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Stock Option Fundamentals

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The use of stock options as a compensation tool has expanded dramatically over the past decade. For example, one commentator noted that the number of employees receiving stock options grew from about 1 million in the early 1990s to between 7 and 10 million in 2002.[1] This past decade also saw an expansion of options grants to a larger number and broader class of employees, unlike the past when options were primarily offered to a small number of top executives or directors.

Although options were more attractive to executives during the stock market boom than today, they remain a common form of executive compensation. There are still corporate, tax, and accounting reasons to offer stock options as compensation. But the recent collapse of Enron Corporation has also focused attention on the "cost" of options to shareholders, and prompted calls for more specific disclosures regarding the value of options granted.

It is important for benefits professionals to understand the changing trends affecting stock options so that they can respond to management, employee, and now, potentially, shareholder inquiries about option plans and alternatives. This column describes the basic structure of three widely used option arrangements—non-statutory stock options, incentive stock options (ISOs) and employee stock purchase plans (ESPPs), as well as the tax consequences of such plans and recent proposals regarding their accounting and required disclosure.

Structure of Option Plans

Option plans offer the optionee the right to buy shares of a company at a set price (the "exercise" or "strike" price). Non-statutory

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stock options, ISOs, and ESPPs differ primarily in their tax consequences and the tax rules defining the options. As discussed below, ISOs and ESPPs are perceived as enjoying better tax results for the optionees, but the "price" of those advantages is decreased flexibility in the form of rules governing the structure of those plans. Non-statutory stock options, as their name implies, are not subject to as many rules regarding their structure, but have fewer tax advantages.

Almost all options are issued pursuant to an option plan. Option plans are often approved by shareholders. Non-statutory stock option plans may or may not require approval depending on the applicable securities laws. Employee stock purchase plans and plans offering incentive stock options must be approved by shareholders within 12 months before or after the date the plan is adopted in order to receive special tax benefits.

Option plans generally specify the type of options permitted and the number of shares subject to the option. They are usually administered by an individual or, more likely, a committee, appointed by the Board of Directors. The committee often determines, among other matters; (1) the employees who qualify for eligibility; (2) the type of grant, if any, each employee will receive; (3) the number of shares subject to each option; (4) the time these options can be exercised (the option's "vesting date"); (5) the duration of the exercise period; and (6) the manner in which the option is exercised. These factors are usually set out in an option agreement signed by the company and employee. As noted below, some of these determinations are limited by statutory requirements. ESPPs generally offer uniform benefits to participants. Subject to the statutory requirements for ISOs, option terms under ISOs and non-statutory stock option plans can differ among optionees.

Specific Statutory Requirements for ESPPs and ISO Plans

Options offered under ESPPs and ISOs must meet certain requirements, detailed below.

ESPPs

As its name implies, ESPPs give employees an opportunity to purchase employer stock through a formal plan. (Sometimes rights under an ESPP are called purchase rights rather than options but the

economic effect is the same.) The requirements for ESPPs are set forth in Section 423 of the Internal Revenue Code (Code).

Options under an ESPP can only be offered to employees. Subject to the limits described below, an ESPP must, by its terms, be offered to all employees of a corporation that offers the purchase rights to any employee. Certain exclusions are permitted. The ESPP may exclude employees with fewer than two years of service, or those whose customary employment is 20 hours or less a week, or those whose customary employment is not for more than five months in a calendar year. Also, officers, supervisors, or highly compensated employees may be excluded.[2]

Although this "universal availability" requirement for ESPPs seems straightforward, it sometimes is not. For example, Microsoft Corporation offered an ESPP to its employees. After the IRS conducted an unrelated payroll audit of Microsoft and Microsoft agreed to reclassify some of its independent contractors as employees for withholding tax purposes, the independent contractors sued Microsoft, arguing that they were "employees" for *all* purposes, including participation in the ESPP. The contractors were successful in arguing that they should be included in the ESPP and entitled to purchase the benefits of a retroactive purchase of Microsoft stock, which had appreciated significantly, at the then purchase price. The case involving the Microsoft ESPP was eventually settled, using a formula approach to determine how much each contractor should receive in lost profits.[3]

By its very nature, then, an ESPP results in widespread ownership of the employer, and such plans are only adopted by employers that want to promote that goal as an employee incentive. Moreover, due to the valuation, accounting and recordkeeping requirements that apply to a program covering such a large number of people, ESPPs are usually offered by large, publicly traded companies.

Options under an ESPP *cannot* be granted to a participant in the ESPP if, immediately after the option is granted, he or she would own 5 percent or more of the total voting power of all classes of stock of the employer. All optionees must have the same rights and features except that options may be granted in different amounts based on a uniform relationship to compensation. For example, a plan could state that the maximum amount of stock that can be purchased is 5 shares per $100 of gross income.

There are also limits on the exercise price, timing of exercise, and the number of shares that can be purchased under an ESPP.

Options can only be exercised by the recipient during his or her life, and cannot be transferred. The exercise price cannot be less than the lesser of (1) the fair market value at the time the option is *granted,* or (2) an amount that under the terms of the option cannot be less than 85 percent of the market value at the time the option is *exercised.* The option must generally be exercised not later than 27 months after the grant date, although if the plan is providing that the exercise price may be less than 15 percent of the fair market value at *exercise,* that period extends to five years.

The plan must provide that no employee may purchase stock whose value exceeds $25,000 in a year, based on the fair market value at the time the option is granted for each calendar year under which the option is granted. This is a cumulative limit. For example, if the fair market value at grant is $100 per share, and no shares are purchased in 2002, 500 shares may be purchased in 2003.

Incentive Stock Options

Incentive stock options must also meet certain requirements, which are set forth in Section 422 of the Code. They must be offered pursuant to a plan adopted by the employer that meets certain terms and conditions. The plan must specify the number of maximum number of options that may be offered as ISOs. Many plans will offer both ISOs and non-ISOs and merely state that the maximum number of shares that may be offered as ISOs, non-ISOS, or a combination of the two. This is acceptable, since one merely determines the maximum number of ISOs by treating all of the options as potential ISOs. Unlike ESPPs, ISOs can be offered to a selected group of employees, but the plan must define the class of employees eligible to receive ISOs and must be in existence for no longer than ten years. Like ESPPs, ISOs can only be offered to employees. If an individual who is an employee terminates employment, he or she must exercise the ISO within three months or forfeit the option right. (This three-month period is extended to one year in the case of disability.) An employee's estate can exercise the option on behalf of a deceased employee, but ISOs generally cannot be transferred.

The purchase price of shares subject to an incentive stock option or nonqualified stock option cannot be less than 100 percent of the fair market value of a share of stock on the grant date (110 percent in the case of incentive stock options granted to holders of more than 10 percent of the employer's voting stock). The option price of the shares must be paid to the employer at the time of exercise either in

cash or in such other consideration as the administrator deems appropriate. The option period, including any extensions that may be granted, may not exceed ten years from the date of the grant (or five years in the case of incentive stock options granted to holders of more than 10 percent of the employer's voting stock).

The Code limits the aggregate value of shares that may be granted to each eligible employee as incentive stock options. The total fair market value of the shares of common stock of the employer with respect to which incentive stock options may be granted under any employer plan to each eligible employee cannot exceed $100,000 for shares that vest for the first time during any calendar year. To the extent that the aggregate fair market value of such shares exceeds $100,000, the options underlying such excess shares will be treated as nonqualified stock options rather than incentive stock options.

The law used to require that ISOs be specified as such. Now that is not necessary; an option that meets the terms of an ISO will be taxed as an ISO unless the terms of the option specify that it is not an ISO.

Nonstatutory Stock Options

Nonstatutory stock options are more flexible than either ISOs or ESPP options. However, there are some limitations on these options as well. Generally, securities or corporate governance laws require that the option be granted pursuant to some sort of plan authorizing the provision of shares to be offered under the options, and the general practice is to have the shareholders approve the plan. State and federal securities and corporate law determine whether shareholder approval is required. As noted above, quite often a plan will offer ISOs in addition to non-statutory options, so shareholder approval is necessary in any event.

Although there is no Internal Revenue Code limit on the exercise price of non-statutory options, at some point the exercise price could be so low that the IRS will maintain that the grant of the option itself is a grant of the stock itself, on the theory that the stock purchase is "too good to pass up." Thus, the Service could attempt to tax such a deeply discounted option when it vests, even if the employee does not exercise the option and owns the stock. The theory here is that the reasonable employee would have no economic disincentive to wait until there was a lower price to exercise the option.

Many employers, particularly high-tech companies who believed that discounted options were a desirable and necessary form of

compensation when they had little available cash, have sought guidance as to when the exercise price of an option may be too low. One Supreme Court case, *Commissioner v. LoBue,* 351 U.S. 243 (1956), has been cited by many practitioners as permitting discounts of up to 75 percent of the cost of the option. The issue in *LoBue* was whether the taxpayer received compensation or a capital interest in the employer. The Court held that an option had been granted and the taxpayer should be taxed at exercise. The question as to whether the discount was "too deep" was not specifically addressed, but under the facts of the case, the exercise price for some of the shares at issue was about 25 percent of the fair market value of the underlying shares on the date of grant.

Two other cases faced similar issues with "penny" stocks. In *Victorson v. Commissioner,* 326 F.2d 264 (2d Cir. 1964), the exercise price for shares that were publicly offered at $.50 a share was $.001, a much more significant discount than *LoBue*. Nonetheless, the court treated the option as an option and not a stock grant. See also *Simmons v. Commissioner,* TCM 1964-237, which reached the same result. Although these options are much more deeply discounted than those in *LoBue,* many practitioners would not recommend such a deep discount.

Other Features of Option Plans

Option plans often offer special features in connection with the option grant. One of the major reasons for these features is that often executives or other optionees do not have the financial resources to exercise the option, thus losing the benefits of the option compensation tool. Employers have found a variety of ways to deal with this problem.

Stock appreciation rights (SARs) are often offered in connection with stock options and avoid the need to spend funds to exercise the option. A stock appreciation right gives the employee the right to receive the appreciated value of the employer's stock rather than the stock itself. The appreciation is measured as the difference in value of the stock on the date of grant of the right and the value of the stock on the date that the right is exercised. Often the exercise of a stock appreciation right results in a cancellation of any option that is issued in tandem with that right. Sometimes the value of the appreciation right can be received in employer stock; this in effect allows the optionee to receive stock without spending any of his or her own funds.

Stock appreciation rights can be granted in connection with both ISOs and non-statutory stock options. However, if the stock

appreciation right is issued in connection with an ISO, it cannot create a right that is inconsistent with the ISO rules (for example, if the right extends the option beyond the ten-year period permitted for ISOs).

Often an option plan authorizes the committee to permit financial assistance or loans to give employees the cash to exercise the option. Some commentators have criticized this practice, particularly if it allows the executive to exercise the option and immediately sell the stock back to the company. In some cases, loans must be disclosed to shareholders; for example, if made to top officers and employees of the company.

Alternatively, option plans often provide that options may be exercised by surrendering previously held shares of stock. As explained below, this technique both saves cash and defers the tax on the appreciated spread with respect to the traded shares.

Another possible feature in an option plan is the automatic grant of a new option (a “reload option”). The reload option may be granted automatically to an eligible individual when he or she exercises an option, in whole or in part, by surrendering previously acquired shares of common stock or a portion of the shares being acquired upon exercise of the option. Any such reload option will be for the number of shares delivered upon the employee’s exercise of an option, and is usually exercisable only in the event shares purchased upon exercise of the original option are held for the holding period specified in the stock option agreement or meet other criteria set forth in that agreement. Often the shares purchased will be forfeited if such shares are sold prior to the expiration of the holding period. For ISOs, the purchase price of shares subject to each reload option cannot be less than the fair market value on the date of the reload option grant. Some companies hesitate to offer reload options because they believe they dilute the employee’s incentive to make the company share price grow.

Finally, companies offering options have faced some pressure to reprice when share prices fall. While repricing is popular with employee/optionees, it has been criticized as giving optionees little or no incentive to improve share performance. Companies are often reluctant to disclose repricing of options, particularly since accounting rules generally require that repricing be changed against earnings.

The Basic Taxation Rules for Option Plans

The rules governing the taxation of stock options are set forth in Section 83 of the Internal Revenue Code. Section 83 of the Code

governs the taxation of transfers of property in connection with the performance of services by employees and others. Section 83 was enacted in large part to deal with the tax treatment of restricted stock plans, that is, grants of stock subject to various "strings" or conditions that would avoid taxation to the employee. Section 83 (e) states that options without a readily ascertainable fair market value are not considered "property" so are not taxed at option grant. An option has a readily ascertainable fair market value if the option is actively traded on an established market, or if certain other requirements are met—it is transferable by the optionee, it is exercisable in full by the optionee, and the fair market value of the option privilege is ascertainable.

Assuming the options are not publicly traded as such and do not have a readily ascertainable fair market value, their tax treatment will depend on whether they are nonqualified stock options, or options granted under an ESPP or as an ISO. Very generally, the executive is taxed on the spread between the option price and the stock's fair market value where he or she exercises a nonstatutory stock option, and the employer receives a corresponding deduction at that time. The income inclusion for the employee and deduction is delayed until the stock is sold with any ISO, and if certain holding period requirements are met, the employee will be taxed at capital gains rates. Thus, assuming the employee's tax rate is higher than the employer's, the ISO has an aggregate economic advantage. The specifics of the tax rules are discussed below.

Nonqualified Stock Options

An employee will not recognize taxable income at the time a nonqualified stock option is granted, and no deduction will be allowed for the employer at that time. Upon exercise, the employee will generally recognize ordinary income in an amount equal to the difference between the fair market value of the shares at the time of exercise and the option exercise price paid for the shares. Such income constitutes taxable wages as of the date of the exercise, subject to unemployment, Social Security, Medicare, and federal and state income tax withholding. Usually employers withhold the amount of required withholding or otherwise ensure that the recipient remits such amount to the employer. The employer normally will be entitled to a deduction at the same time and in the same amount as the employee is considered to have realized as ordinary income in connection with the exercise. Section 83(c)(3) of the Code sets forth a special rule under which an optionee subject to the restrictions on

insider trading under Section 16b of the Exchange Act will not be taxed until the restrictions cease.

If an optionee exercises a nonqualified stock option by surrendering common stock already owned by the optionee with a fair market value equal to all or a portion of the exercise price, the optionee will not recognize any gain or loss upon the surrender of already-owned shares of common stock for an equal number of new shares. The basis and holding period of the old shares is carried over to an equal number of new shares. Gain or loss will be recognized as described above on the balance of the shares received. The basis in the balance of the shares received will be the fair market value as of the date of exercise and the holding period for such shares will commence on the exercise date. For example, assume that the executive owns 1,000 shares of stock that he had previously purchased at an exercise price of $5 a share at a time when the value was $5 a share. The shares now have a current market price of $20 a share. The 1,000 shares are now worth $20,000. He exercises an option to purchase 4,000 more shares at the previously stated exercise price of $5 per share by trading in his 1,000 shares. The employee would be deemed to have exchanged the 1,000 previously owned shares for 1,000 of the new shares in a tax-free exchange. His basis in these shares would be his original exercise price of the share, or $5 per share. (The basis would be increased by the amount, if any, of tax he paid on the spread at the time of exercise.) The 3,000 new shares that he receives would be taxed on the now current spread ($15) and his basis in those shares would be the $5 exercise price plus the $15 spread.

Upon the sale of stock acquired upon the exercise of a nonqualified stock option, the seller will realize a capital gain or loss equal to the difference between the amount realized on such disposition and the employee's basis for the shares. The employee's basis will equal the fair market value of the shares on the date he exercised the option, unless such shares were acquired with previously owned shares. In the latter case, the employee's basis will equal what the employee's basis had been in an equal number of the previously owned shares. The capital gain will be long-term or short-term, depending on the amount of time between the exercise of the nonqualified option and the sale of the shares.

Incentive Stock Options

An optionee will not recognize taxable income at the time an ISO is granted or exercised, other than potentially under the alternative

minimum tax ("AMT") as discussed below. However, if an ISO is exercised more than three months following the optionee's termination of employment for any reason except disability (in which case the three-month holding period becomes one year) or death (that is, a *disqualifying exercise*), the option will be treated as a nonqualified stock option and the optionee will recognize ordinary income in an amount equal to the difference between the fair market value of the shares on the date of exercise and the option exercise price. If an optionee exercises an ISO by surrendering common stock, the same results as discussed above with respect to nonqualified stock options will apply.

Generally, an optionee will recognize income in the year in which he or she sells or makes any other disposition (including a gift) of the shares purchased upon the exercise of an ISO. A disposition of shares will occur in the event the holder transfers legal title to those shares. However, a disposition will not occur if the holder simply transfers the shares to his or her spouse or makes certain other transfers permitted under the Code. If the optionee has held the stock for at least one year after exercise of the ISO and two years after the date the ISO was granted, the sale or disposition will be a *qualifying disposition*, and the optionee will recognize a long-term capital gain equal to the excess of the amount realized upon the sale or disposition over the option exercise price paid for the shares. The optionee will recognize a long-term capital loss if the amount realized from the sale or exchange is lower than the option exercise price paid for the shares.

If, on the other hand, an optionee sells stock acquired upon the exercise of an ISO in a *disqualifying disposition*, that is, within one year after the exercise of the ISO or within two years after the grant of the incentive stock option, the option will be treated as a nonqualified stock option, and the optionee will recognize ordinary income at the time of the disposition in an amount equal to the excess of the fair market value of the shares on the day of exercise over the option exercise price paid for those shares. Any additional gain recognized upon the disqualifying disposition will be capital gain, which will be long-term if the shares were held for more than one year following the date of exercise. If the disqualifying disposition results from a sale or exchange in which the amount realized is less than the fair market value of the shares on the day of exercise, the amount of ordinary income the optionee will recognize will be limited to the difference between the option exercise price of the shares and the amount realized on the sale or exchange. The optionee's

basis in the shares sold is the amount recognized as ordinary income upon the exercise of an ISO added to the option exercise price.

An optionee may have to pay an alternative minimum tax for the year he or she exercises an incentive stock option. The AMT is an alternate method of calculating the income tax an individual must pay each year in order to assure that a minimum amount of tax is paid for the year. The AMT, however, will be payable only to the extent that it exceeds the individual's regular income tax for the year. Generally, the difference by which the fair market value of optioned stock on the date of exercise exceeds the option exercise price (also known as the spread) which escapes the taxation to which it would have been subject if it were a nonqualified stock option, is an item of adjustment that must be taken into account under the AMT rules. The AMT rules are quite complex and their applicability will vary according to individual circumstances. Legislation has often been introduced to limit the effect of the AMT on optionees, but so far Congress has not passed any such relief.

Under proposed IRS guidance,[4] which is currently scheduled to become effective with respect to exercises of ISO or ESPP options on or after January 1, 2003, the excess of the fair market value of the shares received through the exercise of the incentive stock option over the price paid will be treated as wages subject to employment taxes (unemployment, Social Security, and Medicare taxes) but not to federal income tax withholding. Employment or withholding taxes would not apply when the employee disposes of the stock.

The proposed guidance allows the employer to select from a number of methods involving the proper withholding of such taxes. The employer can treat the wages as paid on a specified date, or over a period of time in the year of exercise. It can also choose to treat the wages as if paid on December 31.[5] This latter method would increase the number of people who already had paid the maximum social security for the year (since the Social Security Wage Base is capped) although all wages would be subject to the 1.45 percent HI (health insurance) withholding tax.[6] The IRS will also allow prepayment of the taxes by contract or the use of payroll deductions to pay the tax. There has been significant opposition to these IRS proposals, and legislation has been introduced to prevent implementation of the IRS proposals.[7]

An employer generally is not entitled to a deduction as a result of the grant or exercise of an incentive stock option. However, if the optionee recognizes ordinary income as a result of a disqualifying exercise or disposition, the employer is entitled to a deduction of an

equivalent amount in the taxable year of the employer in which the disqualifying disposition or exercise occurs.

Finally, Section 6039(a) of the Code requires that notices containing information specified by the IRS be sent to individuals when the purchase stock through an ISO plan or an ESPP. Monetary penalties apply if the notices are not provided.

Taxation of ESPPs

Like the recipient of an ISO, a participant in an ESPP does not recognize any income when he receives the option or when he exercises it and acquires the stock. Rather, he will be taxed when he sells the stock. If, at the time of option grant, the exercise price was the fair market value of the stock, the optionee will be taxed on the difference between the exercise price and the fair market value at capital gains rates if he sells the stock at least two years after the date the options was granted and at least 12 months after he exercises it. If he does not meet the holding period requirements, the spread described above will be taxed as ordinary income. If, at the time of grant, the option price was less than the stock's fair market value, the optionee must treat a portion of the amount received at the time of disposition as ordinary income. That amount is the lesser of (1) the fair market value at the time of disposition over the price paid for the stock, or (2) the fair market value of the stock at the time of grant over the exercise price.

Taxation of Stock Appreciation Rights

The grant of stock appreciation rights does not result in taxation, since the employee only has the right to receive property in the future. Most practitioners believe that there is also no constructive receipt problem with the issuance of stock appreciation rights. First, if the stock appreciation rights are issued as an alternative to an option, the employee must give up a valuable right—the option right—if he decides to exercise the stock appreciation rights. Similarly, even if the stock appreciation rights are not issued in connection with the option, the employee loses his right to future appreciation once he exercises the stock appreciation rights. (See Rev. Rul. 80-300, 1980-2 C.B. 165, PLR 8117078 (January 29, 1981).) There are certain circumstances in which the holder of stock appreciation rights might be deemed to be in constructive receipt, however; for example, if there is no future appreciation to be gained.

Amounts received by the employee upon exercise of the stock appreciation rights are taxed as ordinary income in the year of receipt. Generally the employer's deduction occurs at this time. The amount of income realized is equal to the value of the stock. Such amounts are considered wages subject to employment and FICA taxes.

Special Circumstances Affecting Taxation of Options

Companies that issue options must anticipate special rules that can affect both their deduction for the compensation element of the option and the taxation of the optionee. These include the "golden parachute" rules taxing accelerated payments upon a charge of corporate control, and the treatment of options under the Section 162(m) limitations on deductible compensation paid to top corporate officers.

Golden Parachute Rules

In certain cases, if an executive receives an increased benefit upon a "change of control" (change of owners) of the company, very generally, Section 280G of the Code provides that part of that increased benefit may be nondeductible to the company and a 20-percent excess tax on part of the benefit applies to the executive. Under these so-called golden parachute rules, these tax consequences apply if the value of the excess benefit exceeds three times the employee's "base compensation."

Often the vesting requirements for stock options are accelerated upon a change of control, so the option benefits could become part of a golden parachute arrangement. The golden parachute regulations under Section 280G discuss how to determine the value of this increased vesting and thus, whether that increased value causes the compensation to exceed three times base salary. The IRS has recently issued guidance discussing ways to value stock options for this purpose.[8]

Code Section 162(m)

Effective January 1, 1994, Section 162(m) of the Code generally limits to $1 million per individual per year the corporate deduction for compensation paid to the employer's chief executive officer and certain other officers of the employer whose compensation is

required to be reported in the Summary Compensation Table contained in the employer's proxy statement. Under Section 162(m) of the Code, compensation attributable to options that satisfy certain criteria may be considered "performance-based compensation" and as such, would be excluded from the compensation taken into account for purposes of the $1 million compensation deduction limitation. Generally, "performance-based compensation" must meet criteria—that is, the compensation is granted only if certain prescheduled formula goals are met. But because the value of an employee's stock rises and falls based on the company's stock price (which reflects corporate performances), stock options and stock appreciation rights are deemed to meet the requirements for performance-based compensation, if certain conditions are met. These conditions include the requirements that the exercise price be equal to or less than fair market value on the date of grant, and that the optionee is unprotected from a decrease in price (for example, no automatic repricing). In addition, shareholders must approve the option plan and be told the class of employees who are eligible to receive such compensation, the maximum number of shares for which grants may be made to any eligible individual, and the exercise price at grant.

Developments in Accounting and Disclosure Rules for Stock Options

The collapse of Enron has focused attention on the size and scope of stock options paid to corporate executives. In particular, concern has been expressed that the disclosure and accounting rules do not adequately illustrate the potential effect of options on a corporation's economic well-being.

The SEC recently released a rule that would require additional disclosure of options. Under Final Rule—Disclosure of Equity Compensation Plan Information (Release Nos. 33-8048, 34-45189 (December 21, 2001), a company must disclose at least annually the number of securities to be issued upon the exercise of outstanding options, warrants, and grants; the weighted average exercise price of such options, warrants, or grants; and the number of securities available for future exercise. This information must be separately listed for plans approved by shareholders and plans that are not. These new rules apply to Forms 10-K for fiscal years ending on or after March 15, 2002 and for proxy statements for shareholder meetings on or after June 15, 2002.

A more controversial issue involves a proposed accounting change that would require options to be treated as an expense of earnings purposes. APB Option 25, "Accounting for Stock Options," uses a snapshot approach that measures the compensatory value of the option based on the difference between the exercise and fair market value of the shares on the date of grant. (Often this amount is zero.) No increase in value is credited for the right to exercise the option in the future; no decrease occurs when the option has restrictions. FAS 123, issued in 1995, requires that the value of an option be based on a pricing method that takes into account the option's price on the grant date, the stock's volatility, and other factors. After much intense lobbying against the FAS 123 approach, which it had proposed as the ultimate rule, the Financial Accounting Standards Board recommended that options be valued and reported as an actual expenses to the corporation, but gave companies an alternative of listing the options in a footnote to their earnings reports. According to one commentator, of the companies in the Standard & Poor 500, only two—Boeing Company and Winn-Dixie Stores Inc.—list options as an expense. The remainder used the alternative and mentioned the options in footnote as required.[9]

Although accounting standards are not usually set by legislation, technology companies had lobbied heavily both before the FASB and on Capitol Hill to resist reporting the options as an expense. They had argued successfully that options should not be expenses because options are difficult to value and that options give start-up companies a way to compensate talented people without using scarce cash. However, even before Enron, critics had argued that the accounting method that avoided expenses distorted corporate earnings by giving the impression that certain companies—particularly those start-ups that issued options widely—were performing better than they actually were. One example is Cisco Systems, Inc., which reported income of $4.6 billion in 2000. Had options been reported as expenses, the value would have dropped to $2.74 billion.[10] Senator Carol Levin has introduced a bill that would require companies to treat options as expenses for accounting purposes if they also deduct them as compensation costs.

Conclusion

Stock options and employee stock purchase plans will continue to be a popular form of compensation, so the benefits practitioner needs to be able to understand them and to explain how they

operate. As can be seen from the bills introduced to protect their tax advantages, these benefits enjoy significant support in Congress. There will be additional pressure to require that the accounting and disclosure rules regarding options reflect the cost to the company issuing them, but a solution to that question is neither straightforward nor easy.

Notes

1. M. Sullivan, "Stock Options Take $50 Billion Bite Out of Corporate Taxes" (citing statistics from the National Center for Employee Ownership), *Tax Notes* 1396 (Mar. 18, 2002).

2. See Treas. Reg. §1.423-2(e).

3. *Hughes v. Microsoft Corp., Vizcaino v. Microsoft Corp.,* 2001 U.S. Dist. LEXIS 5976 (W.D. Wash. 2001).

4. See IRS Notice 2001-14, 2001-6 I.R.B. 516.

5. See IRS Notices 2001-72, 2001-49 I.R.B. 548; Notice 2001-73, 2001-49 I.R.B. 549.

6. See, e.g., H.R. 3762, Pension Protection Act of 2002, Section 301. This Act was passed by the House of Representatives on Apr. 11, 2002.

7. See H.R. 2695 (Rep. Houghton, R-N.Y.) and S. 1383 (S. Clinton, D-N.Y. and Roberts, R-KS).

8. See 1.280G-1, Q&A-13 and Q&A-33; and IRS Rev. Proc. 2002-13, 2002-8 I.R.B. 549.

9. See Krim, "Tech Firms Fight Shift in Rules on Options," *Washington Post* at E01 (Feb. 20, 2002).

10. Id.