TAXES

JB:

MR

MEMORANDUM

TO: **TOM FREEDMAN**

FROM: **RAVEN MONTGOMERY**

RE: **TAKING STOCK OF TAX DEDUCTIONS FOR OPTIONS**

DATE: **JUNE 23, 1997**

Proposals

- Feels that Congress should opt for tax fairness for the option holders, reducing both the individual tax rates assessed on those gais and the corporate tax benefit.
- Congress needs to recognize and retain the value of the employee options. Would like to halve the corporate deduction on nonqualified option gains, while taxing employees at capital gain rates if they have owned the option for at least one year, and deferring any tax gain until the employee ultimately sells the stock, which would provide incentives to increase real employee stock ownership.
- Congress could also incentivize national savings by exempting 10% of the gain, up to $10,000 if option holders contribute the amount to their 401 (K), IRA or other retirement savings device.
- Congress should weigh the large number of employees who are unfairly taxed against the relatively few corporations who take advantage of a non-cash deduction. By recognizing, the value of human capital, and taxing it the same way capital gains are assesed against the coupon clippers, Congress can go far in eliminating a major unfairness in current tax laws.

JOURNAL

Tom Friedman 202 456-7431

Taking Stock of Tax Deductions for Options

The current clamor for a reduction in the capital gains rates and other tax reductions causes one to hope that Congress will use the opportunity to correct an existing imbalance in the tax code that unfairly taxes employees on their gains on stock option exercises at full rates while taxing shareholders in the same corporations at significantly lower rates and allowing companies a deduction for compensation in the absence of any cash outlay by the company. Congress should now opt for tax fairness for the option holders, reducing both the individual tax rates assessed on those gains and the corporate tax benefit.

Current law allows companies who grant "nonqualified" stock options to employees to deduct the gains earned when options are exercised and then shares are sold. (Companies may also grant "incentive stock options", with reduced tax benefits, but they are now less popular due to the loss of the corporate deduction.) This most commonly occurs when a private company grants stock options, often at low values, then goes public, and sees a major increase in the company's value within a short period. Because many high technology and biomedical companies offer options in a pre-public phase to induce employees to help position the company for a public offering, the employee gains, and the tax deduction for the corporation, can often be substantial. For example, O.C. Sync Research reported that it had over $10 million in gains it would deduct against future taxable income. Microsoft's cash benefit from the deductions of option gains was $325 million for fiscal 1996.

Many of the option holders are like you and me. While they did not invest cash or borrow money to start up a company, they took a chance, and invested their career in a company which was willing to offer them not only wages, but part of the "up side" in exchange for their value as both employees and quasi-investors. While the founders of a company who sell some part of their holdings in a public offering are taxed at capital gain rates (maximum 28%), the employee option holder must include their option gain in their income at ordinary, not capital, rates. Since this gain often increases income for middle and higher income taxpayers, employees may see the gain taxed at 39.6%, and even higher, since the gain is subject to FICA (6.2%, up to $62,000) and Medicare taxes (1.45% unlimited). Add in the current phaseout of personal exemptions and Schedule A deductions that occurs for taxpayers with over $120,000 in income, and the option gains are often taxed at a federal/state rate of over 50%.

US and California law allow companies to deduct the option gains, even though the company makes no cash payment, and in most cases, makes no charge on its financial statements to reflect an expense for the equity shared with the employee option holder. Current FASB standards do not require a charge if the option is granted at fair market value, and the tax savings does not reduce current tax expense, but is simply added to shareholder equity.

Compare to when a company makes an outright grant of stock to an employee: the value of the stock is deductible, and included in both the company's expenses and the employee's income. With nonqualified options, an employee is fully taxed immediately upon exercise of the options, even if the employee chooses to hold the shares after exercise, making it very unlikely that the employee will exercise and then keep the shares.

Much has been reported about the many "millionaires" created at Microsoft through the benefits of option gains. Curiously, Bill Gates'

$16 billion in share value will be taxed at capital gain rates when he sells stock, although the "millionaires" were taxed at rates approaching 50%, because the IRS makes an illogical distinction about the value of the human capital invested by the option holders. And, since Microsoft will deduct the gains at the corporate tax rate, Bill Gates will actually see his share value increase as a result of the reduced corporate taxes which result when his employees exercise nonqualified options.

After years of eliminating one loophole after another, the Congress is finally beginning to recognize the corporate welfare tax shelter offered to corporations with no actual cash or equity outlay. Senators McCain and Levin have introduced a bipartisan bill that would eliminate the corporate tax deduction unless the company actually reflects an income statement charge for the value of the option grant or exercise. Since companies do not want to dilute their earnings with the employee gains, but want to retain the tax savings, it is no surprise that business groups have launched an assault on the bill. There are few real free tax lunches left, and the AEA and Chamber of Commerce do not want to lose this one.

PROPOSAL

Congress would do well to recognize and retain the value of the employee options. While McCain/Levin would eliminate the deduction outright, another less draconian proposal is to halve the corporate deduction on nonqualified option gains, while taxing employees at capital gain rates if they have owned the option for at least one year, and deferring any tax gain until the employee ultimately sells the stock, which would provide significant incentive to increase real employee stock ownership. Finally, Congress could incentivize national savings by exempting 10% of the gain, up to $ 10,000, if option holders contribute the amount to their 401(k), IRA or other retirement savings device.

Finally, Congress should weigh the large number of employees who are unfairly taxed against the relatively few corporations who take advantage of a non-cash deduction. By recognizing the value of human capital which is vital to the formation, creation and maintenance of shareholder wealth, and taxing it the same way capital gains are assessed against the coupon clippers, Congress can go far in eliminating a major unfairness in current tax laws.

Frederick Judd is the Vice President Finance and General Counsel for an Irvine based computer company.

cc: Elena, Tom F.

"Helping Working Families Win"

1. Protecting Paychecks.

- *Taxes:*

Ensure tax cuts benefit working families:
- Distribution test on Tax Bill (i.e. bulk of tax cuts on fully phased-in basis should go to taxpayers making less than $80,000).
- Insist $100 billion of the Tax Bill over 5 years will be allocated to the education and child credits.
- Release Treasury distributional analysis of tax proposals.
- Request CBO distributional analysis of Roth and Archer Tax proposals.
- Highlight CRS report that disputes JTC methodology for assessing winners and losers from Capital Gains cuts.

- Make Child Credit refundable.
- Highlight any Republican deviation from informal Budget Deal agreements on EITC, education credits total, etc.

- Add safeguard to Tax Bill that will automatically reduce tax cuts in case of out years explosion. Insist the gimmicks that balloon in out years be dropped (i.e. capital gains indexing, phased-in estate tax cuts, backloaded IRAs).
- Highlight CBPP report exposing delayed revenue losses in GOP tax proposals.

Close corporate tax loopholes and use as offsets for agenda priorities above. Citizens for Tax Justice has identified $69 billion in corporate tax breaks, $23 billion go to specific industries like oil & gas, insurance, timber and minerals, or benefit companies that operate abroad, or allow for entertainment and meal deductions. [need more specifics]

Force deadbeat oil companies to pay the $440 million in royalties they owe the federal government. (Boxer)

Democratic tax simplification alternative to GOP proposal.

IRA payroll deduction for workers whose employers do not provide pension benefits. (Daschle/Kennedy/Bingaman)

Make health benefits for self-employed tax deductible.

Expand tax deductions for home offices.

- *Job/Wage Security:*

Profitable companies that use mass downsizing schemes must pay 6 months severance or training before they may pay dividends or executive raises or bonuses. (Reich)

Penalties for companies where executive compensation exceeds 50 times the average employee salary. (Bingaman)

Companies that receive federal subsidies or contracts must keep a majority of employees in the U.S. not overseas. (Reich) **or** Eliminate tax break that encourages companies to move jobs overseas. (Dorgan)

Stronger and better enforcement of the Equal Pay Act. (Daschle)

Impose liability on companies and retailers that sub-contract to, or knowingly buy from sweat-shops. (Kennedy); Ban imports made with child labor; (?) Develop labeling to reward products made without child or exploited labor. (Harkin)

- *Workplaces that work for workers:*

Make child care more accessible by providing tax incentives to employers to create on-site day care centers, or help subsidize employees' off-site arrangements. (Dodd) (Kohl/Hatch)

Allow unpaid leave for school or medical appointments. (Murray)

Extend Family and Medical Leave Act to cover small firms with less than 25 employees. (Dodd)

Flex time to give employees more control of their work schedules. Preserve the 40 hour work week. (Baucus/Kerrey)

- *Consumer Protection*

Lower the cost of basic financial services by protecting consumers from excessive automated teller, on-line or telephone banking charges. No bank fees for those who carry no balance on credit cards.

Authorize FCC reregulation of cable rates in markets where no competition has taken hold. Moratorium on cable TV rate increases. (Wyden)

Protect consumers from computer junk-e-mail. (CT Atty General); Prevent or limit trading of credit information over the Internet; Protect Internet privacy for children (FTC); Child-safe labelling of Internet sites (Murray); Develop V-chip type technology to block all non-child-safe Internet sites.

Insurance reform to eliminate Lifetime Limits. (Rockefeller)

Improve service and standards of managed care insurance by with incentives and rule changes to help health care professionals become managers of managed care plans; Set minimum standards of quality care to be observed by all managed care plans (Kennedy); Establish standards and procedures to give policy-holders consumer information about managed care plans.

Aviation safety issues (?)

2. Empowering Parents -- Protecting Children.

Repair crumbling schools by reducing the costs of financing school construction for local authorities. Like the popular COPs program, local authorities would retain control. (Mosley-Braun)

Extend health care coverage to all uninsured children [paid for with tax on cigarettes]. (Kennedy)

Fund HeadStart for all eligible 3 and 4 year-olds by adding a fee, or reducing the tax break, for advertising on children's television programs.

Expand school lunch and breakfast program/child nutrition.

Provide grants to local communities to improve the quality of child care programs [set quality or licensing standards]. (Dodd)

Improve technology training for teachers (Murray); Increase school access to communications networks, hardware and software (Rockefeller/Bingaman/Murray)

Protect Internet privacy for children (FTC); Child-safe labelling of Internet sites (Murray); Develop V-chip type technology to block all non-child-safe Internet sites.

Guarantee community Right-to-know about toxic exposures. (Baucus/Boxer)

Child safety locks on guns. (Kohl)

- *Safer Streets.*

Gun standards to combat "junk guns" would extend the same safety and quality standards currently used for import. (Boxer)

Child safety locks on guns. (Kohl)

Provide incentives to local communities to create After school Safe Havens.

Provide assistance for local communities to keep schools open until 5pm with optional programs for kids with parents who work -- also eases child care problems. Gives kids an alternative to the street and gives working parents peace-of-mind to know their children are in a safe, supervised environment. (Boxer)

Juvenile anti-gang initiative; Juvenile sentencing option for non-violent offenders; Expanded drug courts and drug treatment. (Daschle)

- *Cleaner Communities.*

Make polluters pay for clean-up. [need specifics]

Protect kids from toxic poisons by cleaning up all SuperFund sites within 4 miles of any child's home are cleaned up by 2005. Today 10 million children live within 4 miles of a major toxic waste site.

Guarantee community Right-to-know about toxic exposures. (Baucus/Boxer)

3. Making Retirement More Secure.

Extend Social Security solvency by increasing rate of return on investments and instituting other reforms. [need better description]

Protect pensions from being used to prop up company stock -- Color Tile. (Boxer)

Provide women who stay at home or work part-time with access to pension benefits. (Mosley-Braun)

IRA payroll deduction for workers whose employers do not provide pension benefits. (Daschle/Kennedy/Bingaman)

Make pensions portable. (Bingaman)

Protections against spousal impoverishment for long-term care.

Crackdown on Pharmacuetical price gouging on drugs. (Pryor) Prescription drug coverage for Medicare beneficiaries. (Rep Engel)

Health insurance coverage for early retirees abruptly dropped by insurers. (Daschle)

Others

Incentives for states that lower legal blood alcohol levels.

Increase allies burden sharing of defense costs.

Tarullo

General use 5/27

UNCLASSIFIED FAX FROM
THE NATIONAL ECONOMIC COUNCIL
AND
THE NATIONAL SECURITY COUNCIL OF
THE WHITE HOUSE

SENDER: **DANIEL K. TARULLO**

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PAGES: 2 **DATE:** July 2, 1997

SUBJECT: **International Tobacco Issues Meeting Follow-up**

TO: **Addressees (over)**

I would like to thank all of you who participated in today's meeting -- it was a helpful overview of existing policies and practices, and raised some critical issues that warrant further discussion.

I would also like to reiterate the need to receive your agency's input for the international issues discussion paper by the end of the day Monday, July 7. A draft will be circulated for comments and clearance prior to the opening of business on Wednesday with the expectation that a final draft will be circulated by the end of that day to participants in the Thursday meeting.

Please do not hesitate to contact me (direct phone: 456-5363; fax: 456-5334) should you require any clarification or guidance. I look forward to working with you.

Tobacco: International Issues Sub-Group

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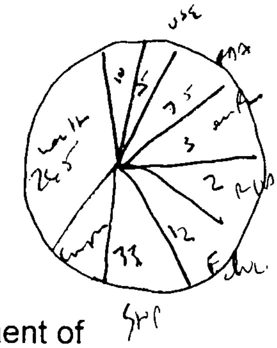

PROGRAMS / FUNDS IN TOBACCO SETTLEMENT

UP-FRONT COMMITMENT ($10 billion over 25 years)

- A one-time, $10 billion payment would be required as of the date of enactment of the settlement. There is no dedicated use for these funds.

BASE PAYMENTS ($333.5 billion over 25 years)

- **Federal and State Uses**

  Reduction in Tobacco Usage ($5.325 billion): For Secretary of HHS to encourage current tobacco users to quit through media-based and non-media based education, prevention and cessation campaigns.

  FDA ($7.5 billion): To the Food and Drug Administration (FDA) to enforce the terms of the settlement.

  Programs like ASSIST ($3.0 billion): For state and local tobacco control, similar to the community-based model of the ASSIST program

  Research ($2.5 billion): On the methods to prevent smoking and help individuals quit.

  Education ($12.5 billion): To fund an Independent, non-profit organization to run a multi-media campaign to discourage and de-glamorize tobacco use.

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- **Cessation Fund ($35.5 billion)**: To create a trust fund to promote effective cessation programs and provide financial assistance to access such programs.

- **Teams' Fund ($1.8 billion):** For 10 years, to compensate events, teams, or entries in such events who lose sponsorship by the tobacco industry as a result of the settlement. After 10 years, funds will be reallocated to education, enforcement of provisions, and community-based programs.

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- **Health / Other ($265.375 billion / possibly $151.264 billion Federal):** Remainder of the Base Payments; no specified use.

PUBLIC HEALTH TRUST FUND ($25 billion over 25 years)

3
- A Presidential Commission will be created to identify and fund specific tobacco-related medical research