Economic Fantasy vs. Economic Reality and the Problems it caused for Tyco and U.S. Sprint Executives.

(Or - Why the IRS always likes to have it both ways)

Real estate tax reform, tax shelter abuse, cash basis of accounting – all efforts by the IRS to enforce their view of taxation and that is: Cash = Income. This bent towards judging a transaction by its basic economics is known as the “economic reality” theory. But what happens when the IRS uses economic fantasy versus economic reality in dealing with stock options? It’s the old heads I win, tails you lose result – the IRS always wins.

So why do I call the taxation of non-qualified stock options, which are governed by Internal Revenue Code Sections 421 and 83, an economic fantasy? Because where else can a taxpayer be forced to pay for something, pay taxes on that something, create negative cash flow, and the IRS call it fair. No wonder that when it comes to options:

1. Executives try to avoid that unfair result by offsetting the income tax generated by the taxation of the options at exercise with other economic fantasy transactions (E.g. U.S. Sprint executives).

2. Executives, who want to hold their options (which a shareholder should encourage because it keeps the executive at risk to perform well), borrow bucket loads of money from the corporation so they can:

    (a) Pay for the exercise price of the option and
    (b) Pay the tax on the exercise of the option when they generate no cash to pay the tax with.

    What’s the good example here? Look no further than the recent Tyco trial, which resulted in a mistrial because the executives were following a tried and true formula of paying for options with loans from the company.

3. Middle level executives almost never end up owning the underlying shares when they exercise their options – why? Because they understand true economic reality. They can’t pay for the stock and pay the income tax on the exercise of the option without money, and the only way to generate money is to sell the stock immediately after the exercise. It would be like the IRS taxing the appreciation on your house, and therefore violates the principle of cash = income.

So it seems that in all three of these cases management really does understand economic reality. That is without (1) offsetting the tax or (2) borrowing from the corporation or (3) selling the stock immediately after exercise, an optionee can never afford to hold onto stock acquired through non-qualified options because the taxation of non-qualified options on their exercise is ECONOMIC FANTASY.

Think of what the New York Times and Wall Street Journal headlines would look like if economic reality governed the tax consequences of the exercise of stock options – No headlines about U.S. Sprint and Tyco executives "abusing" the tax law of misusing corporate funds for stock options.

The solution is as simple as it is politically incorrect. No optionee should pay tax on the exercise of a stock option because no economic benefit or accretion of wealth has occurred. In fact, an erosion of wealth occurs because the optionee must pay for the options and taxes with no money. Thus all taxation of options should be deferred until the sale of the shares acquired from the exercise occurs. At which point you have the matching principle, an accretion of wealth (cash on the sale), and the payment of tax due at that time. To reflect the compensatory nature of stock options, the principle should remain that the spread between option price and the value of the stock at exercise should continue to be taxed at ordinary income tax rates. The new approach would require that to be paid on the sale of the stock. Any excess gain, over that recognized as ordinary income, will be taxed at capital gain rates.

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