

Stacey Sutay

Subject: FW: Income Tax Effects of Equity-Based Compensation

Letter of Comment No: 1058
File Reference: 1101-SCU
Date Received: 10/21/03

-----Original Message-----

From: David Chamberlain [mailto:david.chamberlain@tp-options.com]
Sent: Tuesday, October 21, 2003 11:43 AM
To: Leslie Seidman; Edward Trott; Mike Crooch; Gary Schieneman; Robert Herz; Katherine Schipper
Cc: Michael Tovey; Wendy Metcalfe; Kimberley Crook
Subject: Income Tax Effects of Equity-Based Compensation

Dear Distinguished Board Members:

Transfer Pricing Options Consulting (TPOC) was disappointed that there was no serious reconsideration of the "nature of the transaction" at last Wednesday's FASB meeting (Oct. 15) discussion of the income tax effects of equity-based compensation (EBC). We are hopeful that this reflected the Board's desire to test the limits of its own "two-event" view in preparation for next week's joint FASB-IASB meeting, knowing that the IASB is expected to argue forcefully for the "one-event" view.

TPOC strongly supports the "one-event" view for reasons of principle, policy and practicality. (However, we oppose the IASB's proposed interim re-measurement of tax effects between grant and exercise.) We are continuing to prepare detailed comments on these issues, but have decided to defer finalization and submission until a later date. In advance of the joint FASB-IASB meeting, we wish to offer these more limited comments in hopes of helping the Boards focus on the central principle and policy considerations.

I. Symmetry

While disappointed with the lack of discussion of the "one-event" alternative, TPOC was heartened that the FASB endorsed staff proposals that would treat income tax effects of EBC more consistently. Under current standards, all "windfall" benefits from EBC deductions are reflected in equity, but "shortfalls" in deductions will be treated as income tax expense and appear on the income statement in some cases. The Board agreed, in principle, effects of changes in value of EBC after grant-date should be treated symmetrically.

TPOC considers such symmetrical treatment of tax effects to be the "second-best" solution if the FASB continues to follow the two-event view. In such event, we urge the FASB to keep its guidance broad and principles-based due to the significant and unforeseeable variations in tax treatment of EBC. At last Wednesday's meeting, the Board struggled with several actual or hypothetical variations. We warn both Boards that these variations are only the tip of the iceberg; our forthcoming detailed comments will discuss the large and complex "side effects" of differences between tax and GAAP treatment of EBC in tax areas ranging from transfer pricing to R&D tax credits.

II. Proposal

TPOC's basic proposal is quite simple. We believe that compensation deductions should be treated as tax expense in company financial statements at the same time and in the same amounts as for income taxes. We believe that accounting rules should not "look behind" the current-period compensation deduction to determine the nature of its component parts.

To be perfectly frank, in our opinion, the U.S. tax deduction for "non-qualified" employee stock options based on spread-at-exercise is both irrational and absurd. The rule developed more than 50 years ago as a rule of convenience, and has remained in force through a mix of inertia and lack of knowledge. We believe that Congress should - and in the long run will - reject both "intrinsic value" and exercise-date measures of compensation expense for precisely the same reasons the FASB has.

We are not suggesting that the FASB should attempt to influence tax policy. Rather, we believe that accounting standards should reflect the impact of tax rules - in their wisdom or their folly - as clearly and accurately as possible. For example, if the tax law allowed a deduction equal to 150% of ordinary (i.e., non-EBC) compensation expense, this deduction would be reflected in the tax provision. Why then does the fact that the tax law applies an odd or arbitrary rule to measure EBC result in equity treatment? We suggest that "extraordinary" item treatment may instead be appropriate for certain tax effects.

III. Principle

We realize advocating the "one-event" view may be an uphill battle since most seasoned accounting professionals in the United States believe only the "two-event" view is supported by principle. We will try to demonstrate not only that the "one-event" view is also principle-based, but further that its foundations are sounder and more robust than those underlying the "two-event" view.

Income tax planning is a central responsibility and function of management. Because income taxes are a direct and real burden on the corporation as a whole, the quality of management's tax planning is no less material to shareholders than management's core business decisions. For these reasons, we believe the results of management's tax planning - good or bad - should be reflected in operating results.

It is true that the exercise of a stock option is an equity transaction. Upon exercise, the employee pays the exercise price to the company in order to convert one equity instrument (the option) into another (a share of stock). It does not necessarily follow, however, that the exercise-date income tax deduction should be considered part and parcel of that equity transaction. Consider the case of restricted stock. If the employee has not made a section 83(b) election, the corporate deduction is deferred until vesting and is measured by the value of the stock at that time. Bizarre as this tax deduction may be, it relates solely to a compensation transaction (i.e., the receipt of services over the vesting period); there is no equity transaction between the employee and the company for either tax or financial statement purposes.

Some Board members have expressed concern that adopting the "one-event" view would be inconsistent with other standards. As tax consultants, we do not profess broad expertise in accounting standards; however, we are inclined to agree that equity treatment of income tax effects should be comprehensively reconsidered. Nonetheless, we believe that tax effects of EBC under a "fair value" standard can be distinguished from other income tax items receiving equity treatment (e.g. preferred stock treated as debt under tax rules; or the items other than EBC specified in paragraph 36 of FAS 109) in that only EBC is bifurcated between income and equity components.

There is no wholly satisfying or principled way of bifurcating the income tax deduction for EBC between compensation and equity components. After all, on the exercise date, intrinsic value and fair value converge. Moreover, as was recognized at last Wednesday's meeting, it would be fruitless to try to anticipate all possible combinations of valuation methods and measurements date that might be adopted by various income tax systems around the world. In TPOC's opinion, a more satisfying and robust approach is to follow tax rules for timing and measurement of compensation deductions, treating any variance between tax and accounting amounts as a "permanent difference" under FAS 109.

IV. Policy

Although we believe in the principle that tax effects of EBC should be recognized wholly in the income statement, we would not be overly concerned about equity statement treatment if we were confident that preparers and users of financial statements were not confused or misled. Unfortunately, we have seen firsthand that current standards lead preparers to engage in sub-optimal economic behavior. Companies sometimes adopt tax planning strategies to reduce effective tax rates at the expense of alternatives yielding greater economic benefits.

These situations are complex and will be described in detail in our forthcoming detailed comments. For the moment, we merely emphasize that the "two-event" view cannot be justified by conservatism because there are collateral effects that increase income taxes (essentially, contra-deductions). Standards setters have already reached an inconsistent conclusion with respect to wage withholding/employment taxes on EBC, applying a "one-

event" view in this non-income tax case.

Our greatest concern is that current rules have been misleading to tax policy-makers. Basing the income tax deduction on exercise-date values has led to the perverse result that the fastest growing and most successful high technology companies pay little or no income taxes even as their profit margins are enormous. However, on the face of the companies' income statements (and in the tax provision footnote), these companies appear to be paying substantial income taxes.

Few members of Congress have enough tax and accounting knowledge to be able to interpret cash-flow statements and appreciate the effects of their tax policy choices. We suspect that adopting a "one-event" accounting standard will lead to Congress rationalizing the corporate tax deduction more quickly. While it is not the FASB's role to try to influence tax policy, it is the Board's role and responsibility to design accounting standards that are clear and helpful to users of financial statements, including members of Congress and other tax policy-makers.

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Thank you again for your efforts on this important project and for your consideration of these comments.

Sincerely,

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