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PRIMER

WHAT ARE EMPLOYEE STOCK OPTIONS?

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During the past two decades, the use of employee stock options as a component of compensation has grown substantially. The jump in profitability of these options during the stock market surge from 1982 to 2000 has had a substantial impact on the federal government's budget. Since that time the decline in stock prices has raised new questions about the efficiency of the use of employee stock options as compensation. This primer, the first in a series of briefs about the role of derivatives in global finance, looks at the basic features of stock options, explaining what they are, the major types of stock options, and their respective tax and accounting implications.

WHAT ARE THEY?

In the simplest terms, employee stock options give the holder the right to buy shares of stock at a specified price during a specified term. For example, an employee is granted the right to buy 1000 shares of XYZ corporation for $20 during a period starting on January 1, 2004, and ending December 31, 2007.

COMPONENT OF EMPLOYEE COMPENSATION

Increased flexibility of business cost structures, linking workers' pay more closely to company performance, and enhancing incentives for productive behavior have all become more common practices in the hiring and compensation norms of businesses.[i] As a result, a fundamental shift in the way workers are paid has occurred (see *Primer II*), leading many to question the regulatory and fiscal implications (see *Primer III*).

Traditionally, employment compensation consisted simply of wages or salaries, often accompanied by benefits packages that included retirement, health care, and life insurance. Compensation has recently evolved to include: base wages or salaries, commissions, overtime, paid leave, tips, non-production bonuses, profit sharing, severance pay, referral bonuses, health insurance, pension and retirement, stock options, and stock purchasing plans.

The latter two have increasingly become more prevalent supplements to traditional wage and salary compensation in the past two decades, reflecting a business policy to link job performance with the firm's performance. Employee stock purchase plans, through the use of subsidized share purchases, give the employee an opportunity to share in the potential growth of the employer. Stock option plans have grown in use because of their benefits to employers as well as employees (see *Primer II*). For employers, they are attractive because they are an alternative way to aid in increasing finances due to tax and accounting implications, they align the interests of employees with those of shareholders, and they assist in attracting and retaining talent. For employees, they are attractive because they have potential for fantastic gains and they offer certain tax advantages.

The practice of aligning the interests of employees with those of shareholders is not new. Through profit sharing programs employers have been awarding bonuses and commissions for employees following success at the corporation. During times of superior company performance, profit sharing is rewarded to employees for their contributions that aided the corporations' success. During times of poor company performance, profit sharing rewarded to employees is accordingly much lower, or even non-existent. As a result, risk has been injected to employees' income according to the success of the firm.

Stock options have added another component of risk to employee compensation. The market price of a stock is related to the success of the employer, it is also inherently related to the success of the overall market and macroeconomic conditions of the economy. Accordingly, employee income is immediately and directly dependent to the overall market and macroeconomic condition of the economy, marking a deviation from traditional compensation packages.

MODIFIED "AMERICAN-STYLE" CALL OPTIONS

Most stock options granted in the United States are modified "American-style" call options, which give the employee a contractual right to buy the stock by a specified date for a specified price. The typical stock option allows the employee the right to buy (called exercising the option) a certain amount of shares at a specified price (exercise price) during a specified time period. The option holder or employee can profit by capturing the spread on the difference between the market price and the exercise price. If the market price of the stock rises above the strike price paid, then the employee can exercise his option, and buy the stock at the exercise price. The difference between the current market price and the exercise price is called the spread. If the spread is positive, the option is called in-the-money. If the spread is negative, the option is called out-of-the-money or underwater.

For simplicity, the lifecycle of a stock option can be broken into three periods: vesting, exercisable, and tax conversion. The vesting period begins when the employer grants the option to the employee as a variable component of compensation. During the vesting period, the employee is not allowed to exercise the option. The vesting period ends when the option becomes exercisable under the terms of the option agreement. During the exercisable period, the employee may exercise the option at any time. Once the option has been exercised and the employee takes ownership of the stock, several tax decisions face the employee. During this third period of tax conversion, the employee holds the exercised option until a specific amount of period of time pass between exercising the option and selling the option (normal 365 days). At the conclusion of this period, the tax implications change for the employee, who then can sell the stock and be subjected to the preferential tax treatment.

MAJOR TYPES OF STOCK OPTIONS

There are two principle types of stock options, each with their own unique set of requirements and tax consequences.

QUALIFIED STOCK OPTIONS
In General. Qualified stock options, also referred to as incentive stock options, contain explicit restrictions that result in highly structured agreements. Qualified stock options are granted to employees similar to the description outlined above. Throughout the life of the qualified option, the employee must abide by the restrictions contained in the agreement. So long as the employee abides by the restrictions of the agreement, the employee will receive preferential tax treatment.

For employees, a qualified stock option is not recognized as ordinary income tax when the option is granted or exercised, and accordingly is not subjected to any tax consequences. However, for some employees, exercising may trigger the Alternative Minimum Tax, depending upon the employee's particular situation. With qualified stock options, the employee is taxed only after selling the option stock, and for tax purposes the gain is treated as a long-term capital gain, at a rate of 20%.

If the employee violates any restrictions of the agreement, the qualified option becomes disqualified. Once disqualified, the employee will lose the preferential tax treatment associated with qualified stock options. With disqualification, the employee will recognize an appropriate federal income tax, at a maximum rate of 39.6%, as well as capital gain tax on any gains.

For employers, a qualified stock option provides no tax benefits.

Requirements. The specific requirements for qualified stock options are provided by the IRS under section 422 of the Internal Revenue Code.[ii] The qualified option must meet the requirements of the Code when granted by the employer, and must continued to be met by the employee at all times beginning from the time of the grant until it is exercised.

The highlights of the specific requirements included: the option may be granted only to employees; the employee must not own stock representing more than 10% of the voting power of all stock outstanding; the option cannot be exercised by anyone other than the option holder; the option must be granted under a written agreement; each agreement must list the restrictions placed on the exercise of the option; each agreement must set forth an offer to sell the stock at the option price; each agreement must set forth the period of time during which the option will remain open; the agreement must specifically state that the option cannot be transferred by the option holder; the option must be exercisable only within ten years of grant; and the option price must equal or exceed the fair market value at the time of grant.

NON-QUALIFYIED STOCK OPTIONS
Nonqualified stock options represent all other stock options that do not meet the statutory requirements of a qualified stock option.

For employees, a nonqualified option is taxed when the employee exercises the option. The gain on the nonqualified option is recognized as compensation, and the employee is taxed at an appropriate federal income tax, at a maximum rate of 39.6%. However, if the employee holds the stock for longer than 365 days, the treatment of the gain changes. Instead of being categorized as compensation, the gain is considered a long-term capital gain. Accordingly, the employee is taxed at the capital gains tax rate of 20% when the stock is sold, rather than at the federal income tax rate.

For employers, a nonqualified option allows a tax deduction equal to the gain recognized as compensation by the employee at the time the option is of exercised.

IMPLICATIONS

TAXES
Both employees and employers enjoy tax benefits depending upon the type of stock option granted.

1. Employees: With qualified stock options, an employee recognizes superior tax benefits than with nonqualified stock options. The option is not recognized as ordinary income tax at when the option is granted or exercised, and accordingly is not subjected to any tax consequences – the employee is taxed only upon after selling the option stock, and the gain is treated for tax purposes as a long-term capital gain, at a rate of 20%. With nonqualified stock options, an employee is taxed when the employee exercises the option. The gain on the nonqualified option is recognized as compensation, and the employee is taxed at an appropriate federal income tax, at a maximum rate of 39.6%. However, if the employee holds the stock for longer than 365 days, the treatment of the gain is considered long-term capital gain. The employee has an incentive to hold the stock for up to a year after exercising the option, thus assuming the risk of the change in the spread while waiting for tax conversion.

2. Employer: With nonqualified stock options, an employer recognizes superior tax benefits than with qualified stock options. With qualified stock options, an employer normal does not recognize any tax benefits. However, if the employee causes the qualified option to become disqualified, the employer may take a deduction for that amount recognized by the employee as ordinary income in the same year as the employee recognizes the income. With nonqualified stock options, an the IRS allows employer has a corresponding deduction as the ordinary income recognized by the employee as a compensation expense. However, this same deduction does not appear as an expense on the income statement, leading some to argue the distortive effects of allowing employers to categorize the option an expense in one circumstance, but not the other.

3. Public Interest: Numerous public concerns have been raised as a result of the tax implications of stock options. For employees, concern arises when employees assume the risk for a nonqualified option during the tax conversion period, and the stock market proceeds to turn south, resulting in large tax liabilities on paper gains never realized (see *Primer II*). For employers, the concern arises over tax equity. In 1999, companies such as Microsoft and Cisco avoiding paying federal taxes because deductions taken for nonqualified stock options exercised by employees wiped out profits for tax purposes (see *Primer III*).[iii]

ACCOUNTING

From an accounting perspective, nonqualified stock options are more beneficial to employers because of their treatment in financial reporting purposes, as qualified stock options do not provide an employer with any beneficial financial treatment.

1. In General: When nonqualified stock options are exercised, a corresponding compensation expense is deducted from the employer's tax return, thus lowering its final tax bill. The amount deducted is equal to the gain or spread between the market price and the strike price. The deduction reduces the employer's taxable income and resulting tax payment. On the cash flow statement this tax saving represents an adjustment of increased cash. However, this tax benefit bypasses the income statement (appearing only as a footnote) and instead hits the balance sheet, decreasing liabilities and increasing shareholders' equity. The tax benefit is then factored into the denominator of the earnings per share calculation, thus reducing the dilution caused by the exercise of stock options. A recent study by Bear Stearns reveals that this practice is growing, and in some cases is quite substantial.[iv]

2. Balance Sheet: The employer deducts a compensation expense on its tax return when the employer exercises the option, as permissible by the IRS. Accordingly, the employer enters a journal entry to debit taxes payable. However, according to the Financial Accounting Standards Board (FASB), the employer does not need to enter the compensation expense to its income statement. Rather, to offset this liability, the employer credits shareholders' equity. An example is depicted below.[v]

<u>Compensation Expense:</u>	<u>Corporate Tax Benefit:</u>
Number of Options Exercised: 1,000	Statutory Corporate Tax
Rate: 35%	
Exercise Price: $10	Tax Benefit = Tax Rate x
Comp. Expense	
Stock Price on Exercise Date: $100	Tax Benefit = 35% x $90,000
= $31,500	

<u>Compensation Expense for Tax Purposes:</u>
(Stock Price on Exercise Date – Exercise Price) x Number of Options Exercised =
($100-$10) x 1,000 = $90,000

<u>**Balance Sheet Impact:**</u>

Journal entry to record tax benefit of $31,500

Debit – Taxes Payable		$31,500
Credit – Shareholders' Equity	$31,500	

3. Cash Flow Statement

Although FASB does not permit the tax benefit from the exercise of nonqualified stock options to be recorded on the income statement, an adjustment has to be made to the cash flow, which is recorded on the employer's cash flow statement. However, a conflicting guidance on the subject has resulted in different treatment of the cash flow presentation of the adjustment related to the tax benefit from option exercises.

Financial Accounting Standard (FAS) No. 95 maintains that cash payments for taxes are an operating cash flow. FAS No. 125 states that if the compensation recorded on a tax return for an option grant exceeds the compensation recorded for financial reporting the related tax benefit should be recognized in the shareholders' equity. However, FAS No. 95

holds that cash proceeds from issuing equity securities are a financing inflow. In practice, Bear, Stearns & Co. claims that most companies appear to make the adjustment tin the cash flow from operations rather than financing.[vi]

4. Earnings Per Share

Even though the tax benefit does not appear on the income statement, FAS No. 128 requires that the potential tax benefit to be factored into the computation of diluted earnings per share, thus reducing the dilutive impact of stock options. The dilutive effect of stock options is illustrated below, which contains the usage of the treasury stock method (TSM). TSM is a hypothetical exercise that assumes that stock options are exercised at the beginning of the period and that the proceeds are used to repurchase the company's common stock. When applying this method, the diluted earnings per share, as calculated under FAS No. 128, is $1.92. However, if the FASB did not permit this treatment, the earnings per share in this example would be $1.89.

<u>Diluted Earning Per Share Calculation:</u>

Additional Assumptions: Shares Under Option – 50,000
Net Income - $1,000,000
Exercise Price - $20
Weighted average shares outstanding – 500,000
Average Stock Price - $50

<u>Treasury Stock Method: (FAS No. 128)</u>
Assumed proceeds from option exercise = $20 x 50,000 = $1,000,000
Assumed proceeds from option tax benefit = ($50 - $20) x 50,000 = $1,500,000 x 35% = $525,000
Total assumed proceeds = $1,000,000+$525,000 = $1,525,000
Assumed shares repurchased = $1,525,000 / $50 = 30,5000
Incremental shares = 50,000 – 30,5000 = 19,500
Total shares used in the denominator = 500,000 + 19,500 = 519,500
Diluted earnings per share = $1,000,000 / 519,500 = $1.92

5. Public Concerns

From the Bear, Stearns & Co example, one can conclude that earnings per share for employers with liberal stock option plans may lead to distortive figures. Because many investors rely upon earnings-based valuation measures such as the price-earnings ratio, many believe the accounting treatment of accounting for the valuation of stock options needs to be addressed (*see forthcoming primer on tax consequences of employee stock options.*).

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LIST OF ENDNOTES

[i] Lebow, David et al. 1999. "Recent Trends in Compensation Practices." *Federal Reserve Board Working Paper*.

[ii] Statutory requirements taken from National Center for Employee Ownership. 2000. The Stock Options Book.

[iii] Johnston, David Cay. 2000. "Study Finds That Many Large Companies Pay No Taxes." *The New York Times*.

[iv] McConnell, Pat. 2000. "Employee Stock Options: Income Tax Benefit Improves EPS and Cash Flow, Payroll Tax Expense Reduces EPS and Cash Flow." *Bear, Sterns & Co. Inc*.

[v] *Ibid*.

[vi] *Ibid*.

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