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Options legislation would bring on a tech industry depression

My View *by Donald L. Luskin*

For years reformers have tried to get companies that issue stock options to include the cost of those options in their financial statements. I've never been able to understand why Silicon Valley executives have always fought these reforms so violently, since simply reporting the cost of options wouldn't cost a penny.

Now there's new legislation that would do a lot more that just change reporting conventions. It will cost valley businesses billions and billions of dollars, and it should be fought to the last breath.

Senate Bill 1940 -- "The Ending the Double Standard for Stock Options Act" sponsored by Michigan Democrat Carl Levin, Arizona Republican John McCain, and three other senators -- masquerades as a post-Enron reform.

It is in fact a stealth tax increase, and a gigantic one. And it's an incentive to new forms of corruption by executives and auditors.

S.1940 would increase Cisco's taxes by $1.1 billion based on last-year's numbers. It would increase Oracle's taxes by $988 million. It would increase Sun Microsystems' taxes by $636 million. Extracting that kind of money from Silicon Valley and shipping it off to Washington would turn today's technology recession into a technology depression.

S.1940 works by addressing inconsistencies between accounting rules and tax laws. Currently, companies are not required to report options expenses at all under accounting rules set by the private Financial Accounting Standards Board. But under entirely separate tax laws set by Congress, they can nevertheless deduct options expenses.

S.1940 resolves this "double standard" by limiting a company's tax deduction to whatever options expense it reports in its financial statements.

That means that any company that uses accounting rules to report zero options expenses gets zero tax deduction. Under S.1940, that's quite an incentive for companies to report their options expenses.

Accounting rules permit only one way to report options expenses other than zero – and that's their "fair value" at the time they are issued. On the other hand, present tax laws allow companies to deduct a much higher amount -- the actual value of options at the time they are exercised.

Options are almost always worth more when they are exercised than when they are issued. If they weren't, why would anyone want them in the first place? And that's why S.1940 is a gigantic tax increase: it would require companies to deduct only the lower cost of options issuance, not the higher cost of options exercise.

What's more, switching the tax deduction to "fair value" at the time of issue creates incentives for corruption. The cost of exercise is an objective fact. But "fair value" is calculated by a theoretical model, which must be fed subjective forecasts from executives and auditors before it can come up with a result. Considering the huge tax increase that companies would bear under S.1940, executives would be tempted to jigger those subjective forecasts to produce the biggest deduction they could get away with.

Kicking Silicon Valley when it's down with a huge tax increase is a dangerous idea, even if S.1940 hides its tax increase behind post-Enron reforms. But adding injury to injury, the reforms themselves would only give rise to more corruption.

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