Stock Option Deduction Debate: Journey Down the Rabbit Hole

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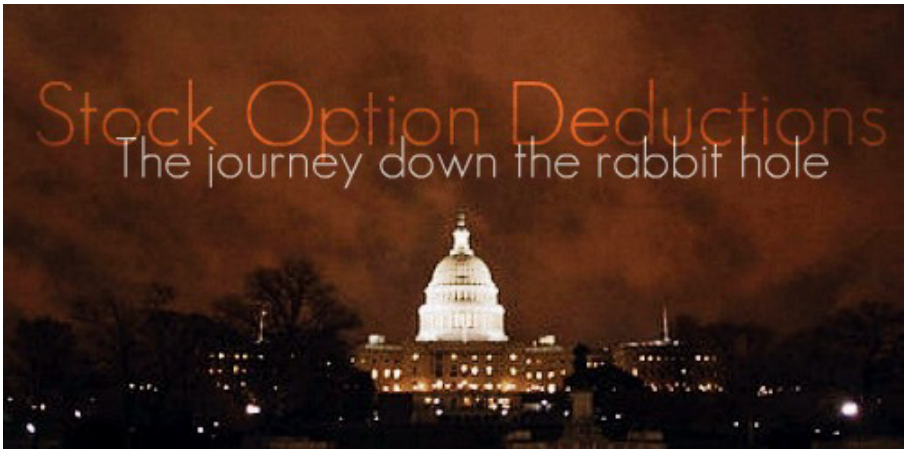

Have you ever wished you'd coined a phrase? I wish I'd coined the phrase "curiouser and curiouser" from *Alice in Wonderland*. As time goes by, our laws and regulations and accounting pronouncements become, by virtue of amendments, inflation (without corresponding adjustments to the indices), interpretations, pronouncements, etc., so confused and conflicting that you *have* to be curiouser and curiouser just to understand how we got to where we are.

In the case of the deduction for stock options, there has been what many would consider to be a "great deal" going on for a long time. This is how it works. If a corporation grants a nonqualified stock option, it gets a deduction when that stock option is exercised in an amount equal to the amount by which the fair market value of the stock underlying the option exceeds the exercise price. This despite the fact that the corporation doesn't have to outlay any cash for this spread. What a great deal! Many very profitable corporations have benefited greatly from what some would call a phantom expense. Think of a grinning kitty. This deduction has allowed many profitable corporations to plow more money into hiring, and arguably helped grow the economy immensely by encouraging corporations to align long-term shareholder value with worker incentives.

But now there is a bill that has been introduced in Congress (S. 1375) that would put a crimp on the fun. S. 1375 would limit the deduction to what corporations have taken as an expense for financial accounting purposes, and force the matching of the financial and tax treatments. What corporations deduct for financial accounting purposes is

frequently less than what the spread and deduction turns out to be. Thus, S. 1375 would make granting nonqualified stock options less attractive to companies.

Stock Option Deductions

The issue is the baby of Sen. Carl Levin, and is currently co-sponsored by Sen. Sherrod Brown. According to the Joint Committee on Taxation, forcing the matching of the accounting and tax treatments would bring in around $25 billion in extra revenues over a 10 year period. Not a ton of revenue when you quantify it over trillions of dollars for sure, but every bit counts.

If this bill does become law, Incentive Stock Options may regain their favor as the preferred type of option for corporations to grant, because there has never been a deduction on the spread for ISOs. Alternatively, corporations may shift to other forms of equity compensation or do less equity compensation altogether. If the bill becomes law it would be, in the author's opinion, an unfortunate continuation of what the author considers an already unfortunate trend in the law, which is–making stock options and other forms of equity compensation more difficult and cumbersome for companies to award to workers generally–witness Internal Revenue Code Section 409A.

The Rabbit Hole

In Levin and Brown's bill, the amount a company could deduct due to stock options could not be more than the amount that they deduct for financial accounting purposes. The bill would also bring stock options under the $1 million cap on deductions for certain executive compensation under Section 162(m) of the Internal Revenue Code.

It is too bad that the law of stock options is so complex as it is. We ought to be making the law of stock options less complex. I believe that we ought not make it more difficult or more expensive for companies to share the equity pie with their workers. I believe we ought to repeal Section 409A, as a start. In my opinion, we should make it possible to share equity with workers free from income and employment tax withholding and repeal the AMT as it applies to ISOs.

From the perspective of startups that are likely not too focused on the deductibility of the spread on NQOs, this bill might seem harmless enough. The trouble is that there is too much complexity in this area of the law already. We need to dig ourselves out of this Alice in Wonderland rabbit hole, rather than burrow ourselves further in.

The opinions expressed here are the author's only.

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