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New York • Chicago • Los Angeles

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FASB Proposes to Tighten the Rules on Stock-for-Tax Withholding

It is commonplace today for companies to have elective or mandatory procedures that provide for shares to be withheld to satisfy tax withholding obligations upon the exercise of stock options or the vesting or earnout of other stock-based awards. Under current accounting rules, these "stock-for-tax" withholding transactions do not result in the recognition of additional compensation cost for companies, so long as the amount withheld does not exceed the *minimum required* federal, state, and (presumably) FICA statutory withholding rates.[1] The federal rate is currently 28 percent. If amounts are withheld in excess of the minimum required rate, companies are supposed to recognize compensation cost for the *total* number of shares withheld, not just on the excess shares withheld.[2] Practice has evolved over the years, however, such that many companies now withhold amounts well in excess of the minimum required rate, with no apparent recognition of compensation cost.[3]

In response to such divergent practice, the Financial Accounting Standards Board (FASB) on February 24 decided to propose changes that would essentially "tighten the rope" on companies that have stock-for-tax withholding provisions in excess of the minimum required rate. For those companies, the proposed rules would require "variable plan" mark-to-market accounting treatment for the *entire* stock option award, not just for the number of shares withheld as under current rules. Specifically, the proposed rules would require variable plan accounting treatment for all stock options granted pursuant to a plan that *expressly permits* excess withholding, unless the optionee irrevocably elects at grant not to withhold in excess of the minimum required rate. If stock options are granted pursuant to a plan that *does not specify* whether excess shares can be withheld, such awards would continue to receive favorable "fixed plan" accounting treatment provided that no excess withholding transactions actually occur. Such awards *would* become subject to variable plan accounting treatment, however, if the company actually withholds excess amounts, expects to withhold excess amounts in the future, or establishes a pattern of withholding excess amounts.

The proposed changes are noteworthy not only because they represent a significant departure from current practice, but also because they are inconsistent with recent actions taken by the FASB's technical arm, the Emerging Issues Task Force (EITF). At a meeting earlier this year, the EITF tentatively concluded that variable plan accounting treatment should be limited to the number of shares withheld in *excess* of the minimum required rate, rather than to the entire stock option award as proposed by the FASB, or to the total number of shares withheld as is the current staff opinion. The FASB decided, however, that this issue more appropriately falls within the scope of its broader stock compensation project dealing with an interpretation of APB Opinion

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1 EITF Issue No. 87-6C

2 Based on discussions with FASB staff; see our letter dated April 26, 1988 and Arthur Andersen's *Accounting for Compensation Arrangements in the United States* (page 31)

3 A recent survey conducted by our firm indicated that approximately *half* of responding companies with stock-for-tax withholding procedures withhold amounts in excess of the minimum required rate

No. 25.[4] The FASB's rationale is that stock-for-tax withholding in excess of the minimum required rate is, in substance, an option to sell shares back to the company, i.e., a "put." Under the Opinion 25 interpretation project, such a put would result in variable plan accounting treatment for the underlying stock option because the put would be exercised (i.e., the shares would be withheld) simultaneously with the exercise of the underlying stock option. Given the FASB's preliminary decision, it is likely that the EITF will drop this issue from its technical agenda at a future meeting.

Now that the stock-for-tax withholding issue is part of the Opinion 25 interpretation project, it will be subject to the same vigorous approval process as the rest of the interpretation prior to becoming effective. This process includes the development and release of an Exposure Draft (expected to be released this month), a 3-month public comment period, and the issuance of a final interpretation (expected to be issued in September of this year). Unlike the other issues covered by the Opinion 25 interpretation project, however, we understand through discussions with the FASB's staff that the proposed changes affecting stock-for-tax withholding transactions will *not* be subject to the controversial December 15, 1998 "look back" date as proposed. Rather, the changes would only be effective prospectively upon the issuance of the final interpretation.

What should companies consider doing now to avoid incurring compensation cost in the future? If the proposed changes are approved, companies would essentially have to discontinue the practice of withholding in excess of the minimum required rate. For companies with plans that do *not* expressly permit excess withholding, no further action other than complying with the minimum required rate limitation should be necessary, i.e., there would be no need to amend plan documents, grant agreements, etc. For companies, with plans that *do* expressly permit excess withholding, further action would be required in the form of either a plan amendment removing the tainted provision or an irrevocable election at grant by the optionee not to withhold in excess of the minimum required rate. Finally, some companies have circumnavigated the excess withholding issue in the past by permitting optionees to use already-owned "mature" shares (i.e., shares owned for at least 6 months) to satisfy tax obligations in excess of the minimum required rate without incurring additional compensation cost. The proposed changes should not affect a company's ability to continue this practice in the future.

General questions about this letter can be addressed to Fred Cook in New York (212-986-6330) or Tom Haines in Chicago (312-332-0910). Specific questions should be addressed to the company's professional accountants. Copies of this letter and other published materials are available on our web site, www.fwcook.com.

4 See our letters dated August 26, 1996, January 10, 1997, June 9, 1998, August 5, 1998, August 28, 1998, and December 18, 1998