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Hedging Your Bets Against Proposed FASB Options Changes

by Robert W. Wood • San Francisco

A "hedge" used to be a dirty word in the tax world, given the IRS view of them over the years. Nonetheless, as noted in *The M&A Tax Report* just last month, the Service has recognized the need for some hedges. It has even proposed regulations under which some of these transactions would receive the imprimatur of ordinary (rather than capital) status. (See "New Temp. Regs. Favor Hedges," 2 *M&A Tax Rep't* 4 (November 1993), p. 1.)

It seems too early to be losing much sleep over the proposed Financial Accounting Standards Board ("FASB") rules regarding the treatment of options. Admittedly, people have been talking about the unattractive effect on earnings treatment on option grants for some time. The FASB proposal made earlier this year—but not scheduled to take effect until 1997—would make options grants for many companies very expensive from a financial statement point of view.

The hardest hit would be start-up companies that have traditionally relied on options to attract talent, and those that have worried about making their financial statements as attractive as possible. Yet, there is already a glimmer of ingenuity that may mitigate the effect of the heavy hand of the FASB, even if the rule is implemented. (See "Banks Devise Ways for Firms to Hedge Against Stock-Option Accounting Rule," *Wall St. J.*, 11/22/93, p. A2.)

Earnings Wallop

Under the FASB proposal, the cost of a stock option would have to be measured on the day of its grant. Its cost would reduce the company's net income for that year. Of course, under the accounting rules already in effect, a corporation is required to deduct the cost of an option if it is related to the performance of the company or individual. The dreaded reduction in earnings is apparently avoidable, though, if the company issues options with fixed exercise prices and offers specific amounts of options to employees.

While it may sound like this technique would not work, there is some evidence that it works very well. AT&T reportedly issued a great volume of options to key employees during 1991, exercisable if its stock rose from 20% to 50% from the day of issuance. No reduction of earnings was taken. Why? The exercise price of the options was higher than the market price of the AT&T stock on the day they were issued. Therefore, they were not considered performa[illegible]-related. (See "Banks Devise Ways for Fi[illegible] Hedge Against Stock-Option Accounting Rule," *Wall St. J.*, 11/22/93, p. A2.)

A slight change in the program might have had vastly different consequences. For example, if the options were keyed to market price on the date they were issued, an earnings reduction would have been required.

A Green Hedge

Since such machinations would apparently be stopped under the new FASB rules, the question is whether there is some way for a company to mitigate the charge to earnings that will result. Enter the hedge. Suppose the issuing corporation bought call options on the company's own stock simultaneously with its grant of the options. The call options would provide the corporation with the right to buy

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the stock at a set price (presumably, a price slightly higher than the current market price), within a particular window of opportunity.

The idea—still untested—is that the exercise of the call options would soften the total "cost" of the option issuance by allowing the company an offsetting tax deduction for the purchase of the call options. There may not be any takers just yet, but if the offsetting nature of the transactions can be confirmed, there likely will be some. There are reportedly some heavyweight advisors touting the benefits of this idea. (See "Banks Devise Ways for Firms to Hedge Against Stock-Option Accounting Rule," *Wall St. J.*, 11/22/93, p. A2.)

Legislative Fight?

There were suggestions not too many months ago that the automatic earnings charge rule would be resolved not on Wall Street, but in Washington. Legislators Senator Levin (D-Mich.) and Rep. Bryant (D-Tex.) had introduced companion bills (S. 259 and H.R. 2878) that would require a charge against earnings for stock options in the event the FASB proposal failed.

Not to be outdone, a number of other Senators (Lieberman, Mack, Feinstein, and Boxer) co-sponsored the Equity Expansion Act of 1993, S. 1175, to overrule any final FASB rule imposing more burdensome treatment for options issuances. At the end of July, a companion measure was introduced in the House by Reps. Johnson (R-Ct.) and Payne (D-Va.). Then, in August, a concurrent resolution (S. Con. Res. 34) was introduced by Sen. Bradley (D-NJ) that urged the FASB to abandon its options proposal.

It seems a relatively safe bet that the FASB will not back off of its position, and that the legislators campaigning *against* the FASB rule are more likely to have to raise their swords than those legislators arguing *for* the earnings charge.

Part of the fundamental debate revolves around the question of just what role options ought to play in the market and the workplace. The proposal in S. 1175 would not only override the FASB's stock-based compensation proposal, but also is supposed to provide new tax incentives to encourage employees to retain stock purchased with options. The bill is also intended to broaden the base of employees that receive options as part of their compensation package.

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Senator Bradley railed against the proposed FASB rule for all companies, particularly those in growth industries. Criticizing the FASB's stated rationale of improving disclosure of executive compensation, particularly for upper-tier executives, Bradley noted that the FASB rule would significantly raise the cost of providing options to low- and mid-level employees.

Options for the Masses?

All this comes at a time when options are again receiving significant attention. With the effect of the 1993 tax rate increases, many executives are more interested in options than before. Some are even choosing to receive options in lieu of some of their cash compensation as a means of achieving some coveted tax deferral. The earliest most options are taxed, of course, is on their exercise, thus pushing off to the future the rate squeeze.

It has been reported that a huge volume of companies already have options plans—between 90% and 95% of all publicly traded companies. A good number of privately held firms have them as well. In addition, there have been suggestions that companies are now rushing to grant options more readily than ever before. (See "Stock Options Can Be a Valuable Tax-Cutting Tool," *Wall St. J.*, 11/24/93, p. C1.) At least one reason for this renewed activity is the anticipation of imminent FASB rule changes,

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changes that would make the options gauntlet more difficult to run.

ISOs vs. Nonqualified Options

The old debate between incentive stock options ("ISOs") and nonqualified options is also on again, with the additional deferral benefits of ISOs (which are not taxed on exercise, but rather, when the underlying stock is sold) being touted. Nonetheless, it seems likely that the overwhelming popularity of nonqualified options (with their ease, flexibility, and exemption from the alternative minimum tax) will continue.

With the negative impact of the 1993 tax rate increases now clear, many option holders may even want to consider the desirability of exercising options today as a hedge against the increased Medicare taxes in 1994. An exercise of nonqualified options this year, with the payment of the resulting tax liability, will ensure that future increases in the value of the stock will be taxed at capital gains rates.

If an option holder expects the stock value to go up materially (or even dramatically), the tax rate differential has to be figured into the equation against the admittedly negative effect of paying tax on the exercise. There were some dramatic examples of large option exercises during the closing weeks of 1992—exercises that certainly turned out right from a tax-rate perspective. While we are unlikely to see such dramatic exercises this year, there may be a few.

Section 83(b) Redux?

In fact, this kind of tax rate, timing, and appreciation analysis may even bring some option holders back to evaluating the Section 83(b) election, under which the holder elects current taxability of the nonqualified options, notwithstanding the fact that they have not yet been exercised. The election must be made within 30 days of the option grant, and is relatively infrequently made because of the tax that must be paid for that year.

The key, though, is value, because the Section 83(b) election only requires inclusion of the then-value of the options (which may be low). Such an election, with a zero or small value reported, would seem to be nice protection. (See *Alves*, 734 F.2d 478 (CA-9, 1984), and Wood, "Using the Section 83(b) Election for Market Value Transfers," 62 *TAXES* 525 (1984).)

Admittedly, Section 83(b) elections are generally made only with actual stock, for example, when an employee receives a stock bonus subject to restrictions, or the employee is allowed to purchase stock. The real beauty of the election is in the latter case, particularly if it can be said that the employee has paid fair market value for the stock, resulting in zero income inclusion.

On the plus side, if the Section 83(b) election is made, thereafter, both the amount of tax and its timing will be positively affected. When the options are later exercised, there will be no tax consequence—tax will only be due on the sale of the underlying stock. In addition, any gain will be capital rather than ordinary. This is the same result as would be the case if the Section 83(b) election had not been made.

Given the heated legislative battle, the only certainty in this complex area is that the last word on this controversial subject will not be heard for quite some time. ■

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