

Are Tax and Accounting Rules Discriminating against Discounted Employee Stock Options Justified?

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Abstract

Contemporaneous grants of both stock and at-the-money options to individual employees of U.S. public companies indicates demand for equity compensation packages that are in the money, i.e., packages of equity pay instruments that in aggregate have payoff profiles and incentive properties that are similar to explicit in-the-money employee stock options. However, several tax rules (and formerly accounting rules) strongly discourage grants of explicit in-the-money options, including recently enacted IRC § 409A, which essentially precludes the use of explicitly discounted options by taxing these instruments at vesting, rather than at exercise, and adding a 20% penalty tax. This article explores whether the tax and accounting distinction between discounted and non-discounted options makes sense.

The stated legislative rationales for rules discriminating against explicit in-the-money options are weak, reflecting a dichotomous view of equity compensation divided between discounted and non-discounted options, when, in fact, option design is a continuum. However, this article sets forth a novel tax policy rationale for forcing firms to bifurcate in-the-money pay packages into discrete grants of stock and non-discounted options, a combination that I refer to as a synthetic in-the-money option. In short, doing so precludes the unwarranted expansion of preferential option tax treatment to instruments resembling restricted stock.

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I. INTRODUCTION

In a variety of contexts and over a period of more than fifty years, Congress and the accounting profession have singled out discounted or “in-the-money” employee stock options, options with exercise prices less than the fair market value of the underlying stock at the time of the grant, for special, generally disadvantageous, treatment relative to non-discounted options. The purpose of this article is to begin to explore, in a preliminary way, whether this persistent distinction makes sense.

Of course, fifty years ago compensatory stock options were rarely observed and not well understood.¹ During the 1990s, however, options came to dominate executive pay at U.S. public companies and to constitute a large fraction of rank and file pay in certain high-technology industries.² Today, options remain central to corporate compensation arrangements despite recent corporate scandals involving options.³ As a result, the tax and financial accounting rules pertaining to options are of great importance economically.

What are those rules, and how do they discriminate against discounted options? Interestingly, the most fundamental and generally applicable rules concerning the taxation of compensatory options do not distinguish between discounted and non-discounted options. Assuming that a discounted option is otherwise a typical employee stock option, i.e., is not immediately exercisable, is not transferable, and is not actively traded, the option would be treated just like any other nonqualified stock option under IRC § 83 and § 1.83-7 of the Treasury Regulations – the employee would be taxed on gains at exercise and the employer would be entitled to an equivalent and contemporaneous deduction.⁴

However, this treatment is trumped by the recently enacted deferred compensation rules of § 409A. Under these rules, compensation income arising from a conventional discounted option (but not a non-discounted option) would be taxed at vesting, rather than at exercise, and would be subjected to an additional 20% penalty tax.⁵ In addition, discounted options are not eligible for the special employee-favorable tax treatment

¹ The seminal articles that led to the Black-Scholes-Merton option pricing model were published in 1973. See *infra* note 96 and accompanying text.

² See Kevin J. Murphy, *Executive Compensation*, in HANDBOOK OF LABOR ECONOMICS 2485, 2515 (Orley Ashenfelter & David Card eds., 1999) (discussing trends in CEO pay and the growing dominance of options in the 1990s); Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSPECTIVES 49, 52 (2003) (documenting the extensive use of options at “new economy” companies).

³ Stock options were obviously central to the backdating scandal that was uncovered in 2006 and they played a key role in the Enron, WorldCom, and Global Crossing scandals a few years prior. See Hall & Murphy, *supra* note 2, at 49-50 (noting the role of options in the latter three scandals).

⁴ IRC § 83; Treas. Reg. § 1.83-7. *C.I.R. v. Lo Bue*, 351 U.S. 243 (1956).

⁵ See *infra* Part III.A.2.

afforded to incentive stock options (ISOs) under the Code.⁶ Discounted options granted to senior executives do not qualify for the safe harbor available for at or out-of-the-money options under § 162(m), which generally limits employer deductions for senior executive pay that is not performance based.⁷ And, finally, prior to 2005, only discounted options resulted in a charge against earnings for financial accounting purposes.⁸

The disparate tax and accounting treatment of discounted options likely distorts corporate compensation design. Economically, in-the-money (ITM) options are not different in kind from non-discounted options. Economically, equity compensation instruments form a continuum with restricted stock – a zero exercise price option – at one end of the spectrum and far out-of-the-money options at the other. However, while grants of explicit ITM options by U.S. firms are exceptionally rare, grants of a combination of stock and at-the-money (ATM) options are quite common, reflecting significant demand by public companies for equity compensation *packages* that are effectively in the money. For example, of 200 large public company CEOs whose 2007 compensation was detailed by the New York Times in April 2008, 150 received stock grants within the fiscal year, 145 received non-discounted option grants, and 116 (58% of the total) received both.⁹

Is there a sound policy reason for discouraging firms from granting explicitly discounted options? This article argues that the distinctions the regulators drew between discounted and non-discounted options in promulgating the discriminatory rules, to the extent they can be discerned from the administrative history, were misconceived or based on now out-dated analytical limitations. Generally, the distinctions reflect a false dichotomy between discounted and non-discounted options, rather than an economic continuum.¹⁰

However, while the stated rationales are unpersuasive, I argue that rules discriminating against discounted options serve a legitimate tax policy purpose. These rules preclude the expansion of the non-qualified stock option (NQSO) and ISO regimes to instruments resembling restricted stock.¹¹

⁶ See *infra* Part III.A.3.

⁷ See *infra* Part III.A.4.

⁸ Pre-2005 GAAP required firms to expense only the discount on options existing at grant. See *infra* Part III.A.5.

⁹ See *Executive Pay: A Special Report*, N.Y. TIMES, Apr. 6, 2008, Sunday Business, at 10-11. Stock grants include conventional time-vested restricted stock, performance-vested restricted stock, and performance shares, which are economically equivalent to performance-vested restricted stock. Option grants include both conventional time-vested options and performance-vested options as well as stock appreciation rights (SARs). These instruments are described more fully in Part II.

¹⁰ See *infra* Part III.B.2.

¹¹ Stock options that do not qualify for ISO tax treatment and are instead taxed in accordance with IRC § 83 and Treas. Reg. § 1.83-7 are commonly referred to as NQSOs.

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The tax policy goals of fairness and efficiency point towards taxing equity compensation on an accrual basis consistent with cash compensation. Although administrative concerns have prevented us from reaching that ideal, deviations from accrual taxation should be minimized. The primary distinction between stock grants and NQSOs from a tax perspective is that the realization of option gains (but not stock gains) can be deferred beyond vesting and is within the (bounded) discretion of the employee. As discussed below, the opportunity to defer income recognition beyond vesting can add to the tax advantage of NQSOs relative to stock.¹² Arguably, however, there are pragmatic reasons for deferring the taxation of options beyond vesting that do not apply to stock compensation. Unlike publicly traded stock, stock options are difficult to value prior to exercise and the pre-exercise valuations that are made for accounting and disclosure purposes are highly manipulable. If firms could easily convert restricted stock grants into deeply discounted options that were respected as NQSOs and afforded standard NQSO tax treatment, this conversion could result in an unwarranted expansion of the option taxation rules.¹³

For some firms and their employees, the tax treatment of ISOs is even more favorable than that of NQSOs and is probably harder to justify as a matter of pure tax policy. Again, permitting this regime to expand to encompass deeply discounted options resembling restricted stock seems undesirable.¹⁴

Although the results were probably unintended and even though I will argue that expansion of the NQSO and ISO regimes to include instruments resembling restricted stock probably would not be disastrous

¹² Although I do not intend to reopen the question of the tax advantage of equity compensation here, this article adds to a growing body of work on the economics of deferred and equity compensation taxation. See Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986); David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B.U. L. REV. 695, (2004); Michael S. Knoll, *The Tax-Efficiency of Stock-Based Compensation*, 103 TAX NOTES 203 (2004); Ethan Yale, *Investment Risk is Important When Assessing the Tax Benefit of Deferred Compensation* (Working Paper, 2007); Daniel Halperin & Ethan Yale, *Deferred Compensation Revisited*, x TAX NOTES 939 (2007).

¹³ See *infra* Part III.C. This analysis is related, but somewhat orthogonal to the literature on taxation and financial product innovation. One theme of articles such as Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L.REV. 460 (1993) and Jeff Strnad, *Taxing New Financial Products: A Conceptual Framework*, 46 STAN. L.REV. 569 (1994) is that instruments that appear to be different, but aren't, should be taxed in the same way to preclude arbitrage. My project deals with a financial instrument, employee stock options, for which we have a special tax regime as a result of administrability concerns. The goal here should be to prevent the spread of this preferential tax regime to instruments that appear to be similar, deeply discounted employee stock options, but that really aren't, at least along the dimension that justifies the special tax regime.

¹⁴ See *infra* Part III.C.

for the public fisc,¹⁵ § 409A and the other tax and former accounting rules arguably serve a legitimate tax policy role. But in distorting compensation design, these rules create inefficiencies and impose costs on U.S. businesses. The magnitude of the efficiency loss depends on the answers to (at least) two questions: How adequately do combinations of ATM options and restricted stock, which I term “synthetic” ITM options, substitute for explicitly discounted options? Would U.S. firms issue discounted options if the tax and accounting playing fields were level?

As we will see, firms can largely replicate the incentive effects of discounted options with combinations of non-discounted options and stock, particularly with performance-vested stock grants that are discussed below.¹⁶ However, perfect economic replication is not achievable, and any special enthusiasm that employees might have for explicitly discounted options presumably would not carry over to synthetic ITM options.

The second question is even harder to answer. We do occasionally observe explicitly discounted options outside the U.S., but public companies might encounter significant investor outrage if they were to grant in-the-money options, even though restricted stock, an infinitely discounted option, does not produce outrage.¹⁷

Ultimately, at this stage of the investigation, it seems a close question whether restricting or discouraging explicitly discounted options is good policy. As a matter of *tax* policy, preventing the expansion of the NQSO and ISO tax regimes to instruments resembling restricted stock is desirable. On the other hand, although the incentive properties of explicitly discounted options can be closely replicated by synthetic ITM options that avoid the discriminatory rules, there probably is an efficiency loss in so strongly discouraging explicitly discounted options.

This article is organized as follows. Part II provides background on equity compensation theory and practice. Part III analyzes the tax treatment of discounted and non-discounted options. It reviews the stated rationales for the disparate treatment of discounted options and develops the tax policy justification outlined above. Part IV briefly considers several non-tax rationales for rules discriminating against explicitly discounted options, and Part V considers the potential efficiency cost of these rules. Part VI concludes.

¹⁵ Diversification concerns would limit the deferral of realization and tax on deeply discounted NQSOs, and even though allowing deeply discounted options to qualify as ISOs would effectively expand the maximum size of ISO grants, ISO grants presumably would remain limited. *See infra* Part III.C.4.

¹⁶ *See infra* Part V.A.

¹⁷ *See infra* Part V. B.

II. EQUITY COMPENSATION PRACTICE AND THEORY

This article is concerned with equity compensation arrangements – devices that explicitly link compensation to share price performance with the intent, in most cases, of enhancing alignment between employee and shareholder interests and facilitating the recruitment and retention of key employees. This part briefly reviews equity compensation practices at U.S. firms and some of the theory bearing on the use of equity pay. It attempts to establish two points before undertaking the tax analysis in Part III. First, firms demand ITM pay packages, a demand which at this point we will assume can be met with either discounted options or combinations of non-discounted options and stock. Second, use of ITM pay packages is consistent with finance theory.

A. Equity Compensation Instruments

Equity pay arrangements are typically described as falling into one of two discrete categories – option-like instruments or deferred stock instruments.¹⁸ In the discussion that follows, “options” should be read to include conventional time-vested employee stock options, including both NQSOs and ISOs;¹⁹ performance-vested stock options, which add a performance criterion to vesting in addition to the traditional retention criterion;²⁰ and stock appreciation rights (SARs), which are contracts, payable in shares or cash, that are economically equivalent to stock options. Options, of course, provide the holder with a right, but no obligation, to purchase shares of stock at a pre-determined strike or exercise price.²¹ Thus, the defining feature of an option is that the

¹⁸ For a more detailed overview of long-term executive incentive compensation practice at large U.S. public companies, see FREDERICK W. COOK & CO., *THE 2007 TOP 250: LONG-TERM INCENTIVE GRANT PRACTICES FOR EXECUTIVES* (2007).

¹⁹ Employee stock options generally become exercisable, or vest, in installments, often ratably across the period beginning on the first anniversary of the grant and ending on the fourth anniversary of the grant. See FREDERICK W. COOK, *supra* note 18, at 14 (providing data indicating vesting schedules of three to five years for 96% of the executive stock options analyzed). If employment is terminated prior to vesting, options generally are forfeited.

²⁰ As an example, in 2007 the CEO of Home Depot received an option grant that does not vest unless the company’s share price exceeds the grant date price by 25% for 30 consecutive trading days. See Home Depot, Proxy Statement (Form DEF 14A), at 32 (Apr. 11, 2008).

²¹ The strike price of employee stock options is almost always a fixed price specified at grant and is almost always equal to the fair market value of the stock at grant. A few firms have experimented with indexing strike prices to a basket of competing stocks or to a broad measure of the stock market, such as the S&P 500, with the idea of focusing the option payout on firm-specific performance rather than market

payoff is based on the positive difference, if any, between the share price at exercise or settlement and the strike price of the instrument. If the share price on a potential exercise date fails to exceed the strike price, the option provides zero payout.

As discussed below, the strike prices of almost all compensatory options issued by U.S. corporations are set equal to the fair market value of the company's stock on the date of the option grant. This is known as an at-the-money option. An option with a strike price less than fair market value at the date of the grant is a discounted or in-the-money option. An option with a strike price in excess of fair market value at grant is known as an out-of-the-money or, sometimes, a stretch option. The positive difference at any time between the strike price and the value of the underlying stock is labeled the option's intrinsic value, and the difference, positive or negative, is often referred to as moneyness.

In the deferred stock category, we observe conventional time-vested restricted stock that becomes nonforfeitable and unrestricted once a period of continued employment has passed;²² performance-vested restricted stock;²³ and performance shares (fka phantom stock). Performance shares are economically equivalent to performance-vested restricted stock.²⁴ Participants in performance share plans are entitled to receive shares (or the cash value equivalent) at the end of a specified period, often three years, but the number of shares actually delivered is a function of some measure of company performance, such as absolute or relative return on equity, earnings growth, etc.²⁵ In the discussion that follows, restricted stock (performance-vested or conventional) and

movements generally. See Alfred Rappaport, *New Thinking on How to Link Executive Pay with Performance*, HARV. BUS. REV. 91, 101 (Mar. – Apr. 1999).

²² Restricted stock awards may vest in installments or “cliff vest” on a single date. As in the case of options, most senior executive stock awards vest on a three to five year schedule. See FREDERICK W. COOK, *supra* note 18, at 14.

²³ Performance-vested restricted stock is analogous to performance-vested options. For example, in 2007 Moody's granted restricted stock to senior executives that vests relatively slowly, or relatively quickly, depending on growth in the company's annual operating income. See Moody's Corporation, Proxy Statement (Form DEF 14A), at 33-34 (Mar. 19, 2008).

²⁴ The difference between the two devices is that restricted stock is granted at the time of the award and is forfeited if the shares fail to vest, while performance shares are not issued until performance criteria are met. But this difference is not significant economically. For example, under either type of plan participants may be entitled to dividends.

²⁵ Northern Trust Corporation's fiscal year 2007 performance share awards are typical. Each participant was assigned a target number of shares. If the company achieves average three year earnings per share (EPS) growth of 10%, 100% of the target shares will vest at the end of three years. If EPS growth is between 8% and 10%, a fraction of the shares will vest. If EPS growth exceeds 10%, a multiple of target shares, up to 125% at 12% average EPS growth, will vest. See Northern Trust Corp., Proxy Statement (Form DEF 14A), at 46 (Apr. 15, 2008).

performance shares will be referred to as deferred stock, restricted stock, or sometimes simply stock.²⁶

B. The Mix of Stock and Options in Executive Pay Packages

This article is not concerned solely with executive compensation, but as a result of the SEC's proxy disclosure rules we have much more information on senior executive pay than we have on the pay of junior executives and rank and file employees. Moreover, while senior executives generally receive more equity pay than other employees and while equity pay usually constitutes a larger fraction of executive pay packages,²⁷ option moneyness and other design features tend to be consistent through the ranks. Thus, this section describes executive equity pay practice both as a matter of independent interest and as a proxy for corporate equity pay practices generally.

Explicitly discounted employee stock options have been rare historically and have recently disappeared entirely. In a study of options granted to CEOs of 1000 companies in 1992, Kevin Murphy found that only 3% were issued in the money.²⁸ In its most recent study of compensation practices at the 250 largest companies included in the S&P 500 Index, Frederick W. Cook & Co. found no instances of discounted options.²⁹ While a few firms issue out-of-the-money options, almost all executive options are issued at the money.³⁰

However, contrasted with the lack of diversity in option moneyness is an increasing diversity in the mix of stock and options granted to executives, which yields a broad diversity in the effective moneyness of equity compensation. Executive equity pay in the late 1990s was dominated by options, with stock grants playing a relatively modest role, but recent data indicates the growing importance of stock grants.³¹

Equity pay received by the top five executives of S&P 500 companies in 2006 is portrayed in Figure 1 below.³² Each observation represents one executive, and the y axis indicates the fraction of equity pay consisting of stock and options by ex ante value. 18% of these

²⁶ Public companies rarely issue unrestricted stock to their employees. [Add cite.]

²⁷ [Add cite.]

²⁸ See Murphy, *supra* note 2, at 2509.

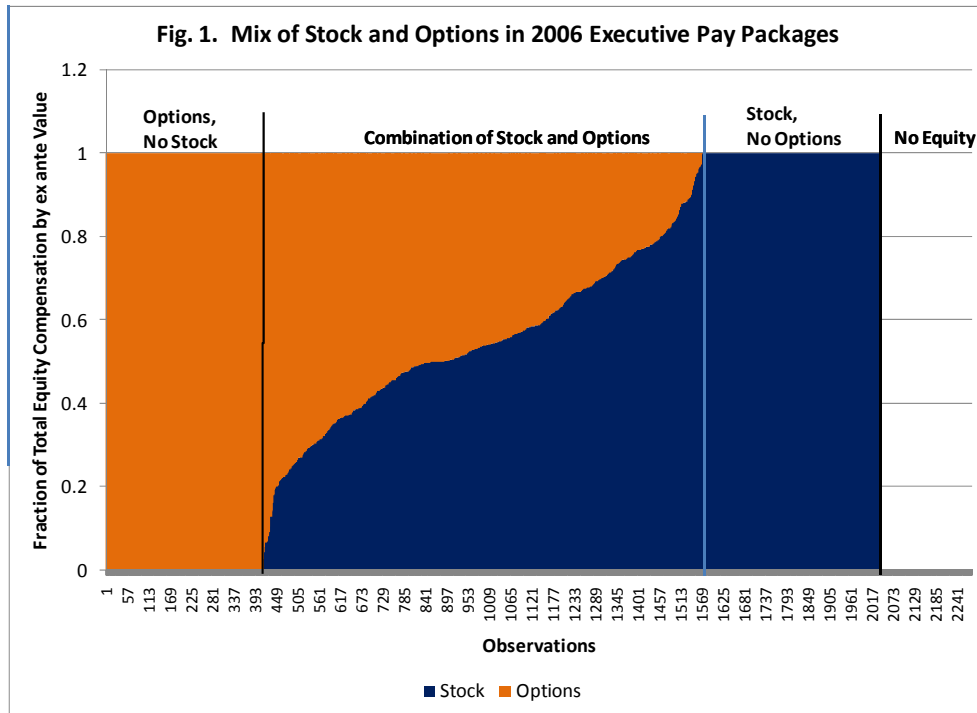
²⁹ See FREDERICK W. COOK, *supra* note 18, at 6.

³⁰ See *id.* at 6, 7; Murphy, *supra* note 2, at 2509.

³¹ See David I. Walker, *The Evolving Composition of Executive Equity Compensation: Theory and Evidence* 13 (Working Paper, Jan. 2009) (documenting a shift from an aggregate ratio of option to stock compensation for S&P 500 executives of more than 4 to 1 in the late 1990s to about a 3 to 2 ratio in favor of stock in 2006 and 2007).

³² The source of this data is Standard & Poor's Compustat database, which extracts data from corporate proxy filings. Generally, firms report compensation data for five executives. However, in some cases data is supplied and coded by Compustat for a greater or lesser number of executives.

executives received a conventional option, a performance-vested option or an SAR grant in 2006, but received no stock grant. 21% received conventional time-vested restricted stock, performance-vested restricted stock, or performance shares, but received no option grant. Strikingly, however, 51% of the executives received both a stock and an option grant in 2006, generating pay packages that were effectively in the money, but less than 100% in the money. 10% of the executives received no equity compensation grants during the fiscal year.



The correspondence between grants of both stock and options and grants of explicitly discounted options is explored in detail in Part V below. The take away point here, however, is that many U.S. executives are receiving equity pay packages that are effectively in the money.

C. Discounted Options from the Perspective of Finance Theory

The empirical data reviewed in the previous section are consistent with corporate finance theory. Finance theory teaches that 1) deferred stock and option compensation actually represent points along an economic continuum and 2) in some situations, optimal equity compensation would consist of discounted options, or combinations of stock and non-discounted options. This section briefly reviews the relevant theory.

1. The Compensatory Stock Option Continuum

Although practitioners, commentators, and regulators tend to think of equity pay as being neatly divided into stock and options, it is widely recognized in the corporate finance literature that traditional time-vested restricted stock is equivalent to an option with a zero exercise price and that equity compensation can be viewed as a continuum running from deferred stock to far out-of-the-money options.³³ The option continuum is portrayed in the following figure.

Figure 2
The Compensatory Stock Option Continuum

Option Exercise Price:	Zero	<100% of grant fmV	100% of grant fmV	>100% of grant fmV
	!		!	
	—————>			
	Deferred Stock	In-the-money option	At-the-money option	Out-of-the-money option

Absent tax and accounting concerns, finance theory suggests that firms wishing to compensate employees with equity pay would select the optimal point along the continuum to minimize agency costs and maximize profits.³⁴

2. Optimal Compensation and Equity Pay Design

Equity pay packages are designed to provide both compensation and incentives, and optimizing the design of equity pay involves a tradeoff. On the one hand, firms want to provide high-powered incentives to encourage employees to work hard and to take on risky projects.³⁵ As one moves to the right along the continuum portrayed in Figure 2, the sensitivity of pay to stock price performance increases and the incentives

³³ See, e.g., Oded Palmon et al., *Optimal Strike Prices of Stock Options for Effort-Averse Executives*, 32 J. BANKING & FIN. 229, 230 (2008) at 230; Gerald A. Feltham & Martin G.H. Wu, *Incentive Efficiency of Stock versus Options*, 6 REV. ACCT. STUD. 7, 8 (2001).

³⁴ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (classic exposition of agency costs in the firm setting).

³⁵ Executives and other employees, whose financial and human capital generally is over-invested in their companies, tend to disfavor risky projects relative to diversified shareholders. See Brian J. Hall, *Six Challenges in Designing Equity-based Pay*, 15 J. APPLIED CORP. FIN. 21, 29 (2003).

become more high-powered.³⁶ On the other hand, pay packages have to be mutually acceptable, and employees, who cannot easily diversify, apply large discounts to high-powered incentive arrangements that provide very risky pay, creating a gap between the cost of such pay arrangements to shareholders and their value to employees.³⁷ The optimal pay arrangement balances incentive generation with risk bearing costs.

The optimal design of these contracts has been studied extensively by corporate finance researchers.³⁸ The following description barely scratches the surface of this literature but should be sufficient for placing the material that follows in context.³⁹

Ideally, employee, firm, and market characteristics should all be considered in determining the optimal moneyness of equity compensation. Numerous employee characteristics have been modeled by finance theorists, but risk aversion appears to be the most important, and certainly the most frequently modeled, individual trait.⁴⁰ A highly

³⁶ The sensitivity of option value to stock price movements is denoted as option delta. The effect of moneyness on option delta will be explored in greater detail in Part V.

³⁷ See Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 5 (2002).

³⁸ Although this section considers equity compensation within an optimal contracting framework, it should be noted that there are other possible explanations for the prevalence of equity-based pay in the U.S. executive suite, including the accounting preference for ATM options discussed *infra* notes 87-93 and accompanying text, as well as competing/complementary theories of how executive pay arrangements are determined. See Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (proposing a managerial power theory of the executive pay setting process); LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* (2004) (same).

³⁹ For a fairly recent overview of the finance literature on equity compensation within an optimal contracting framework, see John E. Core et al, *Executive Equity Compensation and Incentives: A Survey*, FRBNY ECON. POL'Y REV., Apr. 2003, at 27.

⁴⁰ Studies examining risk aversion alone or in combination with other factors include Brian J. Hall & Kevin J. Murphy, *Optimal Exercise Prices for Executive Stock Options*, 90 AM. ECON. REV. 209 (2000); Hall & Murphy, *supra* note 37; Yisong S. Tian, *Too Much of a Good Incentive? The Case of Executive Stock Options*, 28 J. BANKING & FIN. 1255 (2004) [hereinafter Tian (2004)]; Yisong S. Tian, *Optimal Contracting, Incentive Effects and the Valuation of Executive Stock Options* (Working Paper, Apr. 30, 2001) [hereinafter Tian (2001)]; Richard A. Lambert & David F. Larcker, *Stock Options, Restricted Stock, and Incentives* 23 (Working Paper, 2004), available at <http://ssrn.com/abstract=527822>; Ingolf Dittmann & Ernst Maug, *Lower Salaries and No Options? On the Optimal Structure of Executive Pay*, 62 J. FIN. 303, 308 (2007); Feltham & Wu, *supra* note 33, at 6.

Other characteristics that have been modeled include loss aversion, effort aversion, overall wealth, firm equity held, and outside investment opportunities. See, e.g., Anna Dodonova & Yuri Khoroshilov, *Optimal Incentive Contracts for Loss-Averse Managers: Stock Options versus Restricted Stock Grants*, 41 FIN. REV. 451 (2006) (loss aversion); Palmon et al., *supra* note 33, at 230 (effort aversion); Tian (2001), *supra* note 40 at 40 (effort aversion, overall wealth, firm equity held, and

risk averse optionee will more greatly discount options with more remote payoff prospects. Thus, as risk aversion increases, the optimal design shifts in the direction of stock.⁴¹ Firm characteristics that have been modeled revolve around the firm's opportunity set, the marginal productivity of effort,⁴² desired riskiness of projects,⁴³ and leverage.⁴⁴ Firm leverage, for example, should be positively correlated with moneyness, as, all else being equal, increased leverage increases the risk of the option contract.⁴⁵ The overall market environment affects optimal exercise prices in a similar fashion, i.e., market volatility should be positively correlated with moneyness.⁴⁶

Depending on firm and employee characteristics (and on model specifications), researchers have concluded that the optimal equity compensation design ranges from far in-the-money options (i.e., restricted stock) to far out-of-the-money options.⁴⁷ Many studies have concluded, however, that within a certain range of assumptions, in-the-money options with positive exercise prices would be optimal.⁴⁸ These studies suggest that the ITM pay packages documented in the previous section are not accidental.

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outside investment opportunities); Dittmann & Maug, *supra* note 40, at 308 (effort aversion); Feltham & Wu, *supra* note 33, at 6 (effort aversion).

⁴¹ See, e.g., Tian (2001), *supra* note 40, at 32; See also Hall, *supra* note 35, at 31 (noting that under plausible assumptions, the “value-to-cost discount for stock is two to three times less than that of” ATM options).

⁴² See, e.g., Lambert & Larcker, *supra* note 40, at 3.

⁴³ See, e.g., Chongwoo Choe, *Leverage, Volatility and Executive Stock Options*, 9 J. CORP. FIN. 591, 593 (2003) [hereinafter Choe (2003)]; Chongwoo Choe, *Maturity and Exercise Price of Executive Stock Options*, 10 REV. FIN. ECON. 227, 229 (2001) [hereinafter Choe (2001)].

⁴⁴ See, e.g., Choe (2003), *supra* note 43, at 593; Choe (2001), *supra* note 43, at 229.

⁴⁵ See, e.g., Choe (2003), *supra* note 43, at 593.

⁴⁶ See Lambert & Larcker, *supra* note 40, at 3.

⁴⁷ Compare Hall & Murphy, *supra* note 37, at 26-27 (concluding that “when existing compensation is adjusted, incentives are maximized through restricted stock grants rather than options”) and Dittmann & Maug, *supra* note 40, at 305 (reporting results of a model indicating that CEOs should receive restricted stock instead of options) with Lambert & Larcker, *supra* note 40, at 2 (“exercise price in the optimal contract is frequently far ‘out of the money’”).

⁴⁸ See Tian (2004), *supra* note 40, at 1227 (“incentive-maximizing exercise price is typically greater than zero but less than the stock price”); Palmon et al., *supra* note 33, at 230-231 (simulations suggest that options are optimally granted in the money); Tian (2001), *supra* note 40, at 32 (arguing that the optimal option design ranges from at the money to deep in the money, i.e., restricted stock, depending on degree of risk aversion).

This part analyses the disparate tax and financial accounting treatment of discounted options and is the core of the article. Given its length, it may be helpful to begin with a preview and a roadmap.

IRC § 83, the § 83-7 Treasury Regulations, and the case law on nonqualified employee stock options make no distinction between discounted and non-discounted options. Nor do the current financial accounting rules applicable to U.S. public corporations. However, as Section A of this part describes, several specific tax rules, including the recently promulgated rules and regulations under IRC § 409A, do distinguish between discounted and non-discounted options. So too did the accounting rules in force prior to 2005. These specific rules arguably have distorted compensation design, blocking the use of explicit ITM options and channeling equity compensation into the distinct streams documented in Part II – stock grants and ATM options.

There is no suggestion in the legislative history that this result was achieved by design, and, as Section B describes, the stated rationales in the regulatory histories for the rules restricting option discounting reflect a false dichotomy between discounted and non-discounted options.

Although the stated rationales are unpersuasive, one can argue that rules discouraging grants of discounted options represent good tax policy nonetheless, in that they prevent unwarranted expansion of the NQSO and ISO regimes in the direction of restricted stock. Section C lays out the argument.

In brief, the NQSO story is as follows: Under current law, equity compensation can be tax advantaged versus the accrual or cash compensation ideal. The tax advantage arises from exemption of investment returns on the equity instruments conferred. For stock grants, the exemption lasts until vesting; for NQSOs, the exemption extends to exercise. The additional period of deferral enhances the tax advantage of NQSOs relative to stock. Taxing the fair value of options at vesting would be consistent with stock taxation and would eliminate the additional tax advantage of options, but doing so would require the use of option pricing models, which arguably are not sufficiently reliable in this service and which are highly manipulable. Taxation of stock grants at vesting raises no valuation or manipulation issues (at least with respect to public company issuers). Absent rules such as § 409A, firms could achieve NQSO taxation on instruments resembling restricted stock by issuing deeply discounted options instead. The crux of this argument is that the NQSO rules reflect a pragmatic accommodation for options that should not be extended to stock.

A similar story could be told about preserving the sanctity of the ISO rules, but in my view the ISO regime is less defensible than the NQSO regime to begin with. Thus, any expansion of the ISO regime would be regrettable in my view.

This part also considers the impact of expanding the NQSO and ISO regimes to include deeply discounted options under current law (Section C.4) as well as in the presence of a special tax on deferred and equity compensation investment returns as proposed by Professor Halperin (Section C.5).⁴⁹ It also briefly considers whether, aside from cabining the NQSO and ISO regimes, the specific tax rules discriminating against discounted options are sensible within their own terms (Section D).

A. Tax and Accounting Treatment of Discounted and Non-Discounted Options

The primary aim of this section is to document the disparate treatment of discounted options under the Internal Revenue Code and under pre-2005 GAAP. However, the taxation of restricted stock will become important later in the analysis. Thus, this section begins by describing the taxation of both stock and options under IRC § 83 and the § 1.83-7 regulations. As will be evident, these provisions, as well as § 409A, are aimed at reaching the appropriate tax result for compensation. The other tax provisions that I will discuss – § 162(m) and the ISO rules – serve other aims, at least in part. The accounting rules are intended to determine the appropriate amount and timing of book expense recognition related to equity compensation.

1. IRC § 83 and Treasury Regulation 1.83-7

The starting point for analysis of the taxation of equity compensation is IRC § 83. That section provides that the value of property received in exchange for performance of services is includable in income when the property is transferable or no longer subject to a substantial risk of forfeiture. In the absence of a taxpayer election under IRC § 83(b),⁵⁰ the application of § 83 to restricted stock is straightforward. Recipients of restricted stock are taxed, at ordinary income rates, on the value of their shares (less any amount paid for them) at vesting, i.e., when the shares are no longer subject to a substantial risk of forfeiture.⁵¹ The employer is entitled to a corresponding and contemporaneous deduction.⁵²

⁴⁹ Although I do not intend to reopen the general question of the appropriate tax treatment of equity compensation in this article, consideration of the larger picture is to some extent unavoidable. Given the descriptive focus of my project, however, my baseline is the current tax regime.

⁵⁰ If an election is made under IRC § 83(b), the fair market value of the property at grant, ignoring any restrictions that will lapse, over the amount paid, if any, is included in income in the year of the transfer.

⁵¹ Taxation occurs at vesting even if the shares are subject to a further contractual restriction on transfer. Under the Treasury Regulations, restricted property becomes includable in income when it becomes transferable or is no longer subject to a substantial risk of forfeiture, whichever occurs first. *See* Treas. Reg. § 1.83-1(a)(1) & -3(b). *See also* Sakol v. C.I.R., 574 F.2d 694 (2d Cir. 1978) (rejecting constitutional challenge to the application of § 83 to include full restricted stock gain at vesting in

Per IRC § 83 and Treasury Regulation § 1.83-7, recipients of NQSOs typically are taxed on the intrinsic value or option “spread” at exercise at ordinary income tax rates.⁵³ The employer, again, is entitled to a corresponding and contemporaneous deduction.⁵⁴ Option taxation is deferred until exercise even if the instrument vests at grant or vests in the interim between grant and exercise. Compared with stock awards, options permit employees to defer taxation beyond vesting and to control the timing of realization, between the contractual bounds of vesting and expiration.

IRC § 83 and Regulation § 1.83-7 make no distinction between discounted and non-discounted options. NQSO taxation occurs at exercise unless the option has a readily ascertainable fair market value (RAFMV) at the time of grant, in which case it would be taxed at grant.⁵⁵ Unless the option is actively traded on an established market (for employee stock options virtually a null set), an option has a RAFMV at grant only if the option is transferable, the option is immediately exercisable, neither the option nor the underlying stock is subject to any other significant restrictions, and the option value is readily ascertainable.⁵⁶ Needless to say, perhaps, few employee options meet all of these tests and are taxable at grant. Moreover, even if a discounted option met the first three tests, the fact that it was granted in the money would not necessarily mean that it had a RAFMV. As the regulations note, the total value of an option at any time includes both its intrinsic value and the value of the option privilege – the opportunity to benefit from further increases in stock price without risking capital.⁵⁷

Although § 83 and the regulations fail to distinguish between discounted and non-discounted options, it is possible that a court might disregard the option label applied to a deeply discounted NQSO, treating the instrument as restricted stock, which would result in taxation at vesting. However, there is considerable judicial authority, going back at least to *LoBue*,⁵⁸ respecting the option characterization and taxing discounted options at exercise.

income despite restriction on transfer that continued for several years). However, if the sale of vested shares would trigger § 16(b) of the Securities Exchange Act, taxation is deferred until that restriction is lifted. *See* IRC § 83(c)(3).

⁵² IRC § 83(h). The taxation of performance shares is analogous.

⁵³ Recall that intrinsic value or spread at any time is the difference between the fair market value of the underlying stock and the option’s exercise price.

⁵⁴ IRC § 83(h).

⁵⁵ Treas. Reg. § 1.83-7(a).

⁵⁶ Treas. Reg. § 1.83-7(b)(2). *See also*, *Cramer v. C.I.R.*, 64 F.3d 1406 (9th Cir. 1995) (rejecting challenge to the 1.83-7(b)(2) regulation as an invalid interpretation of IRC § 83).

⁵⁷ Treas. Reg. § 1.83-7(b)(3).

⁵⁸ *C.I.R. v. LoBue*, 351 U.S. 243 (1956).

Philip LoBue received discounted options on his employer's stock in the 1940s.⁵⁹ In litigation pre-dating the promulgation of IRC § 83, the Tax Court concluded that the options were non-compensatory and that the stock would be taxed like any other arm's length bargain purchase, i.e., LoBue would take a cost basis in the shares purchased through exercise of the options and recognize gains when the shares were ultimately sold.⁶⁰ The Supreme Court reversed but was split on the appropriate treatment. In dissent, Justice Harlan (joined by Justice Burton) argued that it was appropriate to tax LoBue on the option spread at grant, for the options that vested immediately and otherwise on the spread existing at vesting.⁶¹ Under Harlan's scheme, presumably, the grant/vesting date spread would also be treated as basis; exercise would not be a taxable event; but the amount paid to exercise the option would be added to cost basis.⁶²

The *LoBue* majority followed the Treasury's practice of taxing compensatory options at exercise, consistent with other bargain purchases in the employment context.⁶³ The majority noted that an option that had a RAFMV at grant, was transferable at grant, and (implicitly) was immediately exercisable, might result in grant date taxation, but those were not the facts of *LoBue*.⁶⁴

⁵⁹ Reportedly, the exercise prices on some of LoBue's options were about 25% of the grant date fair market value of the underlying stock, i.e., those options were about 75% in the money at grant. See Judith E. Alden & Murray S. Akresh, *Using Equity to Compensate Executives*, in EXECUTIVE COMPENSATION 67, 188 (Yale D. Tauber & Donald R. Levy eds., 2002).

⁶⁰ See *LoBue*, 351 U.S. at 245-46.

⁶¹ See *id.* at 250-52.

⁶² See *id.* at 252 (Harlan J. concurring in part and dissenting in part) (stating "I would hold the granting [/vesting] of the options to be the taxable event and would measure the income by the value of the options when granted.")

Justice Harlan is not explicit, but his analysis implies that the intrinsic value or spread of the option at vesting would be the measure of compensation taxable as ordinary income. If so, his approach would mirror that of the ISO rules discussed below. For example, suppose a firm issues an at-the-money option that vests immediately. Under Harlan's approach, the recipient would have zero compensation income (and hence the firm would have zero deduction); the employee would have zero basis prior to exercise; and the entire gain would be treated as capital gain.

⁶³ See *id.* at 249. The Treasury's general approach to compensatory bargain purchases goes back at least to 1923. See T.D. 3435, 1923-1 C.B. 50. However, that approach was not as uniform as the *LoBue* opinion suggests. See *LoBue*, 351 U.S. at 249 ("uniform Treasury practice since 1923 has been to measure the compensation ... at the time the option is exercised"). Prior to 1950, in response to conflicting judicial decisions, the Treasury had twice reversed its position on the taxation of stock options and thus returned to exercise date taxation. See *President's 1963 Tax Message: Hearings before the H. Comm. on Ways and Means*, 88th Cong. 463 (1963) [hereinafter *President's 1963 Tax Message*] (testimony of Hon. C. Douglas Dillon, Secretary of the Treasury) (providing a succinct history).

⁶⁴ See *LoBue*, 351 U.S. at 249.

In the years since *LoBue*, its approach has been adopted by the Treasury in its regulations,⁶⁵ and courts have followed quite literally, even in cases in which options were deeply discounted.⁶⁶ Cases in which grant date taxation has been imposed are rare, but not non-existent. In *Morrison v. CIR*,⁶⁷ the Tax Court followed the regulations in holding that the receipt of an option was a taxable event. The option in that case was freely transferable and immediately exercisable, and neither the option nor the underlying stock was subject to significant restrictions.⁶⁸ Moreover, because the fair market value of the underlying stock at grant was \$300/share and the option carried a \$1/share exercise price, the court concluded that the option had a RAFMV, i.e., \$299.⁶⁹

Modestly, the court in *Morrison* respected the option characterization, but found that grant date taxation was dictated under the regulations. Arguably, the court could have reached the same result by disregarding the option characterization and considering the transaction effectively a grant of stock, taxable under the general rule of § 83. Given the precedents, however, it seems unlikely that a court would disregard option characterization unless the instrument was so deeply discounted as to be effectively equivalent to a grant of stock, and perhaps not even then.⁷⁰

2. IRC § 409A

IRC § 409A, enacted in 2004, modifies the tax treatment of discounted employee stock options in a fundamental way. Under § 409A, vested deferred compensation (defined broadly) that runs afoul of certain requirements is currently includable in income and subject to an additional 20% penalty tax.⁷¹ Congress enacted § 409A in an effort to

⁶⁵ See Treas. Reg. § 1.83-7; see also John L. Utz, Tax Mgmt. (BNA), Nonstatutory Stock Options A-8,9 (2001) (noting that *LoBue* “provided the framework” for the regulations, which, in addition, adopted the Court’s “readily ascertainable market value” phrasing).

⁶⁶ See, e.g., *Graney v. U.S.*, 258 F.Supp. 383 (S.D. W. Va. 1966) (respecting option characterization of employee’s right to purchase stock for \$25/share granted when the underlying stock was valued at \$75/share); *Victorson v. CIR*, 326 F.2d 264 (2d Cir. 1964) (upholding option characterization of underwriters’ right to purchase for \$0.001/share stock otherwise sold in a public offering at \$0.50/share). To be sure, in each of these cases, the taxpayer was arguing ex post against its own ex ante option characterization.

⁶⁷ 59 T.C. 248 (1972).

⁶⁸ *Id.* at 260.

⁶⁹ *Id.* at 261.

⁷⁰ At one time, at least, the IRS was more concerned than the courts about the taxation of deeply discounted options. See Rev. Proc. 89-22, 1989-1 C.B. 843 (as amended by Announcement 89-42, 1989-13 I.R.B. 53) (announcing discounted options as a topic of study and suspending advance rulings pending published guidance). However, no published guidance was issued.

⁷¹ See IRC § 409A(a).

combat what it viewed as improper deferrals of income for tax purposes, principally arrangements that provided individuals with security of future payment (such as offshore rabbi trusts) and/or sufficient control to allow them to minimize the risk of nonpayment (such as provisions permitting early withdrawal of deferred compensation with a penalty or “haircut”).⁷²

Although restricted stock and options could be viewed as providing for deferral of compensation, and hence as subject to § 409A, the regulations provide safe harbors for both instruments.⁷³ However, the option safe harbor is narrowly drawn to exclude discounted options.⁷⁴ As a result, while the provision has no effect on income inclusion associated with non-discounted options, under § 409A compensation arising from conventional discounted options would be included at vesting and subjected to a 20% penalty tax, regardless of when the options are ultimately exercised.⁷⁵

Of all the tax and accounting rules this article considers, § 409A is probably the measure that most strongly discourages explicit grants of

Section 409A has been a source of great consternation for the corporate bar. The cost of non-compliance is large, and the regulations implementing the provision are so extraordinarily detailed and complex that they ultimately “fail to provide effective guidance.” Michael Doran, *Time to Start Over on Deferred Compensation*, 118 TAX NOTES 1311, 1313 (2008) (recommending that the existing § 409A regulations be withdrawn and replaced with more focused guidance).

⁷² See H.R. REP. NO. 110-658 (2008) (modifying § 409A and discussing its purposes).

⁷³ See Treas. Reg. §§ 1.409A-1(b)(5)(i)(A) & 1.409A-1(b)(6)(i). There is no safe harbor, as such, for performance shares, but no income is includable under § 409A until the income is no longer subject to a substantial risk of forfeiture. As long as income inclusion under a performance share plan occurs at the time that the performance conditions are satisfied and the shares are delivered to the employee, these plans do not present a concern under § 409A.

⁷⁴ See *id.* § 1.409A-1(b)(5)(i)(A)(1).

⁷⁵ Under § 409A, discounted options are considered deferred compensation. See *id.* § 1.409A-1(b)(5)(i)(C). Plans providing conventional discounted options do not comply with the provisions of § 409A because the holder controls the timing of realization. See IRC § 409A(a)(2) (listing permissible plan distribution events as including only termination, death, disability, a predetermined fixed date, change in control, and unforeseeable emergency). As a result, compensation arising from conventional discounted options would be includable when the income is no longer subject to a substantial risk of forfeiture, i.e., at vesting. See *id.* § 409A(a)(1)(A). And the penalty tax would apply. See *id.* § 409A(a)(1)(B). The measure of compensation is not specified in the statute and regulations on this point have not been promulgated, but presumably some measure of fair value at vesting would be employed.

Of course, another way of avoiding the harsh consequences arising from option discounting under § 409A would be to eliminate employee discretion over exercise timing. A European option that was exercised on a fixed date, say ten years from grant, would presumably satisfy § 409A and avoid accelerated taxation. Given the loss of discretion, however, it seems likely that employees would greatly discount European options.

ITM options.⁷⁶ Section 409A essentially compels firms wishing to create in-the-money equity pay packages to bifurcate these packages into grants of stock and non-discounted options.

3. Statutory Stock Options

If holding period requirements are met, recipients of incentive stock options (ISOs) incur no regular income tax obligation at exercise, but instead pay tax at capital gains rates on gains from ISO transactions when they sell the underlying shares.⁷⁷ From the recipient's point of view, this tax treatment beats that of NQSOs – the employee is able to defer tax beyond exercise and pay tax at what have generally been reduced capital gains rates. The employer, however, is not entitled to a tax deduction for an ISO and, thus, ISOs are not necessarily tax advantaged from a global (i.e., employee plus employer) tax perspective.⁷⁸ In fact, at current top marginal individual and corporate tax rates, ISOs are inferior to NQSOs from a global tax perspective.⁷⁹ However, if a firm faces a low effective marginal tax rate, perhaps because of accumulated losses, ISOs can be tax advantaged, and we often see start-up firms employing ISOs.⁸⁰

There are a number of rules that restrict the use of ISOs. One of these rules is that the exercise price of an ISO cannot be less than the fair market value of the underlying stock on the date of the grant.⁸¹ In other words, ISOs cannot be granted in the money.

⁷⁶ See FREDERICK W. COOK & CO., *supra* note 18, at 6 (stating that “[d]iscount stock options have disappeared because there are adverse tax consequences under the new deferred compensation rules (IRC Section 409A)”).

⁷⁷ See IRC § 421(a). This description assumes, of course, that the employee enjoys a gain. Unlike NQSO transactions, ISO transactions can result in losses, which are treated as capital losses.

Note that no gain goes untaxed under the ISO rules. The employee-level tax advantage versus NQSOs arises from conversion of ordinary income into capital gain. Assume, for example, that an option has a \$100/share strike price, that the shares are worth \$300 each at exercise, and that the stock is ultimately sold for \$600/share. If an NQSO, the employee would recognize \$200/share ordinary compensation income at exercise and \$300/share capital gain on sale of the stock. If an ISO, the entire \$500/share gain would be capital gain. The ISO regime also permits deferral of tax on options beyond exercise to the sale of the underlying shares, but this is only advantageous if option expiration is approaching and the optionee has a non-tax reason for holding the underlying shares post-exercise, such as minimum stock ownership guidelines. Note, however, that the spread on an ISO at exercise (the difference between the then fair market value of the shares and the exercise price) is an adjustment for purposes of computing alternative minimum tax. See *id.* § 56(b)(3).

⁷⁸ See MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY 229 (3d ed. 2005).

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ See IRC § 422(b)(4). In addition, recipients must be employees and hold less than 10% of the companies shares, expiration cannot exceed ten years, and the

4. IRC § 162(m)

IRC § 162(m) limits public company tax deductions for certain senior executive compensation to \$1 million per executive per year.⁸² However, the statute provides an exception for performance-based pay, which is fully deductible. Generally, in order to qualify as performance based, an element of compensation must be payable solely as a result of the attainment of performance goals that are pre-established by an independent committee of outside directors, are included in a shareholder approved plan, and are certified as having been satisfied by the independent committee.⁸³

However, the regulations provide a safe harbor for stock options that deems options to be performance based if granted by the firm's compensation committee in accordance with a plan meeting certain minimal requirements.⁸⁴ But there is another potential bar to reaching the safe harbor – the option may not be in the money.⁸⁵ To be sure, this does not mean that ITM options and restricted stock cannot qualify as deductible performance-based pay, only that, in order to qualify, discounted options and stock must be subjected to specific performance criteria, whereas non-discounted options essentially qualify automatically.⁸⁶

To this extent, then, the contours of the § 162(m) safe harbor discourage the issuance of explicitly discounted options to senior executives. However, the effect of § 162(m) on discounted options should not be overstated. Today, given § 409A, discounted options are off the table in any event. Nonetheless, § 162(m) clearly represents another instance of tax rules discriminating against discounted options.

5. Corporate Financial Accounting

option must be issued under a shareholder approved plan. Also, the size of annual ISO grants to particular employees is limited.

⁸² IRC § 162(m)(1)-(3). Generally, § 162(m) applies to the compensation of a company's CEO plus the four most highly compensated executives other than the CEO.

Financial institutions participating in various aspects of the 2008 financial rescue effort face even more stringent limits on deductibility of senior executive pay. Firms affected may deduct no more than \$500,000 of compensation per executive per year and there are no exceptions for performance based pay. See Treasury Announces Executive Compensation Rules Under the Emergency Economic Stabilization Act, U.S. Dep't of the Treasury Press Release, Oct. 14, 2008.

⁸³ IRC § 162(m)(4)(C).

⁸⁴ Treas. Reg. § 1.162-27(e)(2)(vi).

⁸⁵ *Id.*

⁸⁶ IRC § 162(m) partially explains the increasing popularity of performance shares. As noted, these instruments are economically equivalent to performance vested restricted stock and, although they do not fall within a safe harbor, they are easily qualified as performance based within the regulations.

Prior to 2005, financial accounting for equity compensation was controlled by a standard issued in 1972 by the Accounting Principles Board (APB), a regulator that predated the present Financial Accounting Standards Board (FASB).⁸⁷ Under the 1972 standard, firms were required to recognize as compensation expense the intrinsic value of an option on the date of grant.⁸⁸ That expense was accrued ratably over the option vesting period, and at that point the books on the option were closed.⁸⁹ There was no requirement to update the expense as the intrinsic value of the option fluctuated over time. As a result, no expense was recorded at any point for non-discounted options, because, by definition, these options had zero intrinsic value on the date of grant.⁹⁰

Although the intrinsic value method of accounting for option expense was inadequate, unlike some of the tax rules we have seen, it was not discontinuous. The method undervalued *all* equity instruments except for restricted stock. It incorrectly valued ATM options and out-of-the-money options equally (at zero). But along the continuum ranging from at-the-money options to restricted stock, the intrinsic value method resulted in a continuous, decreasing undervaluation of equity compensation expense.⁹¹ This accounting treatment discouraged firms from granting either discounted options or restricted stock and accounts, in part, for the boom in ATM options issued in the 1990s.⁹²

In 2004, the FASB promulgated a standard requiring all firms to expense the grant date fair value of all equity compensation

⁸⁷ See ACCT. PRINCIPLES BD., OPINION NO. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES (1972) [hereinafter APB 25]. The relevant substance of APB 25 actually originated in an Accounting Research Bulletin issued in 1953. See *infra* notes x-y and accompanying text.

⁸⁸ See *id.* para. 10.

⁸⁹ See *id.* para. 12.

⁹⁰ The FASB attempted to rationalize equity compensation accounting in the 1990s, but they only succeeded in implementing an elective regime that effectively left the 1972 standard in place while requiring firms to include pro forma earnings statements reflecting “fair value” accounting for options in the footnotes to their financials. See FIN. ACCT. STD. BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123 (Oct. 1995). Fair value was and is defined as the value arrived at through use of the Black-Scholes-Merton option pricing model or another appropriate model.

⁹¹ The value of an option at any time is the sum of the option’s intrinsic value and the value of the option privilege. The value of an ATM option is 100% option privilege. The value of deferred stock is 100% intrinsic value. The relationship of intrinsic value to option privilege between these poles is not linear, but it is continuous. See RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 577-581 (8th ed. 2006).

⁹² See David I. Walker, *Financial Accounting and Corporate Behavior*, 64 WASH. & LEE L. REV. 927, 954-57 (discussing evidence).

instruments.⁹³ This standard eliminated the accounting bias in favor of non-discounted options.

B. Stated Rationales for the Disparate Treatment of Discounted Options are Unpersuasive or Outdated

What accounts for the disparate treatment of discounted options under the tax and accounting rules? Although the legislative histories behind the tax provisions should certainly be taken with a grain of salt,⁹⁴ they seem a reasonable place to begin an exploration of the tax distinctions. Unfortunately, we will see that the stated legislative rationales are unpersuasive, reflecting a false dichotomy between discounted and non-discounted options, rather than an economic continuum. We will also observe, by taking the tax provisions chronologically, a general decline over time in the efforts taken to justify the disparate treatment, which might suggest path dependence, or more bluntly, that disparate treatment of discounted options has become an unthinking reaction in tax writing committees.

However, I will begin this section by reviewing the accounting story, which is somewhat clearer. The disparate treatment of discounted options under GAAP prior to 2004 apparently reflected limitations of technology and politics.

1. Corporate Financial Accounting

For many years, the majority view of the accounting profession has been that: 1) stock options are an element of compensation and should be recognized as an expense on the income statement, 2) ideally, the amount of the expense should be determined at grant when the options are transferred, and 3) conceptually, the amount of the expense that should be recognized is the fair market value of the option at grant.⁹⁵ Since 2004, GAAP has reflected these precepts, and as a result, the accounting rules are neutral with respect to the intrinsic value of options at grant. But why wasn't the playing field leveled earlier?

In part, the answer is technology. The accounting profession began grappling with this issue well before Black, Scholes, and Merton figured out how to value stock options in the early 1970s.⁹⁶ In establishing the

⁹³ See FIN. ACCT. STD. BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123 (REVISED 2004).

⁹⁴ [Add cite noting issues with tax legislative histories.]

⁹⁵ See ACCT. PRINCIPLES BD., ACCOUNTING RESEARCH BULLETIN NO. 43, Ch. 13, *Compensation, Section B- Compensation Involved in Stock Option and Stock Purchase Plans* paras. 1, 10, and 11 (1953) (reprinted as App. B to APB 25) [hereinafter ARB 43] (expressing these views).

⁹⁶ The breakthrough articles were Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973) and Robert

intrinsic value method of accounting for options in 1953, the Committee on Accounting Procedure (the regulator that preceded the APB, which preceded FASB) stated that “[a]lthough there is, from the standpoint of the grantee, a value inherent in a restricted future right to purchase shares at a price at or even above the fair value of shares at the grant date, the committee believes it is impracticable to measure any such value.”⁹⁷ In 1972, when the APB essentially reaffirmed the 1953 standard, apparently a majority of the APB was of the same view. Of the eighteen members of the APB, only two dissented from the opinion on the basis that techniques were adequate to value non-discounted options and that the full grant date value of all options, not just intrinsic values, should be expensed.⁹⁸

It seems reasonably clear that the former accounting bias against discounted options was more technical than conceptual. The intrinsic value method of accounting for options was simply the best that the accountants could do before option valuation techniques were developed. Of course, there is a large gap in time between 1973, when the breakthrough papers on option valuation were published, and 2004, when FASB mandated model-based accounting for options. Why did 30 years pass before the fair value method of accounting for options supplanted the intrinsic method? Again, technology may be a partial answer. As we will see in the next section, the Black-Scholes-Merton (BSM) model is not designed for employee stock options and its accuracy in that service is still debated. The larger answer, however, is politics. By the time the bulk of the accounting profession accepted the idea of using option valuation models to calculate compensation expense, option compensation had become so widespread and so intensive that publicly traded companies, particularly technology-related companies, feared the impact of the hit to earnings that would result from the change in methods and lobbied Congress and the FASB not to make the change.⁹⁹

2. Statutory Stock Options

ISOs became a feature of the tax code in 1981, but the concept of a special tax regime applicable to certain options goes back to the restricted stock option rules of the 1950s. In the 1960s and 1970s, the

C. Merton, *Theory of Rational Option Pricing*, 4 BELL J. ECON. & MGMT. SCI. 141 (1973).

⁹⁷ See ARB 43, *supra* note 95.

⁹⁸ See APB 25, *supra* note 87, 479-480 (discussing dissenting views of board members Bows and Gellein).

⁹⁹ See Patricia M. Dechow et al, *Economic Consequences of Accounting for Stock-Based Compensation*, 34 J. ACCT. RES. 1, 2-4 (1997) (describing the backlash created by the FASB’s proposal to require stock option expensing in the early 1990s). Note that interests opposing stock option expensing managed to delay implementation for over ten years after the FASB first officially proposed making the change.

DISCOUNTED EMPLOYEE STOCK OPTIONS

Code featured qualified stock options. As we will see, however, each iteration has included restrictions on strike price discounts as a prerequisite for qualification for the special tax regime. But the rationales offered for distinguishing between discounted and non-discounted options in providing access to the special tax regime have been unpersuasive, perhaps reflecting an unsophisticated understanding of equity compensation arrangements.

In 1950, in proposing that ISO-like tax treatment be afforded to restricted stock options, the Senate Finance Committee argued that exercise date taxation of options impeded their use in creating incentives.¹⁰⁰ The committee noted:

Since the employee does not realize cash income at the time the option is exercised, the imposition of a tax at that time often works a real hardship. An immediate sale of a portion of the stock acquired under the option may be necessary in order to finance the payment of the tax. This, of course, reduces the effectiveness of the option as an incentive device.¹⁰¹

However, the Committee did not intend that taxation would be deferred for all employee stock options until the sale of the underlying shares. It attempted to draw a line between options that were granted for incentive purposes (worthy of special treatment) and those that were merely compensatory (unworthy). How could the two cases be distinguished? “Ordinarily,” the Committee reported, “when an option is used as an incentive device, the option price approximates the fair market value of the stock at ... grant[.]”¹⁰² If an option was discounted, it was presumed to be compensatory, although, in order to allow for pricing uncertainty with respect to unlisted stocks, options with strike prices at least equal to 85% of the fair market value of the stock at grant were allowed to qualify.¹⁰³ The tax treatment of the granting company further reinforced the division between incentive and compensation. Because grants of restricted stock options were “regarded as incentive devices rather than compensation, no deduction [was] allowed the corporation.”¹⁰⁴

¹⁰⁰ S. REP. NO. 81-2375 (1950).

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.* Under the restricted stock option rules, each dollar of gain on options granted with a strike price equal to at least 95% of the underlying stock’s fair market value on the date of the grant was taxed at long-term capital gains rates. If an option was granted with a strike price ranging from 85% to 95% of fair market value at grant, the difference between the strike price and 95% of fair market value was taxed as ordinary income on exercise and the rest of the gain taxed as long-term capital gain. *See id.*

¹⁰⁴ *Id.*

Of course, the distinction the Finance Committee attempted to draw between options granted to create incentives and those granted as compensation is spurious. All forms of equity compensation – including options in, at, and out of the money; restricted stock; and performance shares – both create incentives and provide compensation. To be sure, decreasing moneyness increases the sensitivity of the instrument to firm share price, but, as we have seen, optimal design is a function of many factors specific to a firm, its employees, and general market conditions.¹⁰⁵ As a result, there is no a priori reason to think that a firm granting an option 50% in the money, or a combination of stock and non-discounted options, is any less interested in creating incentives than a firm granting only non-discounted options.¹⁰⁶

The same discontinuous view of the world was reflected when restricted stock options were replaced by qualified stock options in the early 1960s. The Kennedy administration advocated complete repeal of the restricted stock option regime, arguing that options were compensatory and should be taxed as consistently as possible with cash.¹⁰⁷ The House Ways and Means Committee insisted, however, that the incentives provided by options benefited the economy as a whole, and therefore warranted special tax treatment.¹⁰⁸ But the Committee recommended stricter pre-requisites. By 1963, the Committee had concluded that the rule allowing firms to set strike prices as low as 85% of the fair market value of the stock at grant was being abused, and raised the minimum strike price qualifying for special tax treatment to 100% of market in order to “decrease the compensatory nature of the existing stock option provision and to place greater emphasis on the employee’s efforts to improve his company’s business...”¹⁰⁹

In 1981, when qualified stock options were resuscitated and renamed ISOs, no real attempt was made to justify the pre-requisite that qualifying options not be granted in the money. There was initial

¹⁰⁵ See *supra* Part II.C.

¹⁰⁶ To be fair, I should emphasize that options were not well understood by economists, let alone politicians, in the 1950s. The finance literature on employee stock options did not take off until after Black, Scholes, and Merton published their work on option valuation in 1973.

¹⁰⁷ See *President’s 1963 Tax Message*, *supra* note 63, at 460-61 (testimony of Hon. C. Douglas Dillon, Secretary of the Treasury).

¹⁰⁸ H.R. REP. NO. 88-749 at 64 (1963).

¹⁰⁹ *Id.* at 65. Even so, the qualified stock option rules provided that options that were unintentionally discounted would not be disqualified, but that a penalty would be imposed to discourage intentional undervaluation. See *id.*

The nature of the abuse resulting from qualifying discounted options is not perfectly clear. In addition to the (misguided) idea that discounted options were uniquely compensatory, the Ways and Means Committee noted that under the restricted stock option regime discounted options were being used to raise capital rather than provide incentives. See *id.* at 64. But if equity pay was being used to raise capital (as opposed to providing compensation), capital gains tax treatment would seemingly be appropriate.

disagreement between the chambers whether the 85% threshold of the restricted stock options regime or the 100% of market requirement of the qualified stock option regime should apply,¹¹⁰ but ultimately the latter was selected with no preserved discussion. The Senate Finance Committee report, which was adopted on this point, simply echoed the JCT report, which noted that the rules were “designed to encourage the use of stock options for key employees without reinstating the alleged abuses which arose with the restricted stock option provisions of prior law.”¹¹¹

3. IRC § 162(m)

The § 162(m) safe harbor for non-discounted stock options is found in the regulations rather than the statute itself, but its contours and the disparate treatment of discounted options were well fleshed out in the legislative history. As described in the conference report:

Stock options and other stock appreciation rights generally are treated as meeting the exception for performance-based compensation ... because the amount of compensation attributable to the options or other rights received by the executives would be based solely on an increase in the corporation’s stock price.... Stock-based compensation is not treated as performance based if it is dependent on factors other than corporate performance. For example, if 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 the 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, [such] options ... do not meet the requirements for performance-based compensation.¹¹²

As in the case of the statutory stock option legislative history, this passage suggests a dichotomy in equity compensation that does not exist. It is certainly true, as far as it goes, that an executive can profit from a discounted option if the stock price is flat, while profits on non-discounted options require an increase in stock price. However, the suggestion that gains on the former are “dependent on factors other than

¹¹⁰ See STAFF OF JOINT COMMITTEE ON TAXATION, 97TH CONG., COMPARISON OF TAX PROVISIONS: H.R. 4242 (ECONOMIC RECOVERY TAX ACT OF 1981) (Comm. Print 1981) (noting that the House Bill provided that ISO exercise prices must equal or exceed 85% of grant date fair market value while the Senate Bill required non-discounted strike prices).

¹¹¹ STAFF OF JOINT COMMITTEE ON TAXATION, 97TH CONG., REPORT ON THE ECONOMIC RECOVERY ACT OF 1981 159 (Comm. Print 1981); *see also* S. REP. NO. 97-144, at 98-99.

¹¹² H.R. REP. NO. 103-213, at 586-87 (1993) (Conf. Rep.).

corporate performance,” while gains on the latter are not, is clearly overstated. As is well understood, gains on traditional, non-discounted options are in large part due to market movements that are unrelated to specific corporate performance.¹¹³ It is for this reason that some commentators have suggested that the exercise prices of compensatory options be indexed to reduce the influence of market factors and focus option gains or losses on firm-specific performance.¹¹⁴

More generally, even if the lack of strike price indexing were not an issue, the passage reflects an artificial discontinuity at at-the-money options. To be sure, the expected payoffs on restricted stock and deeply in-the-money options are less sensitive to share price movements than the payoffs for at-the-money options. By the same token, however, at-the-money options are less sensitive to stock price performance than out-of-the-money options. It is, after all, a continuum. Thus, the claim that non-discounted options are “inherently performance-based”¹¹⁵ while restricted stock and discounted options are not is unsupportable.

4. IRC § 409A

Neither the legislative history nor the preambles to the regulations attempt to justify the disparate treatment of discounted options under § 409A. The Treasury regulations faithfully follow the legislative history in distinguishing between non-discounted options, which generally are not subject to § 409A, and discounted options, which are.¹¹⁶ The conference report simply states without further explanation that

it is not intended that the term “nonqualified deferred compensation plan” include an arrangement taxable under section 83 providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future.¹¹⁷

¹¹³ See David M. Schizer, *Tax Constraints on Indexed Options*, 149 U. PA. L.REV. 1941, 1942 n.8 (2001) (suggesting that a traditional, non-indexed option be thought of as “an indexed option paired with an option on the market”).

¹¹⁴ See Rappaport, *supra* note 21, at 101; Mark A. Clawson & Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate with Performance*, 3 STAN. J. L. BUS. & FIN. 31 (1997).

¹¹⁵ H.R. REP. NO. 103-213 (1993) (Conf. Rep.).

¹¹⁶ See Notice of Proposed Rulemaking on 409A (Reg-158080-04) (Oct. 4, 2005) (citing legislative history); Treas. Reg. § 1.409A-1(b)(5)(i)(A).

¹¹⁷ H.R. REP. NO. 108-755 at 735 (2004) (Conf. Rep.). The reference to a secondary deferral feature responds to attempts by optionees to defer option taxation beyond exercise, e.g., by converting the intrinsic value of an option into an unfunded, unsecured promise to pay further in the future.

The conference report does not mention restricted stock, but the Treasury regulations separately exclude restricted property from the reach of § 409A, stating that “there is no deferral of compensation merely because the value of the property [received] is not includible in income by reason of the property being substantially nonvested....”¹¹⁸

C. Tax Policy Rationales for Discouraging Firms from Granting Discounted Options

This section develops the tax policy rationale for the disparate treatment of discounted options previewed above. In brief, forcing firms to bifurcate equity pay into discrete bundles of stock and ATM options is desirable as a matter of tax policy in that it blocks unwarranted expansion of the preferential NQSO and ISO regimes to include deeply discounted options and, effectively, restricted stock. The argument rests on the following observations: equity compensation can be tax advantaged relative to the accrual tax ideal; the advantage is in part a function of the period over which tax is deferred; and deferral of tax on options post-vesting is a pragmatic response to problems inherent in valuing ATM options prior to exercise, problems that do not arise in valuing stock or deeply discounted options.

This section also makes two additional points. First, expansion of the NQSO and ISO regimes to include stock-like instruments would not be catastrophic for the public fisc. Directionally, limiting these regimes is good tax policy, but it would be difficult to quantify the benefit. Second, although pre-exercise taxation of options is impractical in my view, the tax advantage of options potentially could be eliminated in other ways, e.g., through the imposition of a special tax on deferred and equity compensation investment returns as proposed by Professor Halperin.¹¹⁹ In such an environment, the tax policy arguments justifying discrimination against discounted options would fall away.

1. Equity Compensation Can Be Tax Advantaged

a. Restricted Stock and NQSOs

Most analysts have concluded that taxation under § 83 and § 1.83-7 provides a tax advantage for firms that compensate their employees with equity.¹²⁰ The reason, in a nutshell, is that investment returns are or can

¹¹⁸ Treas. Reg. § 1.409A-1(b)(6)(i).

¹¹⁹ See Halperin, *supra* note 12, at 539-550, and Part III.C.5, *infra*.

¹²⁰ See Walker, *supra* note 12, at 755-57 (synthesizing the employee and employer taxation of equity compensation); Knoll, *supra* note 12, at 214 (finding that “over a range of circumstances” equity compensation is tax advantaged); see also Halperin, *supra* note 12 (seminal article on time value issues and taxation, including consideration of the tax efficiency of deferred compensation); but see Yale, *supra* note 12 (arguing that the tax benefit of deferred compensation should be viewed as only the

be exempted from tax. There are several ways of portraying this effect. This is one.

I will assume, as is conventional, that an employee invests in the stock of her employer, either directly with after-tax cash compensation, or indirectly, through receipt of equity-based pay. First, consider a firm that is effectively tax exempt due to a large NOL position. Suppose that instead of paying an employee in cash, it grants the employee restricted stock. Absent a § 83(b) election, the employee will not be taxed until the stock vests. Had the employee received cash, she would have been taxed immediately. As is widely recognized in the academic literature, under certain conditions the deferral of taxation is equivalent to imposing the tax initially, but exempting investment returns on the after-tax amount.¹²¹ What about the employer? It has extra cash on hand as a result of compensating the employee with stock, but any investment returns go untaxed because this employer is hypothesized to be effectively tax exempt.¹²²

Second, consider an employer paying tax at the maximum marginal rate. Now we have to consider the possibility that the taxation of investment returns is simply shifted from the employee to the employer who has cash freed up as a result of the decision to compensate the employee with equity. The analysis is quite complex, but we can be sure of exemption of investment returns at the employer level if the firm uses the freed up cash to repurchase its own shares on the market at the time it grants stock to its employee, because, under IRC § 1032, firms are not taxed on gains or losses from trades in their own equity.¹²³

avoided after-tax cost of financing the incremental investment made possible by deferral of the tax).

¹²¹ See E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in *INCOME, EMPLOYMENT AND PUBLIC POLICY* 300-316 (1948); Halperin, *supra* note 12. Equivalence depends on the assumption that tax rates remain constant. A familiar example of the Brown theorem is the economic equivalence between conventional IRAs and 401(k) plans that defer tax on investment income until retirement and Roth IRAs and 401(k)s that provide for tax-exempt earnings on after-tax contributions. However, equivalence in this case is undermined by the fact that the caps on contributions, while nominally the same, are effectively different. See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 746 (5th ed. 2005).

¹²² It is important in any analysis of compensation taxation to consider the taxation of both the employee and employer. See SCHOLLES ET AL, *supra* note 78, at 3.

¹²³ If one assumes that corporate financing decisions and compensation decisions are independent such that firms ultimately repurchase from the market the same number of shares that are issued to employees via stock or option grants (or reduce planned issuances), the investment exemption analysis turns on repurchase (or forgone issuance) timing. If repurchases are made when shares vest or options are exercised and the freed up cash from equity grants generates a taxable return in the interim, substitute taxation would result. If equity grants are perfectly hedged by firms repurchasing shares at the time of the grants, there is no substitute taxation. See Walker, *supra* note 12, at 729-40. If, on the other hand, equity compensation increases equity capitalization because a firm is unwilling or unable to issue additional equity directly, it is very difficult to assess whether substitute taxation arises. Empirical

Many firms manage the dilution resulting from equity compensation programs by repurchasing shares in this manner, and in this scenario, again, neither the employer nor the employee bears any tax on the investment return on the stock grant.¹²⁴

The analysis is analogous, but still more complicated, for NQSO compensation. Again, option compensation definitely results in exemption of investment returns in the case of loss firms and firms that perfectly hedge compensatory options.¹²⁵ However, there is a key difference between stock and options. For stock grants, the deferral of income inclusion and potential exemption of investment returns lasts only until the shares vest. For options, the deferral/exemption extends until exercise, which could be several years later.

But this is not the end of the story. Exemption of investment returns is only advantageous if investment returns are positive. If returns are negative, exemption means the loss of a capital loss.¹²⁶ As a result, in a tax system permitting full deductibility of losses and assuming no trading on inside information, the tax advantage of equity compensation would be quite limited on an ex ante basis.¹²⁷ However, if one assumes that capital loss limitations on outside investments would have real bite and if one considers the fact that insiders generally outperform the market, so that the prospect of gain and risk of loss are not symmetric, equity compensation begins to appear significantly tax advantaged even on an ex ante basis.¹²⁸ Moreover, on the reasonable assumption that investment returns are a function of the investment period, the additional deferral achievable with NQSOs heightens their tax advantage over restricted stock.

b. ISOs

I have already noted that ISO taxation is not advantageous relative to NQSO taxation from a global tax perspective if the employer's marginal tax rate is equal to the statutory rate. Relative to NQSO taxation, the ISO regime converts ordinary compensation income for the employee into capital gain,¹²⁹ but the cost is the complete loss of the employer's

evidence indicates that stock buybacks conducted in conjunction with equity compensation programs are common, although the timing of these buybacks varies. *See id.* at 743-48.

¹²⁴ *See id.*

¹²⁵ *See id.*

¹²⁶ One can think of capital income taxation as a partnership between the taxpayer and the government in which the two share in gains and losses. However, as in the case of some partnerships between natural persons, the government does not share equally in gains and losses on capital investments. *See* IRC § 1211 (limiting deductibility of capital losses).

¹²⁷ *See* Yale, *supra* note 12.

¹²⁸ *See* Walker, *supra* note 12, at 715-720.

¹²⁹ *See supra* note 77 and accompanying text.

tax deduction for compensation conferred.¹³⁰ As Myron Scholes and his colleagues demonstrate, under current law and assuming that the optionee sells the stock received on exercise one year later, the breakeven corporate marginal tax rate is about 24%.¹³¹ If the effective marginal tax rate is greater than 24%, NQSOs are jointly tax advantaged; if less than 24%, ISOs are better. The key to the tax advantage of ISOs, however, is that the regime is elective. Presumably most employers issuing ISOs face a low or zero effective tax rate.¹³² In these cases, there is little or no offset against the employee's conversion of ordinary compensation income into capital gain, and the ISO regime is even further tax advantaged than the NQSO regime.

2. Pre-Exercise Taxation of Options is Problematic

Generally, restricted stock is valued and taxed at vesting. Vesting date valuation and taxation would reduce the tax advantage of options, but, of course, neither the NQSO or ISO regime follows that approach. Rather, both systems adopt a "wait and see" attitude. Under the NQSO regime, we wait until exercise to value gains; under the ISO regime, we wait until sale of the underlying shares. Arguably, difficulties of pre-exercise valuation contribute to the difference in the taxation of stock and options.

This section describes why taxation of options based on their fair value prior to exercise is problematic. It also discusses the alternative of taxing options based on their intrinsic value at vesting. While this alternative is not perfectly consistent with the taxation of restricted stock, it has administrative advantages. Nonetheless, I argue that this approach is also problematic. Finally, this section notes that while pre-exercise valuation concerns might justify NQSO taxation, these concerns do not justify the ISO tax regime.

a. Pre-Exercise Taxation Based on the Fair Value of Option is Problematic

Theoretically, *grant* date taxation of the fair value of stock and options would eliminate any tax advantage of equity compensation relative to the accrual tax ideal. Less ambitiously, *vesting* date valuation and taxation of compensation arising from options would eliminate the tax advantage of options over stock. However, as Victor Fleischer and I

¹³⁰ See *supra* note 78 and accompanying text.

¹³¹ See SCHOLES ET AL., *supra* note 78, at 230, tbl 8.4.

¹³² Corporate effective marginal tax rates exhibit significant variation. See, e.g., John R. Graham, *Debt and the Marginal Tax Rate*, 41 J. FIN. ECON. 41, 49 (1996) (simulating effective marginal tax rates for 11,000 Compustat firms in the years 1980 to 1992 and finding that in any year about 1/3 of firms had effective marginal tax rates equal to the top statutory rate, about 1/5 had effective marginal tax rates of zero, and the remainder had rates in between).

have argued, pre-exercise taxation of options utilizing current technology raises numerous concerns.¹³³ Here I will focus on just two – valuation and manipulation.

Except for the case of a deeply in-the-money option, the intrinsic value of an option at any time represents only a fraction of the option's total value.¹³⁴ As a result, accurate determination of the fair value of options prior to exercise would require the use of an option pricing model, such as the BSM or binomial models that are used to value compensatory options under current GAAP. These models were designed for relatively short-term traded options. The models are not perfect in that service, but their imperfections are magnified when applied to long-dated employee options.¹³⁵ In addition, the models must be adjusted to account for the non-transferability of employee options, and these adjustments can lead to overvaluation.¹³⁶ In short, while these models may be sufficiently reliable to determine aggregate option cost and earnings adjustments firm by firm, they may not be sufficiently reliable to form the basis for taxing individual optionees.

Second, and perhaps more important, the results of these models are highly sensitive to firm-specific projections of stock price volatility, expected time to option exercise, and dividend yields. As a result, the valuations are highly manipulable.¹³⁷ One analyst has determined that a firm seeking to maximize the grant date option value of an ATM option could reasonably select inputs and “report values almost double those reported by an otherwise similar firm seeking to undervalue its options.”¹³⁸

Suppose that employee inclusion and employer deductions for options were based on the fair value of the options at vesting as determined by a pricing model. Subsequent gain or loss would be

¹³³ See David I. Walker & Victor Fleischer, *Book/Tax Conformity and Equity Compensation*, ____ Tax L.Rev. ____ (2009) (describing valuation and manipulation problems inherent in pre-exercise taxation of options); see also David M. Schizer, *Executives and Hedging: The Fragile Legal Foundations of Incentive Compatibility*, 100 COLUM. L. REV. 440, 473 (2000) (noting that pre-exercise taxation “would invite self-serving taxpayer valuations”).

¹³⁴ See BREALEY ET AL., *supra* note 91, at 577.

¹³⁵ See, e.g., Charles W. Calomiris, *Expensing Employee Stock Options* 38 (AEI Working Paper, Aug. 5, 2005), (suggesting that valuation errors may exceed 20% in 10% of the cases); Carol A. Marquardt, *The Cost of Employee Stock Option Grants: An Empirical Assessment*, 40 J. ACCT. RES. 1191, 1214 (2002) (finding that while an adjusted Black-Scholes model provided reasonable estimates of ex post option cost, on average, there was “significant variability in the amount of model error on an option-by-option basis”).

¹³⁶ See Thomas Hemmer et al., *Estimating the “Fair Value” of Employee Stock Options with Expected Early Exercise*, 8 ACCT. HORIZONS 23, 27-38 (1994); Phelim Boyle & William R. Scott, *Executive Stock Options and Concavity of the Option Price*, 13 J. DERIVATIVES 72, 72-77 (2006).

¹³⁷ See Walker & Fleischer, *supra* note 133, at 35-37.

¹³⁸ Mark Rubinstein, *On the Accounting Valuation of Employee Stock Options*, 2 J. DERIVATIVES 8, 17 (Fall 1995).

capital gain or loss for the employee and would have no tax consequence for the employer. A firm in a large NOL position would be able to select model inputs that undervalue options, thus converting employee ordinary income into capital gain. The firm would suffer a reduction in its tax deduction for the options, but given the large NOL, the expected present value of that sacrifice might be small.¹³⁹ On the other hand, if an employee faced a relatively low marginal tax rate on ordinary income, model-based taxation would allow a high marginal tax rate firm to overvalue options and maximize its deduction. The problem, of course, is that the opportunity to manipulate option valuation and the allocation of tax burdens would be essentially elective.

Accuracy and manipulation problems may explain why we do not attempt to tax the fair value of options at vesting consistent with the taxation of restricted stock. However, there are other alternatives to option taxation such as intrinsic value taxation at vesting.

b. Pre-Exercise Taxation of Options Based on Intrinsic Value is Also Problematic

To some extent, the problems discussed above could be avoided by treating the *intrinsic value* at vesting as the measure of compensation arising from an option. The difference between the fair market value of the underlying stock and exercise price of the option at vesting is readily observable and is not manipulable, at least in the case of public companies. To be sure, the intrinsic value will always be less than the fair value of the option.¹⁴⁰ Thus, compared with fair value taxation at vesting, this intrinsic value method would convert employee ordinary income into capital gain. However, there would be an offset in that employer tax deductions would be reduced by the difference between the fair value and the intrinsic value at vesting.

If this method sounds quite like the current ISO rules, it should. It is also the method favored by Justice Harlan in *LoBue*.¹⁴¹ Under this system, if an option had zero intrinsic value at vesting, the employer would receive no deduction, the employee would have no ordinary

¹³⁹ For example, assume that the fair value of an option at vesting is \$300, that the exercise price is \$100, and that the shares ultimately are sold at \$600. Fair value taxation at vesting would result in the employee recognizing \$200 of compensation income at vesting and \$300 of capital gain when the shares are sold. The employer would have a \$200 deduction at vesting. However, if model inputs are manipulated to generate a \$250 value at vesting, the employee would report \$150 ordinary income and \$350 capital gain. The employer would deduct \$150.

¹⁴⁰ As discussed *supra* note 91, the fair value of an option at any time is comprised of the option's intrinsic value and the value of the remaining option privilege. For an option that is at or out of the money, option privilege constitutes 100% of the fair value of the option. For a deeply in-the-money option or a modestly in-the-money option nearing expiration, the value of the option privilege becomes small relative to intrinsic value. See BREALEY ET AL, *supra* note 91, at 577-581.

¹⁴¹ See *supra* notes 61-62 and accompanying text.

income, and all gains would be capital. Firms presumably would react to such a system much as they do to the current ISO regime. Those with low effective marginal tax rates would likely embrace it. At these companies, the conversion of employee ordinary income into capital gain would benefit recipients and come at little or no cost to the firm. Firms with high marginal tax rates would be unenthusiastic and would likely replace options with another form of compensation. As with today's ISOs, for these firms the reduction in the corporate tax deduction would outweigh the benefit of converting a like amount of employee ordinary income into capital gain. Corporate effective marginal tax rates appear to exhibit significant variation.¹⁴² As a result, an intrinsic value method of option taxation would still create a "heads you win, tails I lose" whipsaw for the government.¹⁴³

c. Difficulty of Pre-Exercise Taxation Does Not Justify the ISO Regime

While pre-exercise valuation and manipulation concerns might justify the tax treatment of NQSOs relative to restricted stock, these concerns do not justify the additional tax advantage of the ISO regime. Considered solely as a question of tax policy, the ISO regime seems regrettable and any potential expansion undesirable. As we have seen, as an elective regime, the ISO rules allow NOL firms to confer tax advantaged compensation on their employees with no offsetting tax burden at the firm level. In addition, the ISO rules add complexity and the opportunity for firms that are poorly advised or that cater to their employees rather than their shareholders to get the ISO/NQSO calculation wrong.¹⁴⁴

3. Absent Special Tax/Accounting Rules, Firms Could Achieve NQSO/ISO Taxation on Instruments Resembling Restricted Stock

The heavy lifting in constructing the tax policy argument justifying rules discriminating against discounted options is complete. It remains

¹⁴² See Graham, *supra* note 132, at 48-49.

¹⁴³ It is hard to know how much of this was recognized by the majority in *LoBue* which rejected Justice Harlan's approach. It seems more likely that the Court simply resisted the idea of levying a tax before the fair value of the compensation could be reasonably measured. There is no discussion of the possibility of firms and employees engaging in tax planning with respect to compensation design in *LoBue*.

¹⁴⁴ Firms that grant ISOs have a subsequent opportunity to disqualify the options and achieve NQSO taxation. Studies show that many firms that could reduce combined employer/employee taxes by disqualifying ISOs fail to do so because of complexity and/or earnings considerations. See SCHOLLES ET AL, *supra* note 78, at 232. On the other hand, some firms apparently utilize ISOs despite a global tax disadvantage. Doing so may reduce employee-level taxes, but it is difficult to see how this choice benefits shareholders. See *id.* at 231 & n. 19.

to be shown only that, absent § 409A and the ISO rules, firms could easily achieve NQSO or ISO tax treatment on instruments resembling restricted stock by issuing deeply discounted stock options instead.

Suppose a firm planned to make an outright grant to an employee of 1000 shares of restricted stock at a time when the shares were trading at \$100. Suppose the grant was to cliff vest in three years. Absent a § 83(b) election, the shares would be taxed at vesting based on the fair market value at that point. Absent § 409A and the ISO rules, the firm apparently could substitute a deeply discounted option and defer taxation until exercise or sale of the underlying shares. For example, an option on 1333 shares with a strike price of \$25/share would have the same aggregate intrinsic value as the restricted stock. To be sure, the fair value of the option would be slightly greater than that of the stock, reflecting the fact that even deeply discounted options are worth more than their intrinsic value. The incremental option value, which is not transparent, might drive a wedge between subjective employee valuation and employer cost. But at least some financially sophisticated employees and employers would take advantage of the opportunity to defer tax beyond vesting on deeply discounted options.

Again, this substitution offends tax policy because the pragmatic reasons for allowing deferral of tax on options beyond vesting do not apply to stock. The restricted stock alternative in this case is easily valued at vesting.¹⁴⁵

4. Expansion of NQSO/ISO Regimes to Include Stock Would Not Be Catastrophic for the Public Fisc

Directionally, it seems to me that allowing the NQSO and ISO regimes to expand in the direction of restricted stock would be bad tax policy, and thus the effects of § 409A and the ISO prohibition on discounting are serendipitously positive. However, it is not clear that elimination of these rules would create a large burden on the public fisc.

a. Restricted Stock Conversion into NQSOs

The incremental tax advantage of NQSOs over restricted stock that I have described holds only if recipients retain their options unexercised post-vesting and accept the risk of a stock price decline. As a practical

¹⁴⁵ In fact, in the case of deeply discounted options, we could apply option pricing models with much less concern about accuracy or potential manipulation, because the value of the option privilege, which is what is really being modeled, represents a relatively small portion of the total option value. In the case of a 75% strike price discount, an option's intrinsic value would likely account for more than 90% of the total option value at grant. For example, using the option pricing assumptions of note 150, *infra*, the BSM value of an option with a \$25/share strike price on stock trading at \$100/share at grant would be \$79.60/option share, consisting of \$75 intrinsic value and \$4.60 value of option privilege.

matter, achieving additional deferral of tax through conversion of stock awards into discounted options and holding these options beyond vesting comes at a heavy cost of postponed diversification. Employees, who face a great deal of firm-specific risk, routinely sacrifice potential deferral benefits and option value by exercising options well before expiration, often only shortly after vesting.¹⁴⁶ Thus, it is an empirical question, but it is not clear that the additional income deferral that would actually occur as a result of conversion of stock into discounted options would be terribly significant. We can be sure that the additional periods of deferral generally would be far less than the difference between the average vesting period for the typical grant of restricted stock (about three years)¹⁴⁷ and the ten year contractual life of most options.¹⁴⁸

Deferral through conversion of stock awards into discounted options also carries some risk of the firm failing to perform on the option contract during the period between vesting and exercise. This risk also tends to limit deferral of option exercise and the tax advantage of

¹⁴⁶ See J. Carr Bettis et al., *Exercise Behavior, Valuation, and the Incentive Effects of Employee Stock Options*, 76 J. FIN. ECON. 445, 446 (2005) (finding for a sample of 140,000 option exercises by executives at almost 4000 firms between 1996 and 2002 that, on average, options were exercised a little over two years following vesting and more than four years prior to expiration); Steven Huddart & Mark Lang, *Employee Stock Option Exercises: An Empirical Analysis*, 21 J. ACCT. & ECON. 5 (1996) (finding that the median fraction of option life elapsed at the time of exercise ranged from 0.21 to 0.38 for options granted by seven public companies to a wide range of employees); Jennifer N. Carpenter, *The Exercise and Valuation of Executive Stock Options*, 48 J. FIN. ECON. 127 (1998) (finding for a sample of forty firms (mainly large manufacturers) that executive stock options granted between 1983 and 1984 were, on average, exercised after 5.8 years).

As an alternative to early exercise, some executives enter into hedging transactions that lessen the risk of continuing to hold compensatory stock options. See J. Carr Bettis et al., *Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders*, 36 J. FIN. & QUANTITATIVE ANALYSIS 345, 352 (2001) (identifying 87 zero-cost collar and 2 equity swap transactions entered into by corporate executives between 1996 and 1998 and speculating that their sample represented only a fraction of actual hedging transactions). As David Schizer has demonstrated, a combination of tax rules penalizes executives who hedge options, see Schizer, *supra* note 133, thus, many of these hedging transactions are likely driven by disclosure concerns and can be analogized for our purposes to early exercise.

¹⁴⁷ See FREDERICK W. COOK & CO., *supra* note 18, at 14.

¹⁴⁸ In all likelihood, employees would exercise deeply in-the-money options resembling restricted stock at least as early as traditional ATM options. The value of the option privilege relative to intrinsic value is likely to be less for an option granted deeply in the money than one granted at the money. This suggests that, on average, the holder of an ITM option would have more to gain by early exercise in terms of achieving diversification and less to lose in giving up option privilege than the holder of an ATM option. See Huddart & Lang, *supra* note 146, at 34 (finding that the probability of early exercise was strongly correlated with the ratio of the market price of the stock at exercise to the strike price); but see Bettis et al. (2005), *supra* note 146, at 457 (finding a negative, but statistically insignificant, relationship between early exercise and the ratio of market price at exercise to strike price).

options in the real world. Of course, the performance risk associated with holding employee stock options will vary firm by firm. (Not every firm is an Enron or Lehman waiting to implode.) Moreover, employees may be able to limit performance risk by exercising options and selling shares before disaster strikes.

b. Restricted Stock Conversion into ISOs

Eliminating the prohibition on ISO discounting would roughly double the maximum size of ISO grants, assuming no other change in the ISO rules. While doubling sounds significant, it is worth noting that the maximum value of grants has fallen in real terms by more than half since the regime was put in place in 1981. Given the limit on ISO grants combined with the fact that ISOs are uneconomic for many firms, expanding the regime to include deeply discounted options might have less impact on the public fisc than opening up the NQSO regime. But to explore these points, we will have to delve into the limitation on ISO grants.

Under IRC § 422(d), there is a non-inflation adjusted annual limit on ISO grants of \$100,000 per recipient. The \$100,000 limit applies to the aggregate fair market value of stock subject to ISOs that first becomes exercisable in a given year, and the dollar limit is based on the market value of the stock subject to the option on the date of the grant. Purported ISO shares in excess of this amount are treated as NQSO shares.

Inflated by the CPI, a 1981 dollar is worth \$2.42 today.¹⁴⁹ Thus, in real terms, maximum ISO grants have fallen in value by more than half since the enactment of the ISO regime. Because the cap is based on the value of the shares underlying options rather than the value of the options themselves, much of this decline would be reversed by expanding the ISO regime to include deeply discounted options, if we assume that the form of the limitation was not revised.

To see this, suppose first that a firm issues ATM options as ISOs. For illustration, we will assume that the fair market value of the underlying stock on the date of the grant is \$100/share, and I will adopt a set of assumptions (detailed in the margin) regarding stock price volatility, time to exercise, etc., that would be reasonable for a large manufacturing firm and that will allow us to calculate BSM values.¹⁵⁰ Under these assumptions, the ATM options are worth about \$39/share. Per § 422(d), 1000 shares can vest as ISOs in any given year, for total

¹⁴⁹ Inflated by the rate of growth of *executive* compensation, 1981 dollars would be worth far more than \$2.42 today.

¹⁵⁰ The assumptions made for illustration are as follows: \$100/share grant date stock value, 35% stock price volatility, 6 years to option exercise, a risk free interest rate of 3%, and no dividends. All option values in this article were determined using the calculator found at <http://www.option-price.com/>.

ISO grant value of \$39,000. Now suppose that the firm issues deeply discounted options as ISOs. If the strike price is reduced to \$25/share, for example, the value rises to just under \$80/option share, and the firm can issue to an employee an ISO worth \$80,000.¹⁵¹

Since the ISO regime is elective, presumably most firms that see value in issuing ISOs would want to take full advantage of the opportunity, and issuing deeply discounted options as ISOs would be tempting. Of course, for a senior corporate executive, an increase in the value of an ISO grant from \$39,000 to \$80,000 would be a drop in the bucket. For a rank and file employee of a technology company, however, the difference could be significant.

However, before we conclude that expanding the ISO regime to include deeply discounted options would pose a great threat to the public fisc, two points are worth emphasizing. First, Congress could obviously change the basis of the ISO cap from the value of the underlying shares to the value of the grant. Even if BSM is not an adequate basis for taxation, it is adequate for determining the number of option shares to be treated as an ISO or an NQSO. Second, bear in mind that ISOs are only attractive, relative to NQSOs, for firms with low effective marginal tax rates.

5. A Special Tax on Investment Returns and Discounted Options

I have argued in this part that pragmatic considerations justify the “wait-and-see” approach of the NQSO regime, at least as compared to the alternative of pre-exercise taxation, and when limited to non-deeply discounted options. The Court majority in *LoBue* and the drafters of § 83 and the § 1.83-7 regulations were right, in my view, to reject grant or vesting date taxation of an option unless the fair market value of the instrument was truly ascertainable. However, pre-exercise taxation may not be the only way of eliminating the tax advantage of options.

Having demonstrated that the tax advantage of non-qualified deferred compensation results from the exemption of investment returns, Professor Halperin suggested that a special tax be applied to those investment returns in order to achieve the same overall result as accrual taxation.¹⁵² If adopted for equity compensation, this approach could eliminate the tax advantage of stock and option compensation and, in so

¹⁵¹ The ISO opportunity could be stretched even further by pushing the strike price down near zero, but if Congress simply repealed § 422(d) without specifically embracing deeply discounted options as ISOs, a firm might choose to be conservative to minimize the possibility that a court might determine that the instrument was not an option and could not be an ISO.

¹⁵² Halperin envisioned a tax levied on employers at the maximum marginal employee rates. See Halperin, *supra* note 12, at 539-550 (outlining his special tax proposal and arguing that the tax is needed to avoid subsidizing the retirement plans of highly-compensation individuals and undermining firms’ incentives to create qualified plans).

doing, level the playing field between non-discounted options, discounted options, and restricted stock. If implemented effectively, this special tax regime would eliminate the need to worry about firms converting stock grants into deeply discounted options in order to gain access to a NQSO tax regime. Under such a scheme, the tax policy argument that I have made for rules forcing firms to bifurcate ITM pay packages into non-discounted options and stock would fall away.

Unfortunately, however, as Halperin notes, one must calculate the value of the compensation at grant in order to determine how much investment income arises from deferred or equity compensation and should be subjected to the special tax.¹⁵³ For options, this brings us back to the accuracy and manipulation problems inherent in model-based valuation, although the stakes might be lower under the Halperin approach than in a regime in which the entire tax consequences of options flowed from model-based valuation.¹⁵⁴ In any event, unless and until the taxation of equity compensation is fundamentally reformed, preventing the current option taxation regimes from expanding to include deeply discounted options resembling restricted stock seems desirable as a matter of tax policy.

D. Are the Special Tax Rules Affecting Discounted Options Sensible Within Their Own Terms?

I have argued that one can find a tax policy rationale for discouraging grants of discounted options, but it is unlikely that the rules achieving this outcome were enacted with this particular rationale in mind. This section briefly considers whether the tax rules discriminating against discounted options are sensible within the narrow contexts in which they are found. I have already addressed the stated rationales for these rules, but this is a different inquiry. Here, I seek to determine whether limits on option discounting make sense within the contexts of §§ 162(m), 422, and 409A, irrespective of what the committee reports had to say.¹⁵⁵

1. Can the ATM Option Line Be Justified Under IRC § 162(m)?

¹⁵³ Halperin discusses several other challenges to implementation of his proposal, including determining the proper tax rate, but he concludes that his approach is preferable to accrual taxation or the status quo. *See id.* at 544-549.

¹⁵⁴ The idea is that realized option gains at exercise would continue to be taxed as they are today. Investment earnings on options would bear an additional tax intended to achieve the equivalent of accrual taxation. Model-based valuation would only come into play in determining the surtax. Presumably firms would have an incentive to overstate option value if such a proposal were enacted in order to minimize the surtax imposed on option recipients.

¹⁵⁵ GAAP no longer discriminates against discounted options, and I have already described the context and process under which the current accounting treatment of options evolved. Thus, this section will focus on the tax provisions.

At worst, the promulgation of § 162(m) was simply political theater, a bit of symbolic legislation enacted to demonstrate to the public that Congress was concerned about run-away executive pay. At best, and I use the term advisedly, § 162(m) is an example of Congress using the tax code to regulate non-tax behavior – the design of executive pay packages. Under this view, it is an example of a negative tax expenditure or regulatory tax penalty.¹⁵⁶ As such, we would not expect to find a pure tax rationale for the provision. Instead, we would have to ask whether the at-the-money line drawn in the safe harbor regulation is justified in terms of the non-tax rationale for § 162(m) generally.¹⁵⁷

Some have viewed § 162(m) as an attempt to control run-away executive pay, but given the ability to qualify compensation as performance-based and render it deductible, it is more reasonable to view the provision as an attempt to shape the form of executive pay rather than the total amount, to encourage firms to shift away from salary-heavy packages that did not tie pay to performance to packages in which options or other performance-based pay predominated. The safe harbor for non-discounted options reflected the view that traditional ATM options were substantially performance based, as is. Unlike cash bonuses, ATM options did not need to vest based on achievement of pre-set performance criteria in order to tie pay to performance.¹⁵⁸

Under that view, a safe harbor for options was sensible, but given the decision to create that safe harbor, a line did need to be drawn to avoid having the exception swallow the rule. Arguably, however, the line should have been drawn so as to include restricted stock within the safe harbor. Restricted stock payoffs are less sensitive to stock price performance than ATM options, but clearly they are tied to stock performance. Moreover, researchers have demonstrated that under certain conditions discounted options and deferred stock would represent efficient compensation contracts.¹⁵⁹

¹⁵⁶ See David I. Walker, *Regulatory Tax Penalties* (Working Paper).

¹⁵⁷ This analysis should not be mistaken as an attempt to defend § 162(m). My sympathies lie with the critics who have found § 162(m) to be ineffective in some ways and producing unintended and undesirable consequences in others. See, e.g., Gregg D. Polsky, *Controlling Executive Compensation through the Tax Code*, 64 WASH. & LEE L. Rev. 877 (2007) (arguing that § 162(m) should not have been expected to benefit shareholders under either of the prevailing theories of the executive pay setting process and concluding that the empirical evidence supports the view that it was not).

¹⁵⁸ Even if one views the enactment of § 162(m) as political theater, that does not mean that the staff members who drew up the legislation did not attempt in good faith to realize the stated objectives of the bill's sponsors.

¹⁵⁹ See *supra* Part II.C.2. Of course, if restricted stock were included within the equity compensation safe harbor for the purposes of § 162(m), the statute or regulations would need to include a minimum time to vesting to avoid the possibility of cash compensation being disguised as rapidly vesting restricted stock.

Suppose, however, that a firm were to issue an “option” to an employee with a negative strike price.¹⁶⁰ Under the terms of the contract, on exercise of the option, the employee would receive shares of company stock plus a cash payment from the firm. If the cash payment was large relative to the value of the stock, the instrument would resemble deferred cash compensation with little or no pay-for-performance sensitivity. It would certainly not make sense for a stock option safe harbor within the § 162(m) regulations to cover an “equity” compensation instrument effectively comprised of, say, ninety-nine parts cash and one part stock.

Perhaps it is obvious that a stock option safe harbor within the § 162(m) regulations would not be open to a negative strike price “option,” but if it is not, then it was necessary to define options in such a way as to avoid creating a limitless safe harbor for “performance-based” pay. As noted above, in my view, the most logical place to draw the line would have been at restricted stock, and so I find the distinction between discounted and non-discounted options difficult to justify. However, discounted options and restricted stock can still be qualified as performance-based pay under the general rules of § 162(m), so excluding them from the safe harbor, while inconsistent with the rationale I have presented, may not substantially increase the cost to firms of utilizing these devices. Moreover, while the restriction against discounting in the § 162(m) safe harbor is yet another factor discouraging firms from issuing explicitly discounted options, it probably has little or no impact on discounting. The former GAAP rules and newly enacted IRC § 409A provide such strong disincentives against the use of discounted options that § 162(m) is much less important in this regard.

2. The ISO Regime as a Tax Expenditure Program

I have argued that as a pure matter of tax policy, the ISO regime is regrettable and that any extension, including an extension that reaches deeply discounted options, is undesirable. However, one could view the ISO regime as a tax expenditure program – a tax preference similar to those aimed at encouraging employer-provided health insurance or owner-occupied housing¹⁶¹ – and ask whether limiting the preference to non-discounted options is sensible. The answer is probably no.

The stated aim of the ISO-predecessor rules was to encourage employees to hold stock received on the exercise of options beyond exercise by deferring the imposition of tax until the underlying shares

¹⁶⁰ Although formally denominated an “option,” this cash-equity hybrid instrument would bear little resemblance to positive strike price options, specifically, an employee would have no incentive to defer exercise post-vesting.

¹⁶¹ See GRAETZ & SCHENK, *supra* note 121, at 41-56 (discussing the tax expenditure concept and tax expenditure budget).

were sold.¹⁶² If this were truly the aim of the ISO regime, it is not obvious why one wouldn't be equally interested in encouraging employees to hold the shares underlying discounted options beyond exercise or even to hold formerly restricted stock beyond vesting. Even in the latter case, the dynamics are exactly the same. At vesting, the holder of formerly restricted stock owes tax whether she sells the underlying shares or not. The imposition of tax at vesting discourages her from continuing to hold the shares. Section 83 undermines the use of restricted stock as a long-term incentive just as it undermines the use of NQSOs.

Of course, one could reply that the ISO regime's prohibition on discounted options encourages firms to issue more highly powered incentives. True, but as I have argued above, more highly powered incentives are not always in the best interests of shareholders.¹⁶³

3. Can the Disparate Treatment of Discounted Options under § 409A Be Justified?

IRC § 409A effectively prohibits the issuance of ITM options and serves a tax policy purpose in blocking the expansion of the NQSO regime in the direction of restricted stock, but the distinction between discounted and non-discounted options within the specific context of § 409A is difficult to justify.

In enacting § 409A, Congress was clearly responding to techniques that were being used to minimize the risk to executives that deferred compensation amounts would not be paid while circumventing the application of the doctrine of constructive receipt, which would accelerate taxation to the time of the deferral.¹⁶⁴ Prior to the enactment of § 409A executives often entered into contracts in which they nominally deferred compensation until retirement, but were permitted to take early withdrawals with a penalty. These "haircut" provisions allowed executives to withdraw funds if the financial condition of their companies deteriorated substantially, but the penalties were deemed substantial conditions on exercise that precluded application of the constructive receipt doctrine. Section 409A was intended to curtail this practice.¹⁶⁵

Stock options, of course, also cede timing control to the recipient and could be exercised on the brink of corporate financial distress. Congress apparently recognized the resemblance to traditional elective deferred compensation, but explicitly stated that it did not intend for the embedded deferral feature alone to pull non-discounted options into the § 409A universe. Therefore, in order for a distinction between

¹⁶² See *supra* note 101 and accompanying text.

¹⁶³ See *supra* Part II.C.2.

¹⁶⁴ See Doran, *supra* note 71, at 1311.

¹⁶⁵ See *id.*

discounted and non-discounted options to make sense within the context of § 409A, one would have to conclude that Congress was concerned about elective deferral beyond vesting with respect to discounted options, perhaps with respect to deeply discounted options resembling stock, but not with respect to non-discounted options. Otherwise, the distinction is difficult to justify.

But there is no reason to think that deeply discounted options would be more likely than non-discounted options to be held opportunistically post-vesting.¹⁶⁶ As I argued above, income deferral through delayed exercise of options, no matter how deeply in the money, carries a significant cost in terms of inhibiting diversification.¹⁶⁷ In this respect, either type of option is quite different from the elective cash-based deferred compensation plans that were the primary focus of the legislation. Investments in traditional non-qualified deferred compensation plans can be broadly diversified. Thus, participants have much more of an incentive to defer this compensation for an extended period and to create arrangements that protect a participant's interest against default by the payor. In sum, there is nothing obviously special about discounted options in the context of § 409A.

IV. OTHER EXPLANATIONS FOR TAX RULES DISCRIMINATING AGAINST DISCOUNTED OPTIONS

Part III documented the disparate treatment of discounted options, criticized the rationales for the disparity found in the regulatory histories, and put forward a tax policy rationale that might justify the efficiency loss associated with distorting corporate compensation arrangements. This part briefly suggests three rationales apart from tax that might explain, if not justify, the disparate treatment of discounted options. First, discounted options may appear to be a giveaway to executives. Congress may have wanted to avoid appearing to endorse or encourage the use of such options. Second, Congress may have felt that discounted options would lead to an actual giveaway – that executives would not fully pay for the moneyness of discounted options through reductions in the size of grants or other pay. Third, Congress might have been trying to protect potential recipients from irrational exuberance in favor of discounted options.

A. Symbolic Legislation

Even if compensation packages were optimally designed, it is likely that some observers would consider the issuance of discounted options

¹⁶⁶ See Huddart & Lang, *supra* note 146; Bettis et al (2005), *supra* note 146.

¹⁶⁷ See *supra* notes 146-148 and accompanying text.

to be a giveaway to recipients. These observers would view positive intrinsic value at grant as “money in the pocket” and raise the intuitively appealing argument that recipients can profit from discounted options even if share prices fail to rise.

Congress might wish to avoid the appearance of endorsing specific pay practices that would generate investor outrage. IRC § 162(m) may be viewed in this light generally. It can be seen as symbolic legislation that seeks less to solve a social problem than to demonstrate to voters that Congress shares their concerns and is taking action to deal with the problem, in the case of § 162(m) generally, excessive pay and the perception that pay was not linked to performance.¹⁶⁸

Similarly, the distinction between discounted and non-discounted options in the ISO rules, § 162(m), and § 409A might reflect, in part, congressional concern about the possibility of appearing to endorse or simply countenance explicitly discounted (read giveaway) options.

B. Avoiding an Actual Giveaway

It is possible that, prior to widespread use of the BSM option pricing model, pay packages that included discounted options could have resulted in greater overall executive pay than packages lacking discounted options, at least under a compensation setting process reflecting the managerial power view. Rules discouraging in-the-money options might have responded to this concern.

The upshot of rules discriminating against discounted options is that equity compensation is funneled into two discrete pools – stock awards and ATM options. We see this empirically, and it is not surprising given the tax and accounting rules. Channeling equity into these discrete pools may have facilitated comparison of executive pay packages, particularly prior to the widespread application of the BSM pricing model to compensatory options. Under the managerial power view, greater transparency and comparability inhibits excess compensation because deviations from the pack are easier to spot and attack.¹⁶⁹ If instead of granting just ATM options or combinations of ATM options and restricted stock, firms had issued a diverse range of option instruments of varied moneyness, comparing option grants might have been more difficult and total pay somewhat higher.¹⁷⁰

¹⁶⁸ For more on symbolic legislation, see Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L.REV. 1, 8 (1990); Mark Tushnet & Larry Yackle, *Symbolic Statutes and Real Laws: The Pathologies of the Antiterrorism and Effective Death Penalty Act and the Prison Litigation Reform Act*, 47 DUKE L.J. 1, 74-76 (1997).

¹⁶⁹ See Bebchuk et al., *supra* note 38; BEBCHUK & FRIED, *supra* note 38.

¹⁷⁰ Even under the managerial power view, greater pay does not necessarily follow from discounting strike prices. The reverse effect is also possible. Because intrinsic value is more salient than the value of the option privilege, the ratio of

Today, now that use of the BSM model is more widespread, it would be much easier to compare the value of options issued with varying degrees of grant date moneyness, and it is less likely that executives could extract greater compensation through particular option design, even if the managerial power view holds. Nonetheless, it is possible that this concern helped motivate discrimination against discounted options.

C. Protecting Employees against Irrational Exuberance

During the recent stock option backdating scandal, some observers suggested that one motivation for backdating might have been that option recipients would value the discount on an option beyond the economic value (and shareholder cost) of that discount. Since the accounting rules effectively barred firms from discounting options openly, so this story runs, firms backdated in order to discount options surreptitiously and cash in on this irrational employee exuberance.¹⁷¹ Rules discouraging the grant of discounted options might have the effect, and possibly the intent, of protecting employees against being taken advantage of in this fashion.

There is some evidence that option recipients focus excessively on moneyness in subjectively valuing options,¹⁷² and this is not counterintuitive. Despite easy access to on-line BSM calculators, the intrinsic value of an option at grant is likely to be much more salient than the value of the option privilege – the opportunity to benefit from further increases in stock price without risking capital.¹⁷³ For example, an employee comparing an ATM option on stock trading at \$100/share and an ITM option with a \$90 strike price might think that the latter option is worth \$10/option share more than the former, or something close to that, when in reality the difference in BSM value would more likely be in the \$3 to \$4/option share range.¹⁷⁴ If so, an explicitly discounted option would be more highly valued by the recipient than a package of stock and a non-discounted option, even if that package could be designed to provide identical payoffs.

executive pay to investor outrage may be maximized by granting options right at the money, despite the greater comparability of all options being granted at the money. *See infra* note 175 and accompanying text; *see also* Bebchuk et al., *supra* note 38; BEBCHUK & FRIED, *supra* note 38.

¹⁷¹ *See, e.g.*, Holman W. Jenkins, Jr., *Apple's Gore*, WALL ST. J., Jan. 10, 2007, at A16 (suggesting that “if employees are as prone to fallacious thinking as the media in valuing options packages, their delight in “in the money” options allowed them to be taken to the cleaners....”).

¹⁷² *See* Brian J. Hall, *The Pay to Performance Incentives of Executive Stock Options* 32 (NBER Working Paper No. 6674, Aug. 1998) (finding a “bias toward valuing options according [to] what they would be worth if exercised today”).

¹⁷³ [Cite to Kahneman & Tversky on salience.]

¹⁷⁴ Under the pricing assumptions used throughout this article, the ATM option would have a value of \$39.31/option share; the \$90 strike option would have a value of \$42.96/option share.

Of course, the tax rules have not discouraged firms from granting restricted stock, which is a zero strike price option, but it is unlikely that irrational exuberance in favor of discounted options would extend all the way to restricted stock. Unless an employee viewed an ATM option as being worthless, she could not conceivably view the difference in value between an ATM option and restricted stock as being equal to the difference between their strike prices, since the restricted stock is worth no more than the strike price of the ATM option.¹⁷⁵ Presumably, at some degree of discounting, employees would reframe options as stock and the mental link back to ATM option value would be severed.

If employee preferences for option discounts are respected like any other compensation feature providing utility, harnessing this exuberance might be seen as a win-win for employees and employers. Of course, a paternalistic regulator conceivably might be concerned about firms exploiting employees by paying them with discounted options, but I am skeptical that this story explains rules discouraging discounted options for two reasons. First, it is unlikely that regulators would be aware of the potential irrational exuberance. Second, even if they were aware of the issue, regulators are unlikely to feel a strong paternalistic need to protect the well educated and highly compensated employees and executives in the U.S., who typically receive options, from making poor choices regarding the form of their compensation.

V. THE EFFICIENCY COST OF DISTORTED COMPENSATION ARRANGEMENTS

Rules discouraging firms from granting ITM options distort compensation design and may reduce the efficiency of corporate compensation arrangements.¹⁷⁶ It is difficult to quantify the efficiency

¹⁷⁵ Suppose, for example, that the stock's market value at grant is \$100/share. The difference in strike price between an ATM option and restricted stock would be \$100/share. Assuming the employee values the ATM option positively and the stock at \$100/share, her subjective difference in valuation must be less than \$100/share.

¹⁷⁶ Distortions are not necessarily welfare reducing. A legal rule that distorts private contracts and compensates for market failure can increase social welfare. Moreover, according to the theory of the second best, in the presence of a market failure, we cannot be sure that eliminating one distortion in a market, which does not totally eliminate the market failure, will enhance social welfare. [Add cites on theory of second best.] Many scholars have argued that the market for *executive* talent, at least, is not perfectly competitive because directors are imperfect agents of shareholders in bargaining with senior executives. See, e.g., Bebchuk et al, *supra* note 38; BEBCHUK & FRIED, *supra* note 38. Thus, we cannot be certain that an additional distortion related to executive compensation, even if not specifically justified as overcoming an externality or market failure, is welfare reducing. However, labor markets below the senior executive level should be competitive. To this extent, at least, distortion in compensation design is likely to be efficiency reducing.

loss, but this part considers the distortion issue qualitatively by considering two factors that affect the potential cost of the distortion: 1) the adequacy of combinations of ATM options and restricted stock as substitutes for ITM options and 2) the likelihood that U.S. firms would issue ITM options but for the tax and former accounting rules.

A. The Transmutability of Synthetic and Explicitly Discounted Options

The efficiency cost of any distortion in compensation design resulting from tax or accounting rules discouraging explicitly discounted options is limited if combinations of ATM options and restricted stock, which are not discouraged, serve as a close substitute. And as a matter of pure economics, these instruments are largely transmutable. A firm can roughly approximate the incentive effects of an explicitly discounted option with a combination of conventional time-vested restricted stock and a non-discounted option. The first part of this section explores how these replications may be accomplished and discusses the limitations on replication. Afterwards, I consider details of stock and option design that tend to limit transmutability as well as the possibility, noted above, that explicitly discounted options might be more attractive to recipients than their economics would suggest. This irrational exuberance probably could not be replicated through combinations of stock and non-discounted options.

1. The Economics of Synthetic and Explicitly Discounted Options

One cannot perfectly replicate the economics of an ITM option with a combination of an ATM option and conventional restricted stock, but there are innumerable ways of approximating replication.¹⁷⁷ I will focus here on a method that equalizes the grant date value of the compensation packages as well as the sensitivity of pay to stock price movement at grant as measured by option “delta”.

When economists analyze the incentive effects of options, they use the concept of option delta. Delta refers to the rate of change in an option’s value, and its price if the option is traded, relative to a small change in value of the underlying shares.¹⁷⁸ Put another way, the delta of an option indicates the number of shares that one must hold to duplicate or offset the price risk exposure of the option at any given

¹⁷⁷ Near perfect replication could be accomplished utilizing performance-vested restricted stock that vests all or in part depending solely on the future stock price. However, this type of vesting condition is never observed, and thus I will limit my analysis to the more realistic case of conventional time-vested restricted stock.

¹⁷⁸ See JOHN C. HULL, *OPTIONS, FUTURES, AND OTHER DERIVATIVES* 344 (6th ed. 2006).

time. Although delta is most commonly used in hedging traded options, it provides a useful tool for evaluating employee options as well.¹⁷⁹

Two other introductory comments about option delta will be helpful. First, option delta is dynamic.¹⁸⁰ As the underlying share price changes, as the option moves in or out of the money, the delta moves as well. Traders who seek to hedge option positions must regularly buy or sell shares to manage their exposure.¹⁸¹ Second, the delta of restricted stock – the zero strike price option – is one.¹⁸² This makes sense. If one wished to hedge a short position in one share of stock, one would purchase a single share of stock.

Ideally, then, in order to replicate an explicit ITM option with a combination of restricted stock and an ATM option, one would select the combination that had the same BSM value and the same delta as the explicitly discounted option. However, there is no combination of stock and non-discounted option that provides the same delta as an explicitly discounted option over all potential stock prices. The dynamic nature of delta dooms the attempt. Nonetheless, there is a unique combination of stock and an ATM option that has the same BSM value and delta *at grant* as any ITM option, and this combination provides a fairly close approximation of the economics of the discounted option.

Let us assume, for example, that we wish to replicate a 25% discounted option on stock with grant date value of \$100/share using a combination of an ATM option and restricted stock.¹⁸³ Under the same assumptions I used in Part III in valuing options, the BSM value of this discounted option is \$49.30/option share.¹⁸⁴ Its delta at grant is 0.835.¹⁸⁵ In other words, at the moment of grant, holding 0.835 shares of stock would create the same exposure as holding one 25% discounted option share. Under the same assumptions, the BSM value of an ATM option is \$39.30/option share and its delta at grant is 0.738. A share of restricted stock at the same point would be valued at \$100/share and would have a delta of 1.0. Because the deltas of the instruments in a portfolio are additive,¹⁸⁶ we can determine the replicating package of stock and ATM option with a little algebra. In this case, a combination of 0.99 ATM option shares and 0.10 shares of restricted stock have the

¹⁷⁹ See, e.g., John E. Core & Wayne R. Guay, *Stock Option Plans for Non-Executive Employees*, 61 J. FIN. ECON. 268-270 (2001) (using option delta as the measure of employee option incentives).

¹⁸⁰ See HULL, *supra* note 178, at 345.

¹⁸¹ See *id.*

¹⁸² See *id.*

¹⁸³ The explicit ITM option would have an exercise price of \$75/share.

¹⁸⁴ Those assumptions are: \$100/share grant date stock value, 35% stock price volatility, 6 years to option exercise, a risk free interest rate of 3%, and no dividends.

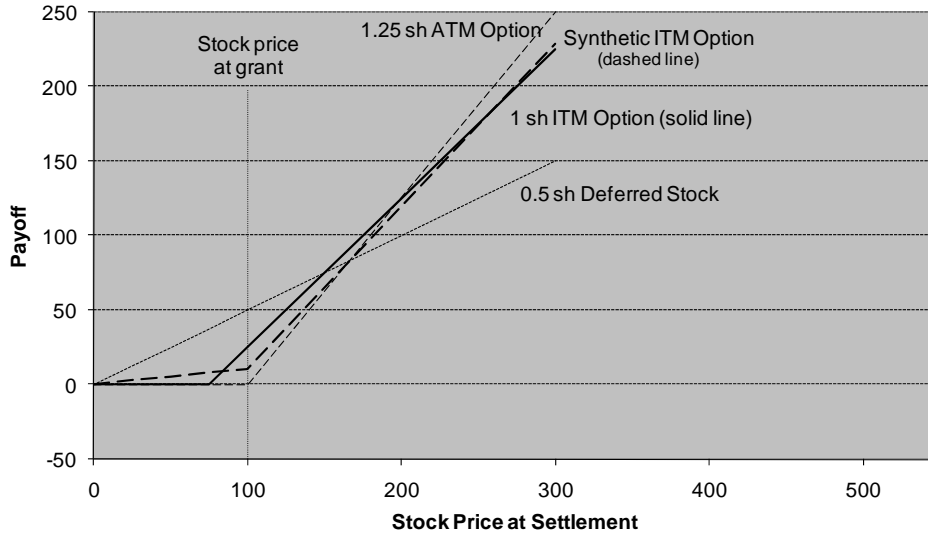
¹⁸⁵ Option deltas were determined using the calculator found at <http://www.option-price.com/>.

¹⁸⁶ See HULL, *supra* note 178, at 345.

same BSM value and delta at grant as a 25% discounted option on a single share.¹⁸⁷

The following figure presents the payoff profiles of four equal value compensation instruments – the explicitly discounted option, the combination of ATM option and stock that provides the same delta at grant, and, for comparison, an ATM option and deferred stock alone.¹⁸⁸

Figure 3
25% ITM Option Replication - Equal Value Instruments



The slopes of the various lines in this figure represent the sensitivity of pay to stock price performance. As the figure illustrates, *per dollar of compensation cost*, ATM options provide the highest powered incentives of this group – the sharpest increase in pay for a given increase in share price – at least over the range of stock prices equal to the grant date price and above. Deferred stock provides the least pay-for-performance sensitivity. The synthetic and explicitly discounted options provide similar pay-for-performance sensitivity that is intermediate to that of deferred stock or ATM options alone.

And this is the primary point to this analysis: not that firms can perfectly replicate ITM options through combinations of deferred stock and ATM options, but that the two approaches can be used to provide similar incentives, which suggests that synthetic ITM options may provide a reasonably close substitute for explicit ITM options, from an

¹⁸⁷ See Appendix.

¹⁸⁸ Because the “premiums” paid for compensatory stock or options take the form of reductions in other compensation, which are unobservable, these payoff diagrams focus solely on the value received by the participant at settlement.

optimal contracting standpoint.¹⁸⁹ However, this rather abstract view of the transmutability of explicit and synthetic ITM options is to some extent tempered by differences in details of stock and option design discussed in the next subsection and by differences in employee perceptions discussed in the following subsection.

2. Differences in Stock and Option Design that Affect Transmutability

The devil, of course, is always in the details, and several details regarding the design of conventional stock and option compensation undermines transmutability. These design features are not cast in stone, but there is undoubtedly inertia behind these conventional features.

a. The Timing of Stock Vesting and Option Exercise

The analysis in this part has been based on a simplifying assumption of European options (options that may be exercised only on a single, pre-specified date) which are exercisable, if at all, on the same date that the restricted stock vests. In reality, U.S. compensatory stock options are Bermudan.¹⁹⁰ They cannot be exercised prior to vesting and in some cases exercise may be proscribed during certain black-out periods, but otherwise they may be exercised at any point between vesting and expiration at the holder's discretion. Expiration, typically, is on the tenth anniversary of the date of grant. Clearly, the ability to time the exercise of an option provides value to the holder that cannot be replicated through deferred stock.¹⁹¹

However, the difference is not as important as one might think. Vesting patterns for stock and option grants tend to be similar,¹⁹² and the evidence indicates that optionees routinely sacrifice option value by exercising the instruments well before expiration, often shortly after

¹⁸⁹ As I have noted, the deltas of the synthetic and explicit ITM options will not track over time. If, for example, the share price doubles to \$200, the delta of the explicit ITM option would be 0.963, while the delta of the combination grant would be 1.017. If the stock fell to \$50/share, the delta of the explicit ITM option would be 0.566, while the combination grant's delta would be 0.529.

¹⁹⁰ U.S. employee stock options are often referred to as American options, but technically an American option may be exercised at any point between the grant of the option and expiration. U.S. employee stock options are a hybrid of European and American options, hence Bermudan.

¹⁹¹ Stock can obviously be held past vesting as well, but holding stock entails greater downside risk than holding an option. Thus, all else being equal, one would expect options to be held longer than stock.

¹⁹² A recent study of executive compensation practices at the 250 largest companies in the Standard & Poor's 500 Index found that 96% of stock options and 95% of restricted stock grants vested in three to five years. Although options were more likely than stock grants to vest in installments, the distribution of vesting periods was quite similar. See FREDERICK W. COOK & CO., *supra* note 18, at 14.

vesting.¹⁹³ As an empirical matter, then, the fact that options can be held unexercised well beyond vesting may not matter very much.

b. IRC § 83(b) Elections

I have assumed throughout that recipients of restricted stock do not make § 83(b) elections. If this election is made, stock compensation is taxed at grant, based on its grant date fair market value, ignoring the restriction on transferability prior to vesting. Gains or losses going forward are capital gains or losses. At first blush, the election might seem advisable for a bullish employee in receipt of restricted stock. Recognizing a small amount of ordinary income at grant and establishing a low basis would convert ordinary income into capital gain. But for two reasons public company employees rarely make § 83(b) elections. First, if they do, and if they forfeit the stock prior to vesting, the tax paid is not recoverable.¹⁹⁴ Second, public company employees can generally purchase shares outside of compensation plans. If their bullish prediction is correct and the stock appreciates, they will be better off deferring the tax on the restricted stock grant by foregoing the § 83(b) election and investing the deferred tax in more shares.¹⁹⁵

On the other hand, bullish employees of private companies, who often cannot purchase shares outside of compensation plans, might reasonably choose to make the election, particularly if they are relatively confident that they will remain with the company through vesting.¹⁹⁶ In these situations, the possibility of a § 83(b) election with respect to stock, but not options, reduces the similarity between explicit ITM options and packages of stock and non-discounted options.

c. Other Differences

There are other important differences between stock and option grants that affect the transmutability of explicit and synthetic discounted options. As Dean Schizer has shown, executives can readily hedge restricted stock grants in the period between grant and vesting, whereas tax and securities laws make it much more difficult and costly for executives to hedge their exposure to options.¹⁹⁷ Holders of restricted stock receive dividends; option holders are not generally entitled to dividends, although executive stock option plans sometimes include

¹⁹³ See *supra* note 146 and accompanying text.

¹⁹⁴ See IRC § 83(b) (clarifying that an individual making a § 83(b) election cannot subsequently claim a deduction if the property is forfeited).

¹⁹⁵ See David I. Walker, Market Symmetry and the Tax Efficiency of Equity Compensation (Working Paper).

¹⁹⁶ See Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874 (2003).

¹⁹⁷ See Schizer, *supra* note 133.

“dividend protection,” which economically approximates dividend rights.¹⁹⁸ Restricted shares may be voted in shareholder elections; options provide no voting rights.¹⁹⁹

3. Employee Attitudes towards Explicit and Synthetic Discounted Options

As discussed in Part IV.C, as a result of a salience bias, employees may perceive explicitly discounted options to be more valuable than economically equivalent packages of non-discounted options and restricted stock. Differences in perceived value would make it costlier for firms to substitute packages of non-discounted options and stock for explicitly discounted options. Of course, this difference has independent normative implications. We may legitimately disregard a “cost” associated with reduced exploitation of employees.

B. Would U.S. Firms Issue ITM Options but for the Tax and Accounting Rules Discouraging Them?

It is clear from the data reviewed in Part II.B that there is significant demand for ITM pay packages at U.S. public companies. This does not mean, however, that in the absence of regulatory barriers, firms would simplify compensation plans and reduce administrative costs by replacing combinations of stock and non-discounted options with explicitly discounted options. Why not? One reason would be that the irrational exuberance of employees in favor of discounted options might well be matched by irrational outrage on the part of investors and the financial press. We are all susceptible to the salience bias, and it might be difficult for firms to convince investors that discounted options represented optimal compensation rather than a giveaway to employees. Given that risk, firms might logically decide to continue granting relatively low outrage packages of non-discounted options and stock, at least to senior executives whose pay is most visible and outrage-inducing, even if there was some loss of efficiency.²⁰⁰

¹⁹⁸ See Murphy, *supra* note 2, at 2510 (noting that the most common form of dividend protection is the payment of accumulated dividends plus interest on option exercise).

¹⁹⁹ Of course, performance shares, which are equivalent economically to restricted stock, are non-voting prior to settlement, just like options.

²⁰⁰ Consider out-of-the-money options. There are no tax or other regulatory barriers to issuing these options, but they are observed almost as rarely as ITM options. Why? Perhaps they are rarely optimal. Perhaps just as employees would tend to overvalue a strike price discount, they might overestimate the cost to them of a strike price premium. But another possibility, put forward by Lucian Bebchuk, Jesse Fried, and myself, is that the ATM line might represent an investor outrage sweet spot for executive stock options. If discounted options draw fire, while firms receive little credit from investors for issuing premium options, the ratio of option value to investor

It is a difficult proposition to assess. One might look elsewhere in the world to see whether discounted options are prevalent, but relationships between directors and shareholders of U.S. firms are somewhat unique, and, moreover, one would find that the U.S. is not alone in discouraging explicitly discounted options. Thus, this international inquiry might not be as fruitful as it might appear at first blush.²⁰¹

VI. CONCLUSION

In my assessment, curtailing the ability of firms and employees to achieve the tax deferral and timing control associated with NQSOs and ISOs for deeply discounted options that resemble stock awards is probably the most compelling argument for rules discouraging grants of explicitly discounted options. I am not convinced that the incremental threat to the public fisc of expanding NQSO & ISO taxation to stock grants is terribly serious, although I would view such expansion as a move in the wrong direction.

Moreover, while one could certainly criticize § 409A's 20% penalty tax on discounted options as being an excessive and uncalibrated

outrage may be maximized by issuing ATM options. *See* Bebchuk et al, *supra* note 38; BEBCHUK & FRIED, *supra* note 38.

²⁰¹ Discounted options are observed in the U.K., but following the 1995 Greenbury Report on best practices for corporate governance, they appear to have been limited to non-executive employees. *See* DIRECTORS' REMUNERATION: REPORT OF A STUDY GROUP CHAIRED BY SIR RICHARD GREENBURY, 17 (1995) (providing, without elaboration, that "executive share options should never be issued at a discount"); MARTIN J. CONYON & CHRIS MALLIN, DIRECTOR'S SHARE OPTIONS, PERFORMANCE CRITERIA AND DISCLOSURE: COMPLIANCE WITH THE GREENBURY REPORT 47 (1997) (providing data indicating that non-executive options issued by FTSE 100 and Mid 250 firms in the mid-1990s were granted with mean discounts of about 19%, while executive options were issued with no discounts, but noting that prior to the Greenbury report many executive options were issued at the money); Konstantinos Stathopoulos et al., *U.K. Executive Compensation Practices: New Economy versus Old Economy*, 16 J. MGMT. ACCT. RES. 57, 77 (2004) (finding that a "substantial portion" of options issued to U.K. retailing employees were issued at a considerable discount).

In Germany, the stock corporation act restricts stock option discounting. *See* PRICEWATERHOUSECOOPERS, EMPLOYEE STOCK OPTIONS IN THE EU AND THE USA: GERMANY ¶ 2.9 (2002). Moreover, tax rules in Belgium, France, Ireland, and Italy (formerly) discourage ITMOs. *See* Francesco Cohen et al., *Employee Stock Options: Italy and the World*, 44 TAX NOTES INT'L 928, 965, 969-70 (Dec. 18, 2006) (describing former and current Italian tax rules and briefly outlining rules applicable in France and Ireland); PRICEWATERHOUSECOOPERS, EMPLOYEE STOCK OPTIONS IN THE EU AND THE USA: OVERVIEW (2002) (noting that discounted options in Belgium are subject to social security tax). Apparently tax or accounting rules in Canada discourage discounted options. *See* Kenneth Klassen & Amin Mawani, *The Impact of Financial and Tax Reporting Incentives on Option Grants to Canadian CEOs*, 17 CONTEMP. ACCT. RES. 227, 235 (2000).

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response - taking discounted options off the table entirely rather than treating and taxing them as part of a continuum – at this stage of the analysis it appears that the efficiency cost of forcing firms to bifurcate in the money pay packages into combinations of non-discounted options and stock is probably modest. Given the additional wildcard of unpredictable subjective valuation of discounted options, which is unlikely to add to social welfare, it is not clear that replacing the § 409A sledgehammer with more nuanced regulation should be a high priority.

APPENDIX: BSM AND INITIAL DELTA EQUIVALENT ITM OPTION
REPLICATION

Under the pricing assumptions listed in note x, *supra*, the BSM values and grant date deltas of the instruments considered in Part V.A.1 are as follows:

	<u>ATM Option</u>	<u>25% ITM Option</u>	<u>Rest. Stock</u>
BSM Value	\$39.3	\$49.3	\$100
Initial Delta	.738	.835	1.0

The combination of shares of restricted stock (x) and ATM options shares (y) that has the same BSM value and initial delta as the 25% ITM option is determined as follows:

$$100x + 39.3y = 49.3.$$

$$1x + .738y = .835.$$

Solving the equations yields $x = .103$, $y = .991$.