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SFAS 109 Implications of Selected Financial Accounting and Income Tax Developments

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SFAS 109 Implications
Of
Selected Financial Accounting
And Income Tax Developments

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Part One:
The Revenue Reconciliation Act of 1993

Carl W. Duyck
I. Amortization of Intangibles

A. The Revenue Reconciliation Act of 1993 enacted much needed simplification dealing with intangibles. Controversies involving the classification, value, life and deductibility of various intangibles have for many years clogged the courts and led to uncertainty in planning and reporting business purchases. In an effort to simplify the law and expedite the backlog of cases pending, the Act provides that most acquired intangible assets are to be amortized over a 15 year period. The treatment of self-created intangible assets, such as a technological process that is developed by the taxpayer or internally generated goodwill, generally is not affected by the Act.

B. In general

1. Intangible assets subject to the new rules, referred to as "Section 197 intangibles," include most intangibles acquired either in stand-alone transactions or as part of the acquisition of a trade or business.

2. This simplification comes at a price. Because the Act provides the same life for all Section 197 intangibles, taxpayers acquiring longer lived intangibles (such as certain franchises that previously were required to be amortized over 25 years) receive a benefit, while those acquiring shorter lived intangibles are disadvantaged. However, all taxpayers are relieved of the risk that amounts allocated to amortizable intangibles will be reallocated to previously nonamortizable goodwill.

   a. Many uncertainties are also eliminated.

   b. Taxpayers are relieved of the cost and effort of defending their positions on amortizing identified intangibles.

3. Section 197 intangibles include:

   a. Goodwill and going concern value;

   b. Workforce, information base, know-how, customer lists and supplier based intangibles;

   c. License, permit or other right granted by a governmental unit;

   d. Covenants not to compete and similar arrangements; and

   e. Franchise, trademark or trade name.

4. Certain intangible assets are specifically excluded from the definition of Section 197 intangibles as follows:

   a. Self-created intangibles;

   b. Financial contracts;
c. Certain computer software;

d. Interests in a corporation, partnership, trust or estate;

e. Professional sport franchise;

f. Interests in films, recordings, patents, and copyrights to the extent not acquired in a transaction involving the acquisition of assets constituting a trade or business;

g. Interests in land; and

h. Leases of tangible personal property.

5. The term Section 197 intangibles does not include intangible assets arising from professional fees and any transaction costs incurred in wholly or partially tax-free reorganizations. In this respect, the intent of the Act is not to override the Supreme Court's 1992 decision in INDOPCO, relating to the deductibility of reorganization expenses.

6. Special rules are provided in the case of acquisitions of mortgage servicing rights or certain software. Mortgage servicing rights that are acquired in a stand-alone transaction are amortized over nine years.

Nonexclusive rights in commercially available software that has not been substantially modified, as well as any other rights in software that are acquired in a stand-alone transaction, are not Section 197 intangibles and are amortized over 36 months unless they are:

a. Purchased as part of the cost of computer hardware; or

b. Currently deductible under Section 174 as research and experimental expenditures.

C. Special Rules and Considerations

A. The rules allow for 15 year amortization of qualifying assets, but also prevent the earlier recognition of the loss if sold or abandoned prior to the running of the 15 year period.

1. While the Act seeks to eliminate disputes over amortizable lives, the basis of each separate Section 197 asset still must be determined. This is because the Act provides for gain to be recognized on the sale of any Section 197 asset.

2. Specifically, the Act provides that no loss may be recognized on the disposition of a Section 197 intangible if the taxpayer retains other Section 197 intangibles acquired in the same transaction or series of transactions. Any loss disallowed by this rule is
added to the basis of the remaining Section 197 intangibles and recovered through prospective amortization.

3. Special attribution rules aggregate the acquisitions of related taxpayers for the purpose of applying this rule to prevent the current recognition of loss (again, it is recognized through amortization). This provision prevents the churning of amortizable assets among related taxpayers, and is known as the "anti-churning" rule.

B. The Act generally applies to property acquired after the date of enactment, August 10, 1993.

1. However, taxpayers may elect to retroactively adopt the intangibles provisions of the Act for intangibles acquired after July 25, 1991 and before August 10, 1993. Prior to deciding whether to make their election, taxpayers need to take into account a number of considerations, including but not limited to, the following:

   a. Related party provisions of the Act;

   b. Adverse impact on intangibles which had useful lives shorter than 15 years, e.g., covenants not to compete.

   c. The impact of the Act on franchises, trademarks and trade names; and

   d. Whether the retroactive provisions will override prior elections made by the taxpayers.

C. Other considerations and planning opportunities

1. Employment service contracts which are based on a "reasonable" compensation level for the continued services being performed are excluded from treatment as "Section 197" intangibles. Additional guidance is necessary, and caution should be exercised in assigning a value or payment level to employment contracts.

2. Finally, an elective binding contract exception is available for taxpayers who wish to retain current-law treatment for acquisitions that occur after the date of enactment (August 10, 1993).

3. Taxpayers with IRS exams or appeals pending may be interested in the IRS' position regarding the settlement of pending cases.

4. The conference report accompanying the Act strongly urges the IRS to expedite settlement of cases under prior law by taking into account the principles of Section 197. However, the IRS is expected to continue its focus on challenging taxpayer positions on proper life and allocation of purchase price for acquisitions not governed by the Act.
D. Recognition and Measurement of Purchase Business Combinations After The Revenue Reconciliation Act of 1993

A. Purchase Business Combinations

1. A deferred tax liability or asset should be recorded at the acquisition date for the income tax consequences of differences between the assigned values and tax bases of assets acquired and liabilities assumed in purchase business combinations regardless of whether the transaction is taxable.

2. Prior to the Act a deferred tax liability or asset was not recognized for a difference between the reported amount and the tax basis of goodwill or the portion thereof for which amortization is not deductible for tax purposes, unallocated "negative" goodwill, and leveraged leases. However, under new law, a deferred tax liability or asset should be recognized to account for timing differences resulting from differences in the book versus tax amortization periods. Generally, these provisions affect taxable acquisitions after the date of enactment, August 10, 1993, absent an election by the taxpayer to retroactively apply the new law to goodwill acquired after July 25, 1991.

B. Recognition and Measurement

1. Nontaxable Business Combinations

   a. The predecessor's tax bases are carried forward

   b. The amounts assigned to particular assets and liabilities may differ for financial reporting and tax purposes.

Illustration I-1: Recognition and measurement of a deferred tax liability and asset in a nontaxable business combination.

The assumptions are as follows:

- The enacted tax rate is 35 percent for all future years, and amortization of goodwill is not deductible for tax purposes, e.g. acquired prior to July 25, 1991.

- An enterprise is acquired for $20,000, and the enterprise has no leveraged leases.

- The tax basis of the net assets acquired is $5,000, and the assigned value (other than goodwill) is $13,000. Future recovery of the assets and settlement of the liabilities at their assigned values will result in $20,000 of taxable amounts and $13,000 of deductible amounts that can be offset against each other. Therefore, no valuation allowance is necessary.

- The proforma balance sheet immediately after the acquisition, exclusive of goodwill is as follows:
Assets Acquired:

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>Tax</th>
<th>Temporary Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$5,000</td>
<td>$5,000</td>
<td>$ –</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>60,000</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment, net</td>
<td>25,000</td>
<td>5,000</td>
<td>20,000</td>
</tr>
<tr>
<td></td>
<td>$90,000</td>
<td>$70,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Liabilities Acquired:

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>70,000</td>
<td>57,000</td>
<td>(13,000)</td>
</tr>
</tbody>
</table>

Net Assets Acquired

|                      | $20,000 | $13,000 | $7,000            |

The amounts recorded to account for the purchase transaction are as follows:

- Assigned value of the net assets (other than goodwill) acquired $13,000
- Deferred tax liability for $20,000 of taxable temporary differences (7,000)
- Deferred tax asset for $13,000 of deductible temporary differences 4,550
- Goodwill ($7,000 + (.35 x 7,000)) 9,450
- Purchase price of acquired enterprise $20,000

2. Taxable Business Combinations

   a. In a taxable business combination, unlike a nontaxable business combination, the purchase price is assigned to the assets and liabilities assumed both for tax purposes and financial reporting purposes.

   b. The amounts assigned to particular assets and liabilities may differ for financial reporting and tax purposes.

   c. The recognition and measurement of a deferred tax liability and asset in a taxable business combination is as follows:
Under the new law, substantially all intangible assets, including goodwill, acquired after August 10, 1993 will be amortized over 15 years. A taxpayer may elect to apply the new law retroactively to all taxable acquisitions made after July 25, 1991. If a taxpayer had allocated the same amount of goodwill for both book and tax purposes for an acquisition consummated after July 25, 1991 and elects to apply the law retroactively, the tax benefit of amortizing the goodwill for tax purposes would be recognized as of the date of enactment, August 10, 1993. Additionally, any effects which are not directly related to the change in law, would result from a post acquisition change in estimate of tax effects arising from a purchase. Accordingly, these effects should be applied (a) first to reduce to zero any goodwill related to that acquisition (b) second to reduce to zero other noncurrent intangible assets related to that acquisition, and (c) third to reduce income tax expense.

Illustration I-2: Accounting for the retroactive election of the Act on Intangibles.

The assumptions are as follows:

- The enacted tax rate is 35% for all future years.
- For maximum simplicity the enterprise is assumed to have a 52-53 week year end.
- The enterprise entered into a taxable asset acquisition on August 15, 1992. $2,000 of the purchase price was allocated to intangible assets, including $1,500 to goodwill.
- Goodwill is amortized over 40 years for book purposes.
- Other intangible assets are amortized over 10 years for book purposes.

The enterprise should record the following entry on August 10, 1993 to record the effect of the retroactive adoption of the new intangibles legislation:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes payable/receivable</td>
<td>$11</td>
</tr>
<tr>
<td>Current provision</td>
<td>5</td>
</tr>
<tr>
<td>Deferred taxes</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$16</td>
</tr>
</tbody>
</table>
The $11 amount was calculated by determining the amount of amortization through August 10, 1993, using a 34% tax rate and a 15-year tax life for all of the intangible assets, summarized as follows:

<table>
<thead>
<tr>
<th>Intangibles</th>
<th>Book</th>
<th>Old Tax Law</th>
<th>New Tax Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>$1,500</td>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>Amortization period</td>
<td>40</td>
<td>--</td>
<td>15</td>
</tr>
<tr>
<td>Amortization expense</td>
<td>$38</td>
<td>$-</td>
<td>$100</td>
</tr>
<tr>
<td>Other Intangibles</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>Amortization period</td>
<td>10</td>
<td>5</td>
<td>15</td>
</tr>
<tr>
<td>Amortization expense</td>
<td>$50</td>
<td>$100</td>
<td>$33</td>
</tr>
<tr>
<td>Expense- New law</td>
<td>$88</td>
<td>$N/A</td>
<td>$133</td>
</tr>
<tr>
<td>Expense- Old law</td>
<td>88</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Change</td>
<td>$-</td>
<td>$-</td>
<td>$33</td>
</tr>
</tbody>
</table>

Increased Amortization expense (tax benefit): $33 x .34 = $11

The $5 of current expense was calculated as follows:

Deferred taxes before law change, e.g., August 9, 1993:

- Taxable temporary difference ($100 - $88) $12
- Tax rate $12 x .34
- Deferred Tax Liability $4

Effect of the rate change on the deferred taxes:

- Taxable temporary difference ($133 - 88) $45
- Rate Change (.35 - .34) .01

$1
The $16 deferred tax liability was calculated as follows:

<table>
<thead>
<tr>
<th>Temporary Difference</th>
<th>Book</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cost</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>( 88)</td>
<td>( 133)</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$1,982</td>
<td>$1,867</td>
</tr>
</tbody>
</table>

The deferred tax liability is: $45

Future tax rate x .35

Deferred tax liability $16

C. Amortization of Goodwill

1. Amortization of goodwill is deductible for tax purposes in some tax jurisdictions.

2. The reported amount of goodwill and the tax basis of goodwill are each separated into two components as of the combination date for purposes of deferred tax calculations as follows:

   a. The first component of each equals the lesser of (a) goodwill for financial reporting or (b) tax-deductible goodwill.

   b. The second component of each equals the remainder of each.

3. A deferred tax liability or asset is recognized for any temporary difference that arises between the book and tax basis of the first component of goodwill in future years.

4. No deferred taxes are recognized for the second component of goodwill.

5. If the second component is an excess of tax-deductible goodwill over the reported amount of goodwill, the tax benefit for that excess is recognized when realized on the tax return, and that tax benefit is applied first to reduce to zero the goodwill related to that acquisition, second to reduce to zero other noncurrent intangible assets related to that acquisition, and third to reduce income tax expense.

Illustration 1-3: Accounting for the tax consequences of goodwill when amortization of goodwill is deductible for tax purposes.

The assumptions are as follows:

- At the combination date, the reported amount and tax basis of goodwill are $600 and $800, respectively.
• For tax purposes, amortization of goodwill will result in tax deductions of $400 in each of years 1 and 2. Those deductions result in a current tax benefit in years 1 and 2.

• For financial reporting, amortization of goodwill is straight-line over years 1-4.

• For purposes of simplification, the consequences of other temporary differences are ignored for years 1-4.

• Income before amortization of goodwill and income taxes in each of years 1-4 is $1,000.

• The tax rate is 35 percent for all years.

Income taxes payable for years 1-4 are:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income before amortization of goodwill</th>
<th>Amortization of goodwill</th>
<th>Taxable income</th>
<th>Income taxes payable (35 percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000</td>
<td>$(400)</td>
<td>600</td>
<td>210</td>
</tr>
<tr>
<td>2</td>
<td>$1,000</td>
<td>$(400)</td>
<td>600</td>
<td>210</td>
</tr>
<tr>
<td>3</td>
<td>$1,000</td>
<td>0</td>
<td>1,000</td>
<td>350</td>
</tr>
<tr>
<td>4</td>
<td>$1,000</td>
<td>0</td>
<td>1,000</td>
<td>350</td>
</tr>
</tbody>
</table>

At the combination date, goodwill is separated into two components as follows:

<table>
<thead>
<tr>
<th>Reported Amount</th>
<th>Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>First component</td>
<td>$600</td>
</tr>
<tr>
<td>Second component</td>
<td>0</td>
</tr>
</tbody>
</table>

A deferred tax liability is recognized at the end of years 1-3 for the excess of the reported amount over the tax basis of the first component of goodwill. A deferred tax asset is not recognized for the second component of goodwill; the tax benefit is allocated to reduce goodwill when realized on the tax returns for years 1 and 2. It is important to note that this scenario can and does occur as a result of differing treatments of acquisition costs for financial accounting and tax accounting purposes.

The second component of goodwill is deductible $100 per year in years 1 and 2. Those tax deductions provide $35 ($100 at 35 percent) of tax benefits that are realized in years 1 and 2. Allocation of those realized tax benefits to reduce the first component of goodwill produces a deferred tax benefit by reducing the taxable temporary difference related to that component of goodwill. Thus, the total tax benefit allocated to reduce the first component of goodwill in each of years 1 and 2 is the sum of (a) the $35 realized tax benefit allocated to reduce goodwill and (b) the deferred tax benefit from reducing the deferred tax liability related to goodwill. That total tax benefit (TTB) is determined as follows:
TTB = realized tax benefit plus (tax rate times TTB)
TTB = $35 + (.35 \times TTB)
TTB = $54

Goodwill for financial reporting for years 1-4 is:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at beginning of year</td>
<td>$600</td>
<td>$396</td>
<td>$210</td>
<td>$105</td>
</tr>
<tr>
<td>Amortization:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$600/4 years</td>
<td></td>
<td>(150)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$396/3 years</td>
<td></td>
<td>(132)</td>
<td>(105)</td>
<td>(105)</td>
</tr>
<tr>
<td>$210/2 years</td>
<td></td>
<td></td>
<td>(105)</td>
<td>(105)</td>
</tr>
<tr>
<td>Total tax benefit allocated to reduce goodwill</td>
<td>(54)</td>
<td>(54)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Balance at end of year</td>
<td>$396</td>
<td>$210</td>
<td>$105</td>
<td>$0</td>
</tr>
</tbody>
</table>

The deferred tax liability for the first component of goodwill and the related amount of deferred tax expense (benefit) for years 1-4 are:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reported amount of goodwill at end of year</td>
<td>$396</td>
<td>$210</td>
<td>$105</td>
<td>$0</td>
</tr>
<tr>
<td>Tax basis of goodwill (first component)</td>
<td>(300)</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Taxable temporary difference</td>
<td>96</td>
<td>210</td>
<td>105</td>
<td>0</td>
</tr>
<tr>
<td>Deferred tax liability: at end of year (35 percent)</td>
<td>34</td>
<td>74</td>
<td>30</td>
<td>0</td>
</tr>
<tr>
<td>at beginning of year</td>
<td>0</td>
<td>(34)</td>
<td>(74)</td>
<td>(30)</td>
</tr>
<tr>
<td>Deferred tax expense (benefit) for the year</td>
<td>34</td>
<td>40</td>
<td>(44)</td>
<td>(30)</td>
</tr>
</tbody>
</table>
Income for financial reporting for years 1-4 is:

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before amortization of goodwill and income taxes</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Amortization of goodwill</td>
<td>(150)</td>
<td>(132)</td>
<td>(105)</td>
<td>(105)</td>
</tr>
<tr>
<td>Pretax income</td>
<td>850</td>
<td>868</td>
<td>895</td>
<td>895</td>
</tr>
<tr>
<td>Income tax expense (benefit): Current</td>
<td>210</td>
<td>210</td>
<td>350</td>
<td>350</td>
</tr>
<tr>
<td>Deferred</td>
<td>34</td>
<td>30</td>
<td>(44)</td>
<td>(30)</td>
</tr>
<tr>
<td>Benefit applied to reduce goodwill</td>
<td>54</td>
<td>54</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>298</td>
<td>294</td>
<td>306</td>
<td>320</td>
</tr>
<tr>
<td>Net income</td>
<td>$552</td>
<td>$574</td>
<td>$589</td>
<td>$575</td>
</tr>
</tbody>
</table>

E. Recognition and measurement of Pooling-of-Interests Business Combination

A. Restatement of Separate Financial Statements

1. The separate financial statements of combining enterprises for prior periods are restated on a combined basis when a business combination is accounted for by the pooling-of-interests method.

2. For restatement of periods prior to the combination date, a combining enterprise’s NOL carryforward does not offset the other enterprise’s taxable income because consolidated tax returns cannot be filed for those periods.

3. However, provisions in the tax law may permit an NOL carryforward of either of the combining enterprises to offset combined taxable income subsequent to the combination date.

B. Filing of Consolidated Tax Returns

1. If the combined enterprise expects to file consolidated tax returns, a deferred tax asset is recognized for either combining enterprise’s NOL carryforward in a prior period.
2. Valuation allowance

a. A valuation allowance is required under FAS 109, to the extent it is more likely than not that a tax benefit will not be realized for that loss carryforward through offset of either (a) the other enterprise's deferred tax liability for taxable temporary differences that will reverse subsequent to the combination date or (b) combined taxable income subsequent to the combination date.

b. The valuation allowance may be less than the sum of the valuation allowances in the separate financial statements of the combining enterprises prior to the combination date. That tax benefit is recognized as part of the adjustment to restate financial statements on a combined basis for prior periods.

3. The same requirements apply to deductible temporary differences and tax credit carryforwards.

C. Taxable Poolings

1. A taxable business combination may sometimes be accounted for by the pooling-of-interests method.

2. The increase in the tax basis of the net assets acquired results in temporary differences. The deferred tax consequences of those temporary differences are recognized and measured the same as for other temporary differences.

3. As of the combination date, recognizable tax benefits attributable to the increase in tax basis are allocated to contributed capital.

4. Tax benefits attributable to the increase in tax basis that become recognizable after the combination date (that is, by elimination of a valuation allowance) are reported as a reduction of income tax expense.

II. Accounting For Other Aspects of The Revenue Reconciliation Act of 1993

A. Rate Change

1. The law enacts new corporate tax rates with retroactive effect to January 1, 1993. However, the key date under FAS 109 is still the date of enactment, August 10, 1993, and adjustments resulting from the tax law change are to be reflected as an expense or credit in the reporting period which includes August 10. The effect of the 1993 law will not be included in the cumulative effect of adoption of FAS 109 except by those fiscal year companies which initially apply FAS 109 as of a date subsequent to August 10, 1993.
2. Companies which have adopted FAS 109 would as of August 10 adjust their deferred tax balances to reflect the newly enacted tax rates. Of course, taxes accrued for the current year would also be adjusted as of August 10. All effects of these adjustments would be reflected in continuing operations pursuant to paragraph 35 of FAS 109.

3. Under paragraph 18 of FAS 109, the applicable rate for providing deferred taxes is the single flat tax rate or, when graduated rates are a significant factor, the average rate expected in reversal periods. The new law applies a 35 percent rate to annual taxable income in excess of $10,000,000 and recaptures the 1 percent applicable to that first $10,000,000 by applying an incremental rate of 38 percent to taxable income between $15,000,000 and $18,333,333. Thus, under the new law, a single flat tax rate of 35 percent is applicable to taxable income in excess of $18,333,333. While the new law creates more rate brackets, the average rate will range only between 34 percent and 35 percent when annual taxable income falls in the $10-18.3 million range. This reduces the possibility that graduated rates will now be a significant factor when they were not previously.

4. Fiscal year companies will have "blended" rates for the tax return which includes January 1, 1993. Assume that book and tax year-end dates are the same and that the procedure suggested above for calculating the adjustment is followed. For companies with fiscal years ending August through November, the rate applied to beginning-of-year deferred tax balances would be the rate now enacted for future years rather than the blended rate, and in calculating the new effective rate for the year, the future rate rather than the blended rate would be used for the deferred component. Companies with years ended January through July would recognize as of August 10, in addition to the results of the suggested calculation, any change in the tax payable for the preceding year.

Illustration II-1: Accounting for the effect of the rate change

The assumptions are as follows:

- The enterprise has a calendar year-end
- The enterprise elected to adopt FAS 109 in calendar year 1992
- The beginning net deferred tax liability is $1,000 and the enterprise does not have any deferred tax assets.
- There are no income taxes payable for the current year.
- The deferred tax liability is expected to reverse at 35%.

The enterprise should record the following entry on August 10, 1993:

\[
\begin{align*}
\text{Current provision} & \quad $10 \\
\text{Deferred taxes} & \quad $10
\end{align*}
\]

The $10 represents the effect of the rate change on the beginning deferred tax balance, e.g. ((.35-.34) x $1,000).
B. Targeted jobs tax credit

1. First, the Act extends the targeted jobs tax credit for 30 months and applies the provision to individuals from certain targeted groups beginning work after June 30, 1992 and on or before December 31, 1994. Under prior law, the targeted jobs tax credit could only be claimed by employers hiring such individuals prior to July 1, 1992.

2. As under prior law, the targeted jobs credit is generally equal to 40 percent of $6,000 of qualified first year wages (i.e., the maximum credit per individual is $2,400) paid to each targeted group member.

C. Research tax credit

1. Secondly, the Act retroactively reinstates the research tax credit for three years, from July 1, 1992 through June 30, 1995. Under prior law, the credit expired for qualified research expenditures incurred after June 30, 1992. The reinstated research tax credit continues to equal 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceed its base amount for that year.

2. While the research tax credit was originally enacted more than 10 years ago, some U.S. companies may have failed to take full advantage of it. In part, some businesses may not be aware of the number and variety of activities that qualify for the credit. The following are situations where some companies may have overlooked credit opportunities in prior years:

   a. The company is involved in a plant modernization program;

   b. The company is developing new or improved manufacturing techniques or processes;

   c. The company is a government contractor; or

   d. The company has developed innovative software for internal use.

3. For "start-up companies," the Act also provides new rules for computing the credit in taxable years after the taxpayer's first 5 taxable years beginning after December 31, 1993 for which the taxpayer has qualified research expenditures. As under prior law, start-up companies are taxpayers that do not have both gross receipts and qualified research expenditures in at least 3 taxable years between 1984 and 1988.
Illustration II-2: Accounting for the retroactive reinstatement of the targeted jobs credit and research and development credits.

The assumptions are as follows:

- The enterprise has $100 of R&D credit from the prior year.
- The enterprise was able to fully utilize the R&D credit in the prior year.

The enterprise should record the following entry on August 10, 1993 to record the effect of the retroactive reinstatement of the R&D credit.

\[
\begin{align*}
\text{Taxes receivable (payable)} & \quad $100 \\
\text{Current provision} & \quad $100
\end{align*}
\]

Note: Refer to Illustration II-3 for the required disclosures.

D. Financial Statement Disclosures

1. Several provisions of the 1993 Act will require accounting recognition as of August 10, 1993, and as such should be disclosed in the financial statements. Paragraph 45 of FAS 109 requires disclosure in the annual financial statements of the significant components of income tax expense attributable to continuing operations, e.g., adjustments to deferred tax assets or liabilities resulting from enacted tax laws or rates.

2. The retroactive effective date of the Act raised an issue with respect to the amount disclosed by a calendar year company, i.e., should the amount disclosed be the total adjustment at the enactment date versus the effect of the rate change on the beginning-of-year deferred tax balances. It appears that either will be acceptable. However, disclosing the effect of the rate change on beginning-of-year deferred tax balances may simplify reporting. Primarily because Paragraph 47 of FAS 109 requires a reconciliation between tax expense charged to continuing operations and the amount computed by applying the statutory rate. If there were no items giving rise to tax entries other than continuing operations prior to August 10, 1993, the adjustment of the beginning of year deferred tax balances will be the reconciling item. One method of satisfying the disclosure requirements of Paragraph 45 is through the rate reconciliation.

3. Furthermore, the effect of the rate change on deferred taxes previously provided against continuing operations during the current year does not seem to be, by itself, particularly meaningful. Current as well as deferred tax balances must be adjusted as of August 10, but there is no specific reference in paragraph 45 to disclosure of the effect of a tax rate change on taxes currently payable. However, when tax entries, either current or deferred have been made previously in 1993 to other than continuing operations, e.g. to discontinued operations or directly to equity, their adjustment as of August 10, which is reflected in continuing operations, is also an item to be disclosed in the rate reconciliation.
Accordingly the following disclosures should generally be adequate:


b. The effect of the rate change on taxes, both current and deferred, provided previously during 1993 other than by charge to continuing operations.


The assumptions are as follows:

- The enterprise has a calendar year end.
- The enterprise has pre-tax book income of $100,000.
- The enterprise has a net deferred tax liability of $20,000 at 12/31/92.
- The enterprise has $5,000 of research and development credits attributable to the prior year.
- Statutory U.S. tax expense was $40,000.
- The enterprise's total provision, ignoring state taxes, was $35,800.
- The enterprise had no permanent differences.

The company should provide the following rate reconciliation for the current years operations:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory U.S. tax rates</td>
<td>$40,000</td>
</tr>
<tr>
<td>Increase (decrease) in rates resulting from:</td>
<td></td>
</tr>
<tr>
<td>Tax credits&lt;sup&gt;(1)&lt;/sup&gt;</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Enacted future rate changes&lt;sup&gt;(2)&lt;/sup&gt;</td>
<td>200</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>$35,800</td>
</tr>
</tbody>
</table>

<sup>(1)</sup> During 1993, Congress enacted the Revenue Reconciliation Act of 1993, which provided for the retroactive reinstatement of the Research and Development Credit to June 30, 1992. The effect of this change was to reduce current year taxes payable and the current provision by $5,000.

<sup>(2)</sup> As discussed in Note 1, comprehensive tax legislation was enacted in 1993, which increased the statutory federal tax rate from 34% to 35%. Accordingly, the deferred tax balances have been adjusted to reflect the increased statutory rate.
III. Intraperiod Tax Allocation

FASB Statement No. 109 requires allocation of tax expense or benefit for a year among continuing operations, discontinued operations, extraordinary items, and shareholders’ equity.

A. Continuing Operations

The tax effects of the following should be allocated to continuing operations:

1. Pretax income or loss from continuing operations for the year.

2. Changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years.

3. Changes in tax laws or rates.


5. Tax-deductible dividends paid to shareholders, except for dividends paid on unallocated shares held by an ESOP or other stock compensation arrangements.

B. Shareholders’ Equity

The tax effects of the following items occurring during the year are charged or credited directly to related components of shareholders’ equity:

1. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error.

2. Gains and losses included in comprehensive income but excluded from net income (e.g., translation adjustments under Statement 52 and changes in the carrying amount of marketable securities under FASB Statement No. 12, Accounting for Certain Marketable Securities).

3. An increase or decrease in contributed capital (for example, deductible expenditures reported as reduction of the proceeds from issuing capital stock).

4. An increase in the tax basis of assets acquired in a taxable business combination accounted for as a pooling of interests and for which a tax benefit is recognized at the date of the business combination.

5. Expenses for employee stock options recognized differently for financial reporting and tax purposes (refer to paragraph 17 of APB Opinion No. 25, Accounting for Stock Issued to Employees).
6. Dividends that are paid on unallocated shares held by an ESOP and that are charged to retained earnings.

7. Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization.

C. Method of Allocation

1. If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item.

2. If there are two or more items other than continuing operations, the amount that remains after the allocation to continuing operations should be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year.

3. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations.

4. The procedures to allocate the remaining amount to items other than continuing operations are as follows:

   a. Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items;

   b. Apportion the tax benefit determined in a. above ratably to each net loss item;

   c. Determine the amount that remains, that is, the difference between (a) the amount to be allocated to all items other than continuing operations and (b) the amount allocated to all net loss items;

   d. Apportion the tax expense determined in c. above ratably to each net gain item.
Illustration III-1: Allocation of income tax expense if there is only one item other than income from continuing operations.

The assumptions are as follows:

- The enterprise's pretax financial income and taxable income are the same.
- The enterprise's ordinary loss from continuing operations is $500.
- The enterprise also has an extraordinary gain of $900 that is a capital gain for tax purposes.
- The tax rate is 35 percent on ordinary income and 30 percent on capital gains. Income taxes currently payable are $120 ($400 at 30 percent).

Income tax expense is allocated between the pretax loss from operations and the extraordinary gain as follows:

<table>
<thead>
<tr>
<th>Total income tax expense</th>
<th>$120</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax benefit allocated to the loss from operations</td>
<td>150</td>
</tr>
<tr>
<td>Incremental tax expense allocated to the extraordinary gain</td>
<td>$270</td>
</tr>
</tbody>
</table>

The effect of the $500 loss from continuing operations was to offset an equal amount of capital gains that otherwise would be taxed at a 30 percent tax rate. Thus, $150 ($500 at 30 percent) of tax benefit is allocated to continuing operations. The $270 incremental effect of the extraordinary gain is the difference between $120 of total tax expense and the $150 tax benefit from continuing operations.

Illustration III-2: Allocation of the tax benefit of a tax credit carryforward that is recognized as a deferred tax asset in the current year.

The assumptions are as follows:

- The enterprise's pretax financial income and taxable income are the same.
- Pretax financial income for the year comprises $300 from continuing operations and $400 from an extraordinary gain.
- The tax rate is 35 percent. Taxes payable for the year are zero because $330 of tax credits that arose in the current year more than offset the $245 of tax otherwise payable on $700 of taxable income.
- An $85 deferred tax asset is recognized for the $85 ($330-$245) tax credit carryforward. Based on the weight of available evidence, management concludes that no valuation allowance is necessary.
Income tax expense or benefit is allocated between pretax income from continuing operations and the extraordinary gain as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total income tax benefit</td>
<td>$85</td>
</tr>
<tr>
<td>Tax (expense) benefit allocated to income from continuing operations:</td>
<td></td>
</tr>
<tr>
<td>Tax (before tax credits) on $300 of taxable income at 35 percent</td>
<td>$(105)</td>
</tr>
<tr>
<td>Tax Credits</td>
<td>330</td>
</tr>
<tr>
<td></td>
<td>225</td>
</tr>
<tr>
<td>Tax expense allocated to the extraordinary gain</td>
<td>$140</td>
</tr>
</tbody>
</table>
Part Two:  
FASB Exposure Draft 
"Accounting for Stock-based Compensation"  
David W. LaRue  

I. Background and Perspective  

A. Nature of the controversy  

1. Stock options are probably the most controversial issue facing FASB right now.  

   a. Shareholder groups, politicians, the SEC and other groups want to have a say as to both how much executives are paid and how their compensation is accounted for and reported to the public.  

   1) "When Michael Eisner, CEO of Walt Disney Co., cashed in $197 million in stock options late last year, he accidentally publicized the burgeoning movement that seeks to limit pay for executives like him." [Horowitz, Investor's Business Daily, August 30, 1993: p. 1]  

   2) As to executive compensation generally: Under the Revenue Reconciliation Act of 1993, non-performance-based compensation--including base salaries--that exceeds $1 million is no longer a federal income tax deductible operating expense.  

      a) New Section 162(m) bars a publicly held corporation's deduction for compensation paid to a "covered employee" in excess of $1 million per year if the compensation is "applicable employee remuneration."  

      b) A "publicly held corporation" is any corporation that has a class of common equity securities that are required to be registered under Section 12 of the Securities Exchange Act of 1934. Sec. 162(m)(2).  

      c) A "covered employee" is any employee who:  

          i) As of the close of the taxable year is the chief executive officer of the corporation (or an individual acting as the corporation's CEO), or  

          ii) Is one of the corporation's four highest compensated officers (other than the CEO) for the tax year whose total compensation for the employee's tax year is required to be reported to shareholders under the 1934 Exchange Act.  

             (1) Sec. 162(m)(3).
d) "Applicable employee remuneration," applies to a covered employee's aggregate remuneration for services performed (either during the deduction year or during another tax year) which would be deductible in its entirety for the tax year if the $1 million limitation did not apply.

i) However, this term does not include--

(1) Commission payments [Sec. 163(m)(4)(B)], or

(2) Other performance-based compensation [Sec. 163(m)(4)(C)], or

(3) Remuneration paid under a written binding contract that was in effect on February 17, 1993 [Sec. 163(m)(4)(D)], or

(4) Qualified plan contributions for employees and certain excludable employee fringe benefits [Sec. 162(m)(4)(E)].

3) As to stock option based compensation: "Interest runs high because much is at stake - over 90% of U.S. publicly held corporations offer top executives some form of stock options." [Rouse and Barton, Journal of Accountancy, June 1993: p. 67.]

a) For many major firms, stock income constitutes the bulk of executive pay.

b) According to Business Week's 1993 annual survey of executive compensation, average CEO pay in 1992 increased by some 56% from 1991. Much of this was due to exercise of stock options.

i) Stock options and other long-term compensation for 19 of the 20 highest-paid CEOs in the survey averaged nearly 14 times higher than their combined salary and bonus income. [Not included in this list of 20 was Disney's Eisner!]

(1) At the top of the list was Thomas F. Frist, chairman and CEO of Hospital Corp. of America. Of his $127 million income in 1992, $126 million took the form of stock options.

c) To Graef S. Crystal, author of In Search of Excess: The Overcompensation of American Executives [1991], such earnings are unconscionable: his research found that only 4% of salary differences among executives can be explained by company performance.

d) Compare this conclusion with that of Michael Kesner of Arthur Andersen & Co. who, using a database that included 129 companies in seven industry groups, concluded that 80% of U.S. executives are paid in line with their performance.

b. Prevalence of stock-option-based compensation for nonexecutives:
1) In 1990, the Industrial Biotechnology Association found that about 75% of its affiliated firms used stock options, and that 60% of these firms extended them to their entire workforce.

2) A 1991 survey by ShareData Inc. found that 68% of all firms with under 100 employees and 54% of all firms with 100 to 499 employees offered stock options to every single employee. Other survey results:
   
a) Firms with 1,000 to 1,999 employees: 19% offered stock options to all of its employees.

b) Firms with 2,000 to 5,000 employees: 10% offered stock options to all of its employees.

c) Firms with over 5,000 employees: Only 5% offered stock options to all of its employees.

3) Venture capital-funded firms also make extensive use of options.
   
a) A 1992 study of almost 600 such firms by VentureOne found that almost 60% of them provided stock options to more than 75% of their employees.

2. In June of 1993, in spite of a ground swell of opposition (prior to the issuance of the Exposure Draft, the FASB received over 400 letters of opposition from the Business Roundtable, the Council of Institutional Investors, large and small public accounting firms, representatives of high-tech and start-up companies and many others), the FASB issued an Exposure Draft titled "Accounting for Stock-Based Compensation."

   a. Under the Exposure Draft:

   1) Options and other equity instruments issued pursuant to stock-based compensation plans would be recorded at their full fair value.

      a) Under Accounting Principles Board (hereinafter "APB") Opinion No. 25, *Accounting for Stock Issued to Employees* (issued in 1972),

      i) Such options, etc. are recorded at their "intrinsic value" (the difference between the exercise price and the fair market value of the underlying stock at the grant date), which is usually zero.

      b) Thus, under the Exposure Draft, even options that are granted with exercise prices equal to or less than the fair market value of the underlying stock at the date of grant will result in the recognition of compensation expense.

      i) Fair value will be estimated using a pricing model which takes into account the exercise price and expected term of the option, the current price of the
underlying stock, its expected volatility, the expected dividend yield on the stock, and the risk-free interest rate during the expected term of the option.

2) Another aspect of the Exposure Draft is that broad-based stock purchase plans will no longer be deemed "noncompensatory."

a) Under APB #25, many broad-based plans are considered "noncompensatory," even if the stock is purchased at discounts of up to 15%.

b) Under the Exposure Draft, such broad-based stock purchase plans will be considered "compensatory" and will thereby be subject to the same full fair value measurement standards as other plans.

i) Since stock is offered to such a large number of employees under many of these plans [supra.], the resulting compensation expense could be very significant.

3) Effective date:

a) Companies will be required to disclose the pro forma effects of applying the Exposure Draft to all grants of options in 1994, 1995, and 1996.

b) But they will not be required to actually reflect the effects of the Exposure Draft in their balance sheets and income statements until 1997.

3. Congress enters the fray: Proposed legislation

a. The issue of executive compensation, in general, and the accounting principles governing the treatment of compensation-based stock options, in particular, have become the focus of spirited debates between members of the U.S. Congress.

b. In an extremely unusual development, senators and representatives on both sides of the issue have proposed legislation that would mandate the intervention of the Securities and Exchange Commission to, on the one hand, force the adoption of the principles set forth in the Exposure Draft (in the event the FASB fails to finalize it), or, on the other hand, to compel the SEC to ignore the resulting FASB Statement if it does become final.

c. Pro-"Exposure Draft" Legislation


2) The Levin-Bryant Bill is part of a larger campaign to get Congress to legislate limits on executive pay.
3) This bill requires the SEC "to issue regulations requiring publicly traded companies to recognize as an expense in their financial statements the fair value of stock options granted to their employees . . . ." and to instruct companies how to calculate the "fair value" of their options.

   a) "It is time to bring stock options under the rules of ordinary compensation," wrote the two lawmakers in an Aug. 6 letter to colleagues.

4) At that time, Senator Levin believed the FASB was working to issue a statement by April 1, 1993, and he delayed taking action on his legislation, in the hope that "the accountants themselves will fix the stock option problem. But if FASB again fails to act, and the SEC again fails to step in, I will be back...."

   a) Subsequent to that time, the FASB came out with the deferred effective date of 1997. It is not clear what effect this will have on his proposed legislation.

d. Anti-"Exposure Draft" Legislation.

1) In June of 1993, "The Equity Expansion Act of 1993" sponsored by Sen. Joseph Lieberman (D-Conn.) and Diane Feinstein (D-Calif.), Barbara Boxer (D-Calif.), and Connie Mack (R-Fla.) was introduced.

   a) A companion measure was introduced in the House on July 27 by Reps. Nancy Johnson (R-Conn), and Lewis Payne (D-Va).

   b) Additionally, Sen. Bill Bradley (D-NJ)--noting that the proposed accounting standard would have "grave economic consequences," especially for companies in "new-growth sectors"--introduced a concurrent resolution on Aug. 6 urging the FASB to abandon its controversial proposal.

2) Most of this proposed legislation relates to the creation of a new employee stock option that would allow tax-free exercise of options and would cut in half the capital gains tax on sale of the stock if held for two years or more.

   a) In return, a company offering such options would forgo their own options-related federal income tax deduction.

3) This same bill would direct the SEC to ignore any FASB rule requiring the deduction of stock option values from earnings and would further direct the SEC to eliminate the current variable plan accounting treatment for performance plans [infra.].

4. Organization of this topic.

   a. Overview Of Current GAAP Pertaining To Compensation Based Stock Options.


II. Overview Of Current GAAP Pertaining To Compensation Based Stock Options.

A. APB Opinion No. 25, Accounting for Stock Issued to Employees, was issued in 1972.

1. Since that time there have been several FASB Interpretations/Technical Bulletins and Emerging Issues Task Force consenses, which have addressed the accounting treatment of innovative and complex compensation plans which were not anticipated by APB No. 25.

   a. [See Paragraphs 266 and 267 of the Exposure Draft for a complete listing.]

2. Note that if the employee stock purchase plan is "noncompensatory," no compensation expense is recorded and only amounts actually paid by an employee upon the exercise of an option to purchase employer stock is recorded in stockholder's equity.

B. Under APB 25, however, most plans are, by definition, "compensatory" in that they do not meet the specific criteria required to be considered "noncompensatory." These criteria are:

   1. The plan must be offered to "substantially all full-time employees meeting limited employment qualifications" [this is the requirement that most plans fail to meet], and

   2. The stock offer must apply equally to all eligible employees or in a ratio of their salaries or wages; and

   3. The option period must be short or reasonable in length, and

   4. The purchase price must not be lower than would be reasonable if the stock were offered to others, and

   5. The grant of the option does not impose any additional obligations on the employees.

C. Most plans are deemed compensatory, but since, under APB 25, the "intrinsic" value of the option [generally on the date of grant] is the measure of the compensation expense, then any plan for which the exercise price equals or exceeds the fair market value of the underlying stock as of the date of grant will result in zero compensation expense.

   1. An exception to this date of grant valuation rule applies where a plan or option contains variable terms contingent on events that may or may not occur after the date of grant [such plans are referred to as "variable plans"].

      a. In such cases, the date for measuring the compensation expense is the first date that both
1) The number of shares, and

2) The option price are known.

b. Since the compensation expense that must [eventually] be recognized under a variable plan is a function of post-grant changes in stock prices, these plans can produce insignificant volatility in earnings.

1) One of the more common variable plans is a performance plan whereby the ultimate number of options or shares to be issued is based on some future performance measure of either the individual, or the company as a whole.

2) It has been argued that the resulting "fixed" vs. "variable" plan accounting gives rise to counter-intuitive results:

a) Variable plans theoretically cost the company less than a traditional fixed plan (and are less valuable to the employee) since the company or the individual is required to meet certain goals for the employee to earn the options, . . .

b) . . . Yet such plans can result in significantly higher compensation expense, because the measurement is done at a later date when the stock price could be much higher.

D. The amount, if any, recognized as a compensation expense under APB No. 25, is then amortized over the "service period" [i.e., the period benefitted by the employee's work associated with the grant of the option].

1. This period is generally difficult to determine and, as a rough surrogate, the resulting compensation expenditure is frequently expensed over the period beginning with the date of grant and ending with the first date upon which the option becomes exercisable.

E. Book entries:

1. At the measurement date [supra.] the total amount of compensation expense to be recognized is debited to a contra-stockholder equity account, called "Deferred Compensation Expense," or some similar account with a corresponding credit to the stockholder equity account,"Paid-in Capital-Stock Options" or a similar account.

2. As this prepaid compensation is amortized, "Compensation Expense" will be debited and "Deferred Compensation Expense" will be credited.

3. When the options are exercised, "Cash" and "Paid-in Capital-Stock Options" will be debited and "Common Stock" and "Paid-in Capital in Excess of Par" will be credited.

Illustration II-1:

On 1/1/93, Executive A is granted a compensatory option to purchase 1000 shares of $10 par value of her employer's common stock for $50 a share. As of the date of the grant of this option, the market price of the stock is $70. Under the terms of the option, Executive A is required to work for four years before the option can be exercised.

* Since the two requirements of measurement date are met, the number of shares to which the option pertains and the exercise price are both known as of the date of grant, that date is the measurement date.

* The compensation expense is computed as: [market price of the stock as of the measurement date less the exercise price of the option] times the number of shares that the option will entitle Executive A to buy, or $20,000 [(70-50) * 1000].

* The compensation expense of $20,000 will be recognized over the four years beginning on the date of grant and ending on the date the option becomes exercisable.

* Entries:

At date of grant:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Compensation Expense</td>
<td>$20,000</td>
</tr>
<tr>
<td>Paid-in Capital--Stock Options</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

["Paid-in Capital--Stock Options" is a stockholders equity account and "Deferred Compensation Expense" is a contra-stockholders equity account.]

For each year 1993-1996, inclusive, the compensation expense is recognized with the following entry:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation Expense</td>
<td>$5,000</td>
</tr>
<tr>
<td>Deferred Compensation Expense</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

Upon the exercise of the stock options, the following entry would be made:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash ($50x1000 shares)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Paid-in Capital--Stock Options</td>
<td>20,000</td>
</tr>
<tr>
<td>Common Stock</td>
<td>10,000</td>
</tr>
<tr>
<td>Paid-In Capital in Excess of Par</td>
<td>60,000</td>
</tr>
</tbody>
</table>
If the employee stays with the company for four years and then allows the options to lapse, the following entry must be made:

Paid-in Capital--Stock Options $20,000
Paid-in capital in Excess of Par $20,000

[This circumstance results in an apparent inequity: the company has given up nothing and yet it has recognized $20,000 of compensation expense and increased its "Paid-in Capital in Excess of Par" account by $20,000!]

III. Overview Of Exposure Draft Provisions

A. Historical perspective.

1. The FASB added the stock compensation project to its agenda in 1984 in response to the following criticisms of APB 25:

a. APB 25 required different accounting treatment for transactions that were substantially the identical in terms of their economic effect.

   1) E.g., a stock option that permits the tender of previously held shares which is accounted for as a "fixed" plan, whereas a stock appreciation right ("SAR") that is payable in shares is accounted for as a "variable plan").

b. Performance plans, which are economically less costly to the employer and, at the same time, less valuable to the employee, potentially result in much higher compensation expense as compared to the more traditional fixed plans.

c. The measurement of compensation cost based solely on the "intrinsic value" (supra.) [and not on both intrinsic value and "time value"] was no longer either necessary or appropriate.

2. In 1988, the FASB decided to defer active consideration of the project until they made further progress on a separate project, "Distinguishing Between Liability and Equity Instruments."

3. In early 1992, the FASB tentatively decided not to make any changes to their existing definitions of liabilities and equity. And at that time--amid growing controversy over executive pay in general, and the introduction of proposed legislation by Senator Levin (supra.) which would direct the SEC to develop a measure of the value of options to be expensed by public companies--the FASB decided to reactivate the project.

B. Scope: The Exposure Draft applies to the following--
1. Transactions in which shares of an employer's common stock, stock options, or other equity instruments are granted or issued to employees.

2. Cash payments made to employees in amounts based on the price of the employer’s stock or other equity instruments.

3. Equity instruments issued to other suppliers of goods and services, such as independent contractors or vendors, and outside members of an entity's board of directors.

   a. Under current GAAP, there is no formal guidance as to accounting for the issuance of equity instruments to nonemployees.

      1) Some entities account for such transactions by analogizing them to the employee compensation rules of APB 25 (using the "intrinsic value" concept).

      2) Others look for guidance to APB Opinion No. 14 (which uses a fair value concept) to determine how to account for these instruments.

      3) The Exposure Draft addresses this issue by including such instruments within its scope.

4. Equity instruments granted to an employee by a principal stockholder, unless the grant clearly is for a purpose other than compensation.

C. General Principles.

1. Generally, when an entity issues equity instruments, it recognizes the fair value of the consideration received for them.

2. However, in the case of equity instruments issued to employees, the consideration received is employee service, and the fair value of such consideration received is difficult to measure.

3. Accordingly, under the Exposure Draft, compensation cost is measured and recorded at the fair value of the equity instruments issued to the employees.

4. At the date of grant, an asset "prepaid compensation" is recorded with an offset to "options outstanding" in shareholders' equity for the total fair value of the instruments issued.

5. This prepaid compensation is then charged to expense as employees render the services, which usually equates to the vesting period.

D. Valuation of equity instruments issued for employee services.

1. The objective of the measurement process is to estimate the fair value at the grant date of equity instruments issued to employees, taking into account the differences between the terms of those instruments and similar instruments issued to third parties.
a. That initial estimate is subsequently adjusted to reflect the outcome of service- and performance-related conditions.

b. However, the fair value of an equity instrument, once estimated at the grant date, is not subsequently adjusted for changes in the price of the underlying stock.

2. Most of the complexity and controversy surrounding the Exposure Draft relates to how the fair value of an employee option is to be determined.

a. The Exposure Draft states, "The fair value of a stock option (or its equivalent) granted by a public entity shall be estimated using a pricing model, such as the Black-Scholes or Binomial Option-Pricing models, which takes into account the exercise price and expected term of the option, the current price of the underlying stock, its expected volatility, the expected dividend yield on the stock . . . and the risk-free interest rate during the expected term of the option."

1) The most complicated factor to estimate will be the "expected volatility."

   a) If a nonpublic entity does not have a trading history to use in estimating volatility, it may estimate the fair value of its options using a method that does not consider expected volatility [this approach is referred to as the "minimum value" approach].

2) The most commonly mentioned option-pricing model is the Black-Scholes model; others include Cox-Ross-Rubenstein and a variation of the Capital Asset Pricing model.

   a) One criticism of some of these models is that they were developed to price publicly traded options, options which do not have the type of restrictions that employee stock options typically have [i.e., vesting requirements, non-transferability, etc.].

   b) Consequently, because the inputs to these models do not consider these restrictions, the resulting values are overstated.

   c) However, the FASB believes that the provisions of the Exposure Draft account for these differences.

      i) With respect to the vesting requirement, the Exposure Draft requires that the fair value of an award of employee stock options at the grant date be reduced to reflect the diminution in value stemming from vesting requirements, based on the best estimate at that date of the employee group's forfeiture rate.

         (1) That estimate is subsequently adjusted to reflect the actual forfeiture rate over the life of the options.
(2) Therefore, ultimately the value of an option that does not vest is zero, and any compensation expense previously recognized is reversed.

ii) With respect to the transferability of the option, employees cannot sell their options, they can only exercise them.

(1) For an option held to its expiration date, the difference is negligible.

(2) However, employee options are frequently exercised prior to the end of their terms.

(3) The FASB therefore concluded that estimating the fair value of an employee option based on its expected life [later adjusted to actual life], rather than its maximum term is a logical and practical means of reducing the option's value to reflect the reality of its nontransferability.

iii) In sum, the initial estimate of the fair value of the equity instrument is subsequently adjusted to reflect the outcome of service- and performance-related conditions such as actual forfeitures and actual exercise dates.

(1) But the initial estimate is not adjusted for subsequent changes in the stock price, expected dividend rate, expected risk-free rate, and the expected volatility.

b. The value of a performance plan is estimated at grant date based on expected performance. [E.g., management expects the company to meet 70% of the target required for options to fully vest, and under the terms of the plan, the options vest ratably based on what percentage of the target is met. Therefore, at grant date, the fair value will be estimated for 70% of the total options].

1) If actual performance varies from the estimate, compensation expense is adjusted in future periods based on the original value per option at grant date.

2) But future changes in the stock price do not affect compensation expense as they do for performance plans under today's accounting.

a) Companies with performance plans may ultimately have lower compensation expense under the Exposure Draft than under current GAAP.

b) They may choose to adopt the provisions of the final Statement, if and when issued before 1997, in order to "fix" the cost of their performance plans.

c. The net result of the valuation process is that a company will ultimately record compensation expense based on the grant date measurement for all options that become exercisable and will record zero compensation expense for options that are ultimately forfeited.
3. At the date of grant, an asset "Prepaid Compensation" is recorded with an offset to "Options Outstanding" in shareholders' equity for the total fair value of the instruments issued.

a. Thus equity is automatically increased at the date of grant.

b. Recall that under current GAAP, the prepaid or deferred compensation is recorded as a contra equity account such that there is no net increase in equity at date of grant.

4. Appendix B of the Exposure Draft includes several illustrations of how the fair values of certain equity instruments are determined and subsequently accounted for.

E. Broad-based stock plans.

1. Under current GAAP, broad-based stock purchase plans which meet the criteria in APB 25 [supra.] are considered noncompensatory.

2. APB 25 specifically states that a statutory employee stock purchase plan that qualifies under Section 423 is an example of a plan that is non compensatory for accounting purposes.

a. Under such a plan, the employee typically may purchase shares at up to a 15% discount from the fair market value of the stock.

b. Some plans allow employees to purchase shares at a 15% discount from market value as of the date of grant or exercise, whichever is lower [this is known as the "look-back" feature].

3. The FASB believes that compensation for all employee stock plans, whether they are broad-based nondiscriminatory plans or executive plans, should be measured in the same way.

a. Consequently, employee discounts in broad-based plans would be included in the fair value determination, and would thereby give rise to compensation expense.

b. In valuing the equity instrument at date of grant, the look-back feature is ignored.

1) If the fair market value of the stock at the exercise date is higher than it was at date of grant, the look-back feature does not come into play, and there is no additional compensation expense recorded. [The employer will then be required to also immediately expense the incremental value of the new right.]

2) However, if the fair market value of the stock at exercise is lower than at date of grant, the employee will pay less for the stock than originally expected.

a) In such case, the Exposure Draft considers this reduction in the employee's purchase price as the grant of a new right.
b) The fair value of the original option will have already been expensed [from date of grant to date of exercise].

c) The employer will then be required to also immediately expense the incremental value of the new right.

F. Other provisions.

1. Cash settlement option.

   a. If the plan includes provisions that allow the employer to settle in either stock or cash at the employer’s option, the instrument is considered an equity instrument regardless of whether it is ultimately settled in cash.

      1) If settlement is made in cash, any excess of the ultimate cash settlement over the original value of the instrument would be recorded directly in stockholder equity [as opposed to the income statement under current GAAP].

   b. On the other hand, if the employee can request cash settlement, the instrument is considered a liability and the amount of such liability is measured each period based on the current stock price, with the adjustment of the liability recorded as compensation expense.

2. Plan modifications.

   a. In general, a plan modification results in a hypothetical new issuance of instruments, and a hypothetical "repurchase" of the old instrument.

      1) The incremental value of the new option over the value of the old option at the date of modification is recorded as additional compensation expense over the remaining vesting period.

3. Reload options.

   a. For an option that has a reload feature [i.e., the employee receives a new option for every option that he or she exercises], the original valuation ignores the reload feature.

   b. Each time the reload feature is triggered, the new options issued are valued and the resulting compensation expense is amortized over the new vesting period.

G. Disclosure requirements and earnings per share issues: Consult Exposure Draft at paragraphs 30 and 31-32, respectively.

IV. Overview Of Current Federal Income Tax Treatment Of Stock Options, Etc.

A. Restricted Stock. Section 83.
1. Summary of tax rules:

<table>
<thead>
<tr>
<th>Transaction</th>
<th>General Rule of Section 83(a)</th>
<th>Section 83(b) Election†</th>
</tr>
</thead>
</table>
| Date stock is transferred to the employee (EE) in exchange for EE's agreement to render services to the corporation | No tax consequences | (1) EE recognizes ordinary income to extent of FMV of stock as of date of receipt
(2) EE’s basis equals FMV of stock at date of receipt
(3) EE’s holding period begins at date of receipt
(4) Employer (ER) gets current deduction* in amount equal to income reported by EE |
| If and when the stock is forfeited by EE | EE gets deduction in amount equal to any amount actually paid for the stock | (1) EE gets a deduction in an amount equal to any amount actually paid for the stock, but gets no deduction for the amount he/she recognized as income in the year of receipt
(2) ER must "recapture" its previously claimed compensation deduction |
| Date when stock is no longer subject to a "substantial risk of forfeiture" or is "freely transferable" | (1) EE recognizes ordinary income to extent of FMV of stock on this date
(2) EE’s basis equals FMV of stock on this date
(3) Holding period begins on this date
(4) ER gets a deduction* in amount equal to the amount of ordinary income reported by EE | No tax consequences |
| Date stock is sold or exchanged in a taxable transaction | (1) Measure of gain or loss is difference between amount realized and adjusted basis (above)
(2) Gain or loss is capital (long-term or short-term depending on holding period (above))
(3) No effect on ER | Same as General Rule of Section 83(a) |

† Factors favoring a Section 83(b) election: (1) "bargain element" is relatively small; (2) high probability that conditions for retention of stock will be met; (3) high probability the stock will appreciate in value during the period the restrictions are in effect; (4) EE has excess losses or expiring carryovers (for example, NOLs, ITC, and so forth) in year stock is received.

* Assuming, of course, the services rendered by EE otherwise qualify ER for a deduction (that is, the services do not give rise to an asset and the expenditure is not rendered nondeductible by another Code provision).
Illustration IV-1:

SH_a, SH_b, and SH_c form New Corp on January 5, 1992. SH_a contributed $1,000,000 in cash for 100 shares of New Corp common stock. SH_b contribute $900,000 in cash for 90 shares of New Corp common stock. New Corp issued the remaining 10 shares of its authorized common stock to SH_c in exchange for his promise to manage the business. This stock, however, was issued with the contractual understanding that it would have to be returned to the corporation if, for any reason [other than death], SH_c’s employment terminated prior to January 5, 1997. Under this agreement, SH_c was not permitted to sell, gift, or collateralize this stock, and a declaration to this effect was stamped on the face of the stock certificates.

The 10 shares of New Corp stock had a FMV of $100,000 at 1/5/92, a FMV of $220,000 at 4/1/94, a FMV of $240,000 at 1/5/97, and a FMV of $300,000 at 6/5/97.

(1) Is the stock held by SH_c subject to a "substantial risk of forfeiture"?

[Solution: The stock is certainly subject to a "risk of forfeiture." As to whether that risk is "substantial," additional facts would be required. [E.g., Are SH_a or SH_b, are "related" to SH_c, etc. See Section 83(c)(1) and Reg. Sec. 1.83-3(c).]

Assume for the purpose of completing this illustration that the risk is "substantial."]

(2) Assuming that SH_c does NOT make the Section 83(b) election:

(a) What tax consequences result to SH_c in 1992?

[Solution: SH_c recognizes no income in 1992, his basis in the New Corp stock is zero, and his holding period does not yet begin. Section 83(a) and (f). New Corp is not entitled to a deduction in 1992 for the contingent compensation paid to SH_c in that year. Section 83(h).]

(b) What tax consequences result to SH_c in 1994 assuming he quits New Corp on 4/1/94?

[Solution: Notwithstanding the economic loss that SH_c has, indisputably, sustained, this loss is not supported by tax basis and, therefore, does not generate a text deduction to SH_c.]

(c) What tax consequences result to SH_c in 1994 assuming he dies on 4/1/94?

[Solution: Under the terms of the arrangement between SH_c and New Corp, the stock will vest if SH_c dies, while still an employee of New Corp, prior to January 5, 1997. According to Regulation Section 1.83-1(d), the income that results from the vesting ($220,000 of ordinary compensation income) is treated as Section 691 "income in respect of a decedent"--taxable, under these facts, on...
the estate's first income tax return. (Since the value of the stock must also be included in SHc's gross estate and subjected to federal estate taxes, Section 691(c) permits the estate to claim an income tax deduction, not a credit, for the marginal estate taxes attributable to the inclusion of such stock.) New Corp recognizes no gain or income upon the exchange of its stock for SHc's services. Section 1032. Additionally, in the tax year which includes the end of the tax year of the employee in which the employee recognizes compensation income, the corporation will generally be entitled to a deduction for such compensation paid to the employee in an amount equal to the amount of compensation income recognized by the employee. Thus, assuming New Corp is a calendar year taxpayer, and that the stock compensation paid to SHc otherwise qualifies as an ordinary and necessary business expense under Section 162(a)(1), the New Corp will deduct $220,000 on its 1994 corporate income tax return.]

(d) What tax consequences result to SHc in 1997 assuming that he still works for New Corp and that he does not sell the stock during that year?

[Solution: SHc will recognize $240,000—the entire amount of which (not just $100,000, the FMV of the stock on the date it was issued to him) will be taxable as ordinary compensation income. His basis in the stock will likewise be $240,000, and his holding period will begin on the date of vesting. New Corp recognizes no gain or income upon the exchange of its stock for SHc's services. Section 1032. Additionally, in the tax year that includes the end of the tax of the employee in which the employee recognizes compensation income, the corporation will generally be entitled to a deduction for such compensation paid to the employee in an amount equal to the amount of compensation income recognized by the employee. Thus, assuming New Corp is a calendar year taxpayer, and that the stock compensation paid to SHc otherwise qualifies as an ordinary and necessary business expense under Section 162(a)(1), New Corp will deduct $240,000 on its 1997 corporate income tax return.]

(e) What tax consequences result to SHc in 1997 assuming that he still works for New Corp and that he sells the stock on 6/5/97 for its FMV?

[Solution: Same as the answer to (d), except that, in addition, SHc must recognize a short-term capital gain of $60,000. The recognition of this capital gain by SHc does not increase or otherwise affect the amount of New Corp's $240,000 compensation deduction.

(3) Assuming that SHc DOES make the Section 83(b) election:

(a) What tax consequences result to SHc in 1992?
[Solution: SHc will recognize $100,000 of ordinary compensation income. His basis in the stock will likewise be $100,000, and his holding period will begin on the date the stock was issued to him (January 5, 1992). New Corp recognizes no gain or income upon the exchange of its stock for SHc's services. Section 1032. Additionally, in the tax year which includes the end of the tax of the employee in which the employee recognizes compensation income, the corporation will generally be entitled to recognize such compensation paid to the employee in an amount equal to the amount of compensation income that was recognized by the employee. Thus, assuming New Corp is a calendar year taxpayer, and that the stock compensation paid to SHc otherwise qualifies as an ordinary and necessary business expense under Section 162(a)(1), New Corp may deduct $100,000 on its 1992 corporate income tax return (or commence amortizing that amount over the related service period).]

(b) What tax consequences result to SHc in 1994 assuming he quits New Corp on 4/1/94?

[Solution: Although SHc must forfeit the stock (and thus, in the final analysis, never really derived any income from the arrangement), he may neither file an amended return for 1992 to exclude the $100,000 of ordinary income originally reported, nor may he claim a deduction for that amount on his 1994 federal income tax return. See Section 83(b)(1) (last sentence). New Corporation must nevertheless "recapture" the tax benefit that it claimed in 1992. Assuming that it deducted the full $100,000 in 1992 as a compensation expense deduction, it must report $100,000 of ordinary income on its 1994 corporate income tax return. Reg. Sec. 1.83-6(c).]

(c) What tax consequences result to SHc in 1994 assuming he dies on 4/1/94?

[Solution: In contrast to the situation described in part 2(c) of this problem, the stock does not constitute "income in respect of a decedent." Neither SHc, on his final income tax return, nor his estate, on its first income tax return, will recognize any income or gain as a result of the stock's vesting. Additionally, the estate (and ultimately the beneficiaries thereof) will be entitled to a $220,000 stepped-up basis under Section 1014 (that is, Section 1014(c)--which denies a stepped-up basis to IRD assets--is not applicable here). No tax consequences to New Corp.]

(d) What tax consequences result to SHc in 1997 assuming that he still works for New Corp and that he does not sell the stock during that year?

[Solution: SHc recognizes no additional income or gain in 1997, and his basis in the New Corp stock is still $100,000. No tax consequences to New Corp.]
(e) What tax consequences result to SHc in 1997 assuming that he still works for New Corp and that he sells the stock on 6/5/97 for its FMV?

[Solution: SHc recognizes $200,000 of long-term capital gain in 1997. No tax consequences to New Corp.]

(f) What tax consequences result to SHc in 1997 assuming that he still works for New Corp and that he sells the stock on 6/5/97 for $12,000?

[Solution: SHc must recognize $88,000 of long-term capital loss in 1997. No tax consequences to New Corp.]

(4) Assume the same facts except that SHc is required to pay $100,000 for the stock on 1/5/92 [its full FMV on that date], but that the stock was nevertheless issued with the contractual understanding that it would have to be sold back to the corporation for the lesser of $100,000 or its FMV as of the date of sale if, for any reason [other than death], SHc's employment terminated prior to January 5, 1997. As before, under this agreement, SHc was not permitted to sell, gift, or collateralize this stock, and a declaration to this effect was stamped on the face of the stock certificates. Assume that SHc DOES NOT make a timely Section 83(b) election and that the stock vests on January 5, 1997 when it has a FMV of $5,000,000.

[Solution: See Alves, 79 T.C. 864 (1982).]

B. Nonqualified Stock Options ["NQSO"].

1. Principal advantages:

   a. Gain from appreciation of stock without capital investment.

   b. Risk of loss of employee's own investment: None.

   c. Flexible--No statutory restrictions concerning

      1) Transferability, or

      2) Exercise prices [vis-a-vis FMV of the stock at date of grant], or

      3) Exercise periods, or

      4) Holding periods following exercise.

2. Tax consequences to the employee.

b. Ordinarily, the employee will recognize ordinary compensation income [subject to withholding, etc.] in the year in which the option is exercised, and in an amount equal to the difference between the FMV of the stock on the date of exercise and the exercise price.

1) The employee's basis in the stock is the exercise price plus the amount of ordinary income recognized upon the exercise of the option.

2) Holding period in the stock acquired with the option begins on the date of exercise.

c. In the less common situation where the option has a "readily ascertainable" FMV on the date that it is granted [or, if later, on the date on which it is no longer subject to a "substantial risk of forfeiture" or is "transferable"], the employee will recognize ordinary compensation income [subject to withholding, etc.] at such time and in an amount equal to the option's FMV.

1) Upon the actual exercise of the option, such employee would not recognize any additional income.

2) Basis in the stock acquired through the exercise of the option is the exercise price plus the amount of compensation income previously recognized.

3) Holding period of the stock acquired with the option begins on the date of exercise.

3. Tax consequences to the employer.

a. Governed by Section 83(h), supra.

b. Generally, the employer recognizes the compensation cost in an amount equal to the amount of ordinary income that the employee recognizes [Sec. 83], and this recognition occurs for the tax year of the employer within which the employee's tax year ends [Reg. Sec. 1.83-6(a)(1)].

c. Note that under Reg. Sec. 1.83-6(a)(2), the employer must withhold income taxes in accordance with Section 3402 in order to recognize this compensation cost.

d. These rules generally apply to all of the equity-oriented compensation discussed in this outline.

C. Incentive Stock Options ["ISO"]. Section 422.

1. An "incentive stock option" is an option that satisfies the ISO qualification requirements and that is granted to an individual, for any reason connected with his/her employment, by his/her employer corporation, or by a parent or subsidiary of the employer corpora-
tion, to purchase stock in the employer corporation or in the employer’s parent or subsidiary corporation. Sec. 422(b).

2. Tax consequences to employee.

a. In general, no regular taxable income is recognized by the employee either on the date of grant or the date of exercise.

1) However, the spread between the option price and the market value of the stock on the date of exercise is a tax preference item for alternative minimum tax purposes. Section 57(a)(3)(a).

2) For AMT purposes only, the employee’s basis in the stock so acquired will be increased by the amount of the preference.

b. When the stock is disposed of by the employee in a taxable sale or exchange, any resulting gain is taxable as long-term capital gain.

c. However, if the employee disposes of the stock prior to the passing of two years from the date of grant and one year from date of exercise, the gain—up to the spread at the exercise date—will be taxed as ordinary compensation income [the balance will be capital gain] in the year the sale takes place.

3. Tax consequences to employer.

a. Generally, since the employee recognizes no compensation income, the employer corporation recognizes no compensation cost as a result of the grant or exercise of the option, or as a result of the subsequent sale of the optioned stock by the employee.

b. However, in the event of a disqualified disposition by the employee [supra.], the employer, under the same rules discussed supra. in connection with NQSOs, would be entitled to recognize a compensation cost in an amount equal to the ordinary income recognized by the employee.

D. Employee Stock Purchase Plans. Section 423.

1. Employee stock purchase plans are a type of statutory stock option.

2. Requirements:

a. The plan must limit the granting of options (A) to employees of the employer corporation, its parent or its subsidiaries, (B) for stock in those corporations.

b. The plan must be approved by the stockholders within twelve months before or after the date the plan is adopted.
1) The options must be granted for reasons connected with the employment by the employer corporation of its related corporations, and the relationship must exist as of the date the option is granted.

c. Other conditions that must be met either by the plan or in the stock offering are--

1) The terms of the employee stock purchase plan or offering must fix the option price so that it is not below the lesser of--

   a) An amount equal to 85% of the fair market value of the stock as of the time the option is granted; or

   b) An amount equal to 85% of the fair market value of the stock as of the time the option is exercised.

2) The option period must not exceed five years from the date of grant where the option price is stated solely in terms of a percentage of the stock's FMV as of date of exercise [e.g., option price is "85% of the stock's date of exercise value"]. Otherwise the option period may not be more than 27 months from the date of grant.

3) The option must be granted to employees generally [with exceptions for certain part-time employees, employees with less than two years of service, and officers, supervisors, and highly-compensated employees], and all such employees must have the same rights and privileges [except that the amount of stock purchased may be a uniform percentage of compensation and the plan may limit the maximum number of shares purchased by any one employee].

4) The terms of the employee stock purchase plan or offering must provide that no employee may be granted an option which at any time permits his/her rights to purchase stock under all the employee stock purchase plans of his/her employer corporation, its parent and subsidiaries, to accrue at a rate in excess of $25,000 of the fair market value of the stock [determined as of the date of grant] for each calendar year in which such option is outstanding.

5) 5% and greater [vote or value] stockholders of the employer corporation, its parent, or its subsidiaries must be ineligible to participate in the plan.

6) The option cannot be transferable.

3. Tax consequences to employee.

a. Date of grant: The grant of an option under an employee stock purchase plan has no tax consequence to the employee who rendered the services for which the option is granted as part of the employee's compensation package.

b. Date of exercise: If an option that was granted under an employee stock purchase plan is exercised and if the requirements of Sec. 423, such as qualification require-
ments, holding period requirements, and employment requirements, are met. The employee likewise recognizes no compensation income on the date of exercise. Section 421(a)(1).

c. Sale of stock/death of employee-stockholder: If the option price of an option granted under a plan that qualifies as an employee stock purchase plan is less than 100% [but at least 85%] of the stock’s fair market value at the date of grant, the optionee is required to recognize as ordinary compensation [and not as capital gain] an amount equal to the lesser of--

1) The fair market value of the stock when the option was granted minus the option price, or

2) The excess of fair market value at the time of the disposition or death over the amount paid for the share under the option.

3) This compensation income is recognized in the year the employee disposes of stock or in the year he dies while owning the stock, whichever is applicable.

4. Tax consequences to employer.

a. Same as with ISOs, supra.

E. Stock Appreciation Rights.

1. SARs entitle an employee to receive a payment in cash [or sometimes employer stock] based on the difference between a specified amount per share of stock [usually FMV as of date of grant] and the market price per share at some future date.

a. SARs are very similar to NQSOs in that the employee enjoys the economic benefits of stock ownership from the potential appreciation in the value of the stock without the risk of loss.

b. However, while NQSOs require the employee to make a cash payment in order to acquire the stock, SARs provide cash [or a smaller amount of stock] to the employee.

2. Tax consequences to the employee.

a. In general, payments of cash or employer stock received by an employee upon his or her exercise of a SAR, are includible in gross income as ordinary compensation income in the year the SAR is exercised in an amount equal to the amount of cash or the FMV of the stock paid to that employee.

b. However, where the terms of an SAR limit the amount that an employee may receive on the exercise of the right, the Service has privately ruled that when that maximum or ceiling is reached, the employee no longer possesses a valuable right which would be forfeited by the SAR’s exercise.
1) Therefore, the "substantial limitation" which would preclude constructive receipt no longer exists and income would be constructively received for the taxable year in which the maximum appreciation permitted is attained.

   a) PLR 8104119.

2) The Service has also ruled that constructive receipt can be avoided if a "ceiling" type SAR is issued in tandem with a stock option.

   a) Rev. Rul. 82-121, 1982-1 C.B. 79.

3. Tax consequences to the employer: Same as with NQSOs.

F. Performance Shares

1. Performance plans are awards which are contingent upon the attainment of some predetermined goal measured over a period of time, usually three to six years.

   a. The most common goals are stated in terms of growth in earnings per share.

   b. The award may be payable in the form of cash or employer stock [or in the form of cash or stock at the option of the employer or the employee].

   c. Awards are normally paid at the end of the predetermined performance period.

2. Tax consequences to employee.

   a. No income until the end of the performance period. Section 83.

3. Tax consequences to employer.

   a. Section 83(h) [supra.]


A. The Exposure Draft includes provisions related to the accounting for the tax consequences of equity instruments issued to employees.

B. Under SFAS No. 109, at the date of grant, a deferred tax liability would be recognized for the taxable temporary difference arising from recognition of the prepaid compensation, with the offsetting debit being recorded in equity.

1. If an option were issued with an exercise price equal to the fair market value of the underlying stock at date of grant, the company would have no tax basis in the prepaid compensation and therefore would record a deferred tax liability related to the total prepaid compensation.

-- 43 --
2. As prepaid compensation is amortized to compensation expense during the service period, a deferred tax benefit would be recognized for the reduction in the deferred tax liability.

3. Finally, any ultimate tax benefit for the excess of the tax deduction received by the company over the tax basis at date of grant will be credited to paid-in capital, as it is under current GAAP.

C. Accounting for the inherent tax benefits of restricted stock and options issued with exercise prices less than the fair value of the stock on the date of grant.

1. The Exposure Draft concludes that the benefit from the tax deduction that will be realized when the option is exercised or the restricted stock vests [assuming the stock price does not change from grant date to exercise date] should be recognized at the grant date as a deferred tax asset.

   a. That inherent tax deduction equals the intrinsic value of an option or the fair value of restricted stock.

      1) If the stock price subsequently decreases, the reduction in the inherent tax benefit is recognized immediately as a charge to income tax expense.

      2) An increase in the inherent tax benefit caused by an increase in the stock price from its price at the grant date is not recognized until it is realized on the tax return [and is then allocated to equity].

Illustration V-1 [Source: Exposure Draft, paragraphs 196-207].

Company S, a public entity, has a stock option plant that grants options with a maximum term of 10 years to officers and other employees of the company. The exercise price of each option equals the market value of the company's stock on the date the options are granted. The options vest at the end of a three-year period (cliff vesting). Options are granted on January 1 each year. The options do not qualify for tax purposes as incentive stock options. The corporate tax rate is assumed to be 34 percent.

The following table shows assumptions and information about options granted on January 1, 2000.

<table>
<thead>
<tr>
<th>Options granted</th>
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<tr>
<td>Employees granted</td>
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<td>Stock price at January</td>
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</tr>
</tbody>
</table>

The fair value of each option is estimated using the expected outstanding life of the option rather than the maximum term of 10 years. Subsequent adjustments to reflect the difference between actual and expected lives, if any, would increase or decrease the estimated fair value of the options and the resulting compensation cost as necessary. This example assumes that the options have an expected average life of six years. For simplicity, the effect of a difference between expected and actual experience in the option life is not illustrated; that difference would be treated in the same way as illustrated for differences between actual and expected forfeitures.
Compensation cost arising from options granted in 2000 will be the fair value at the grant date for all options that actually vest. An estimate of the number of options that will vest is made at the grant date and subsequently adjusted for actual experience. The estimate of the expected number of forfeitures considers historical employee turnover rates and expectations about the future. Company S has had historical turnover rates for employees at the grantees' level with unvested options of 3 percent per year. In this illustration, a 3-percent-per-year turnover rate is used to determine the value of the award as of the grant date. Actual turnover is 3 percent in 2000 and 2001, but it is 4 percent in 2002. The higher number of terminations in 2002 makes it necessary to reduce compensation cost recognized in that year to adjust for the overestimation of the fair value of the award at the grant date.

The number of options expected to vest from the grant of options on January 1, 2000 is 821,406 (900,000 x .97 x .97 x .97). The estimated value of the award at January 1, 2000 would be $14,801,736 (821,406 x $18.02), and compensation cost of $4,933,912 ($14,801,736 ÷ 3) would be recognized during 2000 and 2001. In 2002, when actual forfeitures are 4 percent rather than the estimated 3 percent, the number of vested options is 812,938 (900,000 x .97 x .97 x .96). Total compensation cost recognized by the end of 2002 for the January 1, 2000 award must be $14,649,143 (812,938 x $18.02), as shown in Table 1.

Table 1—Fixed Stock Option—Cliff Vesting

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Value of Award</th>
<th>Pretax Cost for Year</th>
<th>Cumulative Pretax Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>$14,801,736 (821,406 x $18.02)</td>
<td>$4,933,912 ($14,801,736 ÷ 3)</td>
<td>$4,933,912</td>
</tr>
<tr>
<td>2001</td>
<td>$14,801,736 (821,406 x $18.02)</td>
<td>$4,933,912 ($14,801,736 ÷ 3)</td>
<td>$9,867,824</td>
</tr>
<tr>
<td>2002</td>
<td>$14,649,143 (812,938 x $18.02)</td>
<td>$4,781,319 ($14,649,143 - $9,867,824)</td>
<td>$14,649,143</td>
</tr>
</tbody>
</table>

The journal entries to recognize the compensation cost arising from Company S's award of fixed stock options with cliff vesting follow. An asset, prepaid compensation, is recognized for the estimated fair value of the award granted on January 1, 2000. Recognition of the asset gives rise to a taxable temporary difference, resulting in a deferred tax liability.

At January 1, 2000:

Prepaid compensation $14,801,736
Options outstanding $14,801,736

To recognize the value of options granted on January 1, 2000

Options outstanding $ 5,032,590
Deferred tax liability $ 5,032,590

To recognize the deferred tax liability arising from the grant of options on January 1, 2000 and to allocate the tax effect to equity ($14,801,736 x .34 = $5,032,590)

As shown in Table 1, the estimated value of the award, based on an expected annual forfeiture rate of 3 percent, is $14,801,736. In 2002, when the value of the award is adjusted for the actual number of forfeitures, cumulative compensation cost and the options outstanding amount would be adjusted to $14,649,143.
Prepaid compensation is recognized as a cost over the vesting period, and the deferred tax liability is remeasured each period based on the amount of the temporary difference for prepaid compensation at the end of the period. The journal entries to reflect amortization of prepaid compensation at the end of 2000 are as follows:

At December 31, 2000:

Compensation cost $4,933,912
Prepaid compensation $4,933,912
To recognize compensation cost for the year ended December 31, 2000 (refer to Table 1)

Deferred tax liability $1,677,530
Deferred tax expense $1,677,530
To adjust the deferred tax liability to reflect the decrease in the temporary difference for prepaid compensation ($4,933,912 x .34 = $1,677,530)

The net after-tax effect of recognizing compensation cost for the year 2000 therefore is $3,256,382 ($4,933,912 - $1,677,530). Compensation cost and related tax effects for the years 2001 and 2002 would be recognized in the same manner as shown below. As already mentioned, however, the entries for 2002 also would reflect the effect of the difference between actual and expected forfeitures.

At December 31, 2001:

Compensation cost $4,933,912
Prepaid compensation $4,933,912
To recognize compensation cost for the year ended December 31, 2001 (refer to Table 1)

Deferred tax liability $1,677,530
Deferred tax expense $1,677,530
To adjust the deferred tax liability to reflect the decrease in the temporary difference for prepaid compensation ($4,933,912 x .34 = $1,677,530)

At December 31, 2002:

Options outstanding $152,593
Prepaid compensation $152,593
To adjust the value of options granted on January 1, 2000 for the actual number of forfeitures in 2002 ($14,801,736 - $14,649,143 = $152,593)

Deferred tax liability $51,882
Options outstanding $51,882
To adjust the deferred tax liability amount after the adjustment for the value of the grant of options on January 1, 2000 and to allocate the tax effect to equity ($152,593 x .34 = $51,882)

Compensation cost $4,781,319
Prepaid compensation $4,781,319
To recognize compensation cost for the year ended December 31, 2002 (refer to Table 1)

Deferred tax liability $1,625,648
Deferred tax expense $1,625,648
To adjust the deferred tax liability to reflect the decrease in the temporary difference for prepaid compensation ($4,781,319 x .34 = $1,625,648)
The journal entries upon exercise of the options follow. For simplicity, the illustration assumes that all of the options are exercised on the same day and that no adjustment to compensation cost is necessary for differences between the estimated and actual outstanding life of the options. At exercise, the market price of the stock is assumed to be $70.

At exercise:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (812,938 x $50)</td>
<td>$40,646,900</td>
</tr>
<tr>
<td>Options outstanding</td>
<td>$ 9,668,435</td>
</tr>
<tr>
<td>Common stock (no par)</td>
<td>$50,315,335</td>
</tr>
</tbody>
</table>

To recognize the issuance of stock upon exercise of the options. (The options outstanding balance to be closed to common stock is net of deferred income taxes charged to equity [($14,649,143 - ($14,649,143 x .34) = $9,668,435])

The difference between the market price of the stock and the exercise price on the day of exercise is deductible for tax purposes because the options do not qualify as incentive stock options. Statement 109 requires the tax consequences of an event that increases or decreases contributed capital to be allocated to contributed capital. With the stock price at $70 at exercise, the deductible amount is $16,258,760 (812,938 x [$70 - $50]), and the tax benefit realized on the tax return is $5,527,978 ($16,258,760 x .34).

Tax expense $ 5,527,978

Paid-in capital $ 5,527,978

To allocate to equity the tax benefit from deductible compensation cost upon exercise of the options

If the options had instead expired unexercised, the options outstanding account would simply have been closed to paid-in capital. Like the expiration of outstanding stock purchase warrants, the expiration of employee stock options does not affect the entity’s net income.

VI. Concluding Remarks: Planning for the Future
Part Three:  
Environmental Remediation Costs

David W. LaRue

I. Background and Perspective

A. With increasing frequency [and in ever greater amounts], U.S. companies are incurring costs to remove, contain, neutralize existing environmental contamination, and to prevent future contamination.

1. Such costs are often incurred voluntarily, but many are now required by federal, state, or local law.

2. At issue is a wide range of expenditures, including costs associated with:
   a. Testing to determine the extent of contamination and required cleanup;
   b. Removal of contamination [e.g., leakage from underground fuel storage tanks];
   c. Acquiring tangible property [e.g., air pollution control equipment];
   d. Cleaning up environmental contamination of property owned by others [e.g., the cleanup of shoreline contamination resulting from spills by oil tankers];
   e. Cleaning up environmental contamination made to prepare property for sale;
   f. Environmental studies;
   g. Fines levied under environmental laws;
   h. Compensatory damages for victims of environmental contamination [e.g., "Love Canal" in Niagra Falls, N.Y.];
   i. Environmental audits, and the development of compliance manuals;
   j. Research and development into alternative remediation techniques; etc.

B. Should such costs be recognized as a capital expenditure or as a current expense?

1. If a cost is to be capitalized, is such cost amortizable?

2. If it is, over what period?

C. Recent developments:
1. GAAP

a. Emerging Issues Task Force ["EITF"] Issue #89-13, October 26, 1989 ["Accounting for the Cost of Asbestos Removal"]

b. EITF Issue #90-8, May 31, 1990 ["Capitalization of Costs to Treat Environmental Contamination"].

2. Federal Income taxation

a. TAM 9240004 [asbestos removal]

b. TAM 9315004 [PCB toxic waste cleanup]

c. Legislative developments on the tax consequences of environmental remediation.

1) In hearings before the Ways and Means Select Revenue Measures Subcommittee in late September, 1993, Assistant Secretary for Tax Policy Leslie B. Samuels testified that the feasibility of proposing a statutory provision that would require the capitalization and amortization of environmental cleanup costs over a period of years is "under study" by the administration, but that no conclusions had been reached.

2) Despite the revenue to be gained from such a proposal, Subcommittee Chairman Rangel agreed with several witnesses who opposed the idea.

a) "I don't think there's enough money to take that political hit.... I do not think we'll be moving with any special speed on this matter."

b) He also observed that he would not be in favor of the legislation because it might discourage taxpayers from engaging in cleanup efforts.

c) Sampling of other testimony:

i) Michael F. Solomon, partner with the Washington law firm of Ivins, Phillips & Barker, argued that TAM 9240004 and TAM 9315004 send weak and inconsistent messages about environmental remediation, and that if Congress accepts the Service's thinking, it would be changing "67 years of precedent" retroactively.

ii) Fred J. Gentile, senior vice president of the Brooklyn Union Gas Company, said that the provision would also have a far-reaching effect on competitiveness, that it would discourage prompt cleanup and would distort income.

iii) Subcommittee member Michael J. Kopetski (D-Ore.) argued that a distinction should be made between cleanup costs and compensatory damages.
(1) The law now allows people to deduct expenses if they engage in cleanup efforts on their own and also if they are forced to clean up through litigation.

(2) Kopetski argued that removing the deduction for compensatory damages would encourage taxpayers to clean up before cases are brought to court.

D. SFAS 109 implications.

II. Application Of Generally Accepted Accounting Principles: An Overview

A. In general: Little focused guidance.

1. To evaluate the numerous and diverse accounting and auditing problems that arise in connection with environmental prevention and remediation, the AICPA convened a two-day environmental issues roundtable last January.

a. The 30-plus participants included industry CPAs and representatives of the AICPA accounting standards executive committee (AcSEC), the auditing standards board, the Financial Accounting Standards Board, the Securities and Exchange Commission, the American Bar Association and the Canadian Institute of Chartered Accountants (CICA) as well as AICPA technical staff.

b. "Environmental obligations have reached a critical level in the United States. Since the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA) was adopted, U.S. entities have found themselves increasingly identified by the Environmental Protection Agency as potentially responsible parties in hazardous waste disposal site cleanups. This so-called superfund legislation maintains a strict liability standard -- penalties are assessed without regard to fault. Entities failing to respond to EPA cleanup orders are subject to substantial penalties.

1) "With cleanup costs reaching staggering proportions, CPAs need to advise clients on how to properly recognize, measure and disclose environmental costs. Little specific guidance exists currently, however, on how this should be done. Auditors must understand what responsibility they have, if any, to detect and report unrecorded environmental liabilities and how to evaluate environment-related financial statement assertions."

2) Journal of Accountancy 18, April, 1993

c. Objectives:

1) Examine problems CPAs encounter in practice applying generally accepted accounting principles to environment-related financial statement assertions.
2) Identify environmental issues for which authoritative accounting and auditing guidance may be needed.

3) Provide a starting point for developing guidance, including continuing professional education conferences and courses, on applying accounting and auditing standards to environmental matters.

d. Copies of the roundtable proceedings are available for purchase from the AICPA order department.

B. Asbestos removal: Various federal, state, and local laws require the removal or containment of asbestos in buildings, etc. The property owner incurs the costs associated with the "treatment" of asbestos in compliance with those laws.

1. EITF Issue #89-13, October, 1989 identified three issues on which it reached a consensus.

a. Must asbestos treatment costs incurred with respect to a property having an asbestos problem that was known by the purchaser prior to the date of its acquisition be capitalized or expensed?

1) FASB EITF consensus: If incurred within a reasonable period of time after the property is acquired, capitalize to the cost of the acquired property [subject to an impairment test for that property].

b. Must asbestos treatment costs incurred with respect to existing property having an asbestos problem be capitalized or expensed?

1) FASB EITF consensus: In general, such costs should be capitalized as a betterment [subject to an impairment test for that property].

2) But if such costs are incurred in anticipation of the sale of the affected property, they should be deferred and recognized in the period of the sale to the extent that such costs can be recovered from the sales price.

c. Where it is deemed appropriate to charge asbestos costs to expense, should such expenses be classified and reported as an "extraordinary" item under APB Opinion #30?

1) FASB EITF consensus: Such costs should not be reported as "extraordinary."

2. The same EITF observed that the SEC Observer stated that regardless of whether asbestos treatment costs are capitalized or charged to expense, SEC registrants should disclose significant exposure for such costs in "Management's Discussion and Analysis."

C. Capitalization of costs to treat environmental contamination.

-- 51 --
1. EITF Issue #90-8, May 31, 1990 ["Capitalization of Costs to Treat Environmental Contamination"].

2. Four categories of costs identified

   a. "Costs incurred by a company to remove, contain or neutralize (clean up) existing environmental contamination of its property. For example, the cleanup of contamination resulting from leaking of underground tanks of gasoline stations."

      1) Controversial!

      2) After lengthy discussion of the various options available to the Task Force, the Task Force reached a consensus that a company may capitalize as a betterment the costs incurred to treat environmental contamination of its property subject to an impairment test for that property. Costs to treat environmental contamination of property owned by others should be expensed.

   b. "Costs incurred by a company to clean up environmental contamination of property owned by others. For example, the cleanup of shoreline contamination resulting from spills by oil tankers."

      1) These costs are expensed. Such costs do not result in an asset because the related property is not owned by the company incurring the cost of cleanup.

   c. "Costs incurred to mitigate or prevent environmental contamination that has yet to occur and that otherwise may result from future operations or activities. For example, pollution control equipment that mitigates future air pollution that otherwise would occur."

      1) These costs are capitalized. Such costs result in an asset that will benefit the operations of future periods (by mitigating pollution that has yet to occur but that otherwise would result from future operations).

   d. "Costs to clean up environmental contamination made to prepare property for sale."

      1) These costs are capitalized. Practice has routinely capitalized costs incurred to prepare property for sale, provided that those costs are realizable.

   e. Exhibit illustrates application of this consensus to several case examples.

3. This Issue did not address:

   a. When to recognize liabilities related to environmental contamination,

   b. The measurement of those liabilities, or

   c. Whether costs related to environmental contamination that are charged to expense should be reported as an unusual or extraordinary item.
### Examples of the Application of the Consensus on EITF Issue 90-8

<table>
<thead>
<tr>
<th>Environmental Contamination, Treatments</th>
<th>Evaluation of Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Tanker Oil Spill:</strong></td>
<td></td>
</tr>
<tr>
<td>A. Clean up waterway and beachfront</td>
<td>1. Costs to clean up the waterway and beachfront are not eligible for consideration under the first criterion because the oil company does not own the property.</td>
</tr>
<tr>
<td></td>
<td>2. The cleanup of the waterway and beachfront does not mitigate or prevent a future oil spill from future operations.</td>
</tr>
<tr>
<td></td>
<td>3. The waterway and beachfront are not owned assets and, therefore, the third criterion does not apply.</td>
</tr>
<tr>
<td><strong>Conclusion:</strong></td>
<td>Cost incurred for cleanup and restoration in connection with the oil spill should be charged to expense.</td>
</tr>
<tr>
<td>B. Reinforce tanker’s hull to reduce risk of future spill</td>
<td>1. Reinforcing the hull improves the safety compared to when the tanker was originally constructed or acquired.</td>
</tr>
<tr>
<td></td>
<td>2. Reinforcing the hull mitigates the risk that the tanker will experience a similar oil spill during future operations and improves the tanker’s safety compared to when the tanker was originally constructed or acquired.</td>
</tr>
<tr>
<td><strong>Conclusion:</strong></td>
<td>The costs incurred in connection with reinforcing the tanker’s hull may be capitalized under either the first or second criterion.</td>
</tr>
<tr>
<td><strong>2. Rusty Chemical Storage Tank:</strong></td>
<td></td>
</tr>
<tr>
<td>A. Remove rust that developed during ownership</td>
<td>1. Removing the rust has not improved the tank compared with its condition when built or acquired.</td>
</tr>
<tr>
<td></td>
<td>2. Removing the rust has mitigated the possibility of future leaks. However, removing the rust has not improved the tank compared with its condition when built or acquired.</td>
</tr>
<tr>
<td><strong>Conclusion:</strong></td>
<td>Rust removal costs should be expensed unless the tank is currently held for sale and the costs were incurred to prepare the tank for sale.</td>
</tr>
<tr>
<td>B. Apply rust prevention chemicals</td>
<td>1. The application of rust prevention chemicals has improved the tank’s condition compared with its condition when built or acquired.</td>
</tr>
</tbody>
</table>

-- 53 --
2. Rust prevention chemicals mitigate the possibility that future rust will cause leaks and also improve the tank's condition compared with its condition when built or acquired.

**Conclusion:** The costs of applying the rust prevention chemicals may be capitalized under either the first or second criterion.

3. **Air Pollution Caused by Manufacturing Activities:**

   A. Acquire and install pollution control equipment
      1. The pollution control equipment improves the safety of the plant compared with its condition when built or acquired.
      2. The pollution control equipment mitigates or prevents air pollution that has yet to occur but that may otherwise result from future operation of the plant and improves the safety of the plant compared with its condition when built or acquired.

      **Conclusion:** Costs associated with acquisition and installation of the pollution control equipment may be capitalized under either the first or second criterion.

   B. Pay fines for violations of the Clean Air Act
      1. Payment of fines does not extend the plant's life, increase its capacity, or improve its efficiency or safety.
      2. Payment of fines does not mitigate or prevent pollution that has yet to occur but that may otherwise result from future operation of the plant.

      **Conclusion:** Fines paid in connection with violations of the Clean Air Act should be charged to expense. Even if the plant is currently held for sale, the fines should be charged to expense. Even if the plant is currently held for sale, the fines should be charged to expense because the costs would not have been incurred to prepare the plant for sale.

4. **Lead Pipes in Office Building Contaminate Drinking Water:**

   A. Remove lead pipes and replace with copper pipe
      1. Removing the lead pipes has improved the safety of the building's water system compared with its condition when the water system was built or acquired.
      2. By removing the lead pipes, the building's owner eliminated an existing environmental problem and prevented any further contamination from that lead. However, by removing the existing pipes, the
Environmental Contamination, Treatments

Evaluation of Criteria

building's owner has *not* mitigated or prevented environmental problems yet to occur, if any, from future operation of the building.

**Conclusion:** Costs to remove the lead pipes and install copper pipes may be capitalized under the first criterion. The book value of the lead pipes should be charged to expense when removed.

5. Soil Contamination Caused by an Operating Garbage Dump:

A. Refine soil on dump property

1. The life of a garbage dump is not extended by refining its soil. Further, the condition of the soil after refining will not be improved over its condition when the garbage dump was constructed or acquired. Removal of the toxic waste restores the soil to its original uncontaminated condition.

2. Removal of toxic waste from the soil addresses an existing environmental concern. It also prevents that waste from leaching in the future. However, removing the waste does not mitigate or prevent future operations from creating future toxic waste. The risk will continue regardless of how much of the existing soil is refined.

**Conclusion:** Soil refinement costs should be charged to expense unless the garbage dump is currently held for sale and the costs were incurred to prepare the garbage dump for sale.

B. Install liner

1. The liner does not extend the useful life or improve the efficiency or capacity of the garbage dump. However, the liner has improved the garbage dump's safety compared to when the dump was constructed or acquired.

2. The liner addresses an existing and potential future problem. In this example, the garbage dump contains toxic waste from past operations and will likely generate toxic waste during future operations. The liner partly addresses the existing environmental problem by preventing future leaching of existing toxic waste into the soil. The liner also mitigates or prevents leaching of toxic waste that may result from garbage dumping in future periods and has improved the garbage dump's safety compared to when the dump was constructed or acquired.
### Environmental Contamination, Treatments

<table>
<thead>
<tr>
<th>Exhibit [continued]</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Evaluation of Criteria</strong></td>
</tr>
</tbody>
</table>

### 6. Water Well Contamination Caused by Chemicals That Leaked into Wells Containing Water That Will Be Used in Future Beer Production

| A. Neutralize water in wells | 1. The treatment does not extend the life of the wells, increase their capacity, or improve efficiency. The condition of the water is not safer after the treatment compared to when the wells were initially acquired. |
| | 2. By neutralizing the water, the possibility of future contamination of the wells from future operations has not been mitigated or prevented. |
| **Conclusion**: Costs incurred to neutralize well water should be charged to expense unless the wells were held for sale and the costs were incurred to prepare the wells for sale. |
| B. Install water filters | 1. The water filters improve the safety of the wells compared with their uncontaminated state when built or acquired. |
| | 2. The water filters address future problems that may result from future operations. Since the water filters are effective in filtering environmental contamination, they mitigate the effect of spilling new contaminants into the wells during future operations. In addition, the water filters represent an improvement compared with the wells’ original condition without water filters. |
| **Conclusion**: The water filtering system may be capitalized under either the first or the second criterion. |

### 7. Underground Gasoline Storage Tanks Leak and Contaminate the Company’s Property

| A. Refine soil | 1. Soil refinement does not extend the useful life, increase the capacity, or improve the efficiency or safety of the land relative to its unpolluted state when acquired. |
| | 2. By refining the contaminated soil, the oil company has addressed an existing problem. However, the company has not mitigated or prevented future leaks during future operations. |
### Environmental Contamination, Treatments

#### B. Encase tanks so as to prevent future leaks from contaminating surrounding soil

<table>
<thead>
<tr>
<th>Evaluation of Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Conclusion:</strong> Soil refining costs should be charged to expense unless the property is currently held for sale and the costs were incurred to prepare the property for sale.</td>
</tr>
<tr>
<td>1. In some cases, encasement may increase the life of the tanks because of their increased resistance to corrosion, leaking, etc. In other situations, the treatment may not increase the life of the tanks. However, the encasement has improved the tanks' safety compared with their condition when built or acquired.</td>
</tr>
<tr>
<td>2. Encasement has mitigated or prevented future leakage and soil contamination that might otherwise result from future operations. In addition, the encasement has improved the tanks' safety compared with their condition when built or acquired.</td>
</tr>
<tr>
<td><strong>Conclusion:</strong> The cost of encasement may be capitalized under either the first or the second criterion.</td>
</tr>
</tbody>
</table>

#### 8. Air in Office Building Contaminated with Asbestos Fibers

<table>
<thead>
<tr>
<th>Evaluation of Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Conclusion:</strong> The cost of encasement may be capitalized under either the first or the second criterion.</td>
</tr>
<tr>
<td>1. Removal of the asbestos improves the building's safety over its original condition since the environmental contamination (asbestos) existed when the building was constructed or acquired.</td>
</tr>
<tr>
<td>2. By removing the asbestos, the building's owner has eliminated an existing environmental problem and has prevented any further contamination from that asbestos. However, by removing the existing asbestos, the building's owner has not mitigated or prevented new environmental problems, if any, that might result from future operation of the building.</td>
</tr>
<tr>
<td><strong>Conclusion:</strong> Asbestos removal costs may be capitalized as a betterment under the first criterion.</td>
</tr>
</tbody>
</table>
III. Application Of Administrative And Case Law Applying Sections 263 And 162 To Environmental Remediation Expenditures: An Overview

A. Background

1. Section 263 and the regulations under Sections 263 and 162 set forth the traditional general rules used in determining whether amounts expended for work on buildings and other tangible property constitute deductible repairs or capitalizeable improvements.

2. Section 263(a)(1) provides that no current deduction is allowed for an amount paid for permanent improvements or betterments made to increase the value of any property.

a. Under Regs. Section 1.263(a)-1(b), a capital expenditure includes any expenditure that either (1) adds value to property, or (2) substantially prolongs the useful life of the property, or (3) adapts the property to a new or different use.

1) Note that the regulations do not specify the method for determining what constitutes a material increase in the property's value.

2) The courts have superimposed a requirement that costs incurred as part of a general plan of rehabilitation or restoration must be capitalized, even though the same costs would be deductible if incurred separately.

a) The theory is that, at some point, a series of related repairs rises to the level of a capital project.

i) E.g., Jones v. Comm., 242 F.2d 616 (5th Cir. 1957)

b) It is not clear whether the "plan of rehabilitation" doctrine is an exception to the three-prong test, or merely an analytical tool utilized to determine whether any of the three tests have been met.

b. If the capitalized improvement or betterment has a determinable useful life, its cost may be recovered over a period of years through the allowance for depreciation provided by Secs. 167 and 168.

3. Regs. Section 1.162-4 generally permits the current recognition of "incidental repairs" that do not materially add to the value of the property, nor appreciably prolong its life and which are necessary to keep it in an ordinarily efficient operating condition.

a. In the seminal case Illinois Merchants Trust Co. v. Comm. [4 B.T.A. 103 (1926)], the Board of Tax Appeals stated that a "repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition . . . Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use."
4. Note that the ultimate timing and manner of the deduction may also be controlled by other provisions that superimpose additional requirements on these basic rules. For example--

a. Section 461(h) [the "economic performance" requirement]

b. Section 263A [the "uniform capitalization" rules]

c. Section 471 [required use of the accrual method for inventories]

d. Reg. Sec. 1.1502-13 [addressing the taxation of "intercompany transactions" between members of a consolidated group].

B. Despite the apparent simplicity of these rules, their application to specific fact scenarios often proves difficult and controversial: "...the line between repairs and maintenance, and betterments and improvements is shadowy and indistinct." [Black Hardware Co. v. Comm., 16 B.T.A. 551, 553 (1929)].

C. Asbestos removal

1. In TAM 9240004, the Service held that the costs incurred by a taxpayer to remove and replace asbestos insulation in taxpayer's manufacturing equipment must be capitalized.

2. Synopsis of facts:

a. Although the removal and replacement of asbestos insulation was not strictly required by law or regulation, the taxpayer incurred the expenditures in response to governmental concerns about health risks. [The Occupational Safety and Health Administration had lowered the standard set for concentrations of airborne asbestos fiber allowable in the workplace.] Additionally, the state where the taxpayer operated its facility required employers to monitor airborne asbestos concentration to ensure that it did not exceed permissible exposure levels.

   The taxpayer decided to implement a program of asbestos abatement by removing the asbestos insulation in its equipment and replacing it with alternative insulating material, rather than to adopt an alternative program that involved the continuous monitoring of asbestos levels and the encapsulation of disturbed asbestos fibers.

3. Taxpayer's argument:

   a. In treating the asbestos removal costs as deductible repairs, the taxpayer argued--

      1) The removal costs were incidental in relation to total facility repair costs and total assessed value.
2) The costs did not add value to, or substantially prolong the life of, the equipment but merely restored the equipment to its original value. [The replacement insulation performed the same function in the same way as the asbestos insulation.]

3) The costs were not comparable to the types of expenditures generally held to be capitalizable, such as expenditures for new units or components or expenditures incurred as part of a general plan of rehabilitation.

4) In support of its position, the taxpayer relied on Plainfield-Union Water Co. v. Comm., 39 T.C. 333 (1962), nonacq. According to the Tax Court in that decision, the relevant standard was the property's value after the expenditure as compared to its value prior to the existence of the condition necessitating the expenditure. Applying that test here, the taxpayer compared the value of the equipment following the asbestos removal with its value before asbestos became known as a health hazard. Since the value of the equipment as appraised by the tax assessor was reduced by exactly the cost required to abate the asbestos, the removal costs did not increase the value of the equipment, but merely restored it to its original value prior to the time of discovery of the asbestos problem.

4. Service's position

a. The National Office rejected the taxpayer's contention that the asbestos removal and replacement costs are similar to incidental repairs, finding instead that the costs were more in the nature of capital expenditures because they increased the value of the taxpayer's equipment by diminishing the asbestos health risk.

1) The removal program reduced the taxpayer's potential liability to employees and made the facilities more marketable and attractive to potential buyers, investors, and lenders, i.e., property without asbestos is "inherently more valuable" than property containing asbestos insulation and, therefore, asbestos removal costs must be capitalized as an improvement or betterment to property.

2) The National Office rejected the application of the Plainfield-Union test to these facts on the grounds that:

a) That test is relevant only where repairs are necessary because of progressive deterioration [In contrast to Plainfield-Union (which involved the replacement of tar lining with cement lining to cure a pipeline rusting problem), this taxpayer here chose to remove the asbestos for health and economic reasons, i.e., the asbestos had not become less effective as an insulating material.];

b) Because the taxpayer's equipment was manufactured with asbestos, it could not be valued before the existence of the asbestos;

c) The increase in the equipment's value after asbestos removal was based on subjective factors, such as safer working conditions and improved marketability, which are not compatible with the objective valuation approach of Plainfield-Union.
3) For additional support, the Service cited a line of cases [e.g., *Teitelbaum v. Comm.*, 294 F.2d 541 (7th Cir. 1961)] holding that expenditures made to bring property into compliance with local law requirements increase the value of property. Here, since the taxpayer here was subject to federal and state regulation of its asbestos levels, the removal costs made the facilities more valuable because the risk of an operational suspension due to asbestos levels was largely eliminated.

4) Asbestos removal enhanced value by eliminating the need to take expensive and time-consuming precautions to protect employees when equipment undergoes routine maintenance.

5) The National Office held further that capitalization was required because the asbestos removal effected a permanent improvement and not a "repair": A "repair," in the Service's opinion, is not a permanent cure but is instead something that remedies immediate consequences. The asbestos removal here was a permanent improvement because it was a one-time expenditure that resulted in a significant change in the property and was not remedial under this standard.

6) Finally, the National Office also relied on language in the Supreme Court's opinion in *INDOPCO, Inc. v. Comm.* [112 S. Ct. 1039 (1992)] in concluding that the asbestos removal cost must be capitalized. Under INDOPCO an important consideration in determining whether an expenditure is capitalizeable is whether the taxpayer realizes benefits beyond the year in which the expenditure is incurred.

   a) Here the taxpayer derived long-term benefits from the asbestos removal expenditures in the form of safer working conditions, reduced liability risks, and increased marketability, and none of these benefits were found to be "merely incidental."

D. Soil remediation costs.

1. In TAM 9315004, the Service denied a deduction for the costs of an environmental cleanup undertaken to comply with requirements of the Environmental Protection Agency.

   a. The specific costs that were required to be capitalized were costs incurred for:

   1) Testing to determine the extent of contamination and required cleanup;

      a) [A deduction would, however, be permitted for the cost of testing any site if it was determined from the testing that no cleanup operations were necessary.]

   2) Removal and transportation of PCB-contaminated soil, and replacement with clean soil [a process known as "remediation"]; and

   3) Oversight of the cleanup process.
b. A current deduction was permitted for legal fees incurred (1) to defend against Environmental Protection Agency and state regulatory claims arising out of taxpayer's having dumped toxic waste, (2) to defend against private lawsuits arising out of the same activities, and (3) to seek insurance reimbursement for matters arising out of those activities.

c. The Service expressly declined to determine the deductibility of the costs of environmental audits, of developing a PCB compliance manual, and of research and development into alternative remediation techniques.

d. The Service noted that its conclusions will be given further consideration in connection with a study project on environmental cleanup costs.

2. The taxpayer argued that the assessment, remediation, legal, audit, and oversight costs incurred to clean up soil [soil that was primarily on the taxpayer's own property and near its production facilities] that had been contaminated with PCBs were deductible as repairs.

3. However, according to the National Office, the extensive modifications to the property under the cleanup operation constituted, replacements and betterments, and they were therefore not "repairs." The costs constituted a "general plan of rehabilitation and restoration" of properties throughout the taxpayer's system and would benefit such properties for the useful life of the system.

E. The positions taken by the Service in these two rulings have become the focus of considerable criticism and concern on the part of industry executives and tax professionals.

1. See, for example a position paper submitted to I.R.S. Commissioner Richardson in June, 1993, in which the Tax Executives Institute argued that most types of remediation expenditures would be properly deductible as repair and maintenance costs and that the private letter rulings requiring the capitalization of costs associated with asbestos abatement and PCB cleanup "unnecessarily cast a pall of uncertainty over the income tax treatment of these expenses."

   a. TEI challenged the legal analysis and conclusions contained in these rulings and urged Service to reconsider its position and to publicly confirm that environmental remediation expenditures will generally be deductible when incurred.

IV. Concluding Remarks