To: Tom Higginbotham
From: Maryanne McCormick
Subject: S.1175 to overturn FASB's stock option ruling

Legislation to repeal FASB's rules on accounting for stock options and to change the tax treatment of stock options was introduced by Senator Lieberman.

S. 1175, the Equity Expansion Act of 1993, directs the SEC to end the charge against earnings now required on variable options, countering the decision by FASB on April 7, 1993.

Citing that FASB's rule change would have an adverse affect on job creation, Lieberman stated,

As a matter of abstract accounting theory, FASB's approach to stock option accounting may be defensible. But from a public policy, job creation, and competitiveness perspective, it is simply unnecessary and unusually disruptive.

Lieberman promised to provide "an examination of the accounting rationale for retaining the current accounting treatment of employee stock options" in a future floor statement.

He also noted that both Ernst & Young and Coopers & Lybrand examined his bill before introduction, concluding it was revenue positive.

Floor statements by Senators Lieberman and Feinstein and the text of the bill are attached.

cc: Joe Moraglio
    Ian MacKay
    Wayne Upton
    Arlene Rodda
    Legislative Affairs staff
of conflicts between the parties thereto.

Nothing in this Act shall be construed to confer jurisdiction on any court of the United States to consider and resolve such conflicts, or to alter or amend any law existing on the date of the enactment of this Act which may confer such jurisdiction in such courts.

SEC. 182. DEFINITIONS.

For purposes of this Act:

1. MOTOR VEHICLE AND MOTOR VEHICLE PARTS.—

(a) The term "motor vehicle" means any article of a kind described in the following provisions of the Harmonized Tariff Schedule of the United States.

(i) Subheadings 8407.31.00 through 8407.34.20 (relating to spark-ignition reciprocating or rotary internal combustion piston engines). Subheading 8407.34.20 (relating to the compression-ignition internal combustion engines).

(ii) Subheading 8407.40 (relating to parts suitable for use solely or principally with engines described in clauses (i) and (ii))

(iii) Subheading 8606.00.10 and 8606.00.15 (relating to chassis fitted with engines).

(iv) Heading 8707 (relating to motor vehicle bodies).

(v) Heading 8708 (relating to bumpers, brakes and servo brakes, gear boxes, drive axles, non-driving axles, road wheels, suspension shock absorbers, radiators, mufflers and exhaust pipes, clutches, steering columns, steering boxes, and other parts and accessories of motor vehicles).

The Secretary shall by regulation include as motor vehicle parts such other articles (described by classification under such Harmonized Tariff Schedule) that the Secretary considers appropriate for the purposes of this Act.

(b) The term "Japanese motor vehicle" means a motor vehicle which is the product of Japan.

(c) The term "Japanese motor vehicle part" means a motor vehicle part which is the product of Japan.

(2) ENTERED.—The term "entered" means entered, or withdrawn from warehouse for consumption, in the customs territory of the United States.

(3) IMPORT RESTRICTION IMPLEMENTATION PERIOD.—The term "import restriction implementation period" means a calendar year which—

(A) occurs after 1994 and before calendar year 2001, and

(B) follows a calendar year with respect to which the Secretary finds, under section 206(b), that the trade deficit reduction target was not met.

(4) INTERSTATE SALE.—The term "interstate sale" means sale or distribution in the interstate commerce of the output of States.

(5) BASELINE DEFECT.—(A) The term "baseline deficit" means the average monthly merchandise trade deficit, as computed by the Secretary, of the United States with Japan during calendar year 1993.

(B) In computing merchandise trade deficits under this title, the value of bilateral trade between the United States and Japan in—

(i) crude petroleum; and

(ii) common stock option plans, shall not be included.

(6) SECRETARY.—The term "Secretary" means the Secretary of Commerce.

(7) TRADE REPRESENTATIVE.—The term "trade representative" means the United States Trade Representative.

TITLE II—MERCHANDISE TRADE DEFicit REDUCTION

SEC. 281. STAGED TRADE DEFICIT REDUCTION:

(a) Trade Deficit Reduction Targets.—

(i) In General.—The trade deficit reduction target for each of the calendar years listed below is an average monthly merchandise trade deficit of the United States with Japan during such year that does not exceed an amount that equals the applicable percentage of the baseline deficit that appears opposite such year.

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Applicable Percentage of Baseline Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>80 percent</td>
</tr>
<tr>
<td>1995</td>
<td>60 percent</td>
</tr>
<tr>
<td>1996</td>
<td>40 percent</td>
</tr>
<tr>
<td>1997</td>
<td>20 percent</td>
</tr>
</tbody>
</table>

(ii) Special Rule for 1995.—For calendar year 1995, the trade deficit reduction target shall be treated as having been met if the merchandise trade deficit of the United States with Japan during such year does not exceed:

(A) an amount equal to 5 percent of the value of the aggregate bilateral merchandise trade between the United States and Japan during such year; or

(B) $5,000,000,000.

(b) Computations.—

(1) IN GENERAL.—Not later than January 1 following each calendar year listed in subsection (a)(1), the Secretary shall compute the trade deficit reduction target for such year.

(2) ANNOUNCEMENT OF IMPORT RESTRICTION IMPLEMENTATION PERIOD.—If the Secretary finds under paragraph (1) that the trade deficit reduction target specified under subsection (a) for a calendar year was not met, the Secretary shall announce, by publication in the Federal Register, that the import restriction implementation period is in effect beginning on January 1 of the year after the year to which the finding applies.

SEC. 282. COMPUTATION OF IMPORT RESTRICTION IMPLEMENTATION PERIOD.

(a) In General.—On January 1 of the first calendar year (and each calendar year thereafter) for which the import restriction implementation period is in effect, the Secretary shall compute and publish in the Federal Register the quantitative import restrictions for such calendar year.

(b) COMPUTATION.—

(1) IN GENERAL.—For purposes of subsection (a), the term "quantitative import restrictions" means the aggregate quantity of Japanese motor vehicles and the aggregate quantity of Japanese motor vehicle parts that may be entered into the United States (in accordance with paragraph (2) or (3) for a calendar year described in subsection (a).

(2) BASELINE RESTRICTION.—The aggregate quantity of Japanese motor vehicles and Japanese motor vehicle parts that may be entered into the United States during the first calendar year for which an import restriction implementation period is in effect, may not exceed the aggregate quantity of such motor vehicles and the aggregate quantity of such motor vehicle parts entered into the United States during 1993, reduced by 20 percent.

(3) SUBSEQUENT YEARS.—In the case of any calendar year for which an import restriction period is in effect after the first such calendar year, the aggregate quantity of Japanese motor vehicles and Japanese motor vehicle parts that may be entered into the United States shall not exceed the amount of

such motor vehicles and motor vehicle parts entered during the most recent preceding calendar year for which an import restriction implementation period was in effect, reduced by 20 percent.
CONGRESSIONAL RECORD—SENATE
June 29, 1993

S8248

employee creativity and commitment that broad-based employee stock option plans have demonstrated for United States companies. Our Nation's public policy should encourage and promote employee participation through broad use of equity compensation programs. The bill we are introducing today will begin this process.

WHY THIS IS A JOBS BILL

One of our Nation's strongest concerns now is how to stimulate additional job creation in the American economy. We contemplate spending billions of dollars trying to prime the job pump, but we often can't be certain what we will receive in return. As we debate these measures, it's important that we not overlook a powerful job creation tool that is already pumping out thousands of high-quality jobs with a future in this country and generating major tax revenues for us in the process. That engine is small business, and we will use the broad-based employee stock option.

Stock options make it possible to start new companies and create new jobs with significantly less cash than would otherwise be required. These emerging growing companies attract the key people who can make the difference at each stage of a company's progress. Stock options stretch venture capital dollars and allow companies to hire more people than they otherwise could. Stock options also encourage risk-taking and spur technological innovation. America's most dynamic, job-creating companies consistently rely on employee stock options to attract and motivate their employees. Not just their top executives, all their employees.

I often hear from innovative CEO's who tell me they could not have built their companies and created the jobs they have without the ability to offer stock options to attract the work force. These same executives tell me that the rules change soon to be imposed by the Financial Accounting Standards Board (FASB) would have prevented them from creating many of those jobs.

Mr. President, our bill will not only prevent damage to America's growth-oriented industries, it will improve the ability of those companies to share equity more widely with their employees. In the process it will encourage thousands of additional companies to begin granting stock options to their work force, giving them a powerful stake in those companies.

At a time when we are contemplating a variety of reforms, taxes, and other mandates on business that will make it more expensive to create jobs, it is critical that we find new ways to make it easier to start companies and employ people. The Equity Expansion Act is such a bill.

A POSITIVE REVENUE IMPACT

Mr. President, another important reason this bill is attractive is that, unlike most business tax proposals, we believe the Equity Expansion Act will be ruled revenue-positive by the Joint Committee on Taxation. The Joint Committee found a similar bill to be a revenue-raiser in 1979. We asked two national accounting firms to analyze the revenue implications of our bill under today's tax rates and rules.

In a letter dated April 26, 1993, Ernst and Young reached the following conclusions:

- Setting aside matters of timing, to the extent that the performance stock option creates a revenue gain by this bill discards nonqualifying stock options (or equivalently taxed cash compensation), there is an unambiguous revenue gain to the Treasury. This revenue gain is offset to the extent that performance stock options displace incentive stock options; and under the current rate structure, so long as 40 percent or more of the performance stock options would otherwise have been nonqualifying stock options (or equivalently taxed cash compensation), the net impact would be a revenue gain for the Treasury.
- Coopers & Lybrand also examined the revenue implications of our bill. They conclude:

  In summary, the Equity Expansion Act of 1993 appears to offer the combination of reduced individual tax rates and the employee and potentially increased Treasury collections. When compared to a non-qualified stock option, the performance option would induce employees to keep the associated stock for the required holding period and in the situations outlined above, our results are less definitive when the analysis is done using ISOs as a yardstick, but on the employee present tax savings that call the stock immediately, the performance options should also increase government revenue.

At a time when there is intense pressure on all tax provisions, my colleagues and I are pleased to be able to offer a bill that focuses on many of the most productive, job creating companies in the economy and also is likely to generate a revenue gain for the Treasury. I plan to include the full text of the accounting firm analyses, along with the Joint Committee's revenue estimate, in a future statement on this bill.

WHAT ARE STOCK OPTIONS, AND WHO PAYS FOR THEM?

An employee stock option is a right to purchase a set number of company shares for a fixed price at some defined time in the future. Unlike the type of stock options traded on stock exchanges, employee stock options are not transferable. There is no external market to establish their value.

The cost of employee stock options is borne primarily by the shareholders through dilution in the value of their shares. Yet, as described in more detail below, investors willingly support us because they stimulate greater returns. Stock option plans are the only way to tie corporate compensation that already requires the express approval of shareholders. Further, they are subject to annual proxy disclosure and footnote treatment in financial statements.

SUMMARY OF THE EQUITY EXPANSION ACT

The Equity Expansion Act leaves existing forms of stock options in place, companies could continue to offer tax-deductible nonstatutory—nonqualified—stock options if they wish. But companies willing to forgo that deduction and grant options broadly throughout their work force would be able to offer their employees a new form of option, called a performance stock option (PSO), that requires no taxes from employees at exercise and gives them strong tax incentives to hold onto their stock after they acquire it. To qualify, at least 80 percent of a PSO must go to "non-highly compensated" employees, as defined by the IRS. This new form of option essentially restores the benefits of capital gains treatment by excluding half of the tax on the employees' gain when they sell their stock, after a minimum two year holding period.

TAX PROVISIONS

Despite its powerful tax incentives, this new form of option, performance stock option, will not substantially reduce revenue loss to the U.S. Treasury. In fact, a revenue gain is achieved by omitting the employer's expense deduction when PSO's are exercised—as in incentive stock options.

PSO plans will require the approval of the firm's shareholders. They:

- Assure broad participation by requiring at least half of the stock in PSO plans for "non-highly compensated" employees as defined by Congress in IRC §414(q).
- Relieve employees of taxes on their paper profits when they exercise their options. They would still be taxes when they sell their stock.
- Encourage employees to retain their stock after exercise by excluding 50 percent of their gain from tax when the stock is sold, after a minimum 2-year holding period.
- Remove the spread at exercise from the alternative minimum tax, and prevent the IRS from imposing FICA and FUTA taxes on premature vesting.

ACCOUNTING PROVISIONS

The bill directs the SEC to end the charge against earnings now required on variable options, thereby providing management with a flexible and powerful new motivational tool. The number of options the employee could exercise in the future could be increased or decreased by the achievement of performance goals set by the company--shareholder ROI, product development goals, revenue or profitability target, et cetera—without an accounting penalty.

The bill counters the decision on stock option accounting announced by the Financial Accounting Standards Board on April 7, 1993. It directs the SEC to maintain the current financial accounting treatment for nonqualified stock options.

THE NEED FOR THIS BILL

1. STOCK OPTIONS IMPROVE PERFORMANCE OF AMERICAN COMPANIES

In the traditional model for financing a company, investors provide money to
A company and receive stock in return. The company then uses some of the money to compensate its employees. There is no debate over how to account for this simple transaction. But over the past decade a growing number of American companies have learned the value of going back to their investors for a second investment in the form of stock which they then share with large segments of their work force through employee stock option plans.

Because the exercise of employee options will dilute the economic and voting power of shareholders, the corporation laws of virtually every State require that shareholders specifically approve employee stock option plans. And approve them they do, because over the years shareholders have learned that they receive significantly greater returns from companies that share stock to motivate their work force.

For example, it's worth noting that professional venture capital firms are some of the strongest advocates of broad-based employee stock option plans. Veteran American venture capitalists are among the most sophisticated corporate investors, directors, and shareholders in the world. They know that as shareholders they bear the full cost of stock option plans through dilution of their holdings. Yet the venture capitalists insist that they and portfolio companies establish and maintain extensive employee stock option plans that cover all or nearly all of their work force. And they're not hesitant to say why. The professional venture capital industry has learned over the years that broad-based employee stock ownership is essential to achieving the dramatic returns that investors in professional venture capital funds seek.

2. COMPANY-WIDE OPTION PLANS ARE WIDESPREAD AND GROWING

Many people in this country mistakenly believe that options are benefit awarded only to CEO's and other top executives. This misimpression is reinforced by stories about individual executives stock option packages. Hardly any national visibility has gone to the important trend toward companies sharing options with their entire work force. Yet this movement is fundamental to the success American companies have achieved in global competition. In today's world, such highly successful large companies as Chil's, DuPont, Genentech, Kroger, Merck, Nation's Bank, PepsiCo, and Pfizer. And the practice is even more widespread among smaller companies. America's technology companies have been the world's leaders in sharing their stock with their employees and benefiting from the growth that ensues. An example is Microsoft Corp. The New York Times recently estimated that Microsoft's stock option and employee stock purchase plans have created more than 2,000 employee millionaires in that one company. This is an achievement that our public policy should encourage. Not only is it far from an isolated example. A 1990 Radford Associates survey of 300 electronics companies found 85 percent of the companies with options gave them to middle managers and above, while 30 percent even include nonprofessional people. Only 15 percent limited their options to officers.

The Investment Association reports a similar experience. According to IBA, 75 percent of their companies use stock options. Fully 60 percent grant options to their entire work force. Only 8 percent limit their options to officers and a few managers.

In 1991, ShareData, Inc., makers of a widely used PC-based stock option management program, surveyed their 800-firm user group, which includes many companies outside the technology sectors. They received 300 responses. A substantial majority—68 percent—of the smallest companies—fewer than 500 employees—grant stock options to every one of their employees. Even when companies reached 500 employees, more than half—54 percent—of the respondents granted options to their entire work force.

It's well known that the political pressure on FASB stems in large part from the mistaken belief that stock options only go to a few top executives. It's painfully ironic that FASB's new rule will create that illusion into a self-fulfilling prophecy. Top executives will always be able to bargain for equity compensation, and boards of directors will want them to have it, even if FASB doubles its cost. What will be lost, however, is the tradition of granting stock options to a company's entire work force. FASB's proposed charge against earnings would discourage companies now offering their employees to encourage them to purchase stock directly from the company. Both broad-based stock options and employee stock purchase plans will come prohibitively expensive if FASB's plan goes through.

1. U.S. TAX POLICY SHOULD ENCOURAGE STOCK RETENTION BY EMPLOYEES

Nearly every study of what works in successful companies advocates encouraging employees to buy and own meaningful portions of their company's stock. Employee stock options are a powerful technique for making it possible for employees to purchase stock in their companies. Yet today's tax policies strongly discourage employees from retaining their stock after they exercise their options.

When employees exercise their stock options they are only acquiring stock. Ordinarily an income tax liability doesn't develop from purchasing an asset like stock. But in the case of the most widely used form of stock option, nonqualified options, employees are required to pay a tax on their paper profit at the time they purchase their stock—before they actually realize any gain from selling the stock. The law also allows employers to deduct the same amount as a compensation expense.

Since the cost of this tax on employees is in addition to the cost of purchasing the most expensive form of nonqualified options, employees are forced to sell their stock immediately to pay the tax. This destroys the fundamental policy goal of encouraging employee ownership in their companies.

INCENTIVE STOCK OPTIONS HAVE BEEN RENDERED WORTHLESS

In 1981 Congress enacted incentive stock option (ISO's) to solve some of the problems with nonqualified options. ISO's were designed to allow employees to keep their stock after exercising by relieving them of taxes at exercise. In return for dropping the tax on employees, ISO's provide no compensation tax deduction for the company.

ISO's actually raise money for the Treasury because, when they sell their stock, employees pay tax on the full spread from date of grant to the date of sale. Since that revenue is deductible by a deduction from the company, the Treasury comes out ahead.

The Joint Committee on Taxation confirmed this effect in 1978 when it ruled that the ISO is revenue-positive.

But over the years, the usefulness of ISO's have been severely curtailed. Even though they raise money for the Treasury, Congress now treats ISO's like a tax concession and imposes the alternative minimum tax on their exercise. In addition to being conceptually wrong, this means that employees are once again forced to sell their ISO stock to pay the AMT tax. That defeats the whole purpose of the ISO.

The bill we are introducing today will reform that policy.

As noted above, the Equity Expansion Act will create a new form of option, called performance stock options. This new form of option will encourage more companies to grant more options to more of their employees because it is limited to companies that offer broad-based stock option plans to large portions of their work force.

PSO's will require neither an income tax nor an AMT tax payment from employees when they exercise their options. Since any gain in the value of the stock at exercise would not be included in personal taxes to the employee, the company would not receive a compensation expense deduction for it. This foregone corporate deduction generates what Ernst and Young describes as "an unambiguous revenue gain for the Treasury." Our bill then uses a portion of that revenue gain to encourage employees to retain their stock for at least 2 years after exercise. After that holding period, half of the employee's gain will be excluded from tax because he or she ultimately sells the stock. Even with this tax incentive included, we expect the PSO to be ruled revenue-positive to the Treasury.
CONGRESSIONAL RECORD—SENATE

June 29, 1993

S.8250

FUTURE STATEMENTS ON EQUITY EXPANSION ACT ISSUES

Mr. President, a full discussion of the various questions raised by this bill is well beyond the scope of a single floor statement. Therefore, I plan to offer additional remarks over the next weeks and months to consider in more detail some of the topics that are important to understanding the Equity Expansion Act. Among the future issues I hope to review are:

How the Equity Expansion Act can spread the benefits of equity compensation to thousands of companies and millions of Americans who don't receive options today;

A survey of the research showing that extensive use of equity compensation promotes growth and competitiveness in American companies and industries;

Explanations of the revenue impact of the bill from both the public accounting firms and the Joint Committee on Taxation;

An examination of the accounting rationales for retaining the current accounting treatment of employee stock options; and

What positive alternatives to this accounting change are available to answer FASB's concerns.

Mr. President, I ask unanimous consent that the text of the Equity Expansion Act be printed in the Record following my remarks.

There being no objection, the bill was ordered to be printed in the RECORD, as follows:

S.175

Be it enacted by the Senate and House of Representa

tives of the United States of America in Congress assem

bled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Equity Expansion Act of 1993.""?

SECTION 2. PERFORMANCE STOCK OPTIONS.

(a) In general.—Part II of chapter D of title 1 of the Internal Revenue Code of 1986 (relating to certain stock options) is amended by redesignating section 423 as section 425 and by inserting after section 425 the following new section:

"SEC. 424. PERFORMANCE STOCK OPTIONS."

"(a) In general.—Section 421(a) shall apply with respect to the transfer of a share of stock to any person pursuant to the exercise of a performance stock option if no disposition of such share is made by such person within 1 year after the transfer of such share to such person.

"(b) Performance Stock Option.—For purposes of this part—"

"(1) IN GENERAL.—The term "performance stock option" means an option granted to any person for any reason in connection with the performance of services for an entity described in paragraph (4) to purchase stock of any corporation described in paragraph (4).

"(2) ADDITIONAL REQUIREMENTS.—An option shall not be treated as a performance stock option unless the following requirements are met:

"(A) NONDISCRIMINATION.—Either—"

"(I) The option is granted to an employee who, at the time of the grant, is not a highly compensated employee, or

"(II) The employer, immediately after the grant of the option, employees who are not highly compensated employees hold performance stock options which permit the acquisition of at
least 50 percent of all shares which may be acquired pursuant to all performance stock option agreements (whether or not exercisable) as of such time.

For purposes of clause (ii), only that portion of the option is not permitted to be treated as options which are not permitted under stock options, and such portion shall be allocated among options held by such persons in such manner as the secretary or the governing body of the corporation determines.

(3) SPECIFIC NUMBER OF OPTIONS.—The option is granted pursuant to a plan that includes within the aggregate number of shares that may be issued under options granted under the plan, or

(ii) a method by which the aggregate number of shares that may be issued under options granted under the plan can be determined (without regard to whether such aggregate number may change under such method), and

which is approved by the stockholders of the corporation at a meeting within 12 months before or after the date such plan is adopted.

(C) TIME WHEN OPTION GRANTED.—The option is granted by the corporation after the date the plan described in subparagraph (B) is adopted, or the date such plan is approved by the stockholders, whichever is earlier.

(D) TIME LIMITATION.—The option by its terms is not exercisable after the expiration of 10 years from the date such option is granted.

(E) OPTION PRICE.—Except as provided in paragraph (6) of subsection (c), the option price is not less than the fair market value of the stock at the time the option is granted.

(F) TRANSFERABILITY.—The option by its terms is not transferable by the person holding the option, other than—

(i) in the case of an individual, by will or the laws of descent and distribution, or pursuant to a qualified domestic relations order (as defined in subsection (p) of section 414), and

(ii) in the case of any other person, by any transaction in which gain or loss is not recognized in whole or in part.

(G) ELECTIVE NOT TO TREAT OPTION AS PERFORMANCE STOCK OPTION.—An option shall not be treated as a performance stock option if—

(A) as of the time the option is granted the terms of such option provide that it will not be treated as a performance stock option,

(B) as of the time such option is exercised the grantor and holder agree that such option will not be treated as a performance stock option.

(4) ENTITIES TO WHICH SECTION APPLIES.—This section shall apply to an option granted to a person who performs services for—

(A) the corporation issuing the option, or its parent or subsidiary corporation,

(B) a partnership or corporation issuing the option holds at the time of the grant a capital or profits interest representing at least 1 percent of the capital or profits interest of the partnership or corporation,

(C) a corporation or a parent or subsidiary corporation of such corporation issuing or assuming the obligation in a transaction to which section 424(a) applies.

(5) HIGHER COMPENSATED EMPLOYEE.—For purposes of this subsection, the term ‘highly compensated employee’ has the meaning given such term by section 414(q).

(c) SPECIFIC RULES.—

(1) GOOD FAITH DETERMINATION TO VALUE STOCK.—If a share of stock is acquired pursuant to the exercise by any person of an option which would fail to qualify as a performance stock option under subsection (b) because there was a failure in an attempt, made in good faith, to comply with the requirements of subparagraph (E) of subsection (b)(2), the requirement of subparagraph (E) of subsection (b)(2) shall be considered met.

(2) PERMISSIBLE PROVISIONS.—An option that meets the requirements of subsection (b) shall be treated as a performance stock option unless the instrument creating the option includes, without limitation, the following performance requirements—

(A) the option holder may pay for the stock with the stock of the corporation granting the option,

(B) the option holder has the right to receive property at the time of the exercise of the option,

(C) the right to exercise all or any portion of a performance stock option may be subject to any condition, contingency or other restriction, including without limitation, the continued performance of services, achievement of performance objectives, or the occurrence of any event which are determined in accordance with the provisions of the plan or the terms of such option, or

(D) the option is subject to any condition not inconsistent with the provisions of subsection (b).

(3) FAIR MARKET VALUE.—For purposes of this section, the fair market value of stock shall be determined in good faith by the board of directors of the corporation.

(4) DEFINITION OF PARENT AND SUBSIDIARY CORPORATIONS.—For purposes of this section, the terms ‘parent corporation’ and ‘subsidiary corporation’ have the meanings given such terms by subsection (a) and (b) of section 422 except that such subsections shall be applied by substituting ‘50 percent’ for ‘5 percent’ each place it appears.

(5) PERFORMANCE CRITERIA.—In the case of a performance stock option that provides that the exercise of the option is subject to any conditions or criteria described in subparagraph (C) of paragraph (2), the date or time at which the option is granted with respect to each share that may be acquired shall be the date or time of the original performance share option granted subject to the provisions of section 424(b), no portion of the option shall be treated as granted at a time earlier than one day after the date on which such option was exercised.

(6) CONVERSION OF OPTIONS.—If—

(A) there is a transfer of an incentive stock option as a result of a stock dividend, stock split or similar transaction, and

(B) the number of shares that may be acquired pursuant to the performance stock option and the transferred incentive stock option are the same, then the option acquired shall qualify as a performance stock option if the option price pursuant to the performance stock option is no less than the option price under the transferred incentive stock option.

(b) EFFECTIVE DATE.—This section applies to options granted after June 5, 1986.

(c) TRANSITION RULES.—

(1) APPLICABILITY.—This section applies to grants of options made after January 1, 1987.

(2) TRANSITION RULE.—In the case of a performance stock option granted for a period of 5 years or less, the determination of whether an option is a performance stock option after June 5, 1986 shall be made by applying the rules of paragraph (3) of subparagraph (A) of paragraph (1) of section 421(b).
CONGRESSIONAL RECORD—SENATE
June 29, 1993

S 8252

"(2) CAPITAL GAINS AND LOSSES OF TAX-
PAYERS OTHER THAN CORPORATIONS.—In the

case of a taxpayer other than a corporation—

"(A) the amount deductible on account of
losses from sales of capital assets of such
corporation shall not exceed the amount includable
on account of gains from sales or exchanges of
capital assets, and

"(B) by the exclusion provided by subsection (a) of
such Code shall not be allowed.

(11) Subparagraph (B) of section 172(d)(4) of
such Code is amended by inserting "(b)(3)" after "paragraph (1)".

(12) Paragraph (4) of section 64(a) is amended
as follows:

(A) by inserting after paragraph (3) the fol-
lowing new sentence: "Except as provided in
subsection (b) of this section, paragraph (3) of this
section shall not apply to an option or contract to
purchas stock acquired under section 1271(a); and

(B) by inserting at the end of the section the
following new subsection:

"(e) TREATMENT FOR WADE WITHHOLDING AND
EMPLOYMENT TAXES—

(1) PICA TAXES.—Section 512(a) of the In-
ternal Revenue Code of 1986 (defining wages) is
amended by striking "or" at the end of subparagraph (a),
and by adding after subparagraph (a) the fol-
lowing new subparagraph:

"(2) any gain from the exercise of a perform-
cane stock option (as defined in section 422(b) or
from the disposition of stock ac-
cquired pursuant to the exercise of such a perform-
cane stock option; or"

(2) FUTA TAXES.—Section 3306(b) of such Code (defining wages) is amended by
striking "or" at the end of subparagraph (b) and inserting "or", and by adding at the end of
such subparagraph:

"(1) any gain from the exercise of a perform-
cane stock option (as defined in section 422(b) or
from the disposition of stock ac-
cquired pursuant to the exercise of such a perform-
cane stock option; or"

(B) Section 422(b) of such Code (relating to
effect of disqualifying disposition) is amend-
ed by adding at the end the following new sentence: "Any gain from the exercise of a perform-
cane stock option in the case of a transfer pursuant to
an option described in section 422(b) or (c) shall
not be taken into account with respect to gain or stock acquired in the trans-
former.

SEC. 4. STOCK OPTION COMPENSATION.

Section 14 of the Securities Exchange Act of
1934 (15 U.S. C. 78m) is amended by adding at
the end the following new subsection:

"(h) Special rules.—The Commission shall not
permit or require an issuer to recognize any expense or other
charge in financial statements furnished to the security
commission or, attributable to, either the grant, vesting, or exer-
cise of any option or other right to acquire any equity security
under section 3(a)(11) of such title is subject to any conditions, contingen-
cies or other criteria, including, without limitation, the conti-
nuance of performance services, achievement of performance objectives, or
the occurrence of any event which is granted
to its directors, officers, employees, or
other persons in connection with the per-
formace of services, where the exercise price
of such option or right is not more than
the fair market value of the underlying sec-
urity at the time such option or right is
granted.

(b) EFFECTIVE DATE.

The amendments made by this Act shall
apply to options granted after the date of the enactment
of this Act.

Mrs. FEINSTEIN. Mr. President, I rise to offer a
provisions in the Finance Committee, Senators LIEBERMAN, MACK,
and BOXER in introducing the Equity

At a time that California continues
mired in recession, when our econ-
omy is struggling to convert thou-
sands of defense jobs into private sec-
tor jobs, it's a pleasure for me to offer
a bill that will significantly improve
the ability of new companies to start-
up and grow, as well as those existing
companies create new more jobs than
they otherwise could.

My bill will improve the tax and ac-
counting treatment of employee stock
options and encourage many more
companies to offer stock options to their
entire workforce. It will also re-
quire the Financial Accounting Stan-
dards Board to adopt accounting stan-
dards that comply with the recent
declaration to impose huge new ac-
counting charges on the use of em-
ployee stock options. I am seriously
concerned that if FASB's rules are adop-
ted, tens of thousands of desperately
needed jobs in California and the Na-

tion will never be created.

Because of this bill, thousands of
households in California and the rest
of the country should begin to enjoy the
benefits of equity participation in their
companies. At the same time, the com-
p
dies that begin to share equity more
broadly with their employees should find
their earnings improved and their
competition enhanced.

Many of my colleagues here in Wash-
ington may not be familiar with the

dispersed use of employee stock op-
tions in America's fastest growing

capitalistic talent that would be beyond their
ability to attract with cash compen-
sation alone.

A stock option is a right granted to an
employee to purchase stock in his or
her own company, at today's price, for
a specified time in the future. Options
help the company by giving em-
ployees a strong incentive to work to
increase the value of their company's
stock. Stock options help create jobs
by stretching the cash of venture cap-
inators. By sharing stock with employees
in addition to their cash compensation,
more companies and more jobs can be
created from the limited investment

capital pool that is available today.

HOW THE EQUITY EXPANSION ACT WOULD
IMPROVE STOCK OPTIONS

Valuable as employee stock options
plans are for our economy, they are in-
hibited and discouraged by the Federal
Tax Code today.

Under current law employees who
hold the most common form of option,
"nonqualified" options are forced to
pay a tax at the time they exercise their
options and purchase their stock. The
difference between the fair market value
of the stock obtained by nonqualified
options and option exercise price is taxed
as ordinary income. The employee is
generally permitted to deduct the same
amount of ordinary income reported by
the employer.

In the case of the other form of op-
tion currently available, "incentive stock
options," or "ISO's," the differ-
ence between the option price and the
fair market value of the stock when it is
exercised is treated as a tax preference
under the alternative minimum tax (AMT).

So under today's tax regime
employees are forced to pay either an
income tax at the time they exercise their
stock, even though they have not realized
and pocketed any gain. The effect of
this requirement is to force almost all
option recipients to sell their stock at the
time they exercise their options in order to
generate cash to pay their tax. This
destroys the fundamen-
tal policy goal of the option pro-
gram which was to encourage employees
to own as much of their company as
possible.

The Equity Expansion Act would
reform this situation by creating a third
form of stock option, called perform-
ance stock option. This new option
would relieve employees of the obliga-
tion to pay a tax at the time they exer-
cise their options and the company
would receive no corresponding dedu-
cion. In addition, it would give employ-
es a strong incentive to hold onto
their stock after they acquire it, by
excluding half the tax on their gain when
they eventually sell their stock a 2-year
hold.

A REVENUE GAIN FOR THE TREASURY

The tax break offered by performance
stock options should make them ex-
}
June 29, 1993

CONGRESSIONAL RECORD—SENATE

S 8253

Mr. President, I'm well aware that in the past stock options have figured in prominently in stories about runaway executive compensation. Unfortunately all those headlines have obscured the important contribution that options make to the livelihoods of hundreds of thousands of Americans who will never be famous for their wealth. Now that the SEC has imposed an extensive new regime of executive compensation disclosure rules, it will be much easier for shareholders to prevent the kind of abuses we have heard so much about in the past. It is simply not necessary to restrict the use of stock options overall to prevent abuses by a few fat cats.

But it's true that how much the program will prevent top executives from hogging all the tax benefits it offers. The answer is that the Equity Expansion Act requires that companies that choose to offer this new form of option will be required to share at least half the stock in the plan with company employees who are not highly compensated as defined by Congress. This requirement is the reason that a significant number of the options of performance stock options are shared widely in every company that uses them. It will also encourage many companies that today restrict their stock option plans to top executives to broaden their option program. I am very enthusiastic about the prospect that this bill will result in employee stock options becoming available to thousands of households that don't have them today.

The Equity Expansion Act is a carefully crafted bill. It would encourage several of the most widely recommended reforms called for by experts in the debate over executive compensation. For instance, in a recent Harvard Business Review article, Andrew R. Brownstein and Morris J. Panner propose exactly what this bill would deliver.

We suggest that companies take two important steps that make both business and political sense. First, corporations should design plans that provide employees through the organization to share in the large bonuses and generous rewards of stock option plans. Second, corporations should create plans that encourage companies to continue to hold the shares awarded to them in stock option programs.

By expanding the employee eligibility pool for stock options, companies will solve two problems simultaneously. They will take the principle of pay for performance and spread it throughout the organization. And they will address the political problem of pay disparity between workers and executives.

Mr. President, I hope my colleagues in the Senate will join with us in sponsoring and voting for this important legislation making this bill, the Equity Expansion Act of 1993.

By Mr. KOHL.

S. 1176. A bill to clarify the tariff classification of certain plastic flat goods; to the Committee on Finance.

CLARIFYING THE CLASSIFICATION OF CERTAIN FLAT GOODS

* * *

Mr. KOHL. Mr. President, I am introducing legislation today that is important to the health of the domestic flat goods industry in this country and in the State of Wisconsin. Flat goods are items that are carried in your pocket or your handbag, key chains, and eyeglass holders.

When the United States converted to the International Harmonized Tariff Schedule (HTS), a loophole was created which allowed plastic flat goods, which formerly entered at a duty rate of 20 percent, to enter at an effective duty rate of 5.8 percent. The actual and potential number of items subject to reclassification because of this loophole was massive and could result in a loss of revenue to the U.S. Government of up to $9 million.

More important, however, is the fact that the duty loophole is threatening our domestic industry by driving up imports and making it impossible for American producers to stay competitive.

Mr. President, this was clearly not the intent of Congress. In fact, Congress was specific in its intent that the conversion to HTS should be tariff neutral. I firmly believe it is up to Congress to remedy this situation, and the legislation I am introducing today achieves this in the fairest way possible.

My bill is a modification of an earlier bill I introduced in the last Congress, S. 1661, and is based on compromise language put forward by the administration last year. The changes proposed by the administration would, in their words, "restore the duties applicable at the time of the tariff conversion by": First, reintroducing into the HTS a definition of reinforced and laminated plastics; second, providing a duty of 8 percent ad valorem for flat goods with an outer surface of not less than 20 percent leather or leather trim; and third, providing authority for the President to continue staging previously authorized tariff cuts.

Under the former tariff schedules of the United States (TSUS), reinforced or laminated plastics were defined as "rigid, infusible, insubstantial plastics formed by the application of heat and high pressure on two or more superimposed layers of fibrous sheet material which has been impregnated or coated with plastics or rigid plastics comprised of embedded fibrous reinforcing material—such as paper, fabric, asbestos, and fibrous glass—impregnated, coated, or combined with plastics usually by the application of heat or heat and low pressure." This definition was dropped in the conversion to the HTS, leaving HTS 4202.22.10 open to a broader interpretation of this bill, substituting "reinforced or laminated plastics." The change recommended by the administration clarifies that only rigid products would be subject to the lower duty under HTS 4202.22.10.

The administration's recommended changes also address the major concern of importers to the earlier version of my bill—the duty treatment of plastic flat goods with leather trim. Under the TSUS, these items were treated as leather products for duty purposes since the leather trim was considered to be the component of chief value and, therefore, were imported in a leather category, dutiable at 8 percent. With the conversion to the HTS, however, the chief value concept was replaced with essential character. Therefore, plastic flat goods with leather trim were considered plastic, and were dutiable at 20 percent. The administration's recommended change, incorporated in my bill, establishes a new subheading for plastic flat goods with leather trim dutiable at 8 percent and dutiable at 20 percent.

In closing, I urge my colleagues on the Senate Finance Committee to take this measure up at the earliest possible time.

By Mr. ROCKEFELLER.

S. 1177. A bill to amend, title 38, United States Code, to extend the authority of the Secretary of Veterans Affairs to the Committee on Education, and for other purposes; to the Committee on Veterans Affairs.

VETERANS' PROGRAM IMPROVEMENT ACT OF 1993

* * *

Mr. ROCKEFELLER. Mr. President, as chairman of the Committee on Veterans' Affairs, I am pleased to introduce S. 1172, the proposed Veterans' Program Extension Act of 1993. This legislation would extend two VA programs—first, it would extend the Veterans' Advisory Committee on Education by 4 years, from December 31, 1993, until December 31, 1997; and second, it would extend VA's authority to maintain a regional office in the Republic of the Philippines by 18 months, from March 31, 1994, until September 30, 1995.

Mr. President, the Veterans' Advisory Committee on Education is composed of persons who are representatives of the fields of education, labor, and management, representatives of institutions and establishments furnishing education to veterans and their families, and other interested persons. The Advisory Committee works in consultation with the Secretary of Veterans Affairs with respect to the admini-