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 previously discussed: November 16, 2006; March 15, 2007

Previously distributed EITF materials: Issue Summary No. 1, dated October 27, 2006; Issue Summary Supplement No. 1, dated February 28, 2007

References:

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

FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FAS 123)

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 and Prior EITF Discussion

1. At the November 16, 2006 EITF meeting, the Task Force reached a tentative conclusion 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 options should be recognized as an increase in 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 potential future tax deficiencies on share-based payment awards. A draft abstract for this Issue was posted to the website on December 6, 2006, with a comment period that ended on January 22, 2007. A copy of the draft abstract is included in Exhibit 06-11B; no changes have been made to the version that was posted for comment except for the proposed effective date, as discussed below.

2. At the March 15, 2007 EITF meeting, the Task Force discussed the tentative conclusion reached on this Issue at the November 16, 2006 EITF meeting but was not asked to affirm it as a consensus. At that meeting, the Task Force also discussed issues relating to the accounting for a tax benefit from a dividend on a share-based payment award that is forfeited (or is no longer expected to vest). Paragraph A37 of FAS 123(R) contains the following discussion regarding the accounting for **dividends** on equity-classified share-based payment awards:

> In certain situations, employees may receive the dividends paid on the underlying equity shares while the option is outstanding. 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. If employees are not required to return the dividends or dividend equivalents received if they forfeit their awards, **dividends or dividend equivalents paid on instruments that do not vest shall be recognized as additional compensation cost.**[61] [Emphasis added.]
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> [61] The estimate of compensation cost for dividends or dividend equivalents paid on instruments that are not expected to vest shall be consistent with an entity's estimates of forfeitures (paragraphs 43–45).

3. Pursuant to the above guidance, a dividend on an equity-classified share-based payment award is subsequently reclassified from retained earnings to compensation cost when the related

award is forfeited (or is no longer expected to vest). At the March 15, 2007 EITF meeting, the Task Force discussed whether the **tax benefit** from a dividend on an equity-classified 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 Task Force was not asked to reach a conclusion on that question, but requested the FASB staff to provide alternative views with illustrative examples for discussion at the June 14, 2007 EITF meeting. A discussion of alternative views is included in this Issue Summary Supplement and an example illustrating each alternative view is included in Exhibit 06-11A. Pursuant to the direction of the Task Force at the March 15, 2007 EITF meeting, this Issue Summary Supplement (a) only presents alternatives that are consistent with the tentative conclusion from the November 16, 2006 EITF meeting and (b) does not present any alternatives that would require an entity to track the order of usage of excess tax benefits within its APIC pool. If the Task Force reaches a conclusion at the June 14, 2007 EITF meeting on how the tentative conclusion on this Issue should be applied when an entity's estimate of forfeitures changes (or actual forfeitures differ from its estimates), it will be asked to affirm its tentative conclusion on this Issue as a consensus.

Accounting Issue and Alternatives

4. Footnote 61 of FAS 123(R) requires that **dividends** on share-based payment awards be reallocated between retained earnings (for awards expected to vest) and compensation cost (for awards not expected to vest) each reporting period to reflect current forfeiture estimates. Adjustments to additional paid-in capital for reclassifications of the **tax benefits** from dividends on share-based payment awards (that is, when the related dividends are reclassified in accordance with footnote 61 of FAS 123(R)) would increase or decrease the entity's pool of excess tax benefits available to absorb tax deficiencies by a corresponding amount. At the June 14, 2007 EITF meeting, the Task Force will be asked to discuss whether the amount of an entity's pool of excess tax benefits available to absorb tax deficiencies should limit the amount of tax benefits that are reclassified from additional paid-in capital to the income statement.

Issue: Whether the amount of tax benefits from dividends that are reclassified from additional paid-in capital to the income statement (that is, as an adjustment to income tax expense or benefit) when an entity's estimate of forfeitures *increases* (or actual forfeitures *exceed* the entity's estimates) should be limited to the entity's pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification.

View A: The amount of tax benefits from dividends that are reclassified from additional paid-in capital to the income statement when an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) should be limited to the entity's pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification.

5. Proponents of View A believe that the principle underlying the tentative conclusion on this Issue is that income tax benefits relating to deductions from dividends on share-based payment awards in excess of the book compensation cost of those dividends should be treated as excess tax benefits recognized in additional paid-in capital. When an entity's estimate of forfeitures changes in a subsequent period (or actual forfeitures differ from its most recent estimate), the resulting reclassification of prior dividends on the related awards between retained earnings and compensation expense changes the amount of excess tax benefits from those dividends. Accordingly, the tax benefits of those dividends would be reclassified between additional paid-in capital and the income statement (income tax expense or benefit) in the same period that the related dividends are reclassified between retained earnings and compensation expense. However, proponents of View A observe that, under the tentative conclusion on this Issue, the amount recognized in additional paid-in capital for the realized income tax benefit from dividends on share-based payment awards is included in the pool of excess tax benefits available to absorb tax deficiencies. If an entity's estimate of forfeitures increases (or actual forfeitures exceed its most recent estimate), the entity would reclassify dividends from retained earnings to compensation expense. However, because the related tax benefit was previously recognized in additional paid-in capital and included in the entity's pool of excess tax benefits available to absorb tax deficiencies, that tax benefit may have been applied against a tax deficiency on another share-based payment award in an earlier reporting period.

6. To address those situations, View A proponents believe that the amount of tax benefits from dividends that are reclassified from additional paid-in capital to the income statement when an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) should be limited to the entity's pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification. This treatment prevents circumstances in which the tax benefit of a dividend on a share-based payment award might otherwise be double-counted in the income statement because (a) the tax benefit previously offset a shortfall on another share-based payment award and (b) the same tax benefit is subsequently recognized in the income statement when the award to which it relates is forfeited (or is no longer expected to vest). Proponents of View A 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, to record the tax benefit from dividends on equity-classified awards in the income statement). Those proponents believe this Issue should not permit any circumstances in which the tax benefit from dividends would be double-counted in the income statement.

7. View A proponents also observe that if the tax benefits from dividends that could be reclassified from additional paid-in capital to the income statement are not limited to the entity's APIC pool, then the amount recognized in additional paid-in capital from "excess" tax benefits on share-based payment awards could become negative (a debit balance). Those proponents believe that such a result is inconsistent with the accounting treatment for excess tax benefits and tax deficiencies under FAS 123(R), whereby tax deficiencies can be offset only "to the extent of any remaining additional paid-in capital from excess tax benefits from previous awards accounted for in accordance with [FAS 123(R) or FAS 123]. The remaining balance, if any, of the write-off of a deferred tax asset related to a tax deficiency shall be recognized in the income statement." View A proponents observe that this guidance, which is set forth in paragraph 63 of FAS 123(R), would be unnecessary if the Board intended to permit entities to have negative balances in the component of APIC that is comprised of tax benefits from share-based payment awards. Additionally, View A proponents believe that this approach is the less complex alternative because View B can result in circumstances in which new differences are created between the amounts recognized in additional paid-in capital for tax benefits of share-based

payment awards and the entity's pool of tax benefits available to absorb tax deficiencies, resulting in incremental tracking requirements.

View B: The amount of tax benefits from dividends that are reclassified from additional paid-in capital to the income statement when an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) should ***not*** *be limited to the entity's pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification.*

8. Proponents of View B agree with View A proponents that the principle underlying the tentative conclusion on this Issue is that income tax benefits from dividends on share-based payment awards in excess of the book compensation cost of those dividends should be treated as excess tax benefits recognized in additional paid-in capital. However, proponents of View B believe that the tax benefits from dividends that are reclassified from additional paid-in capital to the income statement when an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) should **not** be limited to the entity's pool of excess tax benefits available to absorb tax deficiencies on the date of the reclassification. Those proponents believe that the classification of a tax benefit from a dividend on a share-based payment award as either an equity item (additional-paid in capital) or an income statement item (decrease of tax expense or increase of tax benefit) should be consistent with the classification of the related dividend as an equity item (retained earnings) or an income statement item (compensation expense).

9. Proponents of View B observe that a tax benefit being double-counted in the income statement and causing a negative balance in the component of additional paid-in capital that relates to the tax benefits of share-based payment awards would occur only in limited circumstances. For that circumstance to occur, the entity must have (a) depleted (or nearly depleted) its pool of excess tax benefits available to absorb tax deficiencies and (b) increased its estimate of forfeitures on equity-classified share-based payment awards that pay dividends to the holders prior to vesting or exercise. Additionally, View B proponents believe that the reclassification of the tax benefit resulting from a dividend on a share-based payment award from additional paid-in capital when the related dividend is reclassified from retained earnings to compensation expense does not constitute a "tax deficiency" as contemplated in paragraph 63 of

FAS 123(R). Accordingly, those proponents believe it is not necessary to limit the amount of tax benefits reclassified to the income statement when the related dividends generating those tax benefits are reclassified.

Effective Date and Transition

10. At the November 16, 2006 EITF meeting, the Task Force reached a tentative conclusion that this Issue should be applied prospectively to the income tax benefits of dividends on equity-classified share-based payment awards that are declared in fiscal years beginning after September 15, 2007. Early application would be 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 would be prohibited. Entities would be required to 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 a consensus on this Issue.

11. To give entities sufficient time to make any system modifications necessary to begin tracking the information needed to apply a consensus on this Issue, the FASB staff recommends that the effective date apply to the income tax benefits of dividends on equity-classified share-based payment awards that are declared in fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. At the June 14, 2007 EITF meeting, the Task Force will be asked whether it agrees with this proposed change to the effective date of this Issue.

Exhibit 06-11A

ILLUSTRATIVE EXAMPLE

This Exhibit illustrates the application of the alternative views set forth in this Issue Summary Supplement on the accounting for income tax benefits from dividends on equity-classified share-based payment awards when those dividends are reclassified from retained earnings to compensation expense in a subsequent period because the entity increases its estimate of forfeitures.

> On January 1, 20X7, Company A grants 900,000 nonvested share units that are classified as equity awards, have a grant-date fair value of $100 per share, and cliff vest on December 31, 20X9 (a 3-year vesting period). At the grant date, Company A assumes an annual forfeiture rate of 3 percent and therefore initially expects to receive the requisite service for 821,406 [$900{,}000 \times .97^3$] of the share unit awards (78,594 estimated forfeitures).
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> Employees forfeited 35,000 units ratably during 20X7 but Company A did not revise its estimate of forfeitures as of December 31, 20X7 because it still expected actual forfeitures to average 3 percent per annum over the 3-year vesting period. However, 15,000 employees forfeited their share units during the quarter ended March 31, 20X8. Based on this additional information, Company A increases its estimated forfeiture rate for the entire award to 5 percent per annum and therefore expects to receive the requisite service for 771,638 [$900{,}000 \times .95^3$] of the share unit awards (128,362 estimated forfeitures).
>
> Company A will receive a tax deduction based on the fair value of the shares at the vesting date (that is, no employees made an IRS Sec. 83(b) election). Additionally, Company A declares $3 per share annual dividends that are paid on December 31 of each year and employees with nonvested shares are entitled to receive those dividends. Employees are 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 employees on the nonvested shares are tax deductible by Company A. Additionally, Company A has concluded that it

will have sufficient future taxable income to realize the deferred tax benefits from its share-based payment transactions.

During the first quarter of 20X8, an earlier grant of equity share units became vested and generated significant tax shortfalls that used up the majority of Company A's pool of excess tax benefits available to absorb tax deficiencies. The analysis below illustrates both alternatives in this Issue Summary Supplement (Views A and B) to account for the tax benefits of 20X7 dividends that are reclassified to compensation expense during the quarter ended March 31, 20X8, assuming that Company A's APIC pool immediately prior to its increased forfeiture estimate at March 31, 20X8 is as follows:

- Scenario #1 – $100,000 pool of excess tax benefits available to absorb deficiencies
- Scenario #2 – $30,000 pool of excess tax benefits available to absorb deficiencies
- Scenario #3 – $0 (no excess tax benefits available to absorb deficiencies)

Journal Entries for the Year Ended December 31, 20X7 (amounts rounded to nearest thousand)

Compensation cost [($100 × 821,406) / 3 years]	27,380,000	
Additional paid-in capital		27,380,000

To recognize compensation cost for the awards expected to vest.

Deferred tax asset [$27,380,000 × 40%]	10,952,000	
Income tax benefit [$27,380,000 × 40%]		10,952,000

To record deferred taxes for the temporary difference related to the compensation cost.

Retained earnings [$3 × 821,406]	2,464,000	
Compensation cost [$3 × ((900,000 − 35,000) − 821,406)]	131,000	
Cash dividends paid [$3 × (900,000 − 35,000)]		2,595,000

To recognize dividends paid to holders of nonvested awards expected to vest and holders of nonvested awards not expected to vest.

Taxes payable [$2,595,000 × 40%]	1,038,000	
Income tax benefit [$131,000 × 40%]		52,000
Additional paid-in capital [$2,464,000 × 40%]		986,000

To recognize the tax benefit from deductible dividends in accordance with the tentative conclusion reached at the November 16, 2006 EITF meeting.

Journal Entries for the Quarter Ended March 31, 20X8 (amounts rounded to nearest thousand)

Compensation cost [($100 × 771,638) × 3/36 months]	6,430,000	
Additional paid-in capital		6,430,000

To recognize compensation cost for the awards expected to vest based on revised estimated forfeiture rate.[1]

Deferred tax asset [$6,430,000 × 40%]	2,572,000	
Income tax benefit [$6,430,000 × 40%]		2,572,000

To record deferred taxes for the temporary difference related to the compensation cost.

[1] The reduction of current year compensation cost to adjust previously recognized amounts for the increased forfeiture rate, as well as the related tax effects, are presented as separate journal entries for illustrative purposes. Such entries could also be shown on a net basis, as they are presented in Illustration 4(a) of FAS 123(R).

Additional paid-in capital	1,659,000	
Compensation cost [($100 × (821,406 − 771,638)) ÷ 3 years]		1,659,000

To reverse compensation cost previously recognized in 20X7 for the awards no longer expected to vest based on revised estimated forfeiture rate.

Income tax expense [$1,659,000 × 40%]	664,000	
Deferred tax asset [$1,659,000 × 40%]		664,000

To adjust the deferred tax accounts for the effect of the reversal of compensation cost previously recognized in 20X7 for the awards no longer expected to vest based on revised estimated forfeiture rate.

Compensation cost [$3 × (821,406 − 771,638)]	149,000	
Retained earnings		149,000

To recognize additional compensation cost for dividends paid in 20X7 for the awards no longer expected to vest based on revised estimated forfeiture rate. **The corresponding income tax effects of this entry for the period ended March 31, 20X8 are presented below under each of the alternative views set forth in this Issue Summary Supplement.**

Application of the Alternative Views in this Issue Summary Supplement

View A: The amount of tax benefits from dividends that are reclassified from additional paid-in capital to the income statement when an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) is limited to the entity's pool of excess tax benefits available to absorb deficiencies.

<u>Scenario #1 ($100,000 excess tax benefits available to absorb deficiencies)</u>

Additional paid-in capital [$149,000 × 40%]	60,000	
Income tax benefit		60,000

To reclassify tax benefit from dividends paid in 20X7 that have been recognized as compensation cost in 20X8 based on revised estimated forfeiture rate.

Scenario #2 ($30,000 excess tax benefits available to absorb deficiencies)

Additional paid-in capital	30,000	
Income tax benefit		30,000

To reclassify tax benefit from dividends paid in 20X7 that have been recognized as compensation cost in 20X8 based on revised estimated forfeiture rate. However, the amount of the reclassification is limited to the $30,000 pool of excess tax benefits available to absorb tax deficiencies.

Scenario #3 (no excess tax benefits available to absorb deficiencies)

No entry to record.

*View B: The amount of tax benefits from dividends that are reclassified from additional paid-in capital to the income statement when an entity's estimate of forfeitures increases (or actual forfeitures exceed the entity's estimates) is **not** limited to the entity's pool of excess tax benefits available to absorb deficiencies.*

Scenarios #1 – 3 (Because the amount of reclassification is not limited to the entity's pool of excess tax benefits available to absorb deficiencies, this entry is the same for each scenario)

Additional paid-in capital [$149,000 × 40%]	60,000	
Income tax benefit		60,000

To reclassify tax benefit from dividends paid in 20X7 that have been recognized as compensation cost in 20X8 based on revised estimated forfeiture rate.

Exhibit 06-11B

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 ~~14~~ 15, 2007; <u>June 14, 2007</u>

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.

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

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 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~~December 15, 2007, and interim periods within those fiscal years. 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 [June 27, 2007] meeting, the Board ratified the [consensus] reached by the Task Force in this Issue.

STATUS

8. No further EITF discussion is planned.