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Accounting for Tax Benefits of Employee Stock Options and Implications for Research

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This paper examines how firms account for and report the tax benefits of employee stock options (ESOs). The tax benefits of ESOs reduce taxes actually owed but enter stockholders' equity directly without reducing reported income tax expense. Failing to adjust reported income tax expense for this benefit can lead to poorly specified studies with the distinct possibility of considerable measurement error and flawed inferences.

We explain the adjustments needed for more reliable estimates of effective tax rates, tax burdens, and marginal tax rates often critical to analyses of firm-specific and public policy issues. We document problems with firms' disclosures and, using a sample of large NASDAQ firms likely to be heavy users of ESOs, find that adjusting for the ESO tax benefit is essential to understanding the impact of taxes on those firms.

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