



Inclusion of Stock Option Costs in Pool of Costs to be Shared under Section 482

Issue

The IRS asserts that the “cost” or “value” of compensatory employee stock options must be included in the pool of costs to be shared or charged out pursuant to taxpayers’ qualified cost sharing arrangements under section 482 of the Internal Revenue Code.

Background

Pursuant to the cost sharing regulations under the Internal Revenue Code, the IRS district director shall not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each participant’s share of the costs of intangible development equal to its (the participant’s) share of reasonably anticipated benefits attributable to such development. (Reg. Sec. 1.482-7(a)(2)). A controlled participant’s costs of developing intangibles for a taxable year includes all 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 receives from other controlled and uncontrolled participants. (Reg. Sec. 1.482-7(d)(1)).

The IRS has noticed the increased use of cost sharing agreements, and has begun to issue guidance to examiners on the compliance requirements associated with these agreements. In FSA 200003010 (January 24, 2000), the IRS concluded that the value of stock options granted or exercised by employees that perform an R&D function must be shared among the participants.

In *Seagate Technology, Inc. v. Commissioner*, Tax Court Dkt. No. 15086-89 (“Seagate”), the IRS argued that the taxpayer must include the cost or value of employee stock options in the cost pool for cost sharing purposes. Specifically, the IRS claimed that stock options must be included in the cost pool on one of two valuation dates — the date of grant or the date of exercise. On July 31, 2001, the IRS conceded the stock option issues for the years covered by the 1968 cost sharing regulations and agreed to enter into a closing agreement for taxable years covered by the 1996 cost sharing regulations. Pursuant to the settlement, the IRS conceded the issue under both the 1968 and 1996 cost sharing regulations.



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Background (cont.)

Despite its concession in Seagate, the IRS apparently does not consider the concession therein as a policy change on this issue. Indeed, in an IRS Industry Directive issued January 30, 2002, the IRS said that, for tax years beginning after December 31, 1995, it will require the sharing of stock-option compensation costs attributable to the development of intangibles under a qualified cost sharing arrangement. Further, the Directive requires that, even if stock option costs are included in the cost pool, the method of determining the amount of costs to be shared will be accepted only "if the taxpayer shows that such method is reasonable and is applied reasonably and consistently." Consistent with its settlement in Seagate, the IRS will no longer make adjustments to the cost pool for stock-option compensation for pre-1996 years, and any pending audits with this issue for tax years beginning prior to January 1, 1996 will be discontinued. In addition, the Seagate concession would not appear to affect policy in the IRS Advanced Pricing Agreement ("APA") Program (although the APA office has agreed to bifurcate an APA request to cover only the buy-in issue without having to seek coverage regarding the make-up of the R&D cost pool or method for allocating these costs under a cost sharing arrangement).

Currently, there is a case docketed in the Tax Court, which presents, among other things, the stock option issue. See *Xilinx Inc. v. Commissioner*, Tax Court Dkt. No. 4142-01.

On July 26, 2002, the IRS issued proposed rules (REG-106359-02) that would amend final rules issued in 1995 to clarify that stock-based compensation must be taken into account in determining operating expenses under Reg. Sec. 1.482-7(d)(1), and provide rules for measuring stock-based compensation costs. The guidance is generally proposed to be effective for stock-based compensation granted in taxable years beginning on or after the date these rules are finalized and published in the Federal Register. An IRS hearing was held on November 20, 2002, where witnesses testified that the proposed regulations violate the arm's length standard and are anti-competitive.



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Policy Considerations

The IRS position regarding the stock option issue is inconsistent with the arm's length standard and conflicts with the purpose for which the cost sharing regulations were adopted. Unrelated third parties do not, and would not, share the "cost" or "value" of stock options in similar arrangements.

The IRS proposed position is also inconsistent with all other methods under the section 482 regulations (e.g., cost plus, CPM, cost for nonintegral services, etc.). It is also inconsistent with IRS practice in applying those methods in that for all of the other methods, "Costs" are not treated as including amounts for stock options. Further, the IRS position would classify stock option amounts as "operating expenses," contrary to the characteristics of stock options as capital items and widespread business practices.

In addition, the IRS proposed position is inconsistent with the practice of our treaty partners. Advocating such a position creates the significant likelihood of double taxation since it is unlikely that any other foreign government would accept these costs from the U.S. affiliate.

Recommendation

It is the position of the SVTDG that the IRS proposed rule regarding the stock option issue is inconsistent with the arm's length standard and conflicts with the purpose for which the cost sharing regulations were adopted.