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Senate Investigations Subcommittee Releases New Data on Excessive Corporate Stock Option Deductions Totaling \$52 Billion

WASHINGTON – Today, Sen. Carl Levin, D-Mich., chairman of the Senate's Permanent Subcommittee on Investigations, released new data compiled by the Internal Revenue Service (IRS) showing that corporations who issued stock options to their executives claimed 2008 stock option tax deductions that were collectively \$52 billion larger than the expenses shown on the company books for options granted during the tax year covered by the returns.

"Current stock option accounting and tax rules are out of kilter, lead to corporations reporting inconsistent stock option expenses on their financial books versus their tax returns, and often produce huge tax windfalls for companies that pay their executives with large stock option grants," said Levin. "The latest IRS data from 2008 shows that U.S. companies reduced their taxes by billions of dollars by claiming \$52 billion more in stock option tax deductions than the stock option expenses shown on their books. The figures from prior years are \$48 billion in excess stock option tax deductions in 2007; \$61 billion in 2006; and \$43 billion in 2005. The companies claiming these billions of dollars in tax deductions benefited from an outdated and overly generous stock option tax rule that produces tax deductions that often far exceed companies' reported expenses. It's a stock option tax break we can no longer afford and ought to end."

To address the mismatch between the treatment of stock options on companies' books and tax returns, Sens. Levin and John McCain, R-Ariz., have introduced S. 1491, the Ending Excessive Corporate Deductions for Stock Options Act. This legislation would curb excessive corporate tax deductions for stock options, by requiring that the corporate tax deduction for stock option compensation be no greater than the expense shown on corporate financial reports filed with the Securities and Exchange Commission.

Stock options give the holder the right to buy company stock at a set price for a specified period of time, typically ten years. Many U.S. corporate executives receive stock options as part of their pay. According to *Forbes* magazine, in 2009, the average pay of the Chief Executive Officers (CEOs) at 500 of the largest U.S. companies was \$8 million. Thirty percent of that amount, on average, came from stock options that had been cashed in for an average gain of \$2.4 million. The highest-paid CEO of 2009, from Danaher Corp., received \$954,000 in salary, \$56 million in stock awards, and \$84 million from exercising stock options.

Current accounting rules, under Financial Accounting Standard 123R, require corporations to report stock option expenses on their financial statements using the fair value of the options on the date they are granted. These rules, which took effect in 2005, are the result of more than 15 years of work by the Financial Accounting Standards Board to devise a fair

and accurate method for calculating stock option expenses. Section 83 of the federal tax code, on the other hand, provides that companies deducting stock option expenses on their tax returns use the value realized when the stock options are exercised, an event which often occurs years after the options were granted. These tax rules, essentially unchanged since 1969, have yet to be coordinated with the new accounting rules.

Because current accounting rules value stock options on their grant date, and the tax code values stock options on their exercise date, the two numbers do not match. Stock option data over the past four years shows that the resulting corporate tax deductions, taken as a whole, far exceed the expenses shown on corporate books.

This stock option data, compiled by the IRS at Levin's request, is taken from four years of M-3 tax return schedules, from 2005 to 2008, filed by large corporations required to explain the differences between what they report on their tax returns versus what they report on financial statements. The M-3 schedules include figures supplied by companies who reported one total for their stock option expenses on their tax returns and a different total on their financial statements. The data reflects actual tax return information, rather than estimates.

The latest data is taken from M-3 schedules covering corporate year-end tax returns filed between July 1, 2007, and June 30, 2008. The IRS determined that corporations deducted a total of \$86 billion during the year, exceeding the stock option expenses recorded on their books by \$52 billion. The IRS also found that the \$52 billion stock option book-tax difference was the largest single factor in reported corporate book-tax differences that year. In addition, the IRS data showed that 72 percent of the \$52 billion in excess stock option tax deductions were claimed by only 250 corporations.

The IRS data is further supported by an investigation conducted by the Permanent Subcommittee on Investigations, chaired by Levin, which examined nine specific case histories of U.S. companies that used stock options to compensate their executives. At a Subcommittee hearing in June 2007, data from the nine companies cooperating with the Subcommittee showed that, altogether, the amount of stock option tax deductions they claimed from 2002 through 2006, was about five times greater than the expenses they would have reported to the SEC if the new accounting rules had been in effect when the options were granted. These nine companies reported about \$1.2 billion in total tax deductions compared to a projected total of \$217 million in stock option expenses on their books, for a book-tax difference of about \$1 billion.

"Requiring companies to limit their stock option tax deductions to the amount of stock option expenses shown on their books would eliminate billions of dollars in unwarranted corporate tax deductions each year," said Levin. "Eliminating unwarranted and excessive corporate stock option deductions would likely produce as much as \$5 to \$10 billion annually, and perhaps as much as \$15 billion, in additional corporate tax revenues that we can't afford to lose."

"It makes no sense to have two sets of rules for expensing stock options for accounting and tax purposes," Levin added, "and it makes no sense for taxpayers to be subsidizing stock option pay for corporate executives. Our bill would eliminate this stock option double standard, end existing tax favors for stock options, and remove a federal tax policy that helps fuel sky-high executive pay. It would also produce as much as \$100 billion over ten

years in revenues needed to pay our bills and bring down the deficit.”

In addition to revising the corporate tax deduction for stock options, the bill would subject stock option pay for top corporate executives to the existing \$1 million cap on the tax deductions that publicly traded corporations can now claim for executive pay under Section 162(m) of the tax code.

Bill Summary. The bill would:

- require the corporate tax deduction for stock option compensation to be no greater than the stock option book expense shown on a corporation's financial statement;
- allow corporations to deduct stock option compensation in the same year it is recorded on the company books, without waiting for the options to be exercised;
- ensure research tax credits use the same stock option deduction when computing the “wages” eligible for this tax credit;
- make no changes to stock option compensation rules for individuals, or for incentive stock options under Section 422 of the tax code, which are often used by start-up companies and other small businesses;
- create a transition rule that would apply the new tax deduction to stock option exercises occurring after enactment, permit the old tax deduction rule to apply to options vested prior to adoption of Financial Accounting Standard 123R (June 15, 2005), and allow a catch-up deduction in the first year after enactment for options that vested after adoption of FAS 123R but before the date of enactment; and
- eliminate favored treatment of corporate executive stock options under tax code section 162(m) by making executive stock option deductions part of the existing \$1 million cap on corporate deductions that applies to other types of compensation paid to the top executives of publicly held corporations.

S. 1491 has been endorsed by the Consumer Federation of America, the Tax Justice Network- USA, OMB Watch, and the AFL-CIO. The bill was referred to the Senate Finance Committee in July 2009. No further action has been taken on the bill to date.