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# Taking Stock in Employee Benefits:



The democratization  
of broad-based stock plans

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an employer perspective



AMERICAN BENEFITS  
COUNCIL

## EXECUTIVE SUMMARY

Broad-based, employer-sponsored stock ownership plans are an increasingly important method of rewarding working Americans at all income levels. Once a prerogative of executives, stock ownership programs (such as stock options and stock purchase plans) are now becoming part of the total rewards package of rank-and-file employees across a wide range of businesses. Often offered in response to employee requests, such stock plans are a further indication of the continuing evolution of employer-sponsored benefits programs.

Yet barriers in the form of outdated or inadequate laws and regulations either hamper the further growth of stock benefit programs or create difficulties for those participating in existing plans. The rapid expansion of broad-based, employer-sponsored stock plans — which benefit workers, employers and our national economy alike — will not continue unless these issues are resolved.

This report outlines the major types of stock ownership programs offered by employers today, the tax treatment of stock benefits, and the growth and prevalence of such plans. Public policy issues related to stock ownership programs are discussed in detail, and the report concludes with the recommendations of the American Benefits Council. The Council (formerly APPWP – The Benefits Association) is the national trade association for companies concerned about federal legislation and regula-

tions affecting all aspects of the employee benefits system. The Council's members represent the entire spectrum of the private employee benefits community and either sponsor directly or administer retirement and health plans covering more than 100 million Americans. In summary, the Council recommends that Congress:

- Clarify the tax withholding treatment of statutory stock options;
- Exempt incentive stock options from the reach of the Alternative Minimum Tax (AMT);
- Preserve employer flexibility in the administration of stock plans;
- Encourage ESOP dividend reinvestment;
- Expand incentives for stock ownership plans while maintaining existing plans and the existing regulatory structure;
- Examine more uniform treatment for employees working abroad who receive stock benefits; and
- Review and update existing statutes and regulations in various areas to recognize the recent growth of stock ownership.

Many middle-class, working Americans are participating today in stock ownership plans offered by their employers. The Council urges Congress to help foster this positive development in the workplace by taking action to help employers offer and maintain these plans.

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**E**mployer-sponsored programs that extend the benefits of equity ownership to employees have gained new attention from legislators and regulators. This heightened attention is directly attributable to the increase in the number of employees eligible to receive stock-based benefits. Once a prerogative of executives, stock ownership programs are now becoming part of the pay and benefits package of rank-and-file employees.

*However, more could be done in the policy arena to assist employers that wish to provide broad-based stock ownership programs to their employees. Many of the laws governing compensation, taxation, and employee benefits were developed at a time when stock ownership plans affected few employees. As a result, such laws do not reflect the nature of the new global economy in which broad-based stock ownership programs are an important employee benefit.*

*The failure of the law to reflect the current landscape stifles new stock plan formation, creates burdens for workers participating in existing plans, and precludes employers from competing effectively in a global market.*

*The American Benefits Council (the Council, formerly APPWP — The Benefits Association) wishes to foster better understanding of stock ownership programs because Council members firmly believe that broad employee equity ownership is a positive development for both employers and employees. The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to employee benefit plans covering more than 100 million Americans. This report will provide background on the major types of stock ownership programs, review current policy issues with respect to these programs, and set forth the Council's specific policy recommendations.*

## STOCK OWNERSHIP PROGRAMS ARE GROWING

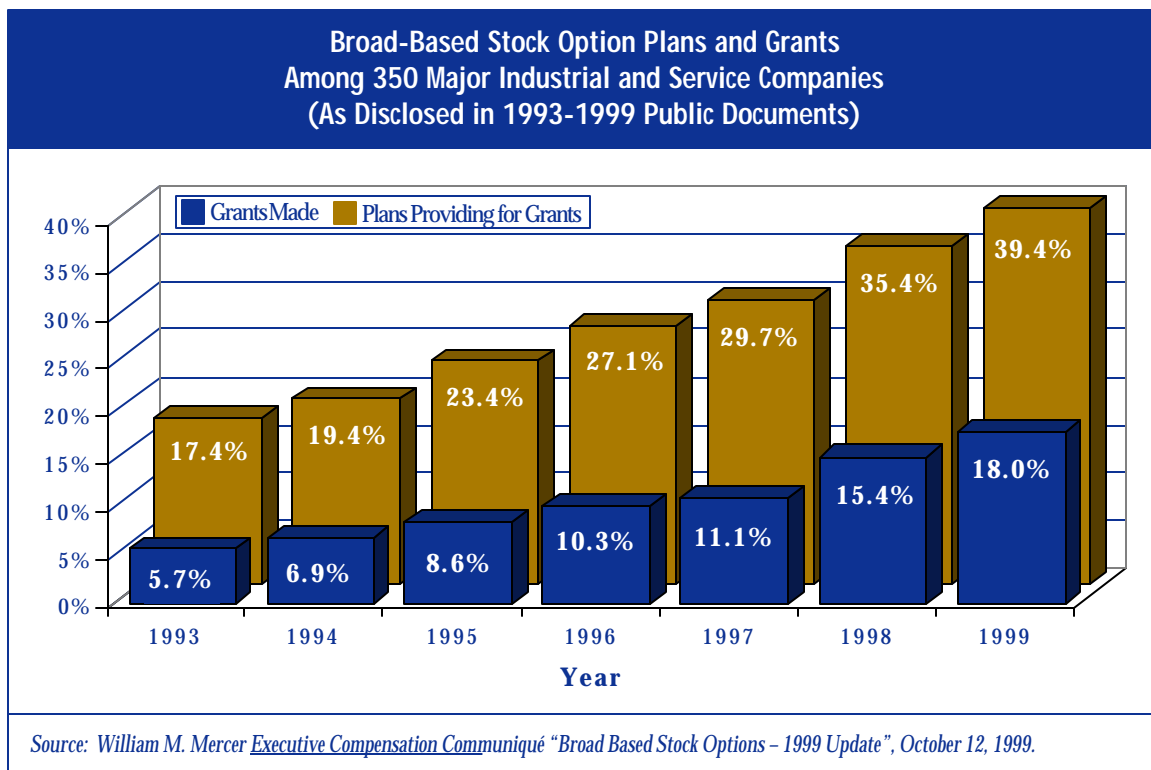
Many more Americans own equity in some form today than in the past, due in part to the growth of employer-sponsored stock plans (see charts on Pages 7 and 9). Many employers extend the benefits of stock ownership to their employees through broad-based stock option programs, employee stock ownership plans (ESOPs), employee stock purchase plans, company stock in 401(k) plans, and other innovative equity participation arrangements. Overall, approximately 56 percent of employers use some form of stock reward program.<sup>1</sup>

Looking just at stock option arrangements, recent surveys show that between seven and 10 million employees are building financial security through stock options,<sup>2</sup> and 39 percent of major companies now have stock option plans that cover over half of their workforce, up from 17 percent in 1993 (see chart on Page 2).<sup>3</sup>

The growth of stock programs is also evident from the increase in employee eligibility for stock option grants. A 1999 study of over 1,200 companies of all sizes and in all fields found nearly 19 percent of all employees were eligible for grants as compared with 12 percent in 1998.<sup>4</sup> Most notably, this growth in stock option holdings has spread to rank-and-file employees. In fact, in a 2000 survey of 345 companies that grant stock options, 47 percent do so to employ-



**Between seven and 10 million employees are accumulating wealth through stock options, and 39 percent of major companies now have stock option plans that cover over half of their workforce.**



ees who are nonexempt under the Fair Labor Standards Act,<sup>5</sup> and these trends are expected to continue (the table on Page 5 provides a distribution of stock ownership plans by employee category). According to a survey that examined anticipated changes to employer stock option plans, 51 percent of companies plan to grant options to a broader range of employees within their organization.<sup>6</sup>

While one often associates stock ownership programs with start-up and high technology firms, equity-based arrangements are increasingly offered across the whole spectrum of American business. A glance at the 50 largest U.S. companies with broad-based stock option plans demonstrates that these plans are being offered by companies in such fields as manufacturing, banking, shipping, household products, aviation, insurance, food products, retail, rail transport, and cable TV, to name but a few.<sup>7</sup>

The depth and breadth of stock ownership programs reflected in the figures above indicates that the extension of equity ownership to rank-and-file employees is becoming an increasingly common business practice.

### **BENEFITS OF STOCK OWNERSHIP PROGRAMS**

Broad-based stock ownership programs prove valuable to both employees and employers. Foremost, they enable workers to become owners of their company, creating a personal stake in the business on the part of employees. Participating employees can benefit directly from their productivity and from the success of the organization. Such programs also provide a significant vehicle of asset accumulation for many workers. Two recent studies put the average annual value of stock option grants to employees at roughly \$1,800 (see chart on Page 3).<sup>8</sup> These annual grants can grow significantly in value for the employee, who can use these

funds to purchase a home, send children to college, or provide for their own financially secure retirement. Employers appreciate stock ownership programs as an important recruitment, retention and motivational tool in a competitive labor market. In particular, the use of stock options as a recruitment tool has helped start-up technology and even more mature companies compete for talented workers, thereby contributing to America's role as a technology leader. Moreover, a recent Rutgers University study found evidence that companies with broad-based stock plans have significantly higher productivity levels and annual growth rates compared to companies without broad-based stock plans.<sup>9</sup> This latter effect may translate into a benefit for the general economy as the number of companies with broad-based stock ownership plans increases.

### TYPES OF BROAD-BASED STOCK OWNERSHIP PROGRAMS<sup>10</sup>

Reflecting the diversity in companies' goals and employee demographics, a wide variety of plans and arrangements are used to achieve today's emphasis on broad-based stock ownership. However, stock ownership programs generally consist of discounted stock purchase programs, options to purchase shares in the future at fixed prices, or outright grants of shares of stock.

A typical stock option gives the employee the right to buy a share of stock in the future at a stated price ("option price") regardless of how the stock's value may change between the time the option to buy is granted (the "grant date") and the time when an employee exercises the right to buy (the "exercise date"). Under the Internal Revenue Code (Code), the taxation of the transaction will often depend on how and when the employee ultimately sells the shares acquired through the option.

| Individual Broad-Based Stock Option Grant Values  |                 |                                       |
|---|-----------------|---------------------------------------|
|   | Value at Grant* | Accrued Value at 6/30/99 <sup>†</sup> |
| 75th Percentile   | \$4,435         | \$19,325                              |
| Median  | \$1,821         | \$2,844                               |
| 25th Percentile   | \$1,381         | \$794                                 |
| * Valued at date of grant using a Black-Scholes option-pricing model.<br><sup>†</sup> Accrued value from date of grant through June 30, 1999. |                 |                                       |
| Source: William M. Mercer <i>Executive Compensation Communiqué "Broad Based Stock Options - 1999 Update"</i> , October 12, 1999.              |                 |                                       |

### Prevalence of Types of Plans

Almost all major employers make use of at least one type of stock plan, and many companies sponsor two or more. In a 2000 survey of 345 U.S.-headquartered companies of all sizes that offer stock ownership incentives, 100 percent granted options under a stock option plan while fewer than 20 percent granted stock outright. Of those granting stock options, 95 percent grant nonqualified stock options while 62 percent used incentive stock option plans. Forty-five percent of those surveyed also provide a Code Section 423 employee stock purchase plan.<sup>11</sup> These various stock ownership plans are detailed in the paragraphs that follow.

### Incentive Stock Options (ISOs)

An incentive stock option receives special tax treatment when it meets the requirements of Code Section 422. These requirements include that the option price must equal or exceed the fair market price of the stock at the time of grant. The exercise of an ISO does not result in taxable income to the employee. Rather, an employee is taxed when he or she sells the stock received through an ISO. The tax treatment of

the sale of ISO stock depends upon whether the stock was held for the requisite statutory holding period before being sold. The statutory holding period is the later of either two years from the grant date of the option or one year from the exercise date. If the shares are held for the requisite period, all of the gain at sale is long-term capital gain. Otherwise, at the time of sale, the employee recognizes any gain between the grant price and the exercise price as ordinary income and any gain above the exercise price as capital gain.



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An employer granting an ISO is generally not entitled to a tax deduction with respect to the issuance of the option or its exercise. If the employee does not hold the stock for the required period, however, the employer may claim a tax deduction for the amount recognized by the employee as ordinary income.

### **Employee Stock Purchase Plans (ESPPs)**

ESPPs qualified under Code Section 423 allow employees to purchase employer stock, often at a discount and typically through payroll deduction. Generally, in a Section 423 ESPP, an employee will receive favorable capital gains tax treatment on the ultimate sale of stock only if (1) the amount of discount on the stock price is no more than 15 percent of the stock's fair market price, (2) with limited exceptions, all employees of the sponsoring employer are

eligible for the plan, and (3) the employee holds the stock for the statutory holding period.

The tax treatment of ESPPs is very similar to ISOs except for treatment of the stock price discount. Proceeds from the sale of Section 423 ESPP stock after holding the stock for the statutory holding period are treated partly as ordinary income (the amount of the stock price discount) and partly as capital gains (the remainder of the gain in the stock price).

### **Nonqualified Stock Options (NQSOs)**

The term "nonqualified" (or "nonstatutory") stock option refers to a number of stock option designs that, for various reasons, do not satisfy the legal requirements to qualify as an ISO or as an option to acquire stock through a Section 423 ESPP. Most nonqualified stock options are structured such that employees receive the right to purchase a certain number of shares of stock at a predetermined price. Such an option may be exercisable immediately or after the occurrence of a certain event or the passage of a specified vesting period.

A nonqualified stock option is taxed as ordinary income to the employee at grant only if the option has a readily ascertainable fair market value at that time. If, as is normally the case, it does not have a readily ascertainable fair market value at grant, the option is taxed as ordinary income at the time of exercise. The employer has a corresponding tax deduction at the time of exercise.

### **Stock Appreciation Rights (SARs)**

A stock appreciation right entitles the employee to receive a payment (usually in cash, occasionally in stock) equal to the rise in value of a stock from the date the SAR is granted to the date the



| Types of Stock-Based Plans Offered by Employee Category (2000) |                |              |             |               |                              |
|--|----------------|--------------|-------------|---------------|------------------------------|
| Employee Group   | Stock Purchase | Stock Option | Stock Grant | Phantom Stock | Company Stock Through 401(k) |
| Nonexempt Hourly Nonunion                                      | 51.6%          | 22.1%        | 51.6%       | 6.0%          | 56.9%                        |
| Nonexempt Salaried   | 50.8%          | 24.4%        | 6.6%        | 1.1%          | 62.1%                        |
| Exempt Salaried  | 54.2%          | 65.7%        | 18.2%       | 5.6%          | 62.8%                        |
| Officers/Executives  | 55.8%          | 92.1%        | 39.5%       | 14.4%         | 61.8%                        |

*Source: WorldatWork, "Total Salary Increase Budget Survey", 2000-2001.*

SAR is exercised. Unlike options, SARs (also known as “phantom stock”) do not confer rights to purchase actual shares of stock. Neither the granting nor the holding of SARs is taxable. The amount paid to the employee when this appreciation right is exercised (i.e., the stock’s appreciation in value) is taxed as ordinary income. The employer receives a tax deduction when the employee includes the SAR payment in income.

**Stock Grants**

Unlike stock options, which give the employee the right to purchase shares under certain conditions, stock grants convey actual shares of stock to the employee. Often, however, the employee will not have complete ownership of the shares until the occurrence of an event, such as completing a certain period of employment. Once this risk of forfeiture passes and the employee has complete ownership of the shares, the employee includes the value of the stock in ordinary income, and the employer takes a corresponding tax deduction.

**Company Stock in Retirement Plans**

An employer may also offer company stock as an investment option in the company retirement plan or make matching contributions to a 401(k) plan in the form of company stock. Moreover,

some defined contribution plans now feature brokerage windows whereby participants can purchase securities, including publicly traded company stock, for their own retirement plan account. Stock held in retirement plans is subject to the Code’s qualified plan rules, Sections 401 et seq., including its taxation of distribution rules. Generally, distributions of company stock from a retirement plan cannot be made except in cases of retirement, death, disability, or termination of employment. The participant is not taxed on any unrealized appreciation in the stock’s value until the shares are sold if the stock received from the plan is a qualifying lump-sum distribution.<sup>12</sup>

**PUBLIC POLICY ISSUES RELATED TO STOCK OWNERSHIP PROGRAMS**

The growth of stock ownership programs has raised a number of important public policy issues now confronting Congress and the relevant regulatory agencies. Below we discuss several of these key issues and present our policy recommendations.

The Council believes the democratization of equity ownership is a positive development for American workers and companies. Many Americans are strengthening their future

financial security through stock ownership programs. We make the following policy recommendations with the aim of facilitating employer-sponsored stock plans and thereby encouraging stock ownership by employees.

### Tax Withholding Obligations under Stock Option Plans

As noted above, selling the stock under an ISO plan before the end of the requisite holding period (two years from date of grant or one year from date of purchase) results in ordinary income to the employee. However, the Internal Revenue Service (IRS) has provided consistent guidance for nearly 30 years that the employer



**Barriers to the growth of broad-based employee stock ownership include outdated laws that inappropriately treat stock benefits as equivalent to wages.**

granting the ISO does not have any income tax withholding obligation with regard to that income, and such income (from either a qualifying or disqualifying disposition) is not considered wages for FICA or FUTA payroll tax withholding purposes.

Since the same statutory provisions, as interpreted by IRS guidance, also apply to ESPPs governed by Code Section 423, employers generally have not paid employment taxes or withheld income tax on ESPP income at the time of purchase or grant.

Despite this long-standing IRS guidance, the IRS recently took the position that FICA and FUTA taxes should be imposed whenever options are exercised under an ESPP. The amount of such tax would be based on the difference between the option price and the fair market value of the

stock at the time of exercise. In recent years, the IRS has sought to impose these withholding obligations retroactively despite clear and directly contradictory guidance in the ISO area.

At the beginning of 2001, however, the IRS imposed a moratorium on the assessment of income and employment tax withholding on stock option transactions until it can issue more definitive and prospective guidance (see IRS Notice 2001-14). The IRS anticipates its future guidance will support imposing employment tax withholding, albeit prospectively, on statutory stock option transactions.

These tax obligations will generate new and substantial costs and burdens for employers, deterring companies from offering broad-based stock purchase programs as well as discouraging employee participation in these plans. Moreover, if withholding is applied, employees, particularly rank-and-file workers, are less likely to retain shares after exercise of ESPP options because they will have to sell some of the stock they receive to cover the additional tax liability. This hinders employee financial security and frustrates the opportunity for long-term appreciation in share value.

The Council has urged the IRS to return to its long-standing position that employers have no payroll tax withholding obligations under ESPPs.

► Despite the current moratorium by the IRS, we are very concerned that future IRS guidance may impose employment tax withholding obligations on certain ESPP and ISO transactions. Congress should pass legislation similar to S. 3265, introduced in the 106<sup>th</sup> Congress by Senator



| Percentage of Families with Direct and Indirect Holdings of Stock  |      |      |      |      |
|--|------|------|------|------|
| Family Characteristic  | 1989 | 1992 | 1995 | 1998 |
| All families   | 31.6 | 36.7 | 40.4 | 48.8 |
| Income (1998 dollars)  |      |      |      |      |
| < 10,000   | *    | 6.8  | 5.4  | 7.7  |
| 10,000-24,999  | 12.7 | 17.8 | 22.2 | 24.7 |
| 25,000-49,999  | 31.5 | 40.2 | 45.4 | 52.7 |
| 50,000-99,999  | 51.5 | 62.5 | 65.4 | 74.3 |
| 100,000+   | 81.8 | 78.3 | 81.6 | 91.0 |
| Age of head (years)  |      |      |      |      |
| < 35   | 22.4 | 28.3 | 36.6 | 40.7 |
| 35-44  | 38.9 | 42.4 | 46.4 | 56.5 |
| 45-54  | 41.8 | 46.4 | 48.9 | 58.6 |
| 55-64  | 36.2 | 45.3 | 40.0 | 55.9 |
| 65-74  | 26.7 | 30.2 | 34.4 | 42.6 |
| 75+  | 25.9 | 25.7 | 27.9 | 29.4 |
| *Ten or fewer observations   |      |      |      |      |
| Source: <i>Federal Reserve Bulletin</i> , "Results from the 1998 Survey of Consumer Finances", January 2000. |      |      |      |      |

Larry Craig (R-ID), clarifying the exemption of ESPP and ISO transactions from employment and income tax withholding.

**Alternative Minimum Tax**

A major obstacle to extending equity ownership to working Americans is the application of the alternative minimum tax (AMT) to the exercise of incentive stock options (ISOs). The AMT, governed by Code Sections 55 through 59, is a special minimum tax imposed if a taxpayer's taxable income is reduced below a certain level due to deductions such as mortgage interest, medical expenses, state and local taxes, miscellaneous deductions and passive activity losses. These "excess" deductions are added back into income to create the alternative minimum taxable income (AMTI), and the resulting amount is taxed at a flat rate of either 26 percent or 28 percent. Taxpayers then pay the higher of their regular tax or the alternative minimum

tax. While certain taxpayers (those earning up to \$45,000 of AMTI for joint filers and \$33,700 for single filers) are exempt from the AMT, this exemption has never been indexed for inflation. The AMT will affect 1 million taxpayers this year, and the Joint Committee on Taxation estimates 14.7 million taxpayers will have to pay the AMT in 2010.

Upon exercise of an ISO, the difference between the fair market value of the stock and the option price is includable in AMTI even though this amount is not includible in ordinary income. With the growth of broad-based plans and the wide reach of the AMT, many rank-and-file workers find themselves having to confront the complexities and costs of this tax. The application of the AMT to stock options discourages workers from holding company stock and thereby frustrates the goals of stock ownership programs.

- ▶ The Council strongly recommends passage of legislation that exempts income resulting from the exercise of stock options under ISO plans from the AMT.

### Employee Classification Issues

Code Section 423 generally requires employee stock purchase plans (ESPPs) to cover all common law employees of the corporation. However, employers may exclude certain narrowly defined groups of workers based upon their status as part-time, short-service, highly compensated, or new employees. Litigation has arisen over whether temporary and part-time workers are entitled to participate in ESPP plans, and questions also exist with respect to whether certain foreign employees must be covered under these plans.

Employers who sponsor ESPPs and other stock ownership programs need flexibility in managing benefits for a workforce with changing demographics. Legislating aggressive new coverage mandates, as had been proposed in H.R. 2298, H.R. 2299, and S. 2946/H.R. 4962 (in the 106th Congress), would impair this needed flexibility. Enactment of such coverage mandates would make stock plans substantially less attractive to employers.

- ▶ Particularly in light of the already broad coverage requirements of ESPPs, the Council urges Congress to stand firm against such mandates and to continue to allow employers needed flexibility in administering their benefit programs.

The existing ESPP rules also work to inappropriately exclude certain full-time workers from participation in these plans. Current rules require that in order to participate in an ESPP,

an employee must work for a corporation (rather than for a partnership or limited liability company (LLC)) and that the firm sponsoring the ESPP must own at least 50 percent of that corporation. Both of these rules exclude workers from ESPP participation, particularly in start-up firms that often take the form of partnerships or LLCs and in joint ventures where the 50 percent ownership threshold is not met.

- ▶ The Council urges Congress to review the ESPP rules as they apply to unincorporated enterprises.

### ESOP Dividends Reinvestment

Employee stock ownership plans (ESOPs) allow employees to benefit from equity ownership through a tax-qualified retirement plan. Bipartisan legislation that passed the House of Representatives and the Senate Finance Committee late in the 106<sup>th</sup> Congress, but was not considered by the full Senate before the end of the session, included an important change in the tax treatment of ESOP dividends that would provide employees with a greater opportunity for enhanced retirement savings and stock ownership.

Under Code Section 404(k), employers may take a tax deduction on dividends paid on employer stock in an unleveraged ESOP only if the dividends are paid to employees in cash; the deduction is denied if the dividends remain in the ESOP for reinvestment. The legislative proposals would allow these deductions when employees choose to leave the dividends in the plan for reinvestment, thereby encouraging the accumulation of retirement savings through the employee's ownership interest in the employer. This provision would reinvigorate

| Direct and Indirect Family Holdings of Stock   |          |          |          |           |
|--|----------|----------|----------|-----------|
| Median value among families with holdings (in 1998 dollars)  |          |          |          |           |
| Family Characteristic  | 1989     | 1992     | 1995     | 1998      |
| All families   | \$10,800 | \$12,000 | \$15,400 | \$25,000  |
| Income (1998 dollars)  |          |          |          |           |
| < 10,000   | *        | \$6,200  | \$3,200  | \$4,000   |
| 10,000-24,999  | \$6,400  | \$4,600  | \$6,400  | \$9,000   |
| 25,000-49,999  | \$6,000  | \$7,200  | \$8,500  | \$11,500  |
| 50,000-99,999  | \$10,200 | \$15,400 | \$23,600 | \$35,700  |
| 100,000+   | \$53,500 | \$71,900 | \$85,500 | \$150,000 |
| Age of head (years)  |          |          |          |           |
| < 35   | \$3,800  | \$4,000  | \$5,400  | \$7,000   |
| 35-44  | \$6,600  | \$8,600  | \$10,600 | \$20,000  |
| 45-54  | \$16,700 | \$17,100 | \$27,600 | \$38,000  |
| 55-64  | \$23,400 | \$28,500 | \$32,900 | \$47,000  |
| 65-74  | \$25,800 | \$18,300 | \$36,100 | \$56,000  |
| 75+  | \$31,800 | \$28,500 | \$21,200 | \$60,000  |
| *Ten or fewer observations   |          |          |          |           |
| Source: <i>Federal Reserve Bulletin</i> , "Results from the 1998 Survey of Consumer Finances", January 2000. |          |          |          |           |

ESOPs as viable retirement savings plans and encourage employers to establish these plans for their employees.

- The Council supports the deductibility of reinvested ESOP dividends and urges Congress to enact this change.

### Incentives for Equity Ownership

As stock ownership programs provide opportunities for enhanced financial security for workers, the Council believes public policy should encourage these plans. A number of legislative proposals made during the 106<sup>th</sup> Congress would have either removed barriers to, or provided incentives for, the establishment or expansion of broad-based stock ownership programs. One legislative initiative, the Wealth Through the Workplace Act (H.R. 3462), sponsored by Rep. John Boehner (R-OH), would have created a stock option with no tax conse-

quences for the employee upon exercise and capital gains treatment upon sale if certain holding and coverage requirements were met. In addition, the sponsoring employer would have received a tax deduction at exercise equal to the difference between the fair market value of the stock on the date of option grant and on the date of exercise.

Another bill, the Universal Stock Options Act of 2000 (H.R. 4972), introduced by Rep. Amo Houghton (R-NY), would have coupled the power of employee pre-tax salary reduction to purchase stock options with an accelerated employer deduction for offering options to employees. Both bills encouraged employees to hold their stock instead of selling it to pay tax liabilities, and employers would have received an incentive to offer stock options to a wider group of employees.

- ▶ The Council supports the goals of legislation such as the former H.R. 3462 and H.R. 4972 and strongly encourages Congress to enact tax incentives to foster employer-sponsored equity plans. We feel strongly that any legislation to provide incentives for broad-based stock ownership plans should incorporate the following principles:
  - It will be important in any legislation to clarify that any new stock option or stock purchase design will not displace or lead to adverse consequences for existing arrangements. Clear protection of existing programs will help new stock plan legislation gain broad-based support from the business and benefits communities.
  - While it is appropriate to include coverage requirements in any new stock plan legislation that provides substantial tax advantages, we feel such requirements should be carefully and flexibly crafted so as not to preclude employers from making use of the new incentives and employees from receiving the benefits of the new designs.
  - Historically, equity arrangements like stock option plans have been established within the Internal Revenue Code and regulated by the Treasury Department and IRS. We strongly recommend that any future legislation continue this historical practice rather than placing stock plans within the Employee Retirement Income Security Act (ERISA) and subjecting them to regulatory oversight by the U.S. Department of Labor.
- We understand that some Members of Congress may be concerned about preventing substitution of stock options for existing wages. We believe this concern is misplaced. Increasingly, the manner in which employers reward workers is responsive to worker demands and expectations and is designed to enable employers to attract and retain needed employees. Employers make determinations about workers' wages and benefits in the context of the appropriate level of total compensation and decide upon the relative place of cash wages and other benefits based on what is competitive in the marketplace. These competitive pressures will not allow companies to reduce cash compensation below what workers demand and what competitor firms provide. We believe, therefore, that legislative restrictions to prevent the substitution of options for wages are unnecessary (and would in any case be highly unworkable).

### **Fair Labor Standards Act**

Barriers to the growth of broad-based employee stock ownership include outdated laws that inappropriately treat stock benefits as equivalent to wages. In response to one such problem, the Worker Economic Opportunity Act (P.L. 106-202) was overwhelmingly passed by Congress in 2000 and signed into law by President Clinton. This legislation made clear that stock option profits do not trigger the overtime pay requirements of the Fair Labor Standards Act.

Similar legislative efforts sought to increase the attractiveness of providing other varieties of stock bonuses and awards to rank-and-file

employees. In 2000, during Senate consideration of the Bankruptcy Reform Act of 1999 (S. 625), an amendment sponsored by Senator Pete Domenici (R-NM) included a provision allowing employers to pay gain-sharing or performance-based bonuses and awards without having to include these awards in an employee’s regular rate of hourly pay for overtime purposes. This change was also contained in Rep. Cass Ballenger’s (R-NC) Rewarding Performance in Compensation Act (H.R. 1381), which was also introduced in the last Congress.

- The Council supports legislation that would help extend the benefits of performance-based compensation, including stock ownership, to all employees.

### International Concerns


Many U.S. companies now have extensive foreign operations, and workers of U.S. companies often find themselves and their careers moving across international borders. Companies operating internationally find that offering stock and stock options to employees overseas is difficult because of the differing tax treatment of stock offerings, dividend distributions, and sales of shares across different countries. Bilateral treaties between the United States and foreign nations govern the international tax treatment of such stock transactions.

- The Council urges Congress to promote more uniform treatment for employees of U.S. companies by investigating and addressing the special problems of offering

equity ownership to U.S. employees working in other countries.

### Taxation of Net Unrealized Appreciation

When an individual receives a distribution of employer stock as part of a “lump-sum distribution”<sup>13</sup> from a qualified retirement plan, the amount of “net unrealized appreciation” on such employer stock is excluded from gross income. The opportunity to defer taxation on net unrealized appreciation, and to have such appreciation taxed at capital gains rates (rather than ordinary income) is a significant benefit to individuals who receive distributions of employer stock from qualified retirement plans. Consequently, the tax benefits associated with distributed stock provide a major incentive for the adoption of stock-based qualified retirement plans, including ESOPs.



**Barriers to the growth of broad-based employee stock ownership include outdated laws that inappropriately treat stock benefits as equivalent to wages.**

This tax benefit is not accorded, however, to all recipients of distributions of employer stock. Participants who have not reached age 59½ and who are not disabled cannot receive this favorable tax treatment unless they first terminate employment. Participants who take their distributions in installments or as part of their minimum required distributions after

reaching age 70½ are likewise prevented from receiving the tax-favored treatment of net unrealized appreciation. In sum, the Code presents a patchwork of rules pertaining to distributions of stock from a retirement plan that confuse participants about what to do and often cause them to make decisions with unfavorable tax consequences.

- ▶ In light of the increasing number of retirees in the coming years, we recommend Congress review the rules on lump-sum distributions and net unrealized appreciation with an eye towards making these rules simpler and more consistent.

### Information Reporting of Stock Option Transactions

Nonqualified stock option plans are the most common type of stock option plan in use by employers. Upon exercise of such options, the employee receives income equal to the excess of the fair market value of the stock at that time over the option exercise price, and such income is reported on the employee's Form W-2. The employee typically sells some or all of the stock on the same day the option is exercised (unless a restriction applies). The broker handling these transactions is required to report on Form 1099-B the payment of gross proceeds to individuals from such same-day sales (even though typically no gain or loss is realized). The employee thus receives duplicative reporting for the same transaction (on both the W-2 and the 1099-B), which can cause confusion. Moreover, if the employee has not provided a certified taxpayer identification number on Form W-9, the broker is required to withhold 31 percent from the gross proceeds of the sale in addition to withholding employment taxes.

For many employees, particularly those working abroad, unintentional errors in W-9 reporting can lead to unfairly large tax burdens (which typically result in subsequent refund of the excess taxes). For foreign nationals working in their own countries, failure to file Form W-8BEN (the non-U.S. version of the Form W-9) compounds unfairly large tax burdens. Both W-9 and W-8BEN filing should be unnecessary

in option exercise and sale transactions since the U.S. corporation sponsoring the option program is responsible for ensuring appropriate taxes are withheld at the time of the transaction.<sup>14</sup>

- ▶ The Council recommends Congress examine these issues and explore ways in which the reporting requirements of the Code can be simplified and streamlined in order to minimize confusion and reduce needless tax burdens.

## CONCLUSION

This issue brief details the impressive and encouraging growth of broad-based stock ownership plans. The Council supports this growth as a means for employees to share in the benefits of equity ownership and to accumulate assets for retirement and other financial needs.

Because many of today's laws do not reflect current employment practices and the recent growth of stock ownership, issues such as employment tax withholding, the alternative minimum tax, employee classification, ESOP dividend reinvestment, and others continue to hinder the growth of broad-based plans. The Council urges Congress to act on these issues in order to encourage employers to offer broad-based stock plans and thereby provide employees with greater access to equity ownership.



## NOTES

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- 1 *2000-2001 Total Salary Increase Budget Survey Results*, WorldatWork, 2000.
- 2 *Current Practices in Stock Option Plan Design*, National Center for Employee Ownership, 2000.
- 3 *Broad-Based Stock Options - 1999 Update*, William M. Mercer, Inc., 1999.
- 4 *Executive Pay in 2000*, Watson Wyatt Worldwide, 1999.
- 5 *The 2000 Stock Plan Design and Administration Survey*, the National Association of Stock Plan Professionals and PricewaterhouseCoopers, 2000.
- 6 *2000-2001 Total Salary Increase Budget Survey Results*, WorldatWork, 2000.
- 7 *Employee Ownership Report*, National Center for Employee Ownership, May/June 1999.
- 8 *Employee Ownership Report*, National Center for Employee Ownership, January/February 2000, and David Lebow et al., *Recent Trends in Compensation Practices*, Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series, No. 1999-32, July 1999.
- 9 *Public Companies with Broad-Based Stock Options: Corporate Performance from 1992-1997*, National Center for Employee Ownership and Blasi, Kruse, Sesil, and Kroumava, 2000.
- 10 Because of the wide variety of programs that provide stock to employees, this paper does not discuss every type of plan. For example, it does not cover executive compensation programs. However, this paper provides fairly complete coverage with respect to the major types of plans that provide stock benefits to a broad section of employees and the related policy issues.
- 11 *The 2000 Stock Plan Design and Administration Survey*, the National Association of Stock Plan Professionals and PricewaterhouseCoopers, 2000.
- 12 In order for a distribution to qualify as a “lump sum distribution” under Code section 402(e)(4)(D), the distribution must be made on account of death, attainment of age 59-1/2, separation from service or disability.
- 13 *Ibid.*
- 14 In a related matter, we would also note a recent complication of the information reporting rules for stock options. On November 16, 2000, the IRS imposed for the year 2001 additional W-2 reporting of compensation received by exercise of a NQSO in Announcement 2000-97. This new requirement, which only allowed six weeks for implementation, is not supported by law, provides no tax benefit, and imposes significant burdens on employers. While IRS Announcement 2001-7 subsequently changed course to make this reporting voluntary, the Council believes the lack of an adequate rationale for the additional reporting is cause enough for Congress to review and simplify the information reporting rules.



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