

## MONTHLY TOPIC (06/11) - "WITH-AND-WITHOUT" OR "TAX-LAW-ORDERING"

Accounting for windfall (i.e., tax deductions in excess of related financial accounting charges) stock compensation involves making an initial election to use either the "with-and-without" or the "tax-law-ordering" method. The following addresses the implications of making the election:

### Accounting for windfall stock compensation - APIC entry background

Generally an APIC entry is recorded for the difference between the current tax provision "with" stock compensation calculation and "without" stock compensation calculation due to windfall tax benefits.

The stock compensation deduction taken on a "with" current calculation is equal to the tax deduction. The stock compensation deduction taken on a "without" current calculation is equal to the lesser of the tax deduction or the related book expense.

#### **Example 1 - APIC entry for windfall stock compensation:**

**FACTS:**

Pre-tax book income	100
Current year book stock comp Employee B	10
Current year tax stock comp Employee A	30 (a)
Employee A related book stock comp	20 (a)
Statutory tax rate	40%

(a) Note: In the current year the company is taking a stock compensation deduction for Employee A's exercise. The tax stock compensation deduction for Employee A, on a "with" basis, is the \$30 tax deduction. On a "without" basis, it is the **lesser of** the \$30 tax deduction or the related \$20 book expense. The related book expense is the P/L book stock compensation (former "FAS 123R" or "APB 25" deduction) related to Employee A's exercise that triggered the tax deduction.

	Current Provision	
	With	Without
Pre-tax book income	100	100
Add back book stock comp	10	10
Deduct tax stock comp	(30)	(20) (without = lesser of tax or related book comp)
Taxable income	80	90
Tax rate	40%	40%
Tax provision	32	36

APIC Journal Entry:

Dr. Income Tax Payable	4	
Cr. APIC		4

Pursuant to ASC 718-20-55-20, a credit to APIC for a windfall tax benefit is recorded when the stock compensation deduction reduces the tax payable. In the example above the current provision is calculated at \$36 but the tax return stock deduction is greater and reduces the payable by \$4.

**APIC entry timing: "with-and-without" vs "tax-law-ordering" method election**

A taxpayer can elect the "with-and-without" or "tax-law-ordering" approach to determine **when** to book the APIC entry related to a windfall tax benefit. The method once chosen is an accounting policy that should be consistently followed.

Based on the "with-and-without" method, a windfall benefit would be recorded to APIC only after utilizing all "non-stock compensation tainted" tax attributes. Therefore all "non-stock compensation tainted" tax attributes (e.g., net operating losses and credits) are used before utilizing stock compensation tainted attributes (refer to example 2 below). Under the "tax law ordering" approach, the tax attributes are taken based on the order utilized for tax return purposes (refer to example 3 below).

**Example 2 - "with-and-without" ordering method:**

**FACTS:**

**Attributes**

	With	Without	Cumulative tax-effected at 40% Stock Compensation Taint			
			Year 1	Year 2	Year 3	
Year 1 NOL	100	80	8	8		(c) 20 x 40%
Year 2 NOL	70	60		4		10 x 40%
Year 3 NOL utilized	(160)	(140)				
Year 3 NOL carryforward	10	0	8	12	4	10 x 40%
Year 1 Credits	20	20	0	0		
Year 2 Credits	10	10		0		
Year 3 Credits	15	15				
Year 3 Credits utilized	0	(8)				
Year 3 Credits carryforward	45	37			8	(c) 20 x 40%
<b>Total "stock comp tainted" attributes</b>			<b>8</b>	<b>12</b>	<b>12</b>	

**Current Provision**

	With	Without
Year 3 Pre-tax income	160	160
NOL utilized	(160)	(140)
Tax Income	0	20
Tax Rate	40%	40%
Tax before credits	0	8
Credits	0	(8)
Net Tax	0	0
APIC entry		0 (b)

(b) An APIC entry is not booked as tax credits are used to reduce the "without" current tax provision to \$0, which equals the \$0 current tax provision on a "with" basis.

(c) Credits of \$8 become "stock comp. tainted" in year three that were previously "tainted" NOLs in year 2 ("substitution" concept).

**Example 3 - "tax-law-ordering" method:**

**FACTS:**

**Attributes**

	With	Without	Cummulative tax-effected at 40% Stock Compensation Taint		
			Year 1	Year 2	Year 3
Year 1 NOL	100	80	8	8	
Year 2 NOL	70	60		4	
Year 3 NOL utilized	(160)	(140)			
Year 3 NOL carryforward	10	0	8	12	4
Year 1 Credits	20	20	0	0	
Year 2 Credits	10	10		0	
Year 3 Credits	15	15			
Year 3 Credits utilized	0	0			
Year 3 Credits carryforward	45	45			0
Total "stock comp tainted" attributes			8	12	4

**Current Provision**

	With	Without
Year 3 Pre-tax income	160	160
NOL utilized	(160)	(140)
Tax Income	0	20
Tax Rate	40%	40%
Tax before credits	0	8
Credits	0	0
Net Tax	0	8
APIC entry ("tax-law-ordering" calculation)		(8) (d)

(d) An APIC entry is booked for \$8 because pursuant to the "tax-law-ordering" approach you need to fully utilize the NOLs both on the "with" calculation as well as the "without" current provision calculation and book the APIC entry before utilizing credits. "Substitution" does not occur.