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Global Tax Alert

News from Transfer Pricing

US: IRS "practice unit" sets forth examination guidance on the inclusion of stock based compensation in cost sharing arrangements

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Executive summary

As part of the Internal Revenue Service (IRS) Large Business and International Division's (LB&I's) knowledge management efforts, on 30 September 2020, the IRS released a new practice unit titled "Cost Sharing Arrangements with Stock Based Compensation" (DCN INT-T-226). The practice unit focuses on the inclusion of stock-based compensation (SBC) as an intangible development cost (IDC) under a cost sharing arrangement (CSA) subject to Treas. Reg. Section 1.482-7 and provides guidance for tax audits together with relevant resources (the SBC practice unit).

As explained below, the SBC practice unit is the most recent IRS guidance regarding the inclusion of SBC as an IDC since the conclusion of the Altera matter. This Alert provides background information on the long-running dispute between taxpayers and the IRS concerning the proper treatment of SBC in a CSA and summarizes the key takeaways from and implications of the SBC practice unit.

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Detailed discussion

Background

Under the cost sharing rules, controlled parties may enter into a CSA to share the costs and risks associated with the development of intangibles (cost shared intangibles) in proportion to each party's share of reasonably anticipated benefits (RAB) expected to result from use of cost shared intangibles. The cost sharing regulations provide that the results of a CSA are consistent with the arm's length standard only if, among other requirements, each controlled participant's share of IDCs is proportionate to its RAB share. Costs included in IDCs are determined by reference to the scope of the intangible development activity (IDA), which is the activity under the CSA of developing or attempting to develop reasonably anticipated cost shared intangibles. The scope of the IDA includes all of the controlled participants' activities that could reasonably be anticipated to contribute to developing the reasonably anticipated cost shared intangibles. With few exceptions, IDCs means "all costs" incurred in the ordinary course of business after the formation of a CSA that, based on an analysis of the facts and circumstances, are directly identified with or reasonably allocated to the IDA. Notably, the cost sharing regulations specifically provide that SBC is a cost that must be included in the pool of IDCs and shared between controlled parties to a CSA.

In July 2015, the United States Tax Court, in a unanimous decision reviewed by the full court, held in *Altera v. Commissioner* that regulations issued in 2003 that required participants in CSAs to share SBC costs violated the Administrative Procedures Act and were therefore invalid.[1] The Tax Court found that the rule requiring the inclusion of SBC in the cost pool did not comply with the "reasoned decision making standard" because the regulation "lack[ed] a basis in fact," noting that the rule was contrary to evidence that Treasury received during the rulemaking process that SBC costs are not shared between unrelated parties and that Treasury had not engaged in any of its own fact-finding to support its position that the regulation was a proper exercise of regulatory authority.[2] Further, the Tax Court found that Treasury had failed to "meaningfully respond" to the numerous comments submitted during the rulemaking process that the rule was inconsistent with unrelated party behavior and hence the arm's length standard.[3]

In June 2019, a divided panel of the United States Court of Appeals for the Ninth Circuit reversed the Tax Court and upheld the regulation requiring controlled participants to include the cost of SBC in a CSA.[4] In rejecting Altera's argument that the arm's length standard requires a traditional comparability analysis, the majority explained that "historically the definition of the arm's length standard has been a more fluid one" and that "courts for more than half a century have held that a comparable transaction analysis was not the exclusive methodology to be employed under the statute."[5] Further, the Court relied on the 1986 addition to Internal Revenue Code[6] Section 482 of the commensurate-with-income (CWI)[7] standard as the basis for why it was reasonable for Treasury to "dispense with a comparable transaction analysis in the absence of actual comparable transactions."[8] Describing the language of the CWI standard as being "as broad as possible," the majority held that it "cannot reasonably be read to exclude the transfers of expected intangible property" and stated that when parties enter into a CSA, "they are transferring future distribution rights to intangibles, albeit intangibles that are yet to be developed."[9]

Shortly thereafter, in July 2019, the IRS formally withdrew Directive LB&I-04-0018-005 (the *Altera* Memo), which had directed IRS audit teams not to initiate any new examinations for issues related to inclusion of SBC costs in a CSA while the Altera case was on appeal to the Ninth Circuit.[10] By withdrawing the Altera Memo, LB&I signaled that examiners should pursue the issue, including opening new examinations. The withdrawal memo stated that "these issues may be factually intensive, and transfer pricing teams should develop the facts to support their analysis and conclusions." Further, the withdrawal memo noted that IRS Issue Teams should consult with the Transfer Pricing Practice Network and IRS Counsel for support in analyzing the issue and that LB&I would monitor any further developments in the case.

In June 2020, the United States Supreme Court announced that it was denying Altera's petition for a writ of certiorari,[11] putting an end to Altera's challenge to the 2003 cost sharing regulations.

SBC practice unit — in general

As described below, the SBC practice unit addresses three separate issues in the context of a simple fact pattern involving a CSA between a US parent corporation (USP) and a wholly-owned controlled foreign corporation (CFC). In the example, USP and CFC enter into a CSA to develop a patent. Employees of USP undertake research and development (R&D) to develop the new patent and work solely on developing the patent and no other projects. USP pays the R&D employees cash salaries and SBC. The same R&D used to develop the patent subject to the CSA will also be used to develop a patent that is outside the scope of the CSA. USP and CFC determine that the economic value attributable to the R&D should be allocated 75% to the CSA patent and 25% to the patent outside the scope of the CSA. USP includes 75% of the cash salaries it pays the R&D employees in the pool of IDCs under the CSA but does not include the cost of SBC. CFC makes a cost sharing payment equal to its RAB share to USP.

Issue 1 — Whether USP has SBC to include in the pool of IDCs under the CSA

The SBC practice unit directs examiners to first determine whether USP is a party to a CSA. In that regard, examiners should review various sources, including: (i) Form 5471 (in particular, Schedules G and M); (ii) Form 1120, Schedule UTP, and Forms 8275 and 8275-R (Disclosure Statements); and (iii) Form 10-K for CSA disclosures or adjustments to tax reserves for SBC. Further, examiners also should issue an initial transfer pricing information document request (IDR) to ascertain the existence of any relevant CSA.

Once it is confirmed that USP is a party to a CSA, examiners next must determine if USP has incurred SBC costs and if the SBC costs are attributable to CSA IDCs. The SBC practice unit focuses on the broad definition of SBC under Treas. Reg. Section 1.482-7, explaining that the term means "any compensation" provided by a controlled participant to an employee, director or independent contractor in the form of equity instruments, stock options or rights with respect to (or determined by reference to) equity instruments or stock options. This includes but is not limited to property to which Section 83 (property transferred in connection with the performance of services) and Section 421 (general rules regarding incentive stock options and employee stock purchase plans) apply, regardless of whether ultimately settled in the form of cash, stock or other property. Types of SBC subject to inclusion as IDCs include, but are not limited to, non-statutory stock options, incentive stock options (ISO), employee stock purchase plans (ESPP), restricted stock awards, restricted stock units, stock appreciation rights and phantom stock arrangements.

To determine whether USP has incurred SBC costs and, if so, to further determine the employees (or other persons) associated with the SBC and the treatment of SBC as an IDC under the CSA, the SBC practice unit recommends that examiners seek and review a broad range of materials and information through a "mix of … IDRs, questionnaires, and/or interviews." As an initial matter, examiners should review Form 1120 and Form 10-K, together with accompanying book financial statements. In addition, examiners should utilize the IDR process to request copies of any CSA plan documents and to obtain detailed information regarding the department(s) responsible for SBC, the names of personnel who are responsible for SBC data records and calculations, and types of SBC data available, including, in particular, cost center keys to trace the amounts of SBC to the financial statements and tax return. Further, applicable transfer pricing documentation and related background materials should be sought, including information regarding IDC pools and IDC and SBC allocation workpapers.

The ultimate purpose of this exercise to identify employees (or other persons) who received SBC and determine if the cost of SBC directly identified with or reasonably allocated to the IDA under the CSA is included in the pool of IDCs. If SBC is not included in IDCs, examiners are directed to "begin developing the data and legal arguments to include all SBC attributable to CSA IDCs" in consultation with IRS Counsel and the Transfer Pricing Practice Network. Finally, as a best practice, examiners are advised to first sample the general SBC calculations to determine that it was correctly calculated before undertaking the exercise of allocating SBC to IDCs.

Issue 2 — Whether the CFC has reimbursed USP for its RAB share related to the SBC that must be included in the pool of IDCs

The SBC practice unit next turns to providing guidance to examiners as to whether the CFC has properly reimbursed the USP for the CFC's share of such SBC costs. The SBC practice unit initially notes that controlled participants are required to share IDCs in proportion to their RAB share. The SBC practice unit then explains that a controlled participant's IDC share is equal to the controlled participant's cost

contributions divided by the sum of all IDCs for the tax years. The controlled participant's cost contributions are computed by adding up the IDCs initially borne by the controlled participant plus all cost sharing transactions (CSTs) made by the controlled participant, less all CSTs received from other controlled participants. The controlled participant's RAB share is equal to its RAB divided by the sum of the RABs of all the controlled participants. The SBC practice unit also explains that the determination of whether SBC is related to the IDA is made as of the grant date of the SBC.

The SBC practice unit further explains that the costs attributable to SBC are generally the SBC amounts that are allowed as a deduction in the relevant tax year. The SBC practice unit notes, however, that even though certain SBC costs are not deductible under tax accounting rules (e.g., ISO under Section 422(a) or an option granted under an ESPP pursuant to Section 423(a)), those costs are nevertheless included for purposes of computing IDCs under the CSA regulations. The SBC practice unit also provides some guidance as to how to compute SBCs for purposes of IDCs when there has been a repricing or other modification of a stock option, or when SBC was not exercised during the term of the CSA. Lastly, the SBC practice unit explains that a taxpayer can elect to use fair value to include SBC costs for options on publicly traded stock and provides additional guidance on what constitutes publicly traded stock and how to compute the fair value amount.

Examiners are instructed to obtain information (whether found in the taxpayer's transfer pricing documentation or obtained through an IDR) that allows them to understand the amount of SBC, calculation of SBC attributable to IDCs, and RAB share allocation. Examiners are also advised to verify additional information, such as the list of personnel that generate SBC costs, calculation of the SBC and calculation of RAB share.

As a last step, examiners are instructed to compute the amount of SBC costs that should have been included on the tax return (taking into consideration the *Altera* decision) and then determining an adjustment to such amount if necessary.

Issue 3 — How to proceed if USP claims that CFC incurred its own SBC costs related to the CSA

Finally, the practice unit mentions that occasionally a taxpayer will assert that a foreign participant to a CSA had SBC costs that need to be addressed. In this situation, examiners are simply instructed to coordinate with IRS Counsel to properly develop the issue.

Implications

The SBC practice unit is the first IRS guidance concerning CSAs with SBC since the conclusion of the *Altera* case and, along with the withdrawal memo, is a strong indication that the IRS plans to aggressively audit the inclusion of SBC in CSAs for taxpayers located both inside and outside of the Ninth Circuit. Given the IRS's favorable outcome in *Altera*, the IRS will likely continue to pursue this issue until it is ultimately resolved by the courts through either appellate decisions or an opinion of the United States Supreme Court.

As a result, taxpayers with CSAs should review and evaluate their positions regarding the inclusion of SBC costs, paying particular attention to the examination methods prescribed in the SBC practice unit.

Endnotes

1. *Altera v. Commissioner*, 145 T.C. 91 (2015).
2. *Id*. at 125.
3. *Id*. at 130-31.
4. *Altera v. Commissioner*, 926 F.3d 1061 (9th Cir. 2019).
5. *Id*. at 1078.
6. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
7. The second sentence of Section 482 provides, in part, that "[i]n the case of any transfer (or license) of intangible property … , the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."
8. 926 F.3d at 1083.
9. Id. at 1076.
10. Directive LB&I 04-0719-008. The IRS's Altera Memo was issued in January 2018.
11. 2020 WL 3405861.

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