



Deferred Taxes Related to FAS123 Expense – Accounting and Administrative Issues

HR Insights 02-18, “New Trends in Stock Compensation Accounting – Is It Time to Adopt FAS 123?” and 02-19, “Stock Compensation – Plan Design Implications for Companies Adopting FAS 123,” discussed the accounting and plan design implications for companies considering the adoption of FAS 123 to account for stock-based awards granted to their employees. With the increased interest by companies in adopting FAS 123, there has been a renewed awareness in the accounting for income taxes related to FAS 123 expense (for both the pro forma disclosure and the recognized FAS 123 expense). In general, the rules are complex and require that the tax benefits arising from stock options and other types of stock-based compensation be tracked on a grant-by-grant and country-by-country basis. This HR Insight discusses the applicable rules and answers questions raised in this regard, and highlights the need to consider changes to administrative systems and procedures to provide the necessary tracking.

Income tax accounting is covered by FAS 109, Accounting for Income Taxes. In addition, FAS 123, Accounting for Stock-Based Compensation, paragraphs 41-44 and 222-231, provides specific rules relating to the accounting for the tax consequences of equity instruments (such as stock options) awarded to employees. These rules clarify how FAS 109 should be applied to the accounting under FAS 123.

Overview of FAS 109

Most items that enter into pretax accounting (book) income also enter into a company's taxable income in the same year. Some events, however, are recognized for book and tax purposes in different years. Some of these differences are permanent, but most differences arise in one period, reverse in another period, and eventually wash out. The resulting differences between the tax basis of assets or liabilities and their basis for financial reporting purposes are called “temporary differences” in FAS 109 and their tax effects give rise to deferred tax assets and liabilities.

In cases where the tax deduction occurs before the book expense is recognized (or where book income is recognized before taxable income), a taxable temporary difference generally results

and a deferred tax liability is reflected on the company's balance sheet. When book expense is recognized before the tax deduction, a deductible temporary difference generally results and a deferred tax asset is recorded. Deferred tax assets are subject to a realization test, whereby a valuation allowance must be established when it is more likely than not—a probability level of more than 50%—that they will not be realized. Realizable means that the company expects a future income tax benefit when the temporary difference reverses, considering available evidence such as cumulative tax losses in prior years, losses expected in future years, and a history of potential tax benefits expiring unused. In making this assessment, more weight is assigned to objectively-verifiable evidence such

as historical cumulative losses than to subjective evidence like future projections.

Deferred tax assets and liabilities are calculated, in general, by multiplying the gross amount of temporary differences by the expected applicable tax rate, based on currently enacted tax law. It may be possible to consider an aggregate rate for US Federal and state income taxes; however, the amounts of deferred tax assets and liabilities would be disclosed separately by jurisdiction if material. A different rate might be appropriate if the deductions enter into the calculation for foreign source income. FAS 109 specifically prohibits present-valuing or discounting deferred tax asset or liabilities.

Specific Tax Accounting Rules in FAS 123

To understand the tax accounting, it is first necessary to understand the tax rules related to various forms of stock-based compensation, including stock options, restricted stock, stock appreciation rights, etc. In the United States, allowable tax deductions are generally measured at a specific date (for example, the exercise date for nonqualified stock options) based on the excess of the stock's market price over the exercise price or price paid by the employee (the "intrinsic value"). However, the tax law provides for certain forms of stock-based compensation (for example, incentive stock options) that do not give rise to a tax deduction. The amount of expense recognized under FAS 123 will not usually correspond to the amount of deductions allowed for tax purposes.

Under FAS 123, the tax attributes of the stock option usually dictate whether a temporary difference will arise upon recognition of compensation expense for financial reporting purposes. If the option does not ordinarily result in a tax deduction, such as an incentive stock option (ISO), no tax benefit is recognized concurrent with the recognition of compensation expense. If an event occurs subsequently that causes the option to result in a tax deduction, such as a disqualifying disposition of the ISO, the tax effect is reflected in income to the extent that the deduction does not exceed the total compensation expense recognized under FAS

123 for that grant, with any excess credited to additional paid-in capital. Such events would be recognized only upon occurrence of the event (disqualifying disposition), not in anticipation of it.

Conversely, recognition of compensation expense for financial reporting in connection with the grant of a nonqualified stock option will give rise to a temporary difference, inasmuch as the company will enjoy a tax deduction if and when the option is exercised. A deferred tax asset is recorded, subject to consideration of its realizability at each financial statement date. As discussed above, it may be appropriate to provide a valuation allowance against the deferred tax asset if the company does not expect future taxable income and thus would not receive any economic benefit from the deferred tax asset even if the options ultimately generate a tax deduction.

Observation: *FAS 123 does not permit a company with "underwater" options (or, for that matter, options for which the intrinsic value is less than the cumulative compensation expense recognized to date) to record a valuation allowance (or otherwise write-off a deferred tax asset) in anticipation that there will be no tax deduction arising from exercise of the options (or less of a tax deduction than would otherwise be inferred based on the related deferred tax asset). Valuation allowances are recorded only when the overall tax position is such that the company anticipates that future taxable income will be insufficient to realize some or all of its deferred tax assets. As a result, the deferred tax asset related to "underwater" options should be reversed only when the options either are canceled due to employee termination, are exercised, or expire unexercised.*

FAS 123 also provides guidance on the tax accounting at option exercise, when an actual tax deduction takes place for a nonqualified stock option. At exercise, if the deduction exceeds the total compensation expense recognized for financial reporting purposes for that grant, the tax benefit for the excess portion of the deduction (often referred to as the "windfall" tax benefit) is credited to additional paid-in capital (APIC). In other words, the actual tax benefit is compared with the deferred tax asset based on FAS 123 expense, and the

excess actual tax benefit is credited to stockholders' equity, not the income statement. If the deduction is less than the compensation expense recognized for financial reporting purposes, the write-off of the excess deferred tax asset, net of any related valuation allowance, is charged first against APIC to the extent there are cumulative credits in APIC resulting from prior recognition of tax benefits from tax deductions in excess of compensation expense recognized for financial reporting purposes under FAS 123; any remainder is charged against income.

Observation: *To properly perform the accounting at exercise, it will be necessary to have in place a system that tracks, on a grant-by-grant basis for all grants after FAS 123 adoption, as well as on a cumulative basis since adoption, the actual tax deduction compared with the FAS 123 expense. For a company that adopts FAS 123 prospectively, this will mean separate tracking of exercises related to grants included in prior years' pro forma disclosures versus exercises related to grants after adoption. This tracking system will need to be implemented on a grant-by-grant and country-by-country basis to allow for the accurate recording of the quarterly journal entries relating to stock options. The following tracking is necessary:*

- *Forfeiture before vesting – compensation expense must be reversed, along with any tax benefit previously recognized.*
- *Cancellation after vesting (for example, when a terminating employee does not exercise underwater options) – option expense is not reversed, but the deferred tax asset is reversed. The write-off would first be charged to APIC to the extent there are cumulative credits in APIC from prior recognition of tax benefits related to exercise of options accounted for under FAS 123; any remainder would be charged to expense (similar to an option exercise).*
- *At exercise – the actual tax deduction must be compared with the deferred tax asset, following the rules set forth above.*
- *At expiration (for example, for underwater options when no valuation allowance has been provided) – compensation expense is not reversed but the deferred tax asset is reversed following the same rules as for exercises set forth above.*

Where deferred tax assets were established on different groups of options granted to employees in different countries (at different tax rates), country-by-country tracking is needed. In some cases where employees are transferred between countries between grant and exercise dates, this tracking will be even more complex.

Implementation Issues

Companies will need to consider several issues relating to implementation of the deferred tax rules under FAS 123. Some pitfalls to avoid include the following:

Failure to separately account for the tax effect of ISOs, thereby incorrectly anticipating a deferred tax benefit rather than waiting for a disqualifying disposition to occur.

Imprecision in determining the appropriate tax rate to apply in computing the deferred tax benefit. For example, using an overall 35% effective tax rate for a company that granted options to employees in numerous foreign countries, instead of reflecting in the deferred tax computation the tax rates applicable to the countries where the deduction will ultimately be taken.

Observation: *Deferred tax computations are generally performed on a jurisdiction-by-jurisdiction basis (generally, country-by-country) taking into consideration the applicable tax laws and rates in each jurisdiction. Accordingly, for global companies with employees in numerous countries, deferred tax computations under FAS 123 should take into consideration each country's tax laws governing tax deductions and the appropriate tax rate. For example, in some countries no tax deduction may be available or the tax deduction may occur at grant date or vesting date, not at exercise. In addition, some companies may set up "chargeback agreements" between the parent company and the foreign subsidiary to attempt to generate a tax deduction in the foreign subsidiary; such agreements should be considered in setting up appropriate deferred taxes under FAS 123. Moreover, some companies may need to consider the special rules for foreign subsidiaries included in APB Opinion No. 23, Accounting for Income Taxes – Special Areas.*

Incorrectly marking-to-market the deferred tax asset based on the post-grant intrinsic value of the stock options.

Failure to track the tax deductions associated with option exercise in establishing how much of the actual tax benefit should be credited against the FAS 123 deferred tax asset and how much credited to stockholders' equity (APIC). In cases where non-U.S. employee grants are significant, such tracking may need to be on a country-by-country, as well as a grant-by-grant, basis. In addition, credits in APIC arising from grants accounted for under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, should be tracked separately from those under FAS 123.

Observation: *If, in connection with its current project to provide alternative transition methods for adopting FAS 123, the FASB adopts the modified prospective and limited restatement approaches, we expect additional implementation issues to arise relating to deferred taxes. In addition, at its September 11, 2002 meeting, the Board discussed the need to consider the tax implications associated with companies that adopt FAS 123. Board members indicated that, under the third transition alternative (retroactive restatement), certain companies may be allowed to offset excess deferred tax assets against amounts accumulated in paid-in capital that result from a retroactive restatement. Companies selecting other transition alternatives may not have the same capability. Accordingly, the Board decided to revisit whether the exposure draft of the proposed statement should include guidance regarding those tax implications. Further, the Board stated that it will consider the IASB's decisions regarding similar issues.*

Example

Illustration No. 1 in FAS 123 provides an example of the computation of deferred taxes and the journal entries necessary to record FAS 123 expense and tax effects. This illustration, however, does not show the effect of a situation where certain grants produce an actual tax deduction less than the deferred tax asset. The following example illustrates that situation.

Assumptions:

- Company adopts FAS 123 prospectively on 1/1/03.
- 10 million options granted 1/1/03, \$25 exercise price equal to stock price at grant date, 3-year cliff vesting, \$15 Black-Scholes value, 8 million options expected to vest, 8.1 million actually vest.
- No grants in remainder of 2003, 2004, or 2005.
- Stock price \$50 on 1/1/06; all 8.1 million vested options exercised.
- 10 million options granted at 1/1/06, \$50 exercise price, 3-year cliff vesting, \$25 Black-Scholes value, 8 million options expected to vest.
- 1/1/07—stock drops to \$10 and 1/1/06 grant stays underwater until expiration; however, company still profitable overall, so no valuation allowance needed.
- Tax rate = 40%.

Expense computation for 1/1/03 grant:

- 8 million options x \$15 = \$120 million expected expense = \$40 million per year over three years.
- Annual deferred tax benefit = \$16 million (\$40 million x 40%).
- True-up for actual vested options of 8.1 million results in revised expense of \$121.5 (8.1 x \$15) million.
- Deferred tax asset at 12/31/05 = \$121.5 x 40% = \$48.6 million.
- Actual tax deduction = \$50 stock price - \$25 exercise price x 8.1 million options = \$202.5 million.
- Actual tax benefit = \$202.5 x 40% = \$81 million.
- Credit to paid-in capital for excess = \$81 - \$48.6 = \$32.4 million.

Expense computations for 1/1/06 grant:

- 8 million options x \$25 = \$200 million expected expense and, at 40% rate, \$80

million expected tax benefit, spread over three years.

- When options expire, \$80 million deferred tax asset written off by first charging APIC to the extent of the cumulative credits to APIC from prior grants (\$32.4 million), with the balance of the charge-off recognized in the income statement.

How PricewaterhouseCoopers Can Help

Many financial statement preparers do not fully understand the deferred tax accounting applicable to stock option expense under FAS 123. As a result, we expect numerous implementation issues to arise as companies begin to more precisely apply the rules in FAS 123 and FAS 109. In particular, companies considering the adoption of FAS 123 may have not focused on the need to track deferred tax assets on a grant-by-grant and country-by-country basis compared with the actual tax deduction at exercise, as well as the amount of excess deductions recognized in additional paid-in-capital. In addition to other items that a

company needs to consider in deciding to adopt FAS 123, significant changes to existing recordkeeping systems may be needed to ensure the proper recording of tax benefits related to equity-based compensation.

PwC is uniquely qualified to address the broad spectrum of accounting, tax, administrative and recordkeeping issues related to stock-based compensation accounted for under FAS 123. In particular, the HRS Total Compensation practice has considerable expertise regarding stock plan administration and process issues, as well as global tax and compliance issues related to stock-based compensation.

If you have any questions on accounting, tax, or HR issues related to stock-based compensation or any of the complex issues discussed in this *HR Insight* – or if you would like help in assessing the impact of FAS 123 adoption on your company – please contact the PwC partner servicing your company or one of our regional Human Resource Solutions partners listed below.

For more information on the topic discussed in this issue or change of address, contact your local PricewaterhouseCoopers professional.

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