among those items which are based on such estimates. *Id.* at 171.

220. *Thor Power Tool Co. v. Comm’r*, 439 U.S. 522, 543 (1979).

However, “with its mandate to preserve the revenue,”<sup>221</sup> the same is not true for tax accounting. Whereas for financial reporting, inaccuracies in the measurement of income at any one given moment are of less concern than inconsistencies across time periods, tax accounting places emphasis on accurate income measurements at each period for every taxpayer.<sup>222</sup> Therefore, the potential errors and variances which flow from the subjective judgments used to determine grant-date option values squarely conflict with the goals of tax accounting.

According to Professors Ethan Yale and Greg Polsky, the inherent difficulty in determining the grant-date fair value of a stock option is “the very reason that NQSOs are excepted from [I.R.C.] § 83(a) in the first place.”<sup>223</sup> The adoption of mandatory accounting standards, which attempt to make such valuations, nevertheless suggests to proponents of the Stock Option Act that those same standards would be satisfactory for tax accounting.<sup>224</sup> However, as Yale and Polsky note and as discussed below, the “malleability” of the accounting rules under SFAS 123R, “make them a poor guide for assessing taxes.”<sup>225</sup>

Option conformity advocates insist that aligning option tax and financial treatment would limit managerial incentives to “game” differences between the two systems.<sup>226</sup> Remember again, however, that under SFAS 123R, firms maintain a wide degree of latitude in choosing both the valuation model and variables to be used for measuring their option’s book expense value.<sup>227</sup> According to Professor Victor Fleischer, when a firm is granted the same discretion in determining its own immediate tax liability, one type of gamesmanship opportunity is merely being replaced with another.<sup>228</sup> For example, closely-held firms which place greater value on reducing taxable income than on reporting high book income might manipulate the variables used

221. *Id.*

222. Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 VA. TAX REV. 301, 357 (2004).

223. Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 590 (2007).

224. *Stock Option Hearing*, *supra* note 9, at 6 (statement of Sen. Carl Levin, Chairman, S. Subcomm. on Investigations).

225. Yale & Polsky, *supra* note 223, at 590-91.

226. *Stock Option Hearing*, *supra* note 9, at 16 (testimony of Mihir A. Desai, Associate Professor of Finance, Harvard Business School) (“[T]he use of options could no longer be rationalized as capitalizing on the generous tax deductions that are associated with deductions of exercises versus grants.”).

227. *See supra* text accompanying note 180-81.

228. Posting of Victor Fleischer to The Conglomerate, <http://www.theconglomerate.org/2007/09/booktax-conform.html> (Sept. 28, 2007).

in determining their stock option book expenses so as to receive a sizeable tax deduction.<sup>229</sup>

Even absent managerial opportunism, the potential for high numbers of valuation disputes is great given the prevalence of option compensation.<sup>230</sup> Professor Tony Luppino cites the resulting administrative burdens in accelerating an employer's deduction to the grant date as a prime concern of tax authorities<sup>231</sup> and as the reason that Treasury avoided such "thorny valuation issues" with stock options.<sup>232</sup>

Another patent flaw in the proposed Stock Option Act is its failure to take into account the consequences of compensatory stock options which are forfeited or expire unexercised. Take for instance the 8 million stock options held by Cisco's CEO that are likely to expire unexercised.<sup>233</sup> Recall that the data collected by Senator Levin indicated that, had SFAS 123R been in effect, those options would have created book expenses of \$139 million.<sup>234</sup> Under Senator Levin's proposal, Cisco would take \$139 million in tax deductions in the year or years that the options were granted; however, assuming they do expire underwater and unexercised, Cisco's CEO will never realize any actual value and thus never pay any actual income tax. Such inequitable results could have widespread implications in a declining market.

Accelerating the employee's inclusion to match the employer's deduction at the time of grant is also an untenable proposal. As the Cisco example demonstrates, the "property" exchanged on the grant date could potentially be worthless. Even if the employee places significant value on options, an inherent liquidity problem is likely to exist.<sup>235</sup> In many cases an executive may lack the adequate free capital to pay income tax on compensation prior to obtaining the rights to acquire the underlying stock.<sup>236</sup>

---

229. See Shaviro, *supra* note 11, at 59; see also *Thor Power Tool Co. v. Comm'r.*, 439 U.S. 522, 544, 99 S. Ct. 773, 787 ("[With book-tax conformity], a firm could decide unilaterally-within limits dictated only by its accountants-the tax it wished to pay.").

230. See Luppino, *supra* note 161, at 174.

231. *Id.* at 173 ("[T]he administrative difficulties frequently inherent in valuing the 'wait and see' right that has been passed to the employee . . . generally postpones the determination of what has transpired until the 'exercise date.'").

232. *Id.* at 174.

233. See *supra* text accompanying note 194-95.

234. See *id.*

235. See Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 *YALE L. J.* 506, 541-42 (1986) (describing liquidity concerns as a "serious obstacle[]" to taxing all deferred compensation up front).

236. See Luppino, *supra* note 161, at 174.

## 2. SFAS 123R and the Narrowing Gap

The recent option-related accounting changes alone will likely compel an appropriate balance in executive stock option pay, thereby curbing excessive option grants which have further increased the book-tax gap. Though it is too early to draw any definitive conclusions, most preliminary evidence indicates that mandatory option expensing will significantly reduce the frequency and size of employee stock option grants in the near future.<sup>237</sup>

Evidence from overseas suggests the same conclusion. In 2004, the International Accounting Standards Board released International Financial Reporting Standards 2, “Equity Based Compensation” (“IFRS 2”), which, similar to SFAS 123R in the U.S., requires all publicly-traded firms in the European Union to expense their employee stock options.<sup>238</sup> A recent survey of publicly-traded companies in France conducted after the implementation of IFRS 2, revealed that the proportion of option-based compensation among French CEOs fell from 51% in 2004 to 38% in 2005.<sup>239</sup> Similarly, in the U.S., pronounced reductions in stock option compensation are already occurring among younger, “cash-poor” technology firms which simply cannot afford the potential reduction in earnings likely to occur with mandatory expensing under SFAS 123R.<sup>240</sup>

Senator Norm Coleman, who spoke at Senator Levin’s June 2007 executive stock option hearing, believes that the new accounting standard will significantly reduce the \$43 billion book-tax gap recorded in 2004.<sup>241</sup> At the hearing he remarked,

---

237. See *Taxing Stock Options*, *supra* note 2, at 62 (“In the United States, Equilar reports that the share of S&P 1500 firms offering stock option awards fell from percent in 2003 to 78 percent in 2005. In February 2005 Time Warner reported that it would no longer grant stock options to employees, citing the new accounting rules as the reason for the change in its compensation practices.”); see Mary Ellen Carter et al., *The Role of Accounting in the Design of CEO Equity Compensation* 4 (March 2006) (unpublished article, on file with the Houston Business and Tax Law Journal) (predicting a reduction in the use of stock option compensation as a result of the higher costs imposed by SFAS 123R).

238. See *Taxing Stock Options*, *supra* note 2, at 61.

239. *Id.*

240. See *id.* at 62 (“[A]fter reporting more than \$200 million in stock-based compensation annually from 2003 through 2005 and more than \$450 million in 2006, Google projects a decline to \$184 million in 2007, \$105 million in 2008, \$44 million in 2009, and just \$700,000 in 2010.”).

241. *Executive Stock Options: Should the IRS and Stockholders be Given Different Information?: Hearing Before the Subcomm. on Investigations*, 110th Cong. 3 (2007) (statement of Senator Norm Coleman, Ranking Minority Member, S. Subcomm. on Investigations) (“[A]lthough differences between the tax rules and accounting rules governing stock options remain, now that every option issued represents a direct hit to

206 *HOUSTON BUSINESS AND TAX LAW JOURNAL* [Vol. IX

“[I]t is already clear that companies are issuing fewer stock options, requiring longer vesting and holding periods, and hopefully setting truer performance benchmarks.”<sup>242</sup>

VI. CONCLUSION

In light of this evidence and the aforementioned difficulties and consequences which naturally flow from implementing a book-tax conformity regime for employee stock options this Comment advocates maintaining the status quo. While overall, greater book-tax conformity is desirable,<sup>243</sup> stock option compensation may be one area where financial and tax principles should maintain their own identity.

Aligning the tax and accounting treatment of employee stock options would considerably limit both executive and corporate windfalls. However, such a change runs counter to long standing corporate tax policy and, in any event, is likely unnecessary in light of the implementation of recent outside financial controls. While the status quo is by no means perfect, the underlying costs of a change to the tax treatment of compensatory stock options—at least in terms of “book-tax” conformity—outweigh any potential benefits.

*Daniel L. Slaton*

---

the company’s bottom line, the \$43 billion book-tax gap that existed in 2004 should narrow significantly.”).

242. *Id.*

243. *See* Shaviro, *supra* note 11, at 61 (predicting that with closer book-tax conformity, the undesirable managerial incentives to “play games” with tax and financial reporting would be significantly limited).