TAX-RELATED POLITICAL COSTS AND INCENTIVES TO VOLUNTARILY EXPENSE STOCK OPTIONS AN ANALYSIS OF THE REGULATORY LANDSCAPE

Jane Mooney*, Kathleen M. Weiden**, J. Barry Lin*

Abstract

The threat of regulation is clear when proposed legislation is introduced in Congress or when other regulatory bodies formally begin consideration of new, tighter requirements. When faced with proposed undesirable regulation, firms may attempt to deflect it in a variety of ways. Accounting and economics research suggests that firms use accounting policy choice as a means of reducing political costs. Prior to 2002, only two firms voluntarily expensed stock options under the provisions of FASB 123. By the end of 2003, a number of firms volunteered to expense stock options in the face of possible mandates from the FASB. A close examination of the record of regulators' activities indicates that, during 2002 and 2003, Congress proposed five pieces of legislation that would increase the tax costs of firms and six pieces of legislation that would increase the taxes of firm managers. We suggest that the decision to begin expensing options reflects firms' and managers' beliefs that the voluntary expensing of stock options for financial reporting purposes would ward off regulatory efforts to convert proposed tax legislation affecting the firms' and managers' taxes into enacted tax law. Our preliminary analysis provides evidence consistent with this general hypothesis. While prior research on the impact of taxes on accounting policy choice has examined accounting policy choice *in response to* enacted tax legislation, this paper provides early evidence on accounting policy choice *in the face of* proposed tax legislation.

Keywords: taxes, political costs, stock options, accounting policy choice

**School of Management, Simmons College, 300 Fenway, Boston MA. jane.mooney@simmons.edu*
***Dolan School of Business, Fairfield University, North Benson Road, Fairfield CT. kweiden@mail.fairfield.edu*
****School of Management, Simmons College, 300 Fenway, Boston, MA 02451. j.lin@simmons.edu*
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I. Introduction

Between 1996 and 2005, firms had two alternatives for accounting for stock options: firms could elect to expense stock option grants on the income statement, or simply disclose in notes the effect on net income of expensing the options.[1] Following the accounting scandals of 2001 and 2002 (e.g., Enron, MCI, etc.), the FASB in 2003 reopened debate of stock-based compensation accounting, and in December 2004, issued a revised standard, requiring expensing of stock options in the future.[2] Prior to 2002, virtually all firms chose to disclose rather than expense.[3] However, during FASB's two-year deliberations on changes to accounting for stock options, approximately 300 firms voluntarily changed their accounting policy on stock options, switching from disclosure to expensing.

Accounting regulators have long recognized that accounting standard setting is a political process (e.g., Armstrong, 1977; Kirk, 1978; Wyatt, 1986), primarily because changes in accounting standards have reallocative economic consequences (Zeff, 1978). Accounting theorists use the term *political costs* for these reallocative economic consequences imposed on firms (i.e., wealth transfers and other costs) because of regulatory processes (e.g. Watts and Zimmerman, 1986). Accounting empiricists report that firms use accounting policy choice to reduce their political costs, either in the face of proposed regulation (e.g., Jarrell, 1979), or in response to enacted regulation (e.g., Jones, 1991). Recent research examining firms' decisions in 2002 to begin expensing options posits that increased pressure from capital market regulators and shareholder activists created a political environment in which some firms used voluntary option expensing to reduce those political costs (Aboody, Barth and Kasnik, 2004).

[1] Financial Accounting Standards Board ("FASB") Statement No. 123, *Accounting for Stock-Based Compensation* (October, 1995)("SFAS 123")
[2] FASB Statement No. 123 (R), *Share Based Payment* (December, 2004)("SFAS 123(R)).
[3] The notable exceptions were Winn-Dixie and Boeing.

The issue of accounting for stock options is somewhat unusual in that FASB conducted deliberations on this issue *twice* over the eleven years ended 2004: the SFAS 123 project ran from 1993 to 1994; the SFAS 123(R) project from 2002 to 2004.[4] While there are several important similarities between the two periods (e.g., the nature of arguments for and against mandatory option expensing, the specific industries arguing against mandatory option expensing, etc.), there are two significant differences.

The first critical difference relates to expectations that expensing stock options would become mandatory. The SFAS 123 project was highly controversial, drawing the attention of industry, the major accounting firms, venture capitalists, industry groups or associations, the Securities and Exchange Commission ("SEC"), and even members of Congress. Overwhelmingly, the consensus was against required expensing of options (DeChow, Hutton and Sloan, 1996). It is likely that firms assessed the probability of mandatory option expensing as extremely low By the time of the SFAS 123(R) project and largely due to the highly publicized accounting scandals, the political consensus had shifted. While certain industry groups supported the *status quo* of optional expensing, most capital market constituents supported its requirement. This led firms to assess the probability of mandatory option expensing as high (Aboody, Barth and Kasnik, 2004; Coyne, 2004).

The second critical difference relates to the relevant regulatory landscape during the respective project periods. During the SFAS 123 project period, stock option expensing was *the* substantive proposal in the public space. Executive compensation had been the focus of recent regulatory attention: the SEC adopted rules requiring enhanced disclosure of executive compensation in 1992 and Congress enacted legislation limiting the deductibility of non-performance based executive pay in 1993. However, there were virtually no other proposed regulations distracting firms from the subject of stock option reporting during that project period. In contrast, during the SFAS 123(R) project period, there were more than thirty proposed regulations addressing corporate governance, manager compensation and stock options, requiring firms to consider and respond to a variety of potential regulatory interventions.[5]

These critical differences suggest that firms faced significantly differing incentives over the two periods with respect to their accounting for stock options. During the SFAS 123 project period, firms faced two questions:

- Given the current political environment, what resources should the firm expend to keep the probability of mandatory stock option expensing low?
- What are the costs and benefits to the firm of adopting proposed accounting policy with a low probability of enactment in the near future?

During the SFAS 123(R) project period, the questions faced were more complex.

- Given the current political environment, what resources should the firm expend to reduce the probability of mandatory stock option expensing from high to low?
- What are the competing political needs for those resources?
- What are the costs and benefits to the firm of early adoption of proposed accounting policy with a high probability of enactment in the near future?
- How is this decision to expense options affected by other regulatory interventions under debate?

Our focus is on the second period and we are most interested in the last question. We examine the regulatory environment during the SFAS 123(R) project period to more clearly identify the set of political costs facing firms. While previous literature points to pressure to reform corporate governance as well as stock option accounting and reporting practices, we note that the set of thirty plus regulations proposed during the SFAS 123(R) project period included *five* that would increase the *tax costs of firms* and *six* that would increase the *tax costs of firm managers*. Based on this, we conclude that firms may have used voluntary expensing of stock options as a means to deflect proposed tax legislation. In other words, firms and firm managers faced tax related *as well as* non-tax related political costs during the period 2002 to 2004, and the former may have provided incentives in the decision to voluntarily expense stock options. This paper analyzes the specific provisions of proposed tax regulation during 2002 and 2003. We examine the economic characteristics and tax attributes of a sample of firms, classified as "expensers" (those announcing voluntary expensing of stock options on their income statements) and "disclosers" (those continuing to disclose this effect *pro forma* in the notes). Our objective is to provide insight into a more

[4] Accounting researchers have reported on the political environment during both periods. Dechow, Hutton and Sloan (1996) examine possible determinants of the likelihood of submitting a comment letter (during the SFAS 123 exposure draft period) opposing mandatory option expensing. Coyne (2005) links campaign contributions and sponsorship/co-sponsorship of proposed Congressional legislation to change or maintain stock option accounting (in advance of or during the SFAS 123(R) deliberations). Aboody, Barth and Kasnik (2004) examine firm and manager incentives for voluntary stock option expensing (in advance of or during the SFAS 123(R) deliberations).

[5] We identify the following as "regulators": Congress, the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASD) and the Securities and Exchange Commission (SEC). We identify the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) as "standard setters."

complex decision environment than has previously been identified, as well as to lay the foundation for future empirical tests of the determinants of the expensing decision.

II. Political Environment

As discussed above, complex regulatory deliberations formed the backdrop for the SFAS 123(R) project period. Exhibit 1 summarizes the extensive set of proposed regulations arising from the deliberations, and reflects the breadth of regulations with provisions related to corporate governance, stock options or CEO pay during this time. The level of activity was intense: 28 regulations were proposed by 7 different Congressional committees and the Sarbanes-Oxley Act was passed by Congress in July 2002. The NYSE and NASD proposed 10 regulations; the SEC supplied 2. This record suggests that there was sufficient momentum for change for firms and managers to believe that these political authorities would likely enact a number and variety of regulations.

Firms and managers' expectations that option expensing would be required were strengthened by the activities of the FASB. While the Congress, the SEC and the stock exchanges deliberated corporate governance and stock option issues, the FASB reopened deliberation of stock-based compensation accounting. The FASB indicated that it expected to decide in early 2003 whether it might revisit its 1995 decision permitting companies to disclose the pro forma effects of stock-based compensation instead of recognizing an expense in the income statement. During the remainder of 2003, the FASB conducted further deliberations, concluding that compensation in the form of options resulted in a cost that should be recognized in the income statement and that fair-value was the appropriate measurement attribute. In November, 2003, the FASB announced that it would continue deliberations on the accounting and reporting for stock options through the fourth quarter of 2003, and that it planned to issue an Exposure Draft in the first quarter of 2004 and a final Statement sometime in the second half of 2004, with a proposed effective date for fiscal years beginning after December 15, 2004.

Exhibit 2 presents a detailed summary of a subset of the proposed regulations, i.e., those affecting the taxes of firms and managers, and highlights expected tax effects. Of the 11 proposed regulations, 5 affect the firm's taxes and 6 affect the manager's taxes. The decision to voluntarily expense options likely was impacted by the extent to which firms and managers believed they could potentially bear additional tax costs from tax-related regulations proposed during 2002 and 2003. In the following section, we examine the specific provisions of this set of proposed tax legislation to identify the extent to which firms and managers could be affected by increased tax costs.

III. Tax Related Political Costs

Both firms and managers faced threatened increases in tax related political costs as a result of the proposed legislation. We have identified six primary potential areas of concern:

- Increased taxes and other costs for domestic multinational corporations
- Increased tax costs for foreign corporations
- Loss of tax deduction for option expense
- Additional required disclosures about income taxes
- Acceleration of taxes on managers' option gains
- Additional taxes and constraints on executive deferred compensation

Each of these is discussed below in more detail, with an assessment of the implications of the threatened regulation on the decision to voluntarily expense options.

Increased taxes and other costs for domestic multinational corporations

The U.S. tax treatment of a corporate group with multinational activities depends upon whether the parent corporation is a domestic or foreign corporation. A corporation incorporated under federal or state law is classified as a domestic corporation for income tax purposes. A corporation incorporated under the laws of a foreign jurisdiction is classified as a foreign corporation. In general, domestic corporations are taxed in the U.S. on worldwide income, whether from U.S. or foreign sources. A foreign corporation is subject to U.S. taxation only on the income that has sufficient nexus to the U.S. Thus, in general, a multinational domestic corporation will pay more in U.S. income taxes than a multinational foreign corporation.

As a strategy to minimize U.S. income taxes, a multinational domestic corporation may reincorporate in a foreign jurisdiction, replacing the group domestic parent with a group foreign parent. This strategy is commonly referred to as an "expatriation" or "inversion." After expatriation, taxable income from foreign operations is no longer subject to U.S. taxation and group-wide tax costs are generally reduced.
Inversions were a target of proposed tax changes. Five regulations (H.R. 3884, 3922, 737; S. 2119, 384) proposed taxing formerly domestic corporations which complete an inversion as if they continue to be domestic corporations (see Exhibit 2). In other words, for income tax purposes, the inversion would be ignored, and the worldwide income of the (now) foreign corporate group would continue to be subject to U.S. taxation. The proposed regulations generally targeted corporate inversions after enactment (although S. 384 would apply to inversions after September 11, 2001), and where the principal market for the public trading of the stock was in the U.S. In addition, H.R. 4831 proposed prohibiting expatriated

firms from being eligible for the award of Federal contracts, and in addition to applying to expatriations after enactment, included a look-back provision to deny Federal contract eligibility for firms expatriating in the ten-year period preceding enactment.

Domestic corporations with significant multinational operations would likely benefit most from a future inversion or expatriation and would therefore be concerned about these proposed regulations. Given the probability of mandatory expensing of options was high, domestic firms with significant multinational activities should be more likely to voluntarily expense options to reduce the probability that regulations denying the tax benefits associated with an inversion and Federal contract eligibility would ultimately be enacted.

Increased tax costs for foreign corporations

While largely undertaken to reduce taxes, expatriation also allows a foreign corporate group to further reduce U.S. taxable income by transactions that result in tax-deductible payments (such as rent, interest, royalties, management fees, etc.) by domestic group members to foreign group members (sometimes referred to as "earnings stripping"). Such payments received by foreign group members from domestic group members are typically subject to U.S. taxation under IRC Section 861 and, under IRC Section 1441, at a rate of 30%. Tax treaties generally contain provisions for reduced tax rates on these types of payments, and in the case of a conflict between a tax treaty and a tax law provision, the U.S. courts attempt to apply both treaty and tax law in a way that does not result in a conflict between the two. In the case of a conflict however, the courts give deference to a congressional expression of intent to sustain or override existing treaty provisions. H.R. 4993 proposed denying any reduced rate of withholding, agreed to in a tax treaty, on a "deductible foreign payment" made by a domestic group member to a foreign group member, thereby making explicit Congress' intent to override existing treaty provisions containing reduced tax rates.

In addition to those provisions, H.R. 5095 called for the Secretary of the Treasury to conduct studies on (1) the effectiveness of current transfer pricing rules and compliance efforts, (2) whether the withholding tax provisions of income tax treaties are providing opportunities for the shifting of income outside the U.S., (3) whether anti-abuse mechanisms are functioning effectively, and (4) the effectiveness of current tax law on earnings stripping and expatriation activities.

We expect that foreign firms with significant U.S. source income have incentives to engage in tax-planning activities, such as deductible payments by domestic group members to foreign group members, to reduce the level of their U.S. federal tax liability. These firms would bear additional costs if the proposed regulations increasing U.S. taxes on certain types of U.S. source income were enacted. Given the probability of mandatory option expensing for financial reporting purposes was high, foreign firms with significant sources of U.S. income should be more likely to voluntarily expense stock options to reduce the probability that these regulations would become effective.

Loss of tax deduction for option expense

During 2002 and 2003, both the Senate Committee on Finance and the House Ways and Means Committee proposed four regulations (S. 1940, H.R. 4075, S.182, H.R. 626) which would defer the tax deduction associated with options until such time as option expense is reported in the financial statement of the firm, and constrain the deduction to the amount reported in financial statements.

Under SFAS 123, firms could choose between the intrinsic value method and the fair value method of accounting for options for financial reporting purposes. Properly constructing the terms of option grants could result in a zero valuation under the intrinsic value method; under the fair value method, option valuation is generally positive. For Federal income tax purposes, *regardless* of which financial reporting method is used, the deductible option expense is measured at option exercise, and is a function of the difference between exercise price and stock price at the exercise date and the actual number of options exercised.[6] Some firms likely believed that they would bear additional costs if the proposed regulation to constrain or eliminate the tax deduction at option exercise were enacted. The disallowance of the deduction would generally increase current and/or future tax liabilities. It could also impose other costs, such as increased debt contracting costs or increased tax planning costs, on firms. Given the probability of mandatory option expensing for financial reporting purposes was high, firms with significant tax deductions from options should be more likely to voluntarily expense stock options to reduce the probability that the tax deduction associated with option exercises would be constrained or even

[6] To illustrate the differences across the two financial reporting option costs and tax reporting option costs, assume the following: (1) the number of options granted is 10,000; (2) the share price at option grant is $15.00; (3) the exercise price is $15.00; (4) the share price at exercise is $25.00; (5) the grant date value of the option is $5.00; and (6) 100% of options granted vest and are exercised. Ignoring constraints as to time of reporting, under these assumptions, option expense under intrinsic value reporting would be $0, under fair value reporting would be $50,000, and for tax reporting purposes, would be $100,000. If the proposed tax regulation were supplied, and the firm retained intrinsic value reporting, tax reporting option expense would be constrained in amount to $0. If the proposed regulation were supplied and the firm adopted fair value reporting, tax reporting option expense would be constrained in amount to $50,000.

eliminated if the proposed tax-related legislation were ultimately supplied.

Additional financial statement disclosures about income taxes

Government analysis and academic research both report that the gap between financial reporting income and tax reporting income grew significantly during the 1990s, suggesting a significant increase in corporate tax sheltering activities (United States General Accounting Office, 2003; Desai, 2002; Mills, Newberry and Trautman, 2002; Plesko, 2004; Slemrod, 2004). In April 2003, the House Ways and Means Committee proposed legislation (H.R. 1556) calling for increased transparency of corporate tax accounting measures and inspection of "true corporate tax liability." Specifically, the proposed regulation called for disclosures including: (1) net corporate income tax as shown on the return for the tax year, (2) the amount reported as Federal income tax in filings with the SEC, (3) taxable income as shown on the income tax return, (4) adjusted book income, (5) the portion of book-tax differences attributable to depreciation, stock options, income from entities consolidated for book but not for tax, income from pension funds or tax-exempt funds, and "other items" that the Secretary of the Treasury deem necessary, and (6) an explanation of the book-tax differences required to be disclosed. The proposed regulation also called for a study, to be conducted by the Secretary of the Treasury, on corporate tax shelter activities. The additional disclosures contemplated by H.R. 1556 would constitute a significant expansion of income tax reporting over current financial reporting rules, as well as provide information to financial statement readers previously known only to the firm and the government. [7] Some firms likely believed that they would bear additional costs if the proposed regulations regarding enhanced financial statement disclosures of taxes were ultimately enacted. In particular, enhanced financial statement disclosures could provide a window into firms' tax sheltering activities (i.e., avoidance, abusive avoidance, or evasion), and invite the scrutiny of the government and investors.[8] While firms engaging in tax evasion and abusive tax avoidance activities would bear the highest costs, even firms engaged in legitimate tax avoidance activities could bear costs following enhanced disclosures about tax sheltering activities. Costs associated with increased financial statement disclosures about taxes include public criticism of firm tax-sheltering activities, corporate "good citizen" arguments, increased IRS audits of prior returns, increased state and other authorities' audits of prior returns, disallowed deductions on prior returns, penalties, legal costs associated with defense or challenge of IRS assertions of tax evasion or abusive tax avoidance, etc.

In addition to concerns about enhanced financial reporting disclosures about taxes and tax sheltering activities, firms might also have been concerned about what those disclosures might reveal about earnings management.[9] If tax disclosures provide information on the firm's earnings management activities or if firms use tax expense to manage earnings, then it is likely that some firms believed they would bear additional costs if the proposed regulations regarding enhanced financial statement disclosures of taxes were ultimately supplied. Given the probability of mandatory option expensing for financial reporting purposes was high, firms concerned about enhanced financial statement tax disclosures (due to either tax sheltering or earnings management activities) should be more likely to voluntarily expense stock options to reduce the probability regulations requiring enhanced financial statement disclosure about book-tax differences would ultimately be supplied.

Acceleration of taxes on managers' option gains

Three separate proposed regulations (H.R. 5088, 5095; S. 2722) called for the inclusion of unrealized gains on unexercised options held by executives of expatriating

[7] In addition to proposed regulation from Congress with respect to enhanced financial statement tax disclosures about book-tax differences, firms were aware that the IRS and the Treasury were beginning to examine ways in which required tax reporting disclosures about book-tax differences could be expanded and/or enhanced. In June 2003, the IRS and the Treasury Department announced the formation of a joint working group to consider changes to book-tax disclosures required on Schedule M-1 of the corporate income tax return, Form 1120. Corporate taxpayers were also aware that the Treasury Department and the IRS were, during 2002 and 2003, studying ways to increase tax advisors' responsibilities for enhanced transparency of, and penalties for, abusive tax avoidance activities.

[8] In terms of tax sheltering activities, tax avoidance (evasion) is generally understood as the legal (illegal) utilization of the tax regulations to reduce the amount of tax payable. However, a tax sheltering activity or product utilized by a firm may face a third categorization by the IRS – "abusive avoidance." In his testimony, on October 21, 2003, before the Senate Finance Committee in hearings on corporate tax shelters, IRS Commissioner Mark W. Everson described abusive avoidance tax transactions as: (1) fashioned in the likeness of legitimate transactions permitted under the Internal Revenue Code ("IRC"), (2) beneficiaries of the IRC's lengthy and complexity and (3) facilitated by the recent growth of financial products and structures, whose own non-transparency provide incentives for use to generate unwarranted tax benefits. The Prepared Testimony of Commissioner of Internal Revenue Mark W. Everson before the Senate Finance Committee Hearing on Corporate Tax Shelters, October 21, 2003, is available at www.irs.gov.

[9] Phillips, Pincus and Rego (2003); Phillips, Pincus, Rego and Wan (2004); Ettredge, Sun, Lee and Anandrajan (2005) provide evidence that deferred tax information is useful for detecting earnings management activities. Dhaliwal, Gleason and Mills (2004) and Comprix, Mills and Schmidt (2004) suggest that firms manage the tax expense account as a means of managing earnings.

corporations in executives' taxable income. The effect of these three proposed regulations would be to accelerate the recognition of taxable income for the managers from the option exercise date to the expatriation date. This would impose costs on managers (i.e., accelerated payment of income taxes normally due at a later time) for a strategic decision by the firm (i.e., to expatriate). The proposed regulations would generally be effective for expatriations after enactment, although H.R. 5088 would apply to expatriations after September 11, 2001.

Given the probability of mandatory option expensing for financial reporting purposes was high, managers of expatriation candidate firms with significant amounts of unrealized gains on options should be more likely to voluntarily expense stock options to reduce the probability that regulations taxing those unrealized option gains would ultimately be supplied.

Additional taxes and contracting constraints on managerial deferred compensation

Four proposed regulations contained provisions relating to the taxation of managerial deferred compensation. The term "deferred compensation" generally refers to compensation earned by an employee currently, with the payment of such earned compensation deferred until a later time. Prior to the enactment of The American Jobs Creation Act of 2004 ("AJCA 04"), taxability of deferred compensation was principally governed by tax doctrines and code sections.[10] Under these doctrines and code sections, deferred compensation is generally not taxable to the employee until received.

S. 1971 from the Senate Committee on Finance proposed denial of an exclusion from current taxable income for deferred compensation plans funded with assets located outside the U.S. In recent years, firms have funded nonqualified deferred compensation plans by setting aside the necessary funds in overseas accounts.[11] The effect of this proposal would be to accelerate the time of taxation of the compensation to the manager. H.R. 5088 proposed denial of an exclusion from current taxable income for deferred compensation arrangements for firms funding a defined contribution plan with employer stock, unless the deferred compensation plan contains certain payout provisions.[12] The effect of this provision would be to eliminate manager discretion as to withdrawal of funds from the plan. In addition to these provisions, H.R. 5088 and H.R. 2101 both proposed the imposition of the golden parachute excise tax on deferred compensation plans following a major stock price decline or a declaration of bankruptcy.

Since the proposed regulations would all apply to amounts deferred after enactment, the extent to which managers would be subject to (and bear the costs of) additional taxes and/or constraints on deferred compensation plan payouts is a function of the extent to which amounts were deferred at the time of enactment (and therefore, grandfathered). While managers with and without deferred compensation plans would both be concerned about the effect of payout constraints on deferred compensation amounts deferred after enactment, managers without deferred compensation plans would have the most to lose under the proposed regulations, as all amounts deferred under plans they might negotiate for with employers in the future would be subject to the proposed regulations. Given the probability of mandatory option expensing for financial reporting purposes was high, firms where managers do not participate in deferred compensation plans should be more likely to voluntarily expense stock options to reduce the probability regulations imposing taxes and payout constraints on executive deferred compensation plans would ultimately be supplied.

To summarize, once mandatory expensing of options appeared inevitable, some firms would act in anticipation of additional proposed regulation and expense their options pre-emptively as a strategy to deflect the additional regulation and resultant tax-related political costs. These firms would likely share certain characteristics and include:

- domestic firms with significant multinational activities.
- foreign firms with significant sources of U.S. income.
- firms with significant tax deductions from options.
- firms concerned about enhanced financial statement tax disclosures (due to either tax sheltering or earnings management activities).
- expatriation candidate firms whose managers had significant amounts of unrealized gains on options.
- firms where managers do not participate in deferred compensation plans.

IV. Economic Characteristics and Tax Related Attributes of Sample Firms

The primary purpose of this paper was to analyze in detail the complex regulatory environment during the

[10] The tax doctrines we refer to are the constructive receipt doctrine and the economic benefit doctrine. The code sections we refer to are IRC Sections 83, 402(b) and 403(c). The funded/unfunded status of the deferred compensation plan also impacts the taxability of the compensation.

[11] Because it is very difficult, if not impossible, for U.S. creditors of the firm to reach assets held overseas, regulators concluded that such accounts were effectively not subject to the claims of creditors, and therefore, not subject to substantial risk of forfeiture. If the funds are not subject to substantial risk of forfeiture, such funded deferred compensation should be treated as constructively received by the manager and taxable at the time the funds are set aside in the account.

[12] Under this proposed regulation, amounts set aside under a deferred compensation plan will be taxable to the employee at the time earned, unless the compensation is payable only upon separation from service, death, at a specified predetermined time or pursuant to a specified predetermined schedule.

SFAS 123(R) project period, in order to better understand firm motivation for anticipatory expensing of options. While a complete empirical analysis of the decision is beyond the scope of this paper, we wanted to provide an exploratory examination of the characteristics of expensing firms along the dimensions discussed above. We identified a sample of 347 entities that announced the voluntary expensing of stock options in 2002 and 2003.[13] We eliminated 41 real estate investment trusts ("REITs"), 3 limited partnerships and 2 limited liability companies, leaving 301 corporations as the initial sample of expensers. The initial sample of disclosers is the firms in the S&P 1500 who are not expensers.

We impose several criteria on our initial sample for retention in the study. First, firms are required to have data available from the ExecuComp, Compustat Annual, Compustat Quarterly, and Compustat Segment databases to calculate the proxy variables for the hypothesized determinants. Second, firms' financial statements and proxy statements must be available for hand-collection of data related to options outstanding and deferred compensation plans. Taken together, these data requirements reduce the initial sample to a final sample of 985 firms, of which 115 are expensers and 870 are disclosers. Table 1 presents the final sample of firms by SIC codes.

We developed variables to identify the firms likely to be concerned about proposed increases in firms' tax costs (variable definitions are included in Table 2).

To identify domestic firms with significant multinational activities and likely concerned about proposed tax increases upon expatriation, we create an interaction variable (US_MNC) to capture the extent to which a domestic firm (USINC) generates significant foreign source income (MNC), where US_MNC is the interaction of USINC and MNC. The indicator variable USINC takes the value of 1 (0) if the firm is a domestic (foreign) firm and the indicator variable MNC takes the value of 1 (0) if the ratio of the firm's foreign sales to domestic sales is greater than 1.0. We assume that when a domestic firm's foreign sales are larger than its domestic sales, significant incentives exist to make expatriation a realistic potential cost (i.e., tax) savings strategy (i.e., the firm is an "expatriation candidate").

To identify foreign firms with significant U.S. income and likely concerned about proposed tax increases on deductible payments, we create an interaction variable (FOR_WITH) to capture the extent to which a foreign firm (FORINC) has incentives to engage in earnings stripping activities (SALE_RATIO1), where FOR_WITH is the interaction of FORINC and SALE_RATIO1. FORINC is an indicator variable that takes the value of 1 (0) if the firm is a foreign (domestic) firm and SALE_RATIO1 is the ratio of U.S. sales to total sales. We assume that higher levels of U.S. sales to total sales create incentives for foreign firms to use earnings stripping type deductible payments to move taxable income from the U.S. to a foreign jurisdiction.

We assume that the firms most likely to be concerned about the loss or reduction of the tax deduction from stock options (OPT_TAX) are positive marginal tax rate firms (MTRI) with large potential stock option tax deductions (OPT), where OPT_TAX is the interaction of MTRI and OPT. The indicator variable MTRI takes the value of 1 if the firms has a positive marginal tax rate, and is 0 otherwise. We use the methodology of Plesko (2003) to assign MTRI values.[14] With respect to potential stock option tax deductions, we hand-collect from financial statements the total number of options outstanding at year-end 2002, as well as the weighted average exercise price of those options. OPT is calculated as [(share price at year-end minus weighted average exercise price of options outstanding) X options outstanding at year-end] / pre-tax income. If share price at year-end is less than the weighted average exercise price of options outstanding (i.e., the options are underwater), then OPT is set to zero.

We assume that the firms most likely to be concerned about enhanced financial disclosures about taxes and book-tax differences are firms who are aggressive with respect to tax reporting. We follow Frank, Lynch and Rego (2005), who report that firms with more aggressive financial reporting also engage in more aggressive tax reporting, and use firm permanent book-tax differences as a proxy for aggressive tax reporting (PERM_DIFF). These authors define PERM_DIFF as {(pretax book income less income attributable to minority interest) – [(current federal income tax expense + current foreign income tax) / statutory tax rate] – (deferred tax expense / statutory tax rate)} / pre-tax income. Positive (negative) permanent book-tax differences indicate more (less) aggressive tax reporting. We assume a statutory tax rate of 35% for all firms and use the Compustat Annual database for the remaining variables required to calculate permanent book-tax differences. Our other variables are designed to identify firms where the manager is likely to be concerned about proposed increases in the manager's taxes. The proposed regulation calling for the acceleration of income taxes on managers' option gains would apply only to the managers of firms that might consider expatriation a realistic tax-saving strategy. We create an interaction variable (EXPAT_OPT) to capture the unrealized gains on unexercised in-the-money options held by managers

[13] McConnell, P., Pegg, J., Senyek, C., 2003. "Companies that currently expense or intend to expense stock options using the fair value method." Bear Stearns Accounting and Taxation Research.

[14] We follow Mills, Newberry and Novack (2003) and use NOL screens suggested by prior research to reduce potential misclassification errors in classifying firms as having an NOL carryforward into 2002.

(BIG) of firms who are expatriation candidates (MNC), where EXPAT_OPT is the interaction of BIG and MNC. We use the ExecuComp database to collect the unrealized gains on options (BIG) held by managers, and MNC is as calculated above.

Since we expect that managers without deferred compensation plans have the most to lose from the proposed regulation of deferred compensation plans, we use an indicator variable to indicate whether managers participate in a deferred compensation plan. DCOMPI takes the value of 1 if the manager does not participate in a deferred compensation plan and 0 otherwise. We hand collect the information on whether a manager participates in a deferred compensation plan or not from firms' proxy statements.

Descriptive Statistics

Table 3 presents mean and median values for selected firm characteristics, along with results of t-tests (Wilcoxon tests) of differences in means (medians) across the two samples, expensers and disclosers. With respect to economic characteristic and tax attributes, with limited exceptions, the expensers differ significantly from the disclosers. Statistically, differences are significant at the 10% level or less.

In terms of economic characteristics, consistent with the findings of previous researchers (Aboody, Barth, and Kasnik 2004), Table 3 indicates that the expensers are significantly larger than disclosers, at both the mean and median. This finding is also consistent across a variety of measures of firm size, including total assets, total sales, pre-tax income, net income and market value. Table 3 also indicates that the expensers are more likely to be foreign firms and are more likely to have positive marginal tax rates. Expensers are marginally less likely to be multinational firms (their foreign sales are less than U.S. sales and U.S. sales as a percentage of total sales is slightly higher for expensers than for disclosers, but not significantly so). The expected tax deductions from options are significantly larger for expensers than for disclosers, and the unrealized gains from options for CEOs are significantly lower for expensers than for disclosers. In terms of tax attributes for purposes of tax-related political costs, Table 3 indicates that expensers are significantly less likely to be expatriation candidates (i.e., U.S. domestic firms with significant multinational activities) than disclosers. This evidence is consistent with recent findings of Rego (2003), who suggests that U.S. domestic firms with significant multinational activities may be more concerned about foreign pre-tax income and tax burdens than U.S. pre-tax income and tax burdens. Rego (2003) basis this conclusion on her finding that lower U.S. pre-tax income and tax burdens of U.S. domestic multinational firms are significantly associated with investments in tax planning. If expatriation candidate firms are less likely to be concerned about threatened increases in U.S. taxes, then expatriation candidate firms are less likely to be expensers. Therefore, it appears that threatened tax increases for expatriation candidate firms may not have factored into firms' decisions to expense options.

Table 3 indicates that expensers are significantly more likely to be foreign firms with higher ratios of U.S. to foreign sales, consistent with concern of foreign firms about proposed regulation that would have the effect of overriding preferential treaty tax withholding rates. It appears that threatened tax increases for foreign firms may have factored into firms' decisions to expense options. Table 3 indicates that expensers are also significantly more likely to be positive tax rate firms with significant option tax deductions, consistent with the notion that these firms were concerned about the threatened loss of a significant tax deduction. Thus, it appears that the threatened loss of the tax benefits associated with options may have factored into firms' decisions to expense options. And finally, Table 3 indicates that expensers had significantly larger permanent book-tax differences than disclosers, consistent with the notion that these firms were concerned about heightened tax disclosure requirements (possibly due to either tax sheltering or earnings management activities). Thus, it appears that the threatened additional financial statement tax disclosures may have factored into firms' decisions to expense options.

In terms of impact of the built-in gains on unexercised options of managers on decisions to expense options, we do not find a statistically significant difference between the sample of expensers and disclosers. This is not surprising, in that we found earlier that expensers are less likely to be expatriation candidates than disclosers. If expensing firms are less likely to be expatriation candidates, then managers of expensers will also have less concern about potential additional costs, since those costs would be triggered only by the firm's decision to expatriate. In addition, Table 3 suggests that managers of expensers are more likely to have deferred compensation plans than disclosers, but not statistically significantly so. This suggests that the threat of additional taxes and other costs for managerial deferred compensation plans did not play a role in firms' decisions to begin expensing options.

V. Summary

In the aftermath of corporate accounting scandals made public during 2001 and 2002 (e.g. Enron, World-Com), politicians, stockholders, investor advocacy groups, unions and others were vocal in their demands for additional regulation, creating a political environment which encouraged political authorities to supply further regulation related to corporate governance, CEO pay and firms' stock option plans. During 2002 and 2003, regulators proposed more than thirty corporate regulations related to governance, CEO pay and stock options. These regulatory authorities include the Congress, the Securities and

Exchange Commission, the Internal Revenue Service (IRS), the FASB and the major stock exchanges. We report on the breadth and depth of regulations with provisions related to corporate governance, CEO pay or stock options proposed or supplied by these political authorities over the two-year period ending on December 31, 2003, and we particularly focus on the subset of these regulations which would have the effect of increasing the tax costs of firms and/or firm managers. Our assessment of the regulatory landscape suggests that decisions to voluntarily begin expensing options were motivated, in part, by a desire by firms and managers to thwart the enactment of the tax-increasing regulations proposed during this time.

An examination of economic characteristics and tax related attributes of expensing firms compared with disclosing firms supports this. Although the evidence is descriptive in nature, the decision to begin expensing options is associated with the extent to which firms and managers would bear tax costs if the tax-related regulations proposed during 2002 and 2003 were supplied.

The prior literature on the relation between tax and accounting policy choice has provided evidence on firms' accounting policy choice in response to specific examples of enacted tax regulation or proposed financial accounting standards. We have analyzed firm behavior as proactive as well as reactive, examining firm accounting policy choice in the face of a complex web of threatened tax regulation as well as changes in accounting standards. It appears that firms may use accounting policy choice to influence the outcome of the tax-related regulatory process, as well as to respond to new regulation.

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Appendices

Exhibit 1
Regulations proposed or supplied during 2002 and 2003 with provisions related to corporate governance, CEO pay and stock options

Date	Political Authority and Regulation Identification	Regulation Title	provisions related to:
	Congress		
7/30/02	P.L. 107-204	Sarbanes-Oxley Act	corporate goverance, CEO pay changes
	Senate Committee on Finance		
2/13/02	S. 1940	Ending the Double Standard for Stock Options Act	tax benefits from stock option compensation
2/27/02	S. 1971	National Employee Savings and Trust Equity Guarantee Act	deferred compensation plans, loans to executives
4/11/02	S. 2119	Reversing the Expatriation of Profits Overseas Act	tax treatment of expatriating corporations
7/11/02	S. 2722	Executive Compensation Tax Reform Act of 2002	loans to executives, insider stock sales, unrealized gains on options
8/1/02	S. 2877	Rank and File Stock Option Act of 2002	stock options for rank and file employees
1/16/03	S. 182	Ending the Double Standard for Stock Options Act	tax benefits from stock option compensation expenses
2/12/03	S. 384	Corporate Patriot Enforcement Act of 2003	tax treatment of expatriating corporations
	House Ways & Means Committee		
3/6/02	H.R. 3884	Corporate Patriot Enforcement Act of 2002	tax treatment of expatriating corporations
3/11/02	H.R. 3922	Save America's Jobs Act of 2002	tax treatment of expatriating corporations
3/21/02	H.R. 4075	Ending the Double Standard for Stock Options Act	tax benefits from stock option compensation
6/21/02	H.R. 4993	No Tax Breaks for Corporations Renouncing American Act	withholding rates on payments to foreign persons
7/10/02	H.R. 5088	Executive Accountability Act of 2002	deferred compensation plans; performance pay; option gains
7/11/02	H.R. 5095	American Competitiveness and Corporate	gains from stock-based compensaton; expatriating corporations
7/26/02	H.R. 5242	Workplace Employee Stock Option Act of 2002	Internal Revenue Code changes to encourage option grants
2/5/03	H.R. 626	Ending the Double Standard for Stock Options Act	tax benefits from stock options compensation
2/12/03	H.R. 737	Corporate Patriot Enforcement Act of 2002	tax treatment of expatriating corporations
4/2/03	H.R. 1556	Corporate Accountability Tax Gap Act of 2003	book-tax disclosure; tax sheltering activities
	Senate Committee on Banking, Housing and Urban Affairs		
7/19/02	S. 2760	Stock Option Fairness and Accountability Act	SEC study of stock option accounting
7/30/02	S. 2822	Prevention of Stock Option Abuse Act	top management stock option grants
1/16/03	S. 181	Stock Options Accounting Review Act	accounting treatment of stock options
3/21/03	S. 690	Prevention of Stock Option Abuse Act	stock options for top executives
5/1/03	S. 979	Broad-Based Stock Option Plan Transparency Act of 2003	employee stock options disclosures
11/19/03	S. 1890	Stock Option Accounting Reform Act	mandatory expensing of stock options granted to executives

Exhibit 1 continued
Regulations proposed or supplied during 2002 and 2003 with provisions related to corporate governance, CEO pay and stock options

Date	Political Authority and Regulation Identification	Regulation Title	provisions related to:
	House Committee on Energy and Commerce		
7/17/02	H.R. 5147	Stock Option Accounting Reform Act	FASB standard setting for stock options
	House Committee on Financial Services		
3/20/03	H.R. 1372	Broad-Based Stock Option Plan Transparency Act of 2003	SEC study of stock options, enhanced disclosures of stock options
11/21/03	H.R. 3574	Stock Option Accounting Reform Act	mandatory expensing of stock options granted to executives
	House Committee on Education and the Workforce		
5/14/03	H.R. 2101	Pension Fairness Act of 2003	deferred compensation plans, performance pay
	House Committee on Government Reform		
5/23/02	H.R. 4831	Patriotic Purchasing Act of 2002	eligibility for government contracts by expatriating corporations
	New York Stock Exchange ("NYSE")		
6/6/02	SR-NYSE-2002-33	Corporate Governance Rule Proposals	shareholder approval of equity compensation plans
10/7/02	SR-NYSE-2002-46	Amendment #1	shareholder approvals and voting on equity compensation plans
6/20/03	SR-NYSE-2002-46	Amendment #2	compliance rules, option plans excluded, definitions, notifications
	National Association of Securities Dealers ("NASD")		
10/9/02	Proposed Rule Change		shareholder approvals, new option plan or material amendments
10/10/02	SR-NASD-2002-140	Amendment #1	shareholder approval rules
3/24/03	SR-NASD-2002-140	Amendment #2	exceptions to shareholder approval rules
6/23/03	SR-NASD-2002-140	Amendment #3	clarifying and conforming changes
8/18/03	SR-NASD-2003-130	Proposed Amendments	listing requirements, excluded plans, inducement grants disclosures
10/2/03	SR-NASD-2003-130	Amendment #1	compensation committee definitions
10/7/03	SR-NASD-2003-130	Amendment #2	technical corrections to language of proposed rule
	Securities and Exchange Commission ("SEC")		
6/30/03	SEC Release No. 34-48108		NYSE Corporate Governance Proposals, NASD Shareholder Approval of Stock Plan Proposals
10/14/03	SEC Release No. 34-48627		approves NASD Proposed Amendments on shareholder approvals

Exhibit 2
Tax regulations proposed during 2002 and 2003 with provisions related to firms and firm managers

REGULATION	POLITICAL AUTHORITY	PROVISIONS
PROVISIONS RELATING TO FIRMS		
S. 1940 S. 182	Senate Committee on Finance	Tax return deductions for stock options shall not exceed the amount reported by the taxpayer in financial reports or statements issued to shareholders, partners, beneficiaries, etc.
H.R. 4075 H.R. 626	House Ways & Means Committee	Tax return deductions for stock options are not allowable until such time as the taxpayer reports option expense in financial reports or statements issued to shareholders, partners, beneficiaries, etc.
H.R. 3884 H.R. 3922 H.R. 737	House Ways & Means Committee	Disregards corporate inversions the shareholders of the acquired domestic corporations own 80% or more of the stock of the acquiring foreign corporation after the inversion, the acquiring foreign corporation does not have substantial business activities in the jurisdiction in which it is incorporated, and the stock is publicly traded with the principal market for the stock in the U.S.
S. 2119 S. 384	Senate Committee on Finance	
H.R. 4831	House Committee on Government Reform	Denies eligibility for government contracts to expatriating corporations.
H.R. 4993	House Ways & Means Committee	Denies reduced withholding tax rates on deductible payments to foreign entities by domestic entities
H.R. 1556	House Ways & Means Committee	Corporate taxpayers required to disclose: net corporate income tax as shown on the return for the year, amount reported as Federal income tax expense in annual statement filed with SEC, taxable income as shown on return, adjusted book income, book-tax differences attributable to depreciation, stock options, income from entities consolidated for book income but not for Federal income tax purposes, income from pension funds or tax-exempt bonds, and other items pursuant to regulations to be issued by the Secretary of the Treasury. In addition, corporate taxpayers required to provide explanations of certain book-tax differences. Information is to be submitted electronically to the Secretary, and will be made public after 30 days as a single document and part of a searchable database.

Exhibit 2 continued
Tax regulations proposed during 2002 and 2003 with provisions related to firms and firm managers

REGULATION	POLITICAL AUTHORITY	PROVISIONS
PROVISIONS RELATING TO MANAGERS		
S. 1971	Senate Committee on Finance	Assets designated for payment of nonqualified deferred compensation, if located outside the United States, shall be treated as not subject to the claims of creditors. This rule shall not apply if the assets are located in the same jurisdiction in which substantially all the services to which the nonqualified deferred compensation relates are rendered.
H.R. 5088	House Ways & Means Committee	If an employer maintains both a defined contribution plan, funded by employer stock, and a funded deferred compensation plan for a corporate insider (any individual subject to the proxy statement compensation disclosure rules of the SEC), and the deferred compensation plan terms permit the deferred compensation to be paid prior to separation from service, death, or pursuant to a schedule fixed at the time the compensation is deferred, such plan shall no longer be treated as subject to a substantial risk of forfeiture.
H.R. 5088 H.R. 5095	House Ways & Means Committee	Insiders of an expatriating corporation shall include as ordinary income, in the year of expatriation, the net unrealized built-in gain on options held by insiders to acquire stock of the corporation or any member of the expanded affiliated group. Gains or losses on subsequent sales of stock acquired by exercise of the options shall be adjusted to reflect the amounts already included in income by virtue of this provision. Insider is defined an any individual subject to the proxy statement compensation disclosure rules of the SEC.
S. 2722	Senate Committee on Finance	
H.R. 5088	House Ways & Means Committee	Payments of severance pay or deferred compensation to a corporate insider after the insider ceases to be employed by the corporation shall be subject to IRC Section 4999 (relating to golden parachute payments) if (a) there is a decline of at least 75% in the value of the stock of the corporation during the one year period following the cessation of employment, or (b) the corporation becomes a debtor under title 11 or similar case during the 180 day period that begins 90 days before the insider ceases to be an employee. Insider is defined an any individual subject to the proxy statement compensation disclosure rules of the SEC.
H.R. 2101	House Committee on Education and the Workforce	
H. R. 5095	House Ways & Means Committee	The value of stock held, by an individual subject to the compensation disclosure rules in proxy statements, in an expatriated corporation, at any time during the 12 month period beginning 6 months before the expatriation, shall be subject to an excise tax of 20% if the individual recognizes gain on stock as a result of the expatriation.
S. 2722	Senate Committee on Finance	If a corporation maintains a transfer-restricted 401(k) plan, amounts realized by a corporate insider (defined as any individual subject to the proxy statement compensation disclosure rules of the SEC) will be treated as "excess parachute payments" under IRC Section 4999, subject to the golden parachute excise tax.

Table 1. Sample by SIC codes

SIC	INDUSTRY	Expensers		Disclosers	
		N	%	N	%
0 - 999	Agriculture, Forestry	1	0.87%	1	0.11%
1000 - 1999	Mining, Construction	9	7.83%	43	4.94%
2000 - 2999	Nondurables manufacturing	25	21.74%	145	16.67%
3000 - 3999	Durables manufacturing	16	13.91%	282	32.41%
4000 - 4999	Transportation	18	15.65%	97	11.15%
5000 - 5999	Durables and nondurables wholesale	13	11.30%	93	10.69%
6000 - 6999	Financial institutions	29	25.22%	56	6.44%
7000 - 7999	Business & personal services	4	3.48%	119	13.68%
8000 - 8999	Professional services	0	0.00%	32	3.68%
9000 - 9999	Miscellaneous	0	0.00%	2	0.23%
	TOTAL	115	100.00%	870	100.00%

Table 2. Variable Definitions

VARIABLE		DEFINITION
Tax-related political costs of firms		
USINC	=	1 if firm is domestic firm; 0 otherwise
MNC	=	1 if [foreign sales/domestic sales] > 1; 0 otherwise
UN_MNC	=	USINC * MNC
FORINC	=	1 if firm is foreign firm; 0 othewise
SALE_RATIO1	=	[U.S. sales / total sales]
FORWITH	=	FORINC * SALE_RATIO1
MTRI	=	1 if firm marginal tax rate is positive; 0 otherwise
OPT	=	[(share price at year-end minus weighted average exercise price of options outstanding) X options outstanding] / pre-tax income; if share price at year-end < weighted average exercise price, then OPT = 0
OPT_TAX	=	MTRI * OPT
PERM_DIFF	=	{(pretax book income less income attributable to minority interest) - [(current federal income tax expense + current foreign income tax) / statutory tax rate] - (deferred tax expense / statutory tax rate)} / pre-tax income, where statutory tax rate=35%
Tax-related political costs of managers		
BIG	=	unrealized gains on unexercised in-the-money options held by CEOs
EXPAT_OPT	=	BIG * MNC
DCOMPI	=	1 if the firm does not maintain a deferred compensation plan; 0 othewise

Table 3. Descriptive Statistics – Expensers versus Disclosers
Economic Characteristics and Tax Attributes

	EXPENSERS (n=115)		DISCLOSERS (n=870)		*p-values*	
	MEAN	MEDIAN	MEAN	MEDIAN	T-Test	Wilcoxon
Assets ($ millions)	$71,069.09	$11,054.00	$5,683.26	$1,601.02	0.00	0.00
Sales ($ millions)	$19,676.66	$5,911.12	$3,816.45	$1,226.98	0.00	0.00
Pretax Income (PTI)($ millions)	$1,630.01	$280.20	$218.39	$72.41	0.00	0.00
Net Income ($ millions)	$925.84	$156.99	$23.33	$41.75	0.00	0.00
Market Value ($ millions)	$23,491.48	$4,791.39	$4,853.58	$1,284.00	0.00	0.00
US Incorporation (USINC)	0.95	1.00	0.99	1.00	0.00	0.00
Multinational Status (MNC)	0.10	0.00	0.16	0.00	0.08	0.04
Foreign Incorporation (FORINC)	0.05	0.00	0.01	0.00	0.00	0.00
US Sales / Total Sales (SALES_RATIO1)	0.81	0.90	0.78	0.86	0.27	0.13
Marginal Tax Rate Indicator (MRTI)	0.80	1.00	0.70	1.00	0.03	0.02
Options Tax Deductions / Pretax Income (OPT)	0.96	0.00	0.21	0.00	0.05	0.33
CEO Unrealied Option Gains / Fair Market Value of Equity Held (BIG)	0.08	0.03	0.11	0.06	0.04	0.06
US_MNC	0.07	0.00	0.15	0.00	0.02	0.01
FOR_WITH	0.02	0.00	0.00	0.00	0.01	0.01
OPT_TAX	0.98	0.00	0.26	0.00	0.05	0.39
PERM_DIFF	1.91	0.11	0.22	0.09	0.01	0.19
EXPAT_OPT	0.01	0.00	0.02	0.00	0.16	0.05
DCOMPI	0.41	0.00	0.49	0.00	0.11	0.05

See Table 2 for variable definitions