FASB Emerging Issues Task Force

Issue No. 06-11

Title: Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards

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Date prepared: February 28, 2007

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Date previously discussed: November 16, 2007

Previously distributed EITF materials: Issue Summary No. 1, dated October 27, 2006

References:

FASB Statement No. 109, *Accounting for Income Taxes* (FAS 109)

FASB Statement No. 123 (revised 2004), *Share-Based Payment* (FAS 123(R))

[*] **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Background

1. At the November 16, 2006 EITF meeting, the Task Force reached tentative conclusions on this Issue and directed the staff to pursue the issuance of a draft abstract for public comment. The draft abstract for this Issue was posted to the website on December 6, 2006, with a comment period that ended on January 22, 2007. For convenience, a copy of the draft abstract is included in Exhibit 06-11A; no changes have been made to the version that was posted for comment.

2. Comment letters received on the draft abstract have been distributed to Task Force members and have been analyzed by the FASB staff. At the March 15, 2007 EITF meeting, the Task Force will have the opportunity to consider those comment letters as it redeliberates the tentative conclusion in the draft abstract and addresses issues raised in this Issue Summary supplement. The Task Force will then be asked to affirm the tentative conclusion as a final consensuses.

Formal Comments Received on the Draft Abstract

3. Two comment letters were received on the draft abstract. One respondent expressed agreement with the tentative conclusion. The other respondent indicated that in order to avoid diversity in practice, the scope of the Issue should be expanded to address the accounting for the income tax benefits from the payment of dividends or dividend equivalents on **liability-classified** share-based payment awards.

Staff Analysis

4. The FASB staff recommends that the scope of the Issue **not** be expanded to address the accounting for income tax benefits from the payment of dividends or dividend equivalents on liability-classified share-based payment awards. The staff observes that FAS 123(R) does not address the accounting for dividends on liability-classified share-based payment awards, irrespective of any related income tax benefits from those dividends. Paragraph A37 of FAS 123(R) indicates that "dividends or dividend equivalents paid to employees on the portion of an award of **equity shares or other equity instruments** that vests shall be charged to retained earnings" (emphasis added). Paragraph B93 of FAS 123(R) specifies that "additional compensation does not arise from dividends on nonvested shares that eventually vest. **Because the measure of compensation cost for those shares is their fair value at the grant date**,

recognizing dividends on nonvested shares as additional compensation would effectively double-count those dividends" (emphasis added). Paragraph A37 specifically addresses equity awards and paragraph B93 specifically addresses awards under which the measure of compensation cost is their fair value at the grant date (that is, equity-classified awards).

5. Some believe that dividends paid on liability-classified share-based payment awards should be charged to compensation cost as incurred, noting that the reporting entity will concurrently recognize a substantially offsetting reduction in compensation cost due to the decrease in the fair value (or intrinsic value) of the related liability-classified award caused by the decrease in the entity's share price on the ex-dividend date.[1] However, among those who believe dividends on liability-classified share-based payment awards should be recorded as compensation cost, there are differing views regarding the recognition of that compensation cost when the related award is partially vested. Some believe that the entire dividend should be expensed as incurred, while others believe a portion of the dividend (based on the unvested portion of the related award) should be deferred and recognized as compensation cost over the remaining requisite service period. Additionally, some believe that the former approach should be applied if the dividends received by employees are nonforfeitable, while the latter approach should be applied if the employees are required to repay the dividends to the company if the related award is forfeited.

6. Because guidance on accounting for dividends on liability-classified share-based payment awards is not specified in FAS 123(R) or in any other authoritative literature, it may be expected that various constituents would reach different interpretations. Consequently, the staff believes it would be necessary to clarify the accounting for dividends paid on liability-classified awards before addressing the accounting for the income tax benefits of such dividends. If the Task Force believes that authoritative guidance on the accounting for dividends on liability-classified awards and the related income tax benefits is needed, the staff recommends that such guidance be addressed separately without modifying the scope of this Issue.

[1] The net effect of this treatment is substantially equivalent to accounting for a dividend on a fully vested liability-classified award as a reduction in the carrying amount of that award.

Other Comments Received on the Draft Abstract

7. During the November 16, 2006 EITF meeting, a Task Force member requested clarification of whether an income tax benefit that is originally recognized in additional paid-in capital under this Issue would subsequently be recognized in the income statement if the related share-based payment award, which was previously expected to vest, is forfeited (or is no longer expected to vest) and the dividend or dividend equivalent that generated the tax benefit is retained by the holder. The staff responded that, in that circumstance, the dividend or dividend equivalent that was previously recognized in retained earnings is required to be reclassified to compensation expense (paragraph A37 of FAS 123(R)). Accordingly, a realized tax benefit from the dividend or dividend equivalent that was previously recognized in additional paid-in capital would also be reclassified to the income statement (that is, as a reduction of income tax expense or an increase of income tax benefit).

8. Subsequent to the November 16, 2006 EITF meeting, the staff was asked whether a tax benefit from a dividend or dividend equivalent should be reclassified from additional paid-in capital to the income statement when the related award is forfeited (or is no longer expected to vest) in circumstances in which that tax benefit may have been applied against a tax deficiency on another share-based payment award. The following example illustrates a circumstance in which this issue arises. For simplification purposes, this example presents an award granted to an individual employee, rather than a broad-based grant to a large number of employees, and it specifies that the entity's pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards was zero at the grant date.

> On January 1, 20X7, Company A grants 10,000 nonvested shares to Employee X that are classified as equity awards, have a grant-date fair value of $20 per share, and cliff vest on December 31, 20X9 (a 3-year vesting period). Company A believes Employee X will satisfy the three-year requisite service period, so the award is expected to vest. Company A will receive a tax deduction based on the fair value of the shares at the vesting date (that is, Employee X did not make an IRS Sec. 83(b) election). Additionally, Company A declares $1 per-share annual dividends that are paid on December 31 of each year and Employee X is entitled to receive those dividends. Employee X is not required to return dividends received

on nonvested awards that are subsequently forfeited. Company A's tax rate is 40 percent and all dividends paid to Employee X on the nonvested shares are tax deductible by Company A. At the grant date, Company A's pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards was zero.

On December 31, 20X7, Company A paid $10,000 of dividends to Employee X on the nonvested shares. The $4,000 tax benefit from those dividends ($10,000 × 40 percent tax rate) was realized as a reduction of taxes payable and, therefore, was recognized as an increase to additional paid-in capital. On June 30, 20X8, another employee exercised outstanding equity share options from a previous share-based payment award. The cumulative compensation cost from that previous award exceeded the tax deduction at exercise, resulting in a tax shortfall. The income statement charge resulting from that shortfall was reduced by the $4,000 pool of excess tax benefits that was generated from dividends paid to Employee X on December 31, 20X7.

Employee X terminated employment with Company A on July 31, 20X8 (prior to that date, the awards were expected to vest). Accordingly, Company A reversed the $105,556 of cumulative compensation cost (10,000 shares × $20 × 19/36 months), reversed the $42,222 tax benefit of that compensation cost ($105,556 × 40 percent tax rate), and reclassified $10,000 from retained earnings to compensation expense for the dividends previously paid to Employee X. The tentative conclusion on Issue 06-11 does not specify whether Company A should reclassify the $4,000 tax benefit from dividends on this award, which were previously applied against a tax shortfall on another award, from additional paid-in capital to the income statement.

9. At the March 15, 2007 EITF meeting, Task Force members will be asked whether they believe it is necessary to provide guidance on whether a tax benefit from a dividend on a share-based payment award should be reclassified from additional paid-in capital to the income statement when the related award is forfeited (or is no longer expected to vest) in circumstances in which that tax benefit may have been applied against a tax deficiency on another share-based payment award. The FASB staff has identified the following alternative approaches that could be applied under the current tentative conclusion to make this determination.

Alternative 1

10. Add a paragraph to the abstract for this Issue to clarify that when dividends or dividend equivalents on equity-classified share-based payment awards that were previously recognized in retained earnings are reclassified to compensation expense because the awards are no longer expected to vest, any realized tax benefit from those dividends that was previously recognized in additional paid-in capital should be reclassified to the income statement (that is, as a reduction of income tax expense or an increase of income tax benefit). It is not necessary to determine whether the amount previously recognized in additional paid-in capital has been used to offset tax shortfalls on other share-based payment awards.

11. Proponents of Alternative 1 observe that it is the least complex approach because it does not impose additional tracking requirements regarding an entity's APIC pool. Proponents of Alternative 1 believe that the costs of those additional tracking requirements would outweigh the financial reporting benefits that may be generated in some situations. At the November 16, 2006 EITF meeting, a number of Task Force members expressed their preference for the current tentative conclusion on this Issue because it provides a relatively non-complex alternative that retains the longstanding principle that income tax benefits exceeding recognized compensation costs in a share-based payment arrangement are to be credited directly to shareholders' equity. Proponents of Alternative 1 believe that some Task Force members supported the current tentative conclusion over View B in Issue Summary No. 1 (that is, record the tax benefit from dividends on equity-classified share-based payment awards as a reduction in the deferred tax asset associated with the related award) because the current tentative conclusion was perceived as the less complex alternative. Those proponents believe that the addition of tracking requirements as proposed under the alternative approaches described herein would make the current tentative conclusion more complex than the alternative proposed under View B in Issue Summary No. 1.

Alternative 2

12. Add a paragraph to the abstract for this Issue to clarify that when dividends or dividend equivalents on equity-classified share-based payment awards that were previously recognized in retained earnings are reclassified to compensation expense because the awards are no longer expected to vest, any realized tax benefit from those dividends that was previously recognized in additional paid-in capital should be reclassified to the income statement (that is, as a reduction of income tax expense or an increase of income tax benefit), provided that the amount recognized in additional paid-in capital has not been used to offset tax shortfalls on other share-based payment awards. Except in simplified circumstances such as the above example in which the entity's APIC pool is zero, it would be necessary under Alternative 2 for entities to adopt a methodology for ordering the usage of excess tax benefits that comprise the entity's APIC pool.

13. Supporters of Alternative 2 observe that in some circumstances, such as those in the example provided above, the application of Alternative 1 could result in the tax benefit from the same dividend being double-counted in the income statement. Those supporters observe that, at the November 16, 2006 EITF meeting, a number of Task Force members cited concerns over the tax benefit from dividends being double-counted in the income statement as their reason for opposing View A in Issue Summary No. 1 (that is, record the tax benefit from dividends on equity-classified share-based payment awards in the income statement). Supporters of Alternative 2 believe this Issue should not permit any circumstances in which the tax benefit from dividends would be double-counted in the income statement.

Alternative 3

14. Add a paragraph to the current tentative conclusion to clarify that the application of either Alternative 1 or Alternative 2 is an accounting policy election. Supporters of this approach believe it is not necessary to impose additional tracking requirements; however, they believe that entities should not be precluded from performing those tracking activities if they elect to do so. Some opponents of Alternative 1 would also object to providing entities with an accounting policy election because they believe that few entities would elect to perform the additional tracking necessary under Alternative 2.

Alternative 4

15. Modify the current tentative conclusion to specify that the tax benefit from a dividend on a share-based payment award does **not** increase an entity's APIC pool until the related award has vested. Proponents of Alternative 4 observe that the question of whether the tax benefit of a dividend can be reclassified from APIC to the income statement when the related dividend is reclassified from retained earnings to compensation expense does not arise under this approach because the tax benefit of the dividend could not have been applied against a shortfall on another share-based payment award. Opponents of Alternative 4 observe that this approach would ultimately result in the same amounts being recorded in additional paid-in capital and in the income statement, respectively, as the amounts that would be recorded under View B of Issue Summary No. 1, except that tracking is more difficult under this approach because it is performed separately from the actual accounting entries. Because the Task Force considered and rejected View B at the November 16, 2006 EITF meeting in favor of a less complex alternative, opponents of Alternative 4 believe that the Task Force should require Alternative 1 or provide entities with a policy election (Alternative 3).

Staff Analysis

16. The staff recommends that the Task Force provide guidance on whether a tax benefit from a dividend on a share-based payment award should be reclassified from additional paid-in capital to the income statement when the related award is forfeited (or is no longer expected to vest) in circumstances in which that tax benefit may have been applied against a tax deficiency on another share-based payment award.

17. If Task Force members oppose Alternative 1 because the tax benefit from dividends could be double-counted in the income statement in some cases, but are concerned with the additional tracking of an entity's APIC pool that would be required under Alternatives 2 and 4, the Task Force could also reconsider View B from Issue Summary No. 1. Under that view, an entity would record the tax benefit from dividends on equity-classified share-based payment awards as a deferred tax item (specifically, as a reduction in the deferred tax asset associated with the related award) until the related award is settled. The "tracking" that would be required under View B from the prior Issue Summary is automatically performed in connection with the

deferred tax accounting treatment, so it does not entail additional “off-the-books” tracking of the entity’s APIC pool.

Exhibit 06-11A

EITF ABSTRACTS (DRAFT[2])

Issue No. 06-11

Title: Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards

Dates Discussed: November 16, 2006; March 15, 2007

References: FASB Statement No. 109, *Accounting for Income Taxes*

FASB Statement No. 123 (revised 2004), *Share-Based Payment*

ISSUE

1. Employees may receive, as part of a share-based payment arrangement, dividends or dividend equivalents on awards of (a) nonvested equity shares and nonvested equity share units during the vesting period or (b) equity share options until they are exercised. In some cases, the payment of dividends on nonvested equity shares, nonvested equity share units, and outstanding equity share options is treated as deductible compensation for income tax purposes, even though the payment of such dividends is charged to retained earnings for awards that vest in the employer's financial statements. Questions have arisen on the accounting for income tax benefits related to the payment of dividends on equity-classified employee share-based payment awards that are charged to retained earnings under Statement 123(R).

2. The issue is how a company should recognize the income tax benefit received on dividends that are (a) paid to employees holding equity-classified nonvested shares, equity-classified nonvested share units, or equity-classified outstanding share options and (b) charged to retained earnings under Statement 123(R).

Scope

3. This Issue applies to share-based payment arrangements with dividend protection features that entitle employees to receive (a) dividends on equity-classified nonvested shares, (b) dividend equivalents on equity-classified nonvested share units, or (c) payments equal to the dividends paid on the underlying shares while an equity-classified share option is outstanding, when those dividends or dividend equivalents are charged to retained earnings under Statement 123(R) and result in an income tax deduction for the employer.

EITF DISCUSSION

4. The Task Force reached a [consensus] that a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity classified nonvested equity shares, nonvested equity share units, and outstanding equity share

[2] ~~**This draft abstract is being exposed for a public comment period that will end on January 22, 2007.**~~

options should be recognized as an increase to additional paid-in capital. The amount recognized in additional paid-in capital for the realized income tax benefit from dividends on those awards should be included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards.

5. In reaching the [consensus], the Task Force considered that dividends or dividend equivalents that are paid to employees for nonvested equity shares, nonvested equity share units, and outstanding equity share options that are charged to retained earnings may result in a tax deduction prior to the actual realization of the related tax benefit because the employer, for example, has a net operating loss carryforward. Pursuant to the guidance in footnote 82 of Statement 123(R), the income tax benefit of those dividends would not be recognized until the deduction reduces income taxes payable. Unrealized income tax benefits from dividends on equity-classified employee share-based payment awards should be excluded from the pool of excess tax benefits available to absorb potential future tax deficiencies on share-based payment awards.

Transition

6. The Task Force reached a [consensus] that this Issue should be applied prospectively to the income tax benefits of dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after September 15, 2007. Early application is permitted for the income tax benefits of dividends on equity-classified employee share-based payment awards that are declared in periods for which financial statements have not yet been issued. Retrospective application to previously issued financial statements is prohibited. Entities shall disclose the nature of any change in their accounting policy for income tax benefits of dividends on share-based payment awards resulting from the adoption of this [consensus].

Board Ratification

7. At its [March 28, 2007] meeting, the Board ratified the [consensus] reached by the Task Force in this Issue.

STATUS

8. No further EITF discussion is planned.