In stock options, accounting simplicity begets payroll complexity

If the payroll office is scrambling to change tax withholdings for folks holding stock options, simplification in the accounting office is the likely reason why. **Tammy Whitehouse** reports.

If there's some scrambling in the payroll office to change tax withholdings for folks holding stock options, you can attribute it to simplification in the accounting office.

The Financial Accounting Standards Board issued an update to accounting standards in March 2016, ASU 2016-09, that aimed to make it easier for companies to account for share-based payment awards. The update followed a post-implementation review of earlier accounting rules that revealed companies were finding the existing accounting unnecessarily costly and complex, while also producing some unpleasant tax consequences for employees.

FASB's newest rules not only simplified the accounting, but also had the effect of potentially easing the tax sting employees often experienced with the vesting or exercise of stock compensation awards. Now, it seems, the burden has shifted to the payroll office to push through the paperwork associated with changing withholding requirements to assure both the accounting and the tax consequences pan out.

"Implementation is prime for foot falls," says Robert Delgado, a tax partner at KPMG. "Getting all of this aligned is a process. Some companies are going through and saying it's worth it to us to make this happen, but we've seen a lot of companies table this until next year. Part of it is the complexity with the withholding rules."

The standard takes effect for public companies with the start of the 2017 reporting year, so calendar-year-end companies, for example, would be adopting it in the current quarter. FASB also permitted early adoption, and accounting experts say some companies chose to put the simplifications into play last year.

Vesting or exercising of share-based payment awards is a taxable event, and companies often settle awards with employees on a net basis, withholding a number of shares equivalent to the tax due to settle the tax obligation. Historically, accounting rules have required companies to withhold tax on such awards at the minimum statutory rate that would apply in the jurisdiction for the individual holding the award.

The minimum rate requirement was critical for companies to win equity classification for the award in the balance sheet; withholding at any amount higher than the minimum rate would trigger classification of the award as a liability. That would mean re-measuring the fair value each reporting period, an alternative about as welcome as getting a root canal. "Companies often don't want awards to be classified as a liability," says Sandie Kim, senior consultation partner at Deloitte & Touche. "It creates volatility in the income statement."

Withholding at the minimum rate for each individual employee, however, has produced loads of complexity for accounting offices. Companies must track the tax differences between what's withheld when the transaction occurs compared with the tax that actually will be due and reflect those differences both for tax and accounting purposes. And for employees, because they are being awarded shares and not cash, the initial withholding at the minimum tax rate often leads to a later cash outlay to settle their tax difference at filing time.

"It's fair to say the new ASU does simplify some of the tracking," says Kim. "But it doesn't eliminate all the tracking or all the complexities in trying to figure out the right tax rate to use for each employee in each jurisdiction."

The accounting simplification represents a loosening of the rules around net settlement for purposes of income tax withholding, says Doug Reynolds, a partner at Grant Thornton. "Now this makes it easier for companies to avoid liability treatment for their awards, and it helps with the amount of taxes that can be withheld for the employee," he says.

The concept has been fairly clear and has provided welcome relief, says Reynolds, but the details are deep. "I've seen very many questions about the mechanics of this," he says.

Mark Shannon, managing director at Crowe Horwath, says some questions have centered on how to address situations where a company has no statutory withholding obligation within a particular jurisdiction at all. Some companies are uncertain whether they'll be stuck with liability classification if they only qualify for equity classification by meeting statutory withholding obligations. "If I have zero withholding obligation, what does that mean?" he asks.

Other questions have focused on what rate to use when employees are mobile and might work in many different jurisdictions. "Does this suggest perhaps you could come up with a blended rate you might apply?" he asks.

Questions also surfaced around how companies could modify stock compensation awards to permit for higher withholdings to enable adoption of the accounting simplification, says Yosef Barbut, a national assurance partner with BDO USA. Modifications of awards might be viewed as an event that would trigger "modification accounting," another root-canal-like outcome companies would prefer to avoid.

"There were a lot of questions back and forth with FASB on this," he says. FASB has a clarification in the works to make it clear that awards modified for purposes of complying with the new accounting guidance or tax law will not trigger modification accounting consequences, provided the changes

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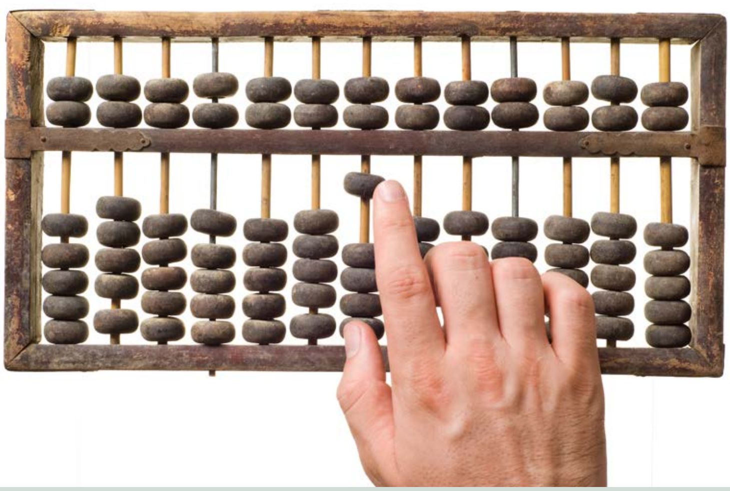
Sandie Kim, Senior Consultation Partner, Deloitte & Touche don't affect fair value, vesting, or classification, he says.

With most companies working through the new accounting, the focus has shifted in recent weeks to payroll offices, says Delgado, which are busy processing changes to withholding requirements that will permit companies to withhold under tax rules in a way that synchronizes with the new accounting simplification.

Because of the way withholding works under Form W-4 filings with the Internal Revenue Service, some employees are finding they need to do multiple, rapid filings to make changes that permit an appropriate withholding for stock compensation purposes without mucking up withholding for routine payroll purposes.



Companies that are still caught up in the payroll complexity of this particular accounting simplification may choose to sit this year out because the change to accounting standards with respect to tax withholding is not mandatory, says Ashby Corum, partner-in-charge in the accounting and income taxes group at KPMG.

"Overall, the ASU is generally effective for calendar-year companies in the first quarter of 2017, and many of the accounting changes are required to be adopted," says Corum. "This particular change allows withholding up to the maximum, but it doesn't require you to withhold up to the maximum." That means companies can continue to withhold as they always have and make the change in a future year. ■

FINANCIAL REPORTING CONSIDERATIONS

Below, PwC explains some of the issues surrounding ASU 2016-09

In March 2016, FASB issued ASU 2016-09, Improvements to Employee Share-based Payment Accounting. One of the provisions in the new guidance relaxes the threshold for the amount of shares that an employer may withhold upon exercise of a stock option to fund the employer's withholding tax obligation.

Under current U.S. GAAP, withholding is limited to the minimum statutory rate in the respective employee's jurisdiction; the new guidance permits withholding up to the maximum statutory tax rates in the applicable jurisdiction without resulting in liability classification of the stock compensation award.

Recently, the issue of whether modification accounting should be applied when changing the terms of an award to allow for maximum tax withholdings as a result of the new guidance was elevated to the FASB staff.

ASC 718 defines "modification" as "a change to any of the terms or conditions of a share-based payment award." Read literally, amending an award or plan document to permit withholding up to the maximum tax rates would constitute a modification, resulting in a new measurement date for awards with performance conditions that are not probable of being achieved at the time of the modification (i.e., Type IV modifications).

Based on recent discussions, we understand that the FASB staff's view is that changing existing awards to allow for higher levels of tax withholding as a result of the expanded provisions in the ASU need not be evaluated as a modification. However, this accommodation is limited to changes to existing tax withholding rates in an award, and should not be applied by analogy to other situations (e.g., it would not apply if withholding provisions that had not previously existed were added to an award). We understand that the SEC staff does not object to the FASB's approach.

Source: PwC