DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

10/17/2000

Number: **200103024**
Release Date: 1/19/2001
CC:INTL:Br6/TL-N-1138-00
UILC: 482.11-08

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: October 17, 2000

MEMORANDUM FOR JAMES W. CLARK, AREA COUNSEL CC:LM:CTM
BARBARA M. LEONARD, ASSOCIATE AREA COUNSEL
CC:LM:CTM(PFTG)
Attention: Caroline T. Chen, Attorney

FROM: Steven A. Musher
Chief, Branch 6
Associate Chief Counsel (International) CC:INTL

SUBJECT:

This Field Service Advice responds to your memorandum dated April 28, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

Affiliate A =

Amount 1 = $
Amount 2 = $
Amount 3 = $
Amount 4 = $

Corporation A =

Country A =

Products =

Tax Year 1 =
Tax Year 2 =

ISSUE

Whether the value of compensatory stock options[1] is a cost that must be shared with affiliates under Treas. Reg. § 1.482-7.

CONCLUSION

Under Treas. Reg. § 1.482-7, the value of compensatory stock options is an item of compensation cost for tax purposes that must be included in the pool of costs shared with affiliates under a qualified cost sharing arrangement.[2]

FACTS

The taxpayer, Corporation A, a United States corporation, designs, develops and markets the Products. Affiliate A, an entity controlled by Corporation A, is organized under the laws of Country A. Throughout Tax Years 1 and 2, Corporation A and Affiliate A were parties to a cost sharing agreement relating to research and development (R&D) with respect to new technology.

The cost sharing agreement provided that the parties would share the costs of all R&D activities performed by the parties in connection with the development of the Products. Such costs were to be shared in proportion to the benefits to be derived by each party from manufacturing and marketing products utilizing the developed technology. Determinations of benefit-sharing and corresponding cost-sharing percentages were to be reviewed annually by the parties.

Costs to be shared under the cost sharing agreement included (1) direct costs related to R&D with respect to new technology; (2) indirect costs incurred by other departments allocable to R&D activities; (3) costs of acquiring from third parties intellectual property rights to be used in R&D with respect to new technology, whether by purchase or license. Calculations of costs were to be based on methods used by Corporation A in accordance with generally accepted accounting principles.

---

[1] For purposes of this advice, we use the term "compensatory stock options" to refer to stock options covered by section 83 and by sections 421-424.

[2] With respect to the valuation and timing of compensatory stock option costs, parties to a cost sharing agreement at arm’s length could choose to measure the cost of compensatory stock options at various points in time using various methods. Accordingly, in the absence of specific regulations under section 482 prescribing particular valuation methods, the Service should consider any reasonable method of valuation and timing, reasonably and consistently applied. In no event, however, can ignoring stock option compensation as a cost be viewed as reasonable.

The costs to be shared under the agreement specifically included costs of labor. Under the direct-cost category, the agreement provided that such labor costs "include, but are not limited to, salaries, bonuses, [and] other payroll costs and benefits. . . ."

For each of Tax Years 1 and 2, costs were shared by the parties in the following approximate percentages: Corporation A, 74%; Affiliate A, 26%. The costs shared were only those costs reflected on Corporation A's financial statements as R&D expenses. For financial accounting purposes, as permitted by Statement 123 of the Financial Accounting Standards Board, Corporation A elected not to reflect stock option compensation directly on its income statement for Tax Years 1 and 2 but rather to disclose it in appended footnotes. Such stock option compensation, including that attributable to R&D employees (and employees in departments from which indirect costs were allocable to R&D) was not shared with Affiliate A under the cost sharing agreement.

For Tax Years 1 and 2, Corporation A claimed deductions under section 162 of Amounts 1 and 2, respectively, attributable to the exercise of nonstatutory stock options (section 83(h)) and disqualifying dispositions of statutory stock options (section 421(b)). Additionally, Corporation A claimed incremental research credits under section 41(a) of Amounts 3 and 4, respectively, for Tax Years 1 and 2, treating stock option compensation as part of wages for qualified services (section 41(b)(2)(A)(i)).

LAW AND ANALYSIS

I. Legal background

A. Section 482

Section 482 provides that the Service may distribute, apportion or allocate gross income, deductions, credits or allowances among controlled entities if necessary "in order to prevent evasion of taxes or clearly to reflect the income" of those entities. Section 482 is intended to be broadly interpreted.[3] Its purpose is to "prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking')."[4]

In order to achieve a clear reflection of each entity's income, the applicable section 482 regulations provide that the Service should consider what each entity's income would be had the controlled entities been dealing with each other at arm's length. Treas. Reg. § 1.482-1 reads in part as follows:

---

[3] Foglesong v. Commissioner, 691 F.2d 848, 850 (7th Cir. 1982).

[4] H. R. Rep. No. 2, 70th Cong., 1st Sess., 1939-1 C.B. (Part 2) 426.

> The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.[5]
>
> * * *
>
> The standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).[6]

If a controlled entity's intercompany transactions meet the arm's-length standard of the regulations, then the entity's income should meet the clear-reflection-of-income standard of the statute.

In implementing the arm's-length standard, the section 482 regulations provide specific transfer pricing methods and announce the "best method" principle under which:

> [t]he arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. . . . Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.[7]

Qualified cost sharing arrangements under Treas. Reg. § 1.482-7 are part of this regulatory scheme.[8]

The second sentence of section 482 provides that "[i]n the case of any transfer (or license) of intangible property . . ., the income with respect to such

---

[5] Treas. Reg. § 1.482-1(a)(1).

[6] Treas. Reg. § 1.482-1(b)(1).

[7] Treas. Reg. § 1.482-1(c)(1).

[8] See T.D. 8632, 1996-1 C.B. 85, 87 (preamble states that final cost sharing regulations "reflect the approach of the final section 482 regulations relating to transfers of tangible and intangible property"); Treas. Reg. § 1.6662-6(d)(2) (enumerating qualified cost sharing arrangements as a "specified method").

transfer or license shall be commensurate with the income attributable to the intangible." This commensurate-with-income standard, added to the Code by the Tax Reform Act of 1986,[9] was enacted to clarify the arm's-length standard by requiring that the division of income between related parties reasonably reflect the relative economic activity undertaken by each and thus to address the problem of selective transfers of high-profit intangibles to tax havens.[10]

The legislative history further noted that Congress intended to continue to recognize cost sharing arrangements for purposes of section 482 as an alternative to the transfer or license of intangibles. However, Congress expected cost sharing arrangements "to produce results consistent with the purposes of the commensurate with income standard in section 482 -- i.e., that "the income allocated among the parties reasonably reflect the actual economic activity undertaken by each."[11]

In particular, the Conference Report to the 1986 Act noted:

> In revising section 482, the conferees do not intend to preclude the use of certain bona fide cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent such agreements are consistent with the purposes of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. Under a bona fide cost sharing arrangement, the cost sharer would be expected to bear its portion of all research and development costs, on successful as well as unsuccessful products within an appropriate product area, and the cost of research and development at all relevant developmental stages would be included.[12] (Emphasis added.)

Thus, if not all of the R&D costs are shared, a cost sharing arrangement may fail the statutory commensurate-with-income standard. Cost sharing arrangements must reflect each entity's actual economic activities.

B. Cost sharing regulations

---

[9] Pub. L. 99-514, § 1231(g)(2).

[10] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. at 1011, 1015 (Comm. Print 1986); Section 482 White Paper on Intercompany Pricing, Notice 88-123, 1988-2 C.B. 458, 472.

[11] Id. at 495.

[12] H.R. (Conf.) Rep. No. 841, 99th Cong., 2d Sess., 1986-3 C.B. (vol. 4) 638 (1986).

The cost sharing rules of Treas. Reg. § 1.482-7 were adopted in an effort to implement the principles of the commensurate-with-income standard with respect to cost sharing arrangements.[13] The regulations provide that, in the case of intangibles that are developed pursuant to a qualified cost sharing arrangement, no allocation will be made with respect to the development of the intangibles "except to the extent necessary to make each controlled participant's share of the costs of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development. . . ."[14]

To constitute a qualified cost sharing arrangement, an arrangement must provide a method to calculate each controlled participant's share of intangible development costs based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits.[15]

The Service may make a section 482 allocation with respect to a qualified cost sharing agreement if the controlled participant's share of intangible development costs is out of balance with that participant's share of reasonably expected benefits from the intangibles. For this purpose, a participant's share of intangible development costs (or benefits, as the case may be) is the ratio of the participant's costs (or benefits) of developing intangibles to the total such costs (or benefits) of all controlled participants.[16]

With respect to identifying the pool of intangible development costs subject to cost sharing, the regulations provide, in pertinent part:

> For purposes of this section, a controlled participant’s costs of developing intangibles for a taxable year means <u>all</u> of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it makes to other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of the following items: operating expenses as defined in § 1.482-5(d)(3),

---

[13] <u>See</u> <u>generally</u> T.D. 8632, 1996-1 C.B. 85, 86 (preamble to final cost sharing regulations).

[14] Treas. Reg. § 1.482-7(a)(2).

[15] Treas. Reg. § 1.482-7(b)(2). The arrangement must also be recorded in a contemporaneous document containing certain contractual provisions and basic information. Treas. Reg. § 1.482-7(b)(4). For purposes of this advice, we assume, without deciding, that these formal requirements have been met. The sole issue herein is whether stock option compensation must be included in the cost pool to be shared.

[16] Treas. Reg. §§ 1.482-7(a)(2), 1.482-7(f).

> other than depreciation or amortization expense, plus (to the extent not included in such operating expenses. . .) the charge for the use of any tangible property made available to the qualified cost sharing arrangement. . . . If a particular cost contributes to the intangible development area and other areas or other business activities, the cost must be allocated between the intangible development area and the other areas or business activities on a reasonable basis. In such a case, it is necessary to estimate the total benefits attributable to the cost incurred. The share of such cost allocated to the intangible development area must correspond to covered intangibles' share of the total benefits. . . .[17] (Emphasis added).

The cross-referenced definition of "operating expenses" appears in the regulations relating to the comparable profits transfer pricing method. Under that definition, operating expenses "includes all expenses not included in cost of goods sold except for interest expense, . . . income taxes . . ., and any other expenses not related to the operation of the relevant business activity."[18] (Emphasis added.)

Controlled participants in a qualified cost sharing arrangement must use a consistent method of accounting to measure costs and benefits.[19] Upon request of the Service, documentation of such accounting method must be produced, and any material differences from U.S. generally accepted accounting principles must be explained.[20]

C. Case law

In Commissioner v. LoBue,[21] the Supreme Court held that "[w]hen assets are transferred by an employer to an employee to secure better services they are plainly compensation. It makes no difference that the compensation is paid in stock rather than in money" The taxpayer in LoBue had argued that his receipt of stock options was a receipt of a proprietary interest in the corporation, and therefore not taxable. The Court rejected this argument and found that the character of the transaction was an arrangement "by which an employer transferred valuable

---

[17] Treas. Reg. § 1.482-7(d)(1).

[18] Treas. Reg. § 1.482-5(d)(3).

[19] Treas. Reg. § 1.482-7(i).

[20] Treas. Reg. § 1.482-7(j)(2)(i)(D).

[21] 351 U.S. 243, 247 (1956).

property to his employees in recognition of their services," with the result that the taxpayer realized taxable gain when he purchased the stock.[22]

In Apple Computer, Inc. v. Commissioner[23] and Sun Microsystems, Inc. v. Commissioner,[24] the Service argued that the spread upon the exercise of nonstatutory stock options and the spread upon the disqualifying disposition of incentive stock options, respectively, were not "wages" for purposes of determining the research credit under section 44F or section 41. This provision authorized a credit as a function of expenses paid or incurred by the taxpayer during the taxable year. Expenses included any wages paid or incurred to an employee for qualified research services. "Wages" were defined by section 3401(a) to include all remuneration for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash. The Tax Court held that the taxpayers' gains upon exercise or disqualifying disposition of stock options were wages for this purpose. It did not matter that the spreads were not treated as expenses for financial reporting purposes. The Service acquiesced with respect to both cases.[25]

In Apple Computer, the Service also argued that in order for wage costs to qualify for the credit, the services generating those costs had to be performed in the year in which the credit was claimed. The Tax Court held that even though the services were performed in a year prior to the year in which the options were exercised and a research credit taken, the Court would not disregard the wage expenses for purposes of the research credit.[26]

II. Legal analysis

Treas. Reg. § 1.482-7(d)(1) specifies that the costs of developing intangibles under a qualified cost sharing arrangement must include "all" of the costs incurred related to the intangible development area. The term "operating expenses" that the regulation employs in defining the universe of such costs expressly "includes all expenses not included in cost of goods sold except for interest expense, . . .

---

[22] Id.

[23] 98 T.C. 232 (1992).

[24] T.C. Memo. 1995-69.

[25] 1992-2 C.B. 1; 1997-2 C.B. 1.

[26] 98 T.C. at 239-41.

income taxes . . ., and any other expenses not related to the operation of the relevant business activity."[27] (Emphasis added.)

All R&D compensation incurred by Corporation A is an operating expense and, therefore, is one of the costs of developing intangibles, all of which must be taken into account in determining Corporation A's appropriate share of costs in proportion to benefits.[28] This conclusion is illustrated by the examples in the cost sharing regulations, which expressly refer to types of researcher compensation (there salaries) by way of illustration of intangible development costs.[29]

Compensatory stock options are a form of compensation. Case law such as LoBue, Apple and Sun Microsystems confirms that amounts in consideration for services are none the less compensation expenses simply because they are incurred in the form of property (specifically, stock options), rather than cash. As the Court expressed it in Apple, "there is no requirement that an expense must be paid in cash (as opposed to property)."[30] Therefore, the value of compensatory stock options is a cost that must be shared with affiliates under a qualified cost sharing arrangement pursuant to Treas. Reg. § 1.482-7.

This interpretation of the cost sharing regulations is consistent with the arm's-length standard and commensurate-with-income principle, which require cost sharing arrangements to "reasonably reflect the actual economic activity undertaken by each" participant, who "would be expected to bear its portion of all research and development costs."[31] (Emphasis added.) At arm's length, a business would be unwilling to expend 100% of the time of its researchers on a project in which the business retained only 74% of the results. The business would be willing to proceed only if the parties receiving the 26% interest reimbursed it for 26% of the compensation value and so defrayed the real opportunity cost to the business of not otherwise employing its R&D labor on a project in which it was entitled to 100% of the fruits. The business would not just ignore a significant element of the value of the researchers' compensation on the purported rationale that the labor is "free of cost" when compensated in stock options. That is precisely the type of distortion that section 482 authorizes the Service to prevent by appropriate adjustment.

---

[27] Treas. Reg. § 1.482-5(d)(3).

[28] Treas. Reg. §§ 1.482-5(d)(3), 1.482-7(d)(1), 1.482-7(a)(2).

[29] Treas. Reg. §§ 1.482-7(d)(2), Ex. 1 and 2.

[30] 98 T.C. at 238.

[31] H.R. (Conf.) Rep. No. 841, 99th Cong., 2d Sess., 1986-3 C.B. (vol. 4) 638 (1986).

Corporation A's position that stock option compensation is cost-less also produces a distortive mismatch of tax deductions and income. Corporation A received 100% of the tax deductions attributable to R&D compensated through stock options, while reporting only 74% of the corresponding income. The remaining 26% of the income is attributed to offshore affiliates and may be entitled to deferral of United States tax liability. This, too, is precisely the type of distortion that 482 authorizes the Service to prevent by appropriate adjustments.

For at least two reasons, the fact that Corporation A did not treat stock option compensation as an expense on its financial statements as permitted by generally accepted accounting principles (here, FASB Statement 123) for Tax Years 1 and 2 is irrelevant to the proper inclusion of stock option compensation in the pool of costs subject to a qualified cost sharing arrangement.

First, the relevant financial accounting principles are consistent with the inclusion of stock option compensation in the cost pool under Treas. Reg. § 1.482-7. Although FASB Statement 123 does permit the choice of the intrinsic value method whereby no cost is charged to the income statement if the price the employee must pay to acquire the stock under the option is equal to the market price of the stock on the date the option is issued,[32] the same Statement also permits, and if anything expresses a preference for, the fair value method,[33] which would take stock option compensation arrangements into account in measuring compensation cost.[34]

Second, case law makes clear that there is no required conformity between the section 482 "cost" concept and financial accounting.[35] The Tax Court has

---

[32] In such a case the company must provide pro forma data in footnotes to the financial statements, disclosing the fair value of the option and the net income and earnings per share that would result had there been a cost charged against the income statement. Financial Accounting Standards Board, Statement No. 123, Accounting for Stock-Based Compensation (1995), ¶ 45.

[33] Id., ¶ 11 ("The Board encourages entities to adopt the fair value method of accounting, which is preferable to the [intrinsic value] method for purposes of justifying a change in accounting principle. . . .")

[34] The particular fair value method prescribed by Statement 123 would value stock option compensation at date of grant using specified pricing models. Id, ¶¶ 17, 19. Nevertheless, as discussed at note 2 above, in the absence of controlling regulations, the Service should consider any reasonable valuation method and timing, reasonably and consistently applied, for section 482 purposes.

[35] The cost sharing regulations themselves expressly recognize that there can be legitimate book/tax differences, requiring only that the taxpayer document and be

(continued...)

considered and rejected similar arguments based on financial accounting treatment of stock option compensation. In Apple, Inc. v. Commissioner,[36] in holding that option spreads were wages for research credit purposes despite their omission from the financial statements, the court quoted the Supreme Court's long-standing position that financial and tax accounting have "vastly different objectives" and that:

> [t]he primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." [Citations omitted] In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable. . . . [and] would create insurmountable difficulties of tax administration.[37]

If you have any further questions, please call (202) 874-1490.

STEVEN A. MUSHER
Chief, Branch 6
Associate Chief Counsel (International)

---

[35](...continued)
prepared to explain material differences. Treas. Reg. § 1.482-7(j)(2)(i)(D). This provision may apply where stock option compensation cost is included in the cost sharing pool while not charged against income on the financial statements.

[36] 98 T.C. 232, 239 (1992).

[37] Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542, 544 (1979); accord, United States v. Hughes Properties, Inc., 476 U.S. 593, 603 (1986).