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MEMORANDUM FOR GORDON L. GIDLUND
ASSOCIATE AREA COUNSEL (LMSB) CC:LM:CTM:SD

FROM: Anne O'Connell Devereaux
Senior Technical Reviewer CC:INTL:Br3

SUBJECT:

This Chief Counsel Advice responds to your request received on October 11, 2001. In accordance with I.R.C. section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Corp X =

FSCsub =

Corp Y =

Product A =

Year M =
Year N =

Tax Year 0 =
Tax Year P =
Tax Year Q =

ISSUE

For purposes of determining foreign sales corporation (FSC) income, is it reasonable for Corp X to apportion stock option compensation expense deductions based on apportionment percentages attributable to the stock option vesting period?

CONCLUSION

It is reasonable for Corp X to apportion deductions related to stock option compensation expense based on apportionment percentages attributable to the stock option vesting period.

FACTS

Corp X, a publicly-traded United States corporation, is an accrual-basis taxpayer. Corp X designs and manufactures Product A. Corp X manufactures all of Product A in the United States. The tax years in issue are Tax Years O, P, and Q. Corp X formed FSCsub in Year M to handle its export sales, and formed Corp Y in Year N to handle its domestic sales. All foreign sales of Corp X are made through FSCsub and Corp X sells the same products both domestically and internationally. FSCsub uses the combined taxable income (CTI) method of transfer pricing provided for by section 925(a)(2) of the Internal Revenue Code (Code) and Temp. Treas. Reg. §1.925(a)-1T(c)(6).

For many years, Corp X, pursuant to various plans, has granted both statutory and nonstatutory stock options to officers, directors, and other key employees in exchange for services. None of the nonstatutory options had a readily ascertainable fair market value on the grant date. The vesting period for stock options granted under the various plans ranged from zero to five years from the grant date. Options expired up to ten years after the grant date. No amounts were included in income by the employees at the time of the grant, during the vesting period, or at the time the options vested. Employees included the amount of the difference between the exercise price and the fair market value of the stock (the “stock option spread”) in income at the time they exercised their options or, as required, at the time of the disqualifying disposition.

For purposes of computing CTI, for one or more of the Tax Years O, P, and Q, and only with regard to certain key employees exercising stock options in those years, Corp X ratably divided the stock option spread over the number of years that the option vested. For each year, it multiplied the divided amount of the spread by the apportionment percentage for the applicable year. Corp X then added together the results for the entire vesting period. The total was then applied to CTI for the year in which the stock option was deducted. For example, Corp X granted stock options to a key employee in Year 1, with a vesting period ending in Year 4. The employee exercised the options in Year 5, with a stock option spread of $200. Corp X determined that its key employees spent, on average, the following percentages of time per year on matters involving foreign sales[1]: 5% for Year 1, 10% for Year 2, 15% for Year 3, and 20% for Year 4. Corp X divided the $200 of stock option spread by the four year vesting period so that $50 of the stock option spread was attributable to each year of the vesting period. Corp X then multiplied the $50 stock option spread for each year by the apportionment percentage ($2.5 ($50 x 5%) for Year 1, $5 ($50 x 10%) for Year 2, $7.5 ($50 x 15%) for Year 3, and $10 ($50 x 20%) for Year 4, for a total of $25. In the year in which the employee exercised the option and included the stock option spread in taxable income, Corp X apportioned the $25 to CTI[2].

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[1] For other key employees, Corp X determined the appropriate apportionment fraction based upon a “weighted average foreign sales percentage” that closely resembled the percentage of foreign and US gross income figures.

[2] It is not clear from the facts submitted whether Corp X’s CTI includes both domestic and foreign source income. To the extent that Corp X’s CTI comprises domestic source income, it may not be reasonable for Corp X to apportion compensation deductions to CTI based on employees’ time spent on foreign activities.

LAW AND ANALYSIS

The determination of CTI under section 925 of the Code requires the computation of taxable income from specific sources or activities. This computation is governed by the regulations under Treas. Reg. §1.861-8, which generally require taxpayers to allocate deductions to a class of gross income and to apportion deductions within the class between statutory and residual groupings of gross income. Treas. Reg. §1.861-8(a)(2). One such statutory grouping is CTI. Treas. Reg. §1.861-8(f)(1)(iii). The apportionment of a deduction must be accomplished in a manner that reflects to a reasonably close extent the factual relationship between the deduction and the grouping of gross income. Temp. Treas. Reg. §1.861-8T(c)(1).

The activities of senior executives or key employees are frequently general and administrative in nature and relate to the production of all gross income. Given our understanding of the facts and circumstances, it is reasonable for Corp X to relate its stock option compensation expense to the period between the granting and the vesting of the option, since the employee who receives the option must continue to perform services for the employer during this period in order to receive the benefit of the option upon its exercise. If the specific facts and circumstances call into question the reasonableness of the taxpayer's method of apportionment then the taxpayer's method cannot be used. For example, if there is a long period of time between the vesting date and the date of exercise of the options, the vesting period method may not be reasonable. Similarly, if Corp X applies different apportionment methodologies with respect to different key employees, or with respect to different years for the same key employee, it would be appropriate to question the reasonableness of those methodologies. It is incumbent upon Corp X to explain why such different treatment is reasonable in this situation.

Please call if you have any further questions.

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