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REDUCING THE TAX COSTS OF INDEXED OPTIONS

DAVID M. SCHIZER[†]

To encourage pay for performance, Congress offers certain tax advantages when stock options are used as compensation.¹ If the options are “incentive stock options” (ISOs), executives generally are taxed at capital gains rates.² If the options are “nonqualified” (NQOs),³ firms gen-

[†] Professor, Columbia University School of Law. Portions of this discussion are based on David M. Schizer, *Tax Constraints on Indexed Options*, 149 U. PA. L. REV. (2001). The author appreciates the valuable comments of Dennis Drapkin, Karen Gilbreath, and Andrew Stumpff, and the helpful research assistance of Huy Chu.

¹ An option gives the holder the right, but not the obligation, to purchase property for a set price called the “exercise” or “strike” price.

² With an ISO, the employer does not receive a deduction. But this tax cost to the employer is offset by a tax benefit to the executive. If the option qualifies as an ISO, no tax is due when the executive exercises it (except alternative minimum tax, in some cases) and, assuming the executive satisfies the relevant holding periods, sale of the stock received upon exercise is taxed at long-term capital gains rates. There also are limits on the annual size of an executive’s ISO grant. See Barbara J. Raasch & Judith L. Rowland, *Stock Option Planning*, TAXES, Jan. 1999, at 39 (discussing tax treatment of ISOs). If the firm and executive are in the same tax bracket, an ISO is not tax efficient because the tax cost to the firm is larger than the tax savings to the executive. Yet ISOs *are* tax efficient when the firm is in a low tax bracket, as is the case, for instance, with hi-tech start-ups. See MYRON S. SCHOLES & MARK A. WOLFSON, TAXES AND BUSINESS STRATEGY 188-89 (1992) (showing that the tax cost to the firm exceeds the tax benefit to the executive, assuming the same tax rate governs both parties).

³ For the typical NQO, the employer has a deduction and the employee has ordinary income when the option is exercised, based on the spread between the exercise price and the value of the stock. See *id.* § 83; Treas. Reg. § 1.83-7. However, the taxable event is the grant date if the option has a “readily ascertainable fair market value,” a condition that the regulations render ex-

erally keep their deduction even if the total pay package is in excess of one million dollars, an occasion on which the deduction might otherwise be disallowed under § 162(m).⁴

Yet these advantages arguably are not available to so-called “indexed” options. Unlike conventional options, which reward executives for *absolute* increases in the stock price, indexed options reward good *relative* performance, as when the firm outperforms competitors or the market as a whole. Although these options create better incentives than traditional grants, indexed options carry unappealing tax costs. This perverse effect is as ironic as it is unintended. The relevant tax rules are supposed to favor performance-based pay and, if anything, indexed options are *more* performance-based than conventional options. As a result, these tax rules should be reformed.

This tax issue should become increasingly important in the coming months. Until now, indexed options have almost never been used,⁵ and firms have had a wholly separate reason for not using them: these options are not eligible for the favorable financial accounting treatment ac-

tremely rare.

⁴ All references to sections are to the Internal Revenue Code of 1986, as amended.

⁵ The rarity of indexed options is well known and has commonly been described as a puzzle. See, e.g., Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 683 & n.34 (1998) (noting that indexed options “would represent a substantial improvement over current contracts” but are seldom used, and observing that “the near complete absence of relative pay seems to be a puzzle”). In explaining the scarcity of these options, commentators generally have not considered tax costs. See, e.g., Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1903 (arguing that tax cannot explain the rarity of indexed options).

corded to conventional options.⁶ While the accounting rules are beyond this Article's scope, it should be noted that they may change, or at least they may become less significant. Congress is considering modifications in this treatment, although there is strong political opposition to any change.⁷ In addition, firms may voluntarily forgo the favorable treatment, as Coca-Cola recently chose to do.⁸ "An important advantage of the expensing policy that The Coca-Cola Company is adopting," Coca-Cola said, "is that it puts the various forms of options on an equal accounting footing, eliminating any bias that may have existed to issue the kind that do not need to be expensed."⁹ Firms that follow Coca-Cola's lead may want to use indexed options, and it is important that there be no tax penalty for doing so.

Part I describes indexed options and their economic advantages. Part II explains why indexed

⁶ In general, the expense from conventional options never appears in the body of a firm's income statement – either when the option is granted or when it is exercised. In the mid-90's, the Financial Accounting Standards Board sought to change this treatment. Since then, the compromise has been to include the option's grant-date value in a footnote. For a discussion, see David M. Schizer, *Tax Constraints on Indexed Options*, 149 U. Pa. L. Rev. 1941 (2001).

⁷ See Richard A. Oppel Jr. *Senator Urges Change in How Stock Options Are Handled*. N.Y. Times, July 13, 2002, at C1; Shailagh Murray, *Senate Faces Stock-Option Issue in Accounting Bill*, W.S.J., July 15, 2002, at A4.

⁸ See Floyd Norris & Sherri Day, *Coke to Report Stock Options as an Expense*, N.Y.T., July 15, 2002, at A1.

⁹ This language comes from a July 14, 2002 press release on Coca-Cola's website. See http://www2.coca-cola.com/presscenter/nr_20020714_atlanta_stock_options.html While the accounting rules for indexed and conventional options become more similar if firms choose to expense the latter, the treatment is not identical. In each case, an expense is listed in the body of the income statement, but this expense is measured differently. For traditional options, the Black

options are thought not to qualify as ISOs. Part III explains why indexed options arguably cannot qualify as “performance- based” under § 162(m). Even if they can, moreover, § 162(m) still discriminates against them. The reason is that a pay package with indexed options is likely to have a larger component of (nondeductible) cash than a pay package with conventional options.

I. Economic Advantages of Indexed Options

Assume that a firm grants executives options to buy stock for \$100, the stock’s then-current fair market value, and the options can be exercised at any time during the next ten years (subject, of course, to vesting limitations). Assume further that the firm’s stock price increases by ten percent during a period in which the market as a whole appreciates by forty percent. Since the firm’s stock price has dramatically underperformed the market as a whole, shareholders should not be particularly pleased with management. Indeed, the ten percent increase in the stock price presumably derives from general market trends, not from firm-specific success. Yet given the structure of a conventional option, which rewards executives for *absolute* increases, not relative ones, executives earn ten dollars per share.

Now assume the firm’s stock price remains at \$100, while the market as a whole loses half its value. By keeping the firm’s stock price stable in a disastrous market, the management team has rendered a valuable service. Yet in this context, the conventional option does not reward execu-

Scholes grant date value is amortized. For indexed options, which are subject to “variable” accounting, the intrinsic value is marked to market.

tives at all (unless, of course, the exercise price is “repriced”).

Unlike a conventional option, an indexed option yields the right answer in the above scenarios. Assume executives receive an option in which the exercise price fluctuates with the Standard & Poor’s 500 Stock Index (“S&P 500”), entitling executives to buy stock (currently worth \$100) for 1/10 the value of the S&P 500 (which is assumed to be 1000 currently). If the firm’s share price increases by ten percent (to \$110) but the S&P 500 increases by forty percent (to 1400), the executive makes no profit: The option yields the right to pay \$140 for stock worth \$110. This result makes sense because the rise in the stock price presumably derives from general market trends, and not the executive’s firm-specific success. On the other hand, if the stock price holds steady at \$100 but the S&P 500 declines by fifty percent (to 500), the executive makes \$50 per share. In basing pay on relative performance, then, indexed options reward good performance even in a falling market, without rewarding poor performers in a rising market. These options limit the influence of factors beyond an executive’s control, such as general market and industry conditions. Because of this advantage, indexed options are widely thought to offer superior incentives.¹⁰

Given recent market developments, a caveat is in order. While indexed options offer advan-

¹⁰ See, e.g., Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 82-83 (1979) (noting that efficient compensation contracts filter out risk that is beyond an employee’s control); Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, U. CHI. L. REV. (forthcoming 2002).

tages, they still share defects of traditional options that have attracted attention recently. For instance, indexed options may encourage executives to take excessive risks or manipulate stock prices. Thus, indexed options should not be viewed as an all-purpose cure for bad corporate governance, but as one element in a broader governance strategy that includes clear disclosure rules, transparent accounting standards, better monitoring by independent directors and shareholders, and the like.

II. Indexing Incentive Stock Options

Notwithstanding the economic advantages of indexed options, practitioners generally believe that an indexed option cannot qualify as an ISO. An option can qualify under the statute only if the “option price is not less than the fair market value of the stock at the time such option is granted.”¹¹ In other words, the exercise price cannot decline. As a result, this language generally is read to reject indexed options because, at some point, the option price can fall below the stock’s grant date fair market value.¹²

¹¹ I.R.C. § 422(b)(4) (“For purposes of this part, the term ‘incentive stock option’ means an option granted to an individual for any reason connected with his employment by a corporation . . . but only if . . . (4) the option price is not less than the fair market value of the stock at the time such option is granted.”).

¹² This language should be compatible with partial indexation. For a description of a partially-indexed option, see *infra* Part III.A.iv. There is also a creative reading that might justify full indexation. The statute arguably can be read to test the option price only on the grant date, and not throughout the term of the option. Under this reading, an indexed option passes muster as long as, on the grant date, the index is at least as valuable as the stock price (i.e., so the option is in-the-money when granted). This reading – which gets to the right result, but is not a natural

The regulations also are hard to reconcile with indexed options: The “option price”—which is defined as the price *actually paid* on the option¹³—“may be determined in any manner so long as *the minimum price possible* under the terms of the option cannot be less than the fair market value of the stock at the date of grant.”¹⁴ An indexed option cannot satisfy this condition because the exercise price *could* fall below this minimum value *at some point* during the life of the option (i.e., if the index declines).¹⁵

reading of the language – treats the phrase “at the time such option is granted” as modifying the whole sentence, including the phrase “option price.” As a result, the rule in effect provides: “The option price *at the time such option is granted* is not less than the fair market value of the stock.” In contrast, under the conventional (and more natural) reading, the “at the time” language is read to modify only “fair market value of the stock,” and not also the rest of the sentence.

¹³ See Treas. Reg. § 1.421-7(e)(1) (defining option price as “the consideration in money or other property which, pursuant to the terms of the option, is the price at which the stock subject to the option *is purchased*”) (emphasis added).

¹⁴ Prop. Treas. Reg. 1.422A-2(e), 49 Fed. Reg. 4504 (Feb. 7, 1984) (emphasis added).

¹⁵ To get to the right policy answer, the taxpayer might try to read this regulatory language (creatively) as requiring only that the minimum price, as of the grant date, cannot be less than the fair market value of the stock on the grant date. In other words, one could read the phrase “at the date of grant” to refer to the entire sentence, and not just the immediately preceding language “fair market value of the stock.” Yet this reading is inconsistent with the definition of “option price” as the price actually paid (and not the price that hypothetically would be paid on the grant date). See Treas. Reg. § 1.421-7(e)(1) (defining the term “option price”). In addition, this reading yields bizarre results. What if the exercise price initially equals the stock price on the grant date but is preset to decline thereafter (for example, by a dollar a day until it reaches zero)? Tested only on the grant date, this option would qualify as an ISO. Yet this is precisely the kind of option that is not supposed to qualify. Indeed, the prior regime for “restricted stock options” explicitly required the option price to be “fixed or determinable at the time the option is granted.” Otherwise, the option would be a so-called “variable price option” that was not eligible for favorable tax treatment. See Treas. Reg. § 1.421-1(d)(2) (describing the requirements for granting a restricted stock option).

To sum up, practitioners generally believe that an indexed option cannot qualify as an ISO, but there is no policy reason to disfavor indexation. A statutory amendment is needed here.

III. Section 162(m), The Firm's Deduction, and NQOs

The inability to index an ISO is unfortunate, but the harm is limited by the fact that ISO grants tend to be a small component of a senior executive's pay.¹⁶ It is even more important for NQOs to be indexed. For these options, though, §162(m) and the regulations thereunder arguably pose a problem, although a favorable ruling from the government would substantially improve the situation and should be feasible. A product of populist concerns about soaring executive pay, §162(m) disallows a publicly traded firm's deduction for compensation exceeding one million dollars. Yet the rule exempts certain performance-based pay.¹⁷ The goal of this exception is either to encourage such pay or, a cynic might say, to render the measure toothless.

A. Can Indexed Options Qualify as "Performance-Based"?

Part I shows that, as a matter of economics, indexed options are even more performance-based than traditional ones. Yet although traditional options clearly qualify as performance-

¹⁶ The reasons are noted in note 2, *supra*.

¹⁷ *See* I.R.C. § 162(m)(1) ("In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000."). The rule applies to the chief executive officer and to the four other most highly compensated employees. *See id.* § 162(m)(3) (defining "covered employee"). The term "applicable employee remuneration" does not include any remuneration "payable solely on account of the attainment of one or more performance goals" if procedural

based under §162(m) (i.e., as long as they are not in-the-money when granted),¹⁸ there is a technical argument that indexed options do *not* qualify as “performance- based,” and thus are not deductible in excess of one million dollars.

i. The Adverse Reading of the Rule for Options

This odd result derives from regulations applying Section 162(m) to stock options and stock appreciation rights:

“[I]f the amount of compensation the employee will receive under the grant or award is not based *solely on an increase* in the value of the stock after the date of grant or award (e.g., in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation”¹⁹

In other words, compensation must be based “solely on an increase” in the employer’s stock price. The legislative history contains similar language.²⁰ The problem is that, with indexed op-

requirements are satisfied. *Id.* § 162(m)(4)(C).

¹⁸ The regulations and conference report treat grants of at-the-money and out-of-the-money conventional options as “performance-based” compensation. Treas. Reg. § 1.162-27(e)(2)(vi) & examples 9 through 11; *see also* H.R. CONF. REP. NO. 103-213, pt. 4 (1993).

¹⁹ Treas. Reg. §1.162-27(e)(2)(vi) (emphasis added).

²⁰ The legislative history also includes this “increase” language, as well as a statement that “automatic repricing” is problematic:

“Stock options or 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 executive would be based solely on an *in-*

tions, executives can profit even as the stock price *declines* – as long as the price declines *less than* the benchmark. In the above example, for instance, if the stock price remains constant and the S&P 500 loses half its value, executives will earn \$50 per share, even though there has been no absolute increase in the share price. Because of this scenario, an indexed option arguably cannot qualify as “performance-based.”²¹

Given the absurdity of this outcome, creative arguments that get to the “right” answer as a matter of policy might well receive a sympathetic hearing from a judge or from the I.R.S., even if these interpretations are not the most natural readings of the relevant language. In this spirit, the taxpayer might offer three arguments. Admittedly, they are all debatable and, in the absence of guidance, they may not be solid enough to support a strong opinion from counsel. Yet these arguments could be used to justify a revenue ruling, as long as the government is sympathetic to the policy goal (and, based on conversations with officials at the Treasury Department and the

crease 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 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, stock options that are granted with an exercise price that is less than the fair market value of the stock at the time of grant do not meet the requirements for performance-based compensation. Similarly, if the executive is otherwise protected from decreases in the value of the stock (such as *through automatic repricing*), the compensation is not performance-based.” H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess. 586-87 (1993), reprinted in 3 C.C.H. Standard Fed. Tax. Rep. 21,822 (emphasis added).

I.R.S., my sense is that the government is, indeed, sympathetic).

ii. The First Technical Response: Reliance on the General Rule

First, the “increase” language is found in a special rule for options (paragraph (e)(2)(vi)(A) of the relevant regulation), but the general rule (paragraph (e)(2)(i)) is more lenient. It merely requires “preestablished, objective performance goals,” a concept that is defined flexibly:

“A performance goal need not . . . be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion).”²²

If this were the only governing standard, it would be relatively straightforward to conclude that an indexed option is based on a preestablished and objective performance goal – the firm’s stock must outperform the benchmark – and the executive is compensated to the extent that this goal is achieved.

For this reading to prevail, though, the (e)(2)(vi)(A) rule for options must be read, in effect, as a safe harbor, rather than as the exclusive means for options and stock appreciation rights to comply. Fortunately, there is support for this reading. The general rule of (e)(2)(i) mentions that “business criteria could include, for example, stock price,” so at least some compensation based on stock price is governed by this general rule. The first line of the (e)(2)(vi)(A) rule reads like a

²¹ I am indebted to Dennis Drapkin for this observation, which did not appear in the version of this article published in the *University of Pennsylvania Law Review*.

safe harbor, moreover, in stating *affirmative* conditions that clearly satisfy the general rule.²³

More importantly, the (e)(2)(vi)(A) rule expressly acknowledges at least one scenario in which equity compensation that flunks this rule can still be performance-based under the general rule – that is, when receipt of this equity compensation is based on satisfaction of *some other* objective performance goal.²⁴ For instance, a CEO can receive an in-the-money option in return for generating a preestablished increase in earnings. While an in-the-money option itself is not performance-based, the earnings target is adequate (assuming, of course, that it is sufficiently rigorous). By analogy, a formal vesting condition can be added to an indexed option: The option becomes exercisable only if the stock price outperforms the benchmark – causing the option to be

²² Treas. Reg. § 1.162-27(e)(2)(i).

²³ See Treas. Reg. § 1.162-27(e)(2)(vi)(A) (“Compensation attributable to a stock option or a stock appreciation right *is deemed to satisfy the requirements* of this paragraph (e)(2) if the grant or award is made by the compensation committee; the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee; and, under the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.”) (emphasis added). In contrast to this affirmative formulation (i.e., which focuses on when options “are deemed to satisfy” the rule), the prior paragraph – which deals with compensation that is contingent upon attainment of a performance goal – is phrased negatively. See Treas. Reg. 1.162-27(e)(2)(v) (“Compensation *does not satisfy* the requirements of this paragraph (e)(2) if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained.”).

²⁴ See Treas. Reg. § 1.162-27(e)(2)(vi)(A) (“The rule that the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock after the date of grant or award does not apply if the grant or award is made on account of, or if

in-the-money – at some point after the vesting date. With this addition, the taxpayer can argue that the condition satisfies the performance-based requirement,²⁵ even though the indexed option (by itself) does not.²⁶

Admittedly, this argument is not unassailable. The extra vesting condition is merely a re-statement of the exercise price. In effect, the option vests only if the executive would want to exercise it, and not otherwise. The vesting condition thus is not changing the economic terms of the option at all. If the government is unsympathetic, the vesting requirement might be ignored as lacking economic substance. In addition, unsympathetic government officials could assert that the most natural reading of the language quoted in the prior paragraph is not a safe harbor, but a bottom-line condition: “[I]f the amount . . . is not based solely on an increase . . . none of

the vesting or exercisability of the grant or award is contingent on, the attainment of a performance goal that satisfies the requirements of this paragraph (e)(2).”).

²⁵ Obviously, it is important that this theory not circumvent the option rule where this rule *should* apply. As a limit, the government should accept this theory only if the vesting condition is genuinely difficult to satisfy. For instance, assume the executive receives an in-the-money conventional option with an exercise price is \$70, while the grant date stock price is \$100. The option clearly is not performance-based. What if a condition is added, such that the option vests only if the stock price closes above \$70 at some point after the vesting date? The difference between this in-the-money conventional option and an at-the-money indexed option is that the need to keep the stock price from falling thirty percent (without regard to the overall market’s performance) is too easy.

²⁶ Arguably, the formal fix of adding a vesting condition is not necessary. Under this view, the exercise price itself might be viewed as an adequate performance goal under the general rule. Yet it may be a stretch to characterize the exercise price as a condition independent of the option.

the compensation attributable to the grant or award is qualified. . . .”²⁷

To sum up, then, the general rule offers an argument that is plausible, but not indisputable. As a practical matter, unless the government provides favorable guidance, practitioners are unlikely to give a flat opinion based on this interpretation, and firms are unlikely to bet multi-million dollar deductions. Yet my sense, based on conversations with officials at the Treasury Department and the I.R.S., is that this argument would be greeted favorably.

iii. The Second Technical Response: “Increase” as Relative Increase

The preceding argument relies on the general rule to trump the special rule for stock options in (e)(2)(vi). Assuming this argument fails, such that the special rule governs, the taxpayer might assert an alternative reading of the word “increase.” As noted above, the (e)(2)(vi) rule requires stock option compensation to be “based solely on an increase in the value of the stock.” Yet must the “increase” be absolute, or is a *relative* increase (i.e., compared to the benchmark) adequate? For example, if the stock price declines by ten dollars, while the benchmark declines by fifteen, there has been a ten dollar *absolute* decline in the stock price, but a five dollar *relative* increase. If relative increases are sufficient, then indexed options pass muster. Yet the more

²⁷ In response, the taxpayer might assert that this language is not meant to extend the scope of the special rule, but merely to provide the consequences when this rule already applies. Specifically, this language provides an “all or nothing” result. If an option flunks the test, *all* the profit is disallowed. Thus, profits on a slightly in-the-money option are not bifurcated. If some of the executive’s profit is already available when the option is granted, the rest of the profit is tainted

natural reading is that only absolute increases count.²⁸ Thus, like the general-rule argument discussed above, this relative-increase argument can give a sympathetic decision-maker a way to get to the “right” policy answer, but a firm is unlikely to gamble its deduction on this reading without guidance.

iv. The Third Technical Response: Partial Indexation

Assuming the above two technical arguments are unsuccessful, so that a fully indexed option cannot be squared with the regulations under § 162(m), there may still be a case for partial indexation. Assume the option’s exercise price is set to be the *greater* of (a) the current market price (e.g., \$100 in our example) or (b) the value of the index (e.g., 1/10 of the S&P 500). This option offers some (though not all) the economic benefits of indexation. It rewards executives who outperform a *rising* market, but not a *falling* market.²⁹ The technical advantage of this structure is that compensation is based on an “increase” in the stock price. A possible problem, though, is that pay is also based on something else – an increase in the S&P 500 – and the language, read literally, requires the compensation to be “based *solely* on an increase in the value of

too. Yet the language arguably does not govern when no profit is already available on the grant date, as is the case with an at-the-money indexed option.

²⁸ Cf. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION (7th ed. 1994) (noting that the legislative history of § 162(m) “apparently regards ‘performance’ as an absolute rather than a comparative measure of executive success”).

²⁹ If the stock price rises by ten percent but the market as a whole increases by forty percent, the option would not yield a profit. But if the stock price holds at \$100 and the market falls, the option also yields no profit.

the stock.”³⁰

v. Recommendation

To sum up, the government should issue a ruling or modify the regulatory language to clarify that indexed options can be “performance-based” under § 162(m). At the same time, the new “performance-based” test should be structured with care so that inappropriate practices are not inadvertently authorized. Instead of focusing on whether compensation is based solely on “increases” in the stock price, the new test should focus on two factors: first, whether any compensation will be earned if the option is exercised on the grant date; and, second, whether, measured as of the grant date, the option’s exercise price is substantially certain to decline, as is likely to be the case, for instance, if the exercise price is based on an index of poor performers (e.g., the five worst performers in the S&P 500), or if the exercise price is preset to decline (e.g., by a dollar per day).

B. The Need for More Cash to Accompany an Indexed Grant

Even if a ruling is issued or the regulation is changed, so that indexed options clearly qualify as deductible “performance-based” pay, § 162(m) is still likely to distort compensation practices, encouraging firms to use traditional options instead of indexed ones. The reason, which is explained in this Section, is that a pay package with indexed option is likely to include more (non-deductible) cash than a pay package with conventional options.

³⁰ Treas. Reg. 1.162-27(e)(2)(vi) (emphasis added).

To see the point, assume that the firm and executive agree on a particular level of firm-specific risk that the executive should bear, and they do *not* want the executive to bear *more* firm-specific risk than this.³¹ Assume also that the total compensation package will be worth \$10 million dollars. If § 162(m) were not on the books, the firm would offer the firm-specific risk through indexed options, rather than through traditional options, because, as discussed above, indexed options create superior incentives. The firm would pay the rest of the executive's salary in cash. For instance, the firm would offer an indexed grant worth \$4.5 million, and \$5.5 million in cash. Under Section 162(m), however, this pay package is unappealing. Cash in excess of one million dollars is not deductible, causing the firm to owe almost \$1.6 million of extra tax.³²

To retain its deduction, the firm theoretically could increase the size of the indexed option grant so it is worth \$9 million, while reducing the cash compensation to \$1 million. Yet while the deduction is safe, the firm's business goal is not. The executive is now bearing more firm-specific risk, something the parties are (plausibly) assumed not to want.

³¹ Of course, some firm-specific risk is needed to produce useful incentives. But if too much is imposed, undiversified executives could demand an unduly high premium. See Brian J. Hall & Kevin J. Murphy, *Optimal Exercise Prices for Executive Stock Options*, 90 AM. ECON. REV., PAPERS & PROCS. OF THE ONE HUNDRED TWELFTH ANN. MEETING OF THE AM. ECON. ASS'N, May 2000, at 209 (arguing that too much risk is imposed on executives if the risk premium rises more than the added productivity benefits from intensifying the incentive). Firms may also worry that too much firm-specific risk could induce executives to take foolish gambles or manipulate stock prices. Levmore, *supra* note 5, at 1924-26.

³² Loss of a \$4.5 million deduction would cost the firm \$1.575 million, assuming the 35% federal corporate tax rate applies.

Is there a way, then, for the firm to keep its deduction without increasing the executive's exposure to firm-specific risk? In the abstract, what is needed is a currency that, as an economic matter, does not convey more firm-specific risk – and thus is not really performance-based – but, nevertheless, is treated as performance-based under § 162(m). Traditional options thread this needle. They include a bet on the market as a whole,³³ which is not performance-based as an economic matter (i.e., because it is unrelated to the executive's individual efforts), but is still treated as such under § 162(m). Thus, the firm can offer the executive \$1 million in cash and a traditional option grant worth \$9 million – a grant that, in fact, offers approximately the same exposure to firm-specific risk as an indexed grant worth \$4.5 million.³⁴

³³ As Professors Johnson and Tian have shown, a single traditional option is worth three times as much as a single indexed option on plausible assumptions. See Shane A. Johnson & Yisong S. Tian, *The Value and Incentive Effects of Nontraditional Executive Stock Option Plans*, 57 J. FIN. ECON. 3 (2000) (noting that an indexed option is worth \$13.56 and a traditional option is worth \$40.35, assuming an at-the-money exercise price of \$100, volatility of .20, a risk-free rate of 8%, and a dividend yield of 2%). The difference between the two is the bet on the market as a whole. Indeed, a traditional option is comparable to an indexed option paired with an option on the market as a whole. For instance, assume that the traditional option authorizes purchase of the stock for \$1000 (the current price). A similar economic return is also offered by two securities: an indexed option entitling the executive to buy stock for the current value of the S&P 500 (which is assumed currently to be 1000) and an option to buy the S&P for \$1000. Admittedly, these alternatives are not perfectly equivalent. For instance, as noted above, the traditional option makes no payment if the firm stock price declines, even if this stock price outperforms the S&P 500. In contrast, the pair of options does make a payment because gains on the indexed option are not netted against losses on the S&P option (i.e., since the executive will not exercise the S&P option if it is out-of-the-money). For another difference, see *infra* note 36.

³⁴ As Professors Johnson and Tian have shown, the indexed option grant will be almost twice as sensitive to changes in the stock price as a traditional grant of equivalent value. See Johnson

In short, for a pay package with indexed options to offer the same level of firm-specific risk as a pay package of equivalent value that uses conventional options, the indexed option package will include more cash. But this extra cash is not deductible. The three pay packages in the above example are compared below:

Comparison of Three Pay Packages

& Tian, *supra* note 33, at 16-17 (noting that delta of an indexed grant is ninety-three percent lar-

Pay Package	Firm-Specific Risk	Nondeductible Portion
\$5.5 million cash \$4.5 million indexed option	Desired level	\$4.5 million cash
\$1 million cash \$9 million indexed option	More intense than desired level	0
\$1 million cash \$9 million traditional option	Desired level (like \$4.5 million indexed option)	0

Thus, traditional options preserve the firm's deduction, while limiting the executive's firm-specific risk. Yet if not for § 162(m), the parties would have two reasons to prefer a package with a (smaller) indexed grant and more cash. First, the indexed grant offers better incentives than a traditional grant, as discussed above. Second, cash presumably is more attractive to an executive than the market bet embedded in a traditional option. After all, some executives might

ger than delta of a traditional grant).

not want to invest their money in the market.³⁵ Those who do, moreover, are likely to prefer a different investment vehicle.³⁶ Thus, § 162(m) causes the parties to depart from the pay package they really want, while at the same time yielding a pay package with inferior incentives.

To sum up, even if a ruling is issued or the regulations are clarified to offer a deduction for indexed options, § 162(m), in limiting the deduction for cash, will inadvertently favor traditional options (which are likely to be accompanied by less cash) over indexed ones (which are likely to be accompanied by more cash). A range of responses can address this problem. One is to treat

³⁵ This cost should not be overstated, though, because many executives would invest in the market anyway. See Li Jin, CEO Compensation, Diversification and Incentives 32 (Dec. 9, 2000) (unpublished manuscript) (“[T]he cost to [the] firm of moving market risk from shareholder[s] to the CEOs is not high CEOs naturally want to hold some market risk as long as it is fairly priced. Even if CEOs are given only risk-free cash compensation, they are likely to invest some of their wealth in the risky assets themselves”), available at http://papers.ssrn.com/sol3/papers.cfm?cfid=450743&cftoken=73769900&abstract_id=254260.

³⁶ Indeed, it is likely that executives who affirmatively *want* market risk would still rather get it another way. If the market bet is embedded in a traditional option, profits can be offset by firm-specific losses. Yet such “netting” would not occur if, for instance, the executive received S&P options (or cash used to purchase them) and separate indexed options. To see the difference, compare two scenarios. First, assume the executive receives a traditional option to buy stock for its current market price of \$1000 (which is also assumed to be the current value of the S&P 500). What if the firm stock price remains at \$1000, even though the S&P 500 increases to \$2000? The executive has no profit. In contrast, assume the executive receives an indexed option to buy stock for the current value of the S&P 500, and also uses cash to buy a separate at-the-money S&P call option with an exercise price of \$1000. On the assumed facts, the executive nets a \$1000 profit on the S&P option. Even though the stock underperformed the S&P 500 by \$1000, the executive has no *loss* on the indexed option (other than the salary foregone to get it). Unlike the traditional option, this \$1000 underperformance *does not cancel out* the \$1000 profit

traditional options as only *partially* performance-based, disallowing the deduction for payouts that derive from appreciation in the overall market. Specifically, a cap can be placed on the issuer's deduction, based on the amount the firm could have deducted if, instead, it had issued an equivalent number of at-the-money indexed options.³⁷

A more drastic response, which avoids complexity associated with a hypothetical indexed option grant, is to treat traditional options as simply not deductible *in their entirety*. Yet this step gives short shrift to a traditional option's firm-specific component. In many cases, profits from a conventional option will reflect firm-specific returns – and thus the excellence of the management team.

While these targeted responses are plausible, the problems identified here suggest a more fundamental point. There are significant risks in using the tax law to regulate corporate governance. An imperfect practice may be rewarded because drafters of tax rules are not experts on corporate governance, and thus do not know that an even better practice is possible. As a result, this suboptimal approach may become embedded in the law, keeping superior alternatives from gaining wider use. So it has been with § 162(m), and Congress should give serious thought to

on the S&P option.

³⁷ Obviously, an assumption is needed here about the indexed option's underlying benchmark. To avoid disputes about what the firm's peer group really is, a broad market measure such as the S&P 500 would seem advisable.

repealing the measure.