FASB Emerging Issues Task Force

Issue No. 06-11

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

Document: Issue Summary No. 1

Date prepared: October 27, 2006

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Date previously discussed: None

Previously distributed EITF materials: None

References:

AICPA Statement of Position No. 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans* (SOP 76-3)

AICPA Statement of Position No. 93-6, *Employers' Accounting for Employee Stock Ownership Plans* (SOP 93-6)

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))

FASB Statement No. 128, *Earnings per Share* (FAS 128)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Staff Position FAS No. 123(R)-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards* (FSP FAS 123(R)-3)

International Accounting Standard 12, *Accounting for Income Taxes* (IAS 12)

Background

1. Employees may receive, as part of a share-based payment arrangement, dividends or dividend equivalents on (a) nonvested share awards and nonvested equity share unit awards during the vesting period or (b) share option awards until they are exercised. Such "dividend protection" provisions may take a variety of forms. For example, a share-based payment arrangement may entitle employees to receive (a) dividends or dividend equivalents on a nonvested equity share or a nonvested share unit, (b) payments equal to dividends on the underlying equity shares while a share option is outstanding, or (c) reductions to the exercise price of a share option based on the dividends paid on the underlying equity shares while the option is outstanding.

2. In some cases, the payment of dividends on nonvested equity shares, nonvested equity share units, and outstanding share options is treated as deductible compensation for 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 share-based payment awards that are charged to retained earnings under FAS 123(R).

Accounting for Dividend-Protected Awards under FAS 123(R)

3. FAS 123(R) requires that dividend protection features be appropriately reflected in estimating the fair value of a share-based payment award. The fair value of a dividend-paying equity share already incorporates the expected payment of dividends; therefore, an entity would not adjust the fair value of a *nonvested* share for the expected payment of dividends during the vesting period if employees are entitled to receive those dividends. However, if employees do not receive dividends declared on the class of shares granted to them until the shares vest, the grant-date fair value of the award is measured by reducing the share price at that date by the present value of the dividends expected to be paid on the shares during the requisite service period, discounted at the appropriate risk-free interest rate.

4. For share option awards, expected dividends are taken into account in using an option-pricing model to estimate their fair values because dividends paid on the underlying shares

reduce the fair value of those shares. Therefore, the fair value of a share option that pays dividends must be adjusted to appropriately reflect the dividend protection. For example, if a dividend paid on the underlying equity shares is applied to reduce the exercise price of a share option, paragraph A36 of FAS 123(R) indicates that the effect of the dividend protection is appropriately reflected by using an expected dividend assumption of zero in the option-pricing model (that is, the fair value of the dividend-protected share option is not reduced for expected dividends to be paid on the underlying shares while the option is outstanding).[1]

5. FAS 123(R) states that dividends or dividend equivalents paid to employees on the portion of an award of equity shares or other equity instruments that vests are charged to retained earnings. Because the measure of compensation cost for a share or share option is its fair value at the grant date, which already reflects dividend protection, recognizing dividends on nonvested shares or outstanding share options as additional compensation would effectively double count those dividends. However, if employees are not required to return the dividends or dividend equivalents received during the vesting period if they forfeit their awards, dividends or dividend equivalents paid on awards that do not vest are recognized as compensation cost.[2]

Income Tax Treatment of Dividends or Dividend Equivalents on Nonvested Shares or Outstanding Share Options

6. If an employee makes an Internal Revenue Code Section 83(b) (IRS Sec. 83(b)) election for nonvested shares, the employee will receive capital gain treatment during the vesting period. In contrast, if the election is not made, then the IRS treats the appreciation in the shares during the vesting period as ordinary income. If an IRS Sec. 83(b) election is made, the dividends paid on the nonvested shares during the vesting period are treated like ordinary dividends paid to shareholders for U.S. Federal income tax purposes, and the company does not receive a tax benefit for the payment of those dividends. However, if an employee does not make this

[1] Different forms of dividend protection for share options (for example, a cash payment versus a reduction in the exercise price) may have different effects on the fair value of an option. Accordingly, FAS 123(R) requires that dividend protection be appropriately reflected in estimating the fair value of a dividend-protected option, but does not specify a single method of doing so (paragraph B91 of FAS 123(R)).

[2] FAS 123(R) requires companies to make an estimate of expected forfeitures of share-based payment awards and to adjust periodic compensation cost for the effect of estimated forfeitures. The estimate of compensation cost for dividends or dividend equivalents paid on instruments that are not expected to vest must be consistent with an entity's estimates of forfeitures for compensation cost recognition.

election, the IRS treats the payment of dividends on nonvested shares as compensation and the employer receives a tax deduction on the dividends paid. Likewise, dividend equivalents paid to holders of share options equal to the dividends on the underlying equity shares are treated as compensation for U.S. Federal income tax purposes, resulting in a tax deduction for the employer.

Accounting for the Tax Effects of Share-Based Compensation Awards under FAS 123(R)

7. FAS 123(R) specifies that the cumulative amount of compensation cost recognized for equity-classified share-based payment awards that ordinarily would result in a future tax deduction under existing tax law are considered to be a deductible temporary difference in applying FAS 109. That deductible temporary difference is based on the compensation cost recognized for financial reporting purposes. The deferred tax benefit (or expense) that results from increases (or decreases) in that temporary difference is recognized in the income statement.[3]

8. FAS 123(R) provides guidance on the accounting for excess tax benefits (that is, the amount by which the realized tax benefit from a deduction reported on a tax return for a share-based payment award exceeds the deferred tax asset previously recognized for that award) and tax deficiencies (that is, the amount by which the realized tax benefit from a deduction reported on a tax return for a share-based payment award is less than the deferred tax asset previously recognized for that award). Under FAS 123(R), excess tax benefits are recognized as additional paid-in capital in the period the benefit is realized. However, excess tax benefits are recognized in the income statement to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for financial reporting purposes and a later measurement date for tax purposes.

9. A tax deficiency is first offset to the extent of any remaining additional paid-in capital from realized excess tax benefits from previous awards accounted for in accordance with FAS 123 or

[3] Compensation cost that is capitalized as part of the cost of an asset, such as inventory, is considered to be part of the tax basis of that asset for financial reporting purposes.

FAS 123(R). However, if that existing balance in additional paid-in capital from realized excess tax benefits from previous awards is not sufficient to absorb the full amount of the tax deficiency, the remaining shortfall amount is recognized in the income statement as an increase to tax expense (or a reduction of tax benefit).[4]

Scope

10. 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 FAS 123(R) and result in an income tax deduction for the employer.

Accounting Issue and Alternatives

How a company should recognize the 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 FAS 123(R).

View A: A tax benefit from dividends or dividend equivalents that are paid to employees for nonvested equity shares, nonvested equity share units, and outstanding share options should be recognized in the income statement (that is, as a reduction of income tax expense or an increase of income tax benefit).

11. Proponents of View A believe a tax deduction resulting from dividends paid to an employee holding nonvested equity shares, nonvested equity share units, or outstanding share options that are charged to retained earnings should be recognized in the income statement. Those proponents reference paragraph 62 of FAS 123(R), which states:

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[4] For entities that continued to use APB 25's intrinsic value method prior to adoption of FAS 123(R), paragraph 81 of FAS 123(R) and FSP FAS 123(R)-3 provide alternatives for calculating the pool of excess tax benefits available to absorb tax deficiencies that are recognized subsequent to the adoption of FAS 123(R).

> If a deduction reported on a tax return for an award of equity instruments exceeds the cumulative compensation cost for those instruments recognized for financial reporting, any resulting realized excess tax benefit that exceeds the previously recognized deferred tax asset for those instruments (the excess tax benefit) shall be recognized as additional paid-in capital.[31] **However, an excess of a realized tax benefit for an award over the deferred tax asset for that award shall be recognized in the income statement to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for accounting purposes and a later measurement date for tax purposes.** [Emphasis added.]
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> [31]If only a portion of an award is exercised, determination of the excess tax benefits shall be based on the portion of the award that is exercised.

12. Proponents of View A believe that the guidance on excess tax benefits and tax shortfalls in FAS 123(R) is intended to address differences between the compensation cost recognized for financial reporting purposes, which is measured at grant date fair value for equity-classified awards, and the deduction allowed under income tax regulations, which is generally measured as the intrinsic value of an instrument on a specified date. Those proponents refer to the above guidance from paragraph 62 of FAS 123(R), which requires that an excess tax benefit must be recognized in the income statement to the extent that the excess stems from a reason other than changes in the fair value of an entity's shares between the measurement date for financial reporting purposes and a later measurement date for tax purposes. View A proponents observe that the amount of a tax deduction on dividends paid to employees for nonvested equity shares, nonvested equity share units, or outstanding share options is based on the amount of the dividend, not the fair value of the entity's equity shares. Accordingly, they believe the tax benefit received on dividends that are paid to employees for nonvested shares, nonvested share units, and outstanding share option awards should be recognized in the income statement. Proponents of View A observe that such treatment is the least complex alternative presented in this Issue Summary because the tax benefits from all deductible dividends on equity-classified share-based payment awards would be recognized in the income statement, regardless of whether the related award is expected to vest.

13. Proponents of View A believe that an analogous circumstance is the payment of dividends on allocated shares in an employee stock ownership plan (ESOP). *Allocated shares* are the

shares in an ESOP trust that have been assigned to individual participant accounts based on a known formula. For any particular participant in an ESOP, such shares may be vested, unvested, or partially vested. Paragraph 22 of SOP 93-6 specifies that dividends on allocated shares should be charged to retained earnings. Under FAS 109, the tax benefits from dividend deductions on those allocated shares are recognized in the income statement. Specifically, paragraph 145 of FAS 109 states, in part:

> The Board believes that a tax deduction received for the payment of dividends (exclusive of dividends paid on **unallocated** shares held by an ESOP) represents, in substance, an exemption from taxation for an equivalent amount of earnings. For that reason, the Board concluded that the tax benefit should be recognized as a reduction of tax expense and should not be allocated directly to shareholders' equity. [Emphasis added.]

14. Proponents of View A observe that allocated shares in ESOPs are assigned to a particular participant in the plan and may be vested, unvested, or partially vested. Likewise, in the case of outstanding share options with dividend protection, those awards have been granted to an individual participant and may be vested, unvested, or partially vested. View A proponents believe that recognition of the tax benefits from dividends on nonvested equity shares, nonvested equity share units, and outstanding share options that are charged to retained earnings should be consistent with the recognition of tax benefits from dividends on allocated shares in an ESOP, which are also charged to retained earnings.

15. Opponents of View A observe that dividend protection features are reflected in the fair value of nonvested shares and outstanding share options. They refer to the Board's conclusions in FAS 123(R) that dividends paid to employees on the portion of an award of equity shares or other equity instruments that vests should be charged to retained earnings because recognizing those dividends as additional compensation would effectively double count the dividends. Similarly, opponents of View A believe that recognizing the tax benefit from such dividends through the income statement would effectively double count the tax benefit from those dividends if the award ordinarily would result in a future tax deduction under existing tax law,

because the deferred tax asset that arises as compensation cost is recognized over the service period is already recognized in the income statement as a reduction of income tax expense.

View B: A realized tax benefit from dividends or dividend equivalents that are paid to employees for nonvested equity shares, nonvested equity share units, and outstanding share options should be recorded as a reduction in the deferred tax asset that is associated with the award, such that the deduction will ultimately affect the amount of excess tax benefit or tax deficiency that is accounted for pursuant to the guidance in FAS 123(R).

16. Proponents of View B believe that a tax deduction resulting from dividends paid to an employee holding nonvested equity shares, nonvested equity share units, or outstanding share options that are charged to retained earnings should be considered part of the overall tax benefit of the related award for purposes of determining the amount of any excess tax benefit or tax deficiency under FAS 123(R). Accordingly, realized tax benefits from dividends on nonvested equity shares, nonvested equity share units, or share option awards that are charged to retained earnings should be recorded as a reduction of the deferred tax asset provided on the cumulative book-compensation cost for that share-based payment award. In some circumstances, equity-classified awards that do not ordinarily result in a tax deduction upon vesting or exercise (for example, incentive stock options (ISOs)) may contain dividend protection that provides for the payment of tax deductible dividends or dividend equivalents that are charged to retained earnings under FAS 123(R). In the period of the deduction, the tax benefit from dividends on awards that do not ordinarily result in a tax deduction upon vesting or exercise would be recognized in the income statement up to the amount of cumulative compensation cost recognized for financial reporting purposes (tax-effected). If the aggregate deductions from the payment of dividends on an award that does not ordinarily result in a tax deduction upon vesting or exercise exceeds the cumulative compensation cost recognized for financial reporting purposes (tax-effected), such excess would be recognized as an increase to additional paid-in capital.

17. View B proponents observe that the fair value of an equity share is reduced when dividends are paid (that is, the fair value of an equity share is reduced on the ex-dividend date). They refer to the guidance in paragraph A36 of FAS 123(R), which states that "expected dividends are

taken into account in using an option-pricing model to estimate the fair value of a share option because **dividends paid on the underlying shares reduce the fair value of those shares**…" (emphasis added). As a result, the payment of a deductible dividend may accelerate a tax deduction that would otherwise have been generated on the vesting date of a share award or the exercise date of a share option. Therefore, View B proponents believe that the recognition of tax benefits in the income statement or as an increase to additional paid-in capital should be consistent whether the deductions are generated through the payment of dividends or upon vesting (or exercise) of the award.

18. View B proponents also observe that expected future dividends are reflected in the fair value of a share-based payment award. Therefore, they believe that the payment of those dividends and a resulting tax deduction that reduces current taxes payable represents a partial realization of the deferred tax asset that was established when the compensation cost associated with that award was recognized. Consequently, View B proponents believe a tax deduction from the dividends embodies a partial reversal of the deductible temporary difference associated with the compensation cost recognized for the award that should be recognized as a reduction in the related deferred tax asset.

19. Additionally, proponents of View B observe that it is the only alternative in this Issue Summary that provides consistent accounting for the tax benefits of a dividend protection feature regardless of whether its form is (a) a cash payment for dividends on the equity shares underlying a share option (within the scope of this Issue) or (b) an adjustment to the exercise price of a share option based on the dividends paid on the underlying equity shares (not within the scope of this Issue). As discussed in paragraph A36 of FAS 123(R), dividend protection may provide for reductions to the exercise price of share options based on the dividends paid on the underlying equity shares while the options are outstanding. Because adjustments to the exercise price based on the dividends paid on the underlying equity shares do not affect the financial statement carrying amount or tax basis of an equity-classified share option, such adjustments will ultimately impact the amount of any excess tax benefit or tax deficiency under FAS 123(R). Opponents of View B observe that a deductible dividend payment to an option holder that provides an unconditional tax deduction to the employer, differs from a reduction to the exercise

price of an option for which the tax benefit is conditional on the option ultimately being exercised. Accordingly, opponents of View B do not believe it is necessary for there to be consistent accounting for the tax benefits resulting from those different forms of dividend protection.

20. Opponents of View B believe that this model would result in an inappropriate reduction of the deferred tax asset relating to a dividend-protected share-based payment award. Those opponents observe that paragraph 59 of FAS 123(R) specifies that a deductible temporary difference on an equity-classified share-based payment award must be based on the compensation cost recognized for financial reporting purposes. The guidance in FAS 123(R) does not provide for adjustments to the carrying amount of the resulting deferred tax asset, except in circumstances in which it is more likely than not that some portion of that deferred tax asset will not be realized such that a valuation allowance is required under FAS 109. Accordingly, View B opponents do not believe an entity is permitted to adjust the carrying amount of a deferred tax asset for tax deductions resulting from dividends paid to employees holding nonvested equity shares, nonvested equity share units, or outstanding share options that are charged to retained earnings.

21. Additionally, opponents of View B observe that this model requires the entity to track dividend deductions on an award-by-award basis, which could create additional complexity in accounting for the income tax effects relating to share-based payment awards. In response, proponents of View B observe that entities are already required to track the deferred tax assets resulting from cumulative compensation cost on an award by award basis, so a requirement to adjust those deferred tax assets for dividends paid (which are typically the same amount for each class of equity shares) does not add incremental tracking requirements that are not already present in FAS 123(R).

View C: A tax benefit from dividends or dividend equivalents that are paid to employees for nonvested equity shares, nonvested equity share units, and outstanding share options should be recognized as an increase to additional paid-in-capital (APIC).

22. View C proponents believe that a tax deduction resulting from dividends paid to an employee holding nonvested equity shares, nonvested equity share units, or outstanding share options that are charged to retained earnings should be accounted for similarly to other tax consequences of share-based payment arrangements. However, View C proponents believe that tax deductions resulting from the payment of dividends that are charged to retained earnings should be treated as a separate unit of account from the related share-based payment award. They believe that because the payment of dividends on nonvested equity shares, nonvested equity share units, or outstanding share options that are expected to vest are charged to retained earnings, the entire realized tax benefit from such dividends should be treated as an excess tax benefit recognized in additional paid-in capital.

23. Under this view, a tax deduction from dividends on nonvested equity shares, nonvested equity share units, and outstanding share options that are charged to retained earnings may occur in a period prior to the actual realization of the tax benefit because the entity, for example, has a net operating loss carryforward. Because View C proponents believe tax deductions from dividends on nonvested equity shares, nonvested equity share units, and outstanding share options that are charged to retained earnings should be recognized as an excess tax benefit under a stock compensation arrangement, the guidance in footnote 82 of FAS 123(R) affects the application of this view. That is, when a tax deduction from dividends on nonvested equity shares, nonvested equity share units, or outstanding share options that are charged to retained earnings is not realized by the entity, an increase to additional paid-in capital would not be recognized until that deduction reduces taxes payable. Such unrealized excess tax benefits should be excluded from the pool of excess tax benefits available to absorb tax deficiencies.

24. View C proponents reference paragraphs 36(f) and 36(e) of FAS 109 because those paragraphs specify that the tax effects of expenses for (a) employee stock options recognized differently for financial reporting purposes than for tax purposes (refer to paragraphs 58–63 of FAS 123(R)) and (b) dividends paid on unallocated shares held by an ESOP that are charged to

retained earnings[5] are credited directly to shareholders' equity. Proponents of View C believe that the guidance in paragraph 35 of FAS 109, which states that tax deductible dividends paid to shareholders should be allocated to continuing operations, except as set forth in paragraph 36 for dividends paid on unallocated shares held by an ESOP *or any other stock compensation arrangement*, recognizes that the guidance in paragraph 36(f) may apply to stock compensation arrangements other than ESOPs.

25. View C proponents believe that this approach is consistent with the principles underlying the guidance in FAS 123(R) regarding the tax effects of share-based payment awards, whereby the tax effect of a deduction in excess of the cumulative compensation recognized for financial reporting purposes must be recognized as an increase to additional paid-in capital. Some View C proponents acknowledge the conceptual merits of View B, which applies the existing guidance in FAS 123(R) to determine the amount, if any, of a tax benefit from a share-based payment arrangement that must be credited directly to shareholders' equity. However, they believe that the model in FAS 123(R) for determining excess tax benefits and tax deficiencies is complex and the application of View C results in a less complex alternative that retains the longstanding principle that income tax benefits exceeding recognized compensation costs in a share-based payment arrangement be credited directly to shareholders' equity.

26. Opponents of View C believe that an entity should not be required to recognize tax benefits on dividends paid to employees for nonvested equity shares, nonvested equity share units, or outstanding share options that are charged to retained earnings as an increase to additional paid-in capital in circumstances in which there is a tax deficiency on the overall share-based payment award (including the tax deductions for dividends or dividend equivalents). Additionally, those opponents believe that it is not appropriate for realized tax benefits on dividends paid to employees for nonvested equity shares, nonvested equity share units, or outstanding share options that are charged to retained earnings to be available to offset deficiencies on other share-based payment awards because, ultimately, there could be a tax deficiency on the overall share-

[5] Because dividends on unallocated shares are not charged to retained earnings under SOP 93-6, the guidance from paragraph 36(f) of FAS 109 does not apply to ESOP shares accounted for under SOP 93-6. Rather, the guidance in paragraph 36(f) of FAS 109 applies to ESOP sponsors who elected to continue their previous accounting under SOP 76-3 for ESOP shares acquired before January 1, 1993, in accordance with the transition provisions of SOP 93-6.

based payment award (including the tax deductions for dividends or dividend equivalents) that is generating those benefits.

International Convergence

27. This Issue is not explicitly addressed by International Financial Reporting Standards. Some believe that View C would be required under IFRS based on the guidance in paragraph 61 of IAS 12, which specifies that current tax and deferred tax shall be charged or credited directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity. However, others observe that (a) the guidance in paragraph 61 does not specifically address tax benefits arising from share-based payment awards and (b) the guidance on accounting for the tax benefits of share-based payment awards (paragraphs 68A–68C of IAS 12) specifically refers to paragraph 61 as a basis for allocating tax benefits between earnings and direct adjustments to equity. Additionally, the accounting for the tax effects of share-based payment awards under IAS 12 differs in certain respects from the guidance in FAS 123(R). For example, under IAS 12, the deferred tax asset for a deductible temporary difference is based on the expected amount the taxation authorities will permit as a deduction in a future period, rather than the cumulative compensation cost recognized for financial reporting purposes.

Transition and Effective Date

28. The FASB staff believes that the application of a consensus on this Issue could result in a significant change for entities that applied an approach different from that consensus. Therefore, the FASB staff recommends that a consensus on this Issue be applied prospectively to the income tax benefits of dividends on equity-classified share-based payment awards that are declared after the effective date. To give entities sufficient time to make any system modifications necessary to begin tracking the information needed to apply a consensus on this Issue, such guidance should be effective in annual periods beginning after June 15, 2007. Early application of this Issue is permitted for new awards and awards modified 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.