In ethics and taxes, nothing simple about stock options

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They were designed to make executives accountable for their company's share price, to make managers of corporate franchises personally affected by the rise and fall of their employer's stock price.

But the reality is that stock options — contracts that allow executives to purchase shares at a fixed price in the future — have become the ethical nightmare of the boardroom, an issue that has produced more moral hazards than anyone ever envisioned when options became vogue a decade or so ago.

The latest scandal involves Sprint Chief Executive William Esrey and President Ronald LeMay, both of whom were asked to step down recently over their combining options with a questionable tax shelter strategy.

The scandal has rocked Sprint, destroyed two successful careers and brought a harsh spotlight to the sometimes conflicted roles of high-powered executives whose personal financial goals might conflict with the best interests of their companies.

"You're really operating on the fringe when you do these things," said Dana Forgione, director of the accounting school at Florida International University.

Esrey and LeMay used hundreds of millions of dollars worth of stock options as the base for a complicated tax shelter set up for them by Ernst & Young, the company's auditor. Essentially, it involved selling their options to a trust controlled by their family members, who then exercised some of the options.

How was tax avoided?
The men didn't actually get paid cash for their options. Instead, they received an interest-only note, which came due in 30 years. Meanwhile, at least on paper the trusts had paid the full price for the options — they just hadn't paid cash, but rather the 30-year note. So the trusts had no taxable gain.

It helped the men avoid tens of millions in taxes.

There are many perfectly legal ways to shelter income from taxes — deducting mortgage interest is common — but the IRS tends to frown on complicated systems that seemed designed solely to evade Uncle Sam.

But the problem is, the Internal Revenue Service never said the tax shelter complied with federal law. In fact, the IRS now says it is looking at
Stock options — ethical nightmare of the boardroom

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The transaction, a suggestion that the tax-dodging method is going to be disallowed.

And of course the transactions involve complicated trusts, the very kind of investment vehicle that has drawn IRS ire before, particularly those that were set up offshore, in the banking havens of the Caribbean.

Forgione, of FIU, is betting the transactions will be deemed taxable.

"When you look at how some of these shelters were put together, it is so patently obvious there was no legitimate business purpose except to avoid taxes," he says.

In addition to losing their jobs, the men could face financial ruin. The reason: To pay a big tax bill, they would need to sell their remaining Sprint stock. But the stock has lost three quarters of its value since the shelter was set up.

The Sprint case reveals in stark relief the ethical issues bubbling to the surface regarding the extravagant option packages that have been lavished on executives in recent years.

These issues include:

1. Should executives be allowed to use their company's auditors for personal financial planning? In this case, the executives paid Ernst & Young millions of dollars in fees personally.

On top of that, the executives also controlled who got the company's auditing contract. Big companies like examples of executives secretly dumping shares right before the stock falls.

"Options are an incentive for management to do a very good job," said Miami Beach CPA Gary Gerson. "So the basic premise for them is good. But it's also an incentive, since management only gets the value when the stock goes up, for management to push the envelope."

TWO FACTORS

Gerson said two factors have helped create the scandals of the last couple of years.

One, public firms still aren't required to record options as an expense to the company.

The result is that many boards see options as free money that can be shoveled into executive portfolios.

"It waters down the company's value, but it's not an expense," he said. Several companies, in the post-Enron era, have said they voluntarily intend to take a charge against earnings related to options, however.

Secondly, the options grants have mushroomed in size in recent years, creating unforeseen moral hazards.

"What might have been an incentive to think of the average shareholder when the executives got a few thousand shares, for instance, has morphed into something else entirely with hundreds of millions of dollars on the line."

Consider: Esrey and LeMay never actually got the money for their options. They were content to earn interest at a few percentage points a year.
Sprint pay millions of dollars in fees annually for auditing services.

Critics say this could produce a situation where an auditor might be faced with picking what's best for a private client — the executive — over the interests of the company's shareholders.

Ernst & Young defended its behavior, however.

"Ernst & Young's long-established policy is to provide tax planning for its clients that is appropriate and has the highest probability of being approved if reviewed by the IRS," the company said in a prepared statement. "Because this policy was strictly adhered to in the case of the Sprint executives, we stand by the tax advice and counsel we provided. Ernst & Young stands by the tax advice and counsel it provided."

**CONFLICT OF INTEREST?**

- How many hats should auditors wear?

Ernst & Young audited Sprint, gave tax advice to the executives and also arranged for legal advice regarding setting up the shelters.

For some observers, that's just too cozy a relationship to foster good corporate governance. And the fundamental mission of the outside auditor is independent oversight of a company's books.

"There's no doubt that there's a conflict of interest" in such situations, said Greg McLaughlin, a Miami tax attorney. "I think the whole thing ties into the situation the whole [accounting] industry was in. They were under so much pressure to produce income from these tax strategies. They kind of let some of their ethical foundations go."

- As Enron revealed, managers that have huge stock options have an incentive to do anything to bolster the stock price. In many cases, this has produced allegations of fraud, incredibly complex corporate structures that investors don't understand and, in some cases, on the value — an amount that ran to millions of dollars annually.

Requiring companies to expense options would help stamp out many of the abuses, Gerson contends. That is, companies would simply take a charge against earnings every time they awarded options.

**MORE CHANGES**

Other changes in corporate governance would also help limit the number of scandals, experts say.

One, simply, would be greater transparency. That is, executives' financial relationships with auditors and investments that involve the company stock should be clearly disclosed.

Indeed, the secrecy with which Ernst & Young set up the structures should have been a warning sign to the executives themselves, said Marc List, a Palm Beach tax attorney.

"These are not unsophisticated people," he said. "But when somebody's going to charge you $7 million to set something up, and make you sign a confidentiality agreement, their antennae should have gone out."

One move the Sprint executives made to protect themselves was obtain a letter of opinion from an attorney beforehand. Letters of opinion in most cases simply state that a plan is legal, and obtaining one typically provides protection against criminal prosecution in the future.

But it's important to note that letters of opinion are simply that: opinion. And whether the IRS will share that opinion is another issue. If the IRS rules against the shelter — as could happen with the Sprint executives — they'll still owe taxes and possible fines later on.

"The law is not always clear," said Hank Raattama, a South Florida tax attorney. "My advice to clients is, what is your tolerance for pain? I enjoy talking to the IRS. Some others might not."