Stock options are under attack — in the international tax world as well as in the business world. In the wake of Enron, WorldCom, and other corporate “implosions,” stock options are picking up blame for causing executives to obsess about short-term stock gains at the expense of the long-term health of the company instead of aligning management interests with those of shareholders. A related question is whether employee stock options represent an economic cost that should be reflected in earnings to portray fairly the company’s financial situation. The tension in this latter issue parallels the high-stakes international tax issue of whether compensatory stock options are costs to be shared when cross-border corporate relatives jointly develop intangible property.

Corporate America has long taken the view that employee stock options are costless in an income statement sense, and need not be expensed in determining reported earnings. This view has persisted despite the preferred position of the Financial Accounting Standards Board (“FASB”) that companies recognize the fair value of employee stock options as a compensation expense. Most companies instead merely disclose the pro forma effect on earnings in footnotes to their financial statements.1

The tide is suddenly turning. A number of prominent U.S. companies have recently announced that they will change to expensing the fair value of options. Bills relating to both the financial treatment and the tax treatment of employee stock options are proliferating in Congress.2 The International Accounting Standards Board (“IASB”) plans to issue a proposal that would require companies using IASB standards to recognize stock option expenses beginning in 2004, and FASB is seriously considering such a proposal as well.3

Despite the controversy surrounding financial accounting for compensatory stock options, their basic income tax treatment is settled (absent any legislative changes). The issuing company deducts the spread between the exercise price and the fair market value of the underlying stock upon the exercise of a nonstatutory stock option, and the employee has an equal amount of taxable income. Statutory stock options do not generate tax deductions (or income to the employee) except in the case of a “disqualifying disposition.”

It is on a different front that the Internal Revenue Service (“IRS”) appears in the current fray. Its battle is whether options granted to researchers are a cost that must be shared under “qualified” cost sharing arrangements (“CSAs”) for the development of intangibles under Regs. §1.482-7. The IRS and taxpayers have been at loggerheads on this issue since the mid 1990s. Although the IRS unexpectedly conceded the issue in one of its lead cases last year,4 it continues to vigorously litigate its position that option expense must be included in the cost base for a qualified CSA. In July 2002, in an apparent attempt to seize the offensive, the IRS issued proposed regulations mandating such treatment. As discussed in the following pages, these proposed regulations raise serious questions.
COST SHARING ARRANGEMENTS UNDER §482

One cannot appreciate the CSA stock-option debate without a brief journey through the evolution of CSAs and their relationship to the arm’s length standard of §482.5

Guiding Principles

The Arm’s Length Standard

Section 482 authorizes the IRS to make adjustments to transactions among commonly controlled taxpayers to clearly reflect income and to prevent the evasion of taxes. Accordingly, a taxpayer engaged in a transaction with another commonly controlled entity is placed “on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer” under the arm’s length standard.6 The regulatory explication of this overarching standard bears recitation:

In determining the true taxable income of a controlled taxpayer, 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 . . . . 7

Cost Sharing Arrangements

Often one member of a controlled group will own intangible property that other members of the controlled group wish to use. Under regulations promulgated in 1968 and in effect until 1996, the §482 approach to such transactions was determined under rules similar to those for other types of controlled transactions, such as sales of tangible property. The sale, license, loan, or assignment of intangible property by one member of a controlled group (the transferee) to another was respected as long as the transferee received arm’s length consideration. Arm’s length consideration could be in the form of royalties, lump-sum payments, or any other form (including reciprocal licensing rights) that might reasonably have been adopted by unrelated parties under the same circumstances.8

The 1968 regulations provided an alternative method for related parties to achieve an arm’s length result with respect to intangibles — by entering into a “bona fide cost sharing arrangement” covering the development of the intangibles (referred to hereinafter as a “Bona Fide CSA”). The regulations precluded any IRS adjustments with respect to intangibles acquired pursuant to a Bona Fide CSA “except as may be appropriate to reflect each participant’s arm’s length sharing of the costs and risks of developing the property.” An arm’s length sharing of the costs and risks was defined as involving “terms and conditions . . . comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement.” 9

Commensurate-With-Income Rule

In the 1986 Tax Reform Act (“1986 Act”), Congress amended §482 to require that the income with respect to any transfer or license of intangible property be “commensurate with the income attributable to the intangible.” The objective was to combat the selective transfer to tax havens of high-profit intangibles for which appropriate comparables were unavailable.

The only aspect of a Bona Fide CSA at odds with the commensurate-with-income standard was, as with basic licenses, a temporal one — a Bona Fide CSA required terms consistent with those that unrelated parties would enter into based on anticipated exploitation of the intangible, whereas the commensurate-with-income standard considers how the parties actually end up exploiting the intangible. In adding the commensurate-with-income requirement, “Congress did not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties.” Congress did, though, envision “that the allocation of R&D cost-sharing arrangements generally should be proportionate to profit as determined before deduction for research and development.” 10

Congress also directed the IRS to conduct a comprehensive study of intercompany pricing rules to determine if the existing §482 regulations should be modified in any respect. This directive resulted in a 1988 “White Paper,” 11 comprehensive revised regulations on many aspects of §482 in 1994, and new

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5 Section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), and the regulations thereunder, unless otherwise stated.

6 Regs. §1.482-1(a)(1). Regs. §1.482-1(i) contains definitions of “controlled taxpayer” and “controlled transactions,” inter alia.

7 Regs. §1.482-1(b)(1).

8 Regs. §§1.482-2A(d)(1)(i) and -2A(d)(2)(i).

9 Regs. §1.482-2A(d)(4).

10 Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 1017 (5/4/87).

11 A Study of Intercompany Pricing Under Section 482 of the

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cost sharing regulations in 1995 (which added the retrospective evaluation necessitated by the commensurate-with-income rule).

**Qualified CSAs**

Under the 1995 cost sharing regulations, if an arrangement is a “qualified” CSA (hereinafter referred to as a “QCSA”), no intercompany royalties are required and the IRS will generally not make any §482 adjustments except to the extent necessary to make each affiliate’s share of the costs equal to its share of the expected benefits from exploiting the intangibles. The regulations contain detailed requirements for QCSAs, including provisions for periodic adjustments to shares to account for actual benefits realized, inter alia, and the handling of preexisting intangible property made available to the QCSA and the addition or departure of participants (“buy-ins” and “buy-outs”). However, aside from the commensurate-with-income-driven features and others included for anti-abuse purposes, there is no suggestion that the fundamental concept of a CSA was altered.

**Stock Option Dispute**

The IRS position that compensatory stock options are an expense that must be shared in CSAs first received attention in 1998 when Seagate Technology filed a Tax Court petition challenging an assessment on that basis for 1991 and 1992. The issue received wider attention in early 2000 with the publication of the underlying Field Service Advice (“FSA”) 200003010. In the FSA, the IRS Chief Counsel’s Office concluded that sharing of stock option expenses was required under the applicable 1968 cost sharing regulations. In FSA 2000103024 allegedly the Xilinx facts, discussed below), the Chief Counsel’s Office concluded that stock option expenses must be shared under the 1995 regulations as well. The IRS reinforced its commitment to its position by making

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12 Seagate Technology, Inc. v. Comr., Tax Court No. 15086-98.

13 This FSA was issued January 21, 2000. For a detailed discussion of FSA 200003010, see Lewis and Kochman, “Cost Sharing Agreements Come of Age,” Tax Mgmt. Memo. 363 (8/28/00). See also Laurey, “Untangling the Stock Option Cost Sharing Loophole,” 55 Tax Law., 761 (No. 3), hereinafter referred to as “Laurey.” The first indication that the IRS considered the value of stock options a cost that must be shared in a CSA apparently came in a 1993 telephone response, which stated, “If part of an engineer’s compensation is in stock options which can be valued, the cost of those options should be shared.” Chief Counsel Office Memorandum, Field Assistance (6/9/93), reprinted in “Value of Stock Options Should Be Subject To Cost-Sharing Rules,” 95 TNT 17-38 (1/26/95). The IRS also addressed the issue in FSA 1997-7 (2/21/97).

14 This FSA was issued October 17, 2000.


16 DTR (8/3/01), at G-3.


18 Moses, “IRS Auditors to Enforce Sharing of Costs From Stock Options for 1996, Later Years,” DTR (1/31/02), at G-1.


20 T.C. No. 3480-01, relating to 1997. Another Xilinx case, T.C. No. 10077-00, relating to earlier years and, primarily, buy-in payments, was settled in March 2002.

21 T.C. No. 4142-01.
triggered strong reactions from taxpayers and practitioners, with U.S.-based high-tech companies, in particular, strongly disputing the IRS’s view. Concerns have been expressed about departure from the arm’s length standard, the proper method for valuing options, and inconsistent treatment of stock option costs by foreign tax authorities. The stakes are high: the amounts involved in the recent cases (Seagate — adjustments totaling $16 million for the two years initially at issue; Adaptec — $15 million for one year; Xilinx — $10 million for two years) are undoubtedly just the tip of the iceberg.

PROPOSED REGULATIONS

Basic Rules

Mandatory Cost Sharing of Stock-Based Compensation

Undaunted by concession or controversy, the IRS is now seeking to cement its position by regulations: proposed regulations issued on July 26, 2002 would require taxpayers to include stock-based compensation in “operating expenses” that must be shared under QCSAs. Under the proposed regulations, stock-based compensation means any compensation provided by a QCSA participant to an employee or independent contractor in the form of equity instruments, stock options, or rights with respect to (or determined by reference to) such instruments or options. Stock-based compensation is intended to include restricted stock, nonstatutory stock options, statutory stock options, stock appreciation rights, and phantom stock options. The preamble to the proposed regulations notes that statutory stock options are within the scope of the definition regardless of whether the employer is entitled to an income tax deduction with respect to those options (it generally is not).

Grant-Date Identification Rule

The proposed regulations provide that stock-based compensation is related to the development of intangibles covered by a CSA if, at the time the stock-based compensation is granted, the employee is performing research related to the CSA. Thus, the exercise or vesting during the term of a QCSA of a previously granted option will not result in a cost that must be shared under the QCSA, but an option granted during the term of the QCSA must, at some point, be reflected in the cost pool even if it is not exercised during the term of the QCSA. (Options neither vested nor exercised during the QCSA term may escape, unless the QCSA is reinstated.) The IRS believes that this grant-date identification rule is appropriate because the grant represents the economic event most closely associated in time with the services being performed, it promotes neutrality of treatment among various forms of compensation, and, because it applies regardless of the method used for the amount or timing of the shared costs, it promotes neutrality in choice of measurement methods allowed under the proposed regulations.

Deduction-Based Measurement and Timing Rule

The general rule prescribed for measurement and timing of stock-based compensation is based on the amount and timing of the income tax deduction associated with stock-based compensation. Thus, for nonstatutory stock options, the spread at the time of exercise is included in the cost pool. Statutory stock options — which do not ordinarily generate tax deductions because of the nonrecognition provisions of §421 — are given hypothetical deductions for this purpose by simply disregarding §421. That is, although a statutory stock option does not result in a deduction unless there is a disqualifying disposition, the spread on a statutory option is to be included in the cost pool at the time of any exercise as if the statutory stock option were a nonstatutory stock option. A hypothetical approach is also extended to options exercised by employees of foreign CSA participants not eligible for a deduction under U.S. income tax law, by considering the deduction that would have been allowable to a U.S. taxpayer.

An exception to the general timing rule provides that stock-based compensation eligible for exercise that is unexercised upon termination or expiration of a QCSA is treated as if it were exercised just prior to such termination or expiration. Similarly, if a stock option is repriced or otherwise modified and is determined to represent a new option under §424(h), the

22 “Operating expenses” for this purpose are defined by reference to Regs. §1.482-5(d)(3), and include all expenses not included in cost of goods sold, except for interest expense, foreign and domestic income taxes, and “any other expenses not related to the operation of the relevant business activity.”

23 For purposes of this discussion, “QCSA participant” refers to those participants who are members of a controlled group, even though nonmember participants are permitted.

24 Prop. Regs. §1.482-7(d)(2)(i).


30 Prop. Regs. §1.482-7(d)(2)(iii)(A)(3). This treatment is limited to cases where the fair market value of the underlying stock at that time exceeds the exercise price.
original option is treated as exercised for purposes of the exercise measurement rule.\textsuperscript{31}

Alternative GAAP-Based Measurement and Timing Rule for Publicly Traded Stock

The proposed regulations provide an alternative, elective, measurement and timing method for options on the U.S. publicly traded stock of companies subject to U.S. generally accepted accounting principles ("GAAP") financial reporting. In such cases, a company may use the same amount and timing as used in its audited financial statements (i.e., the fair value of the options reflected as a charge against income or disclosed in footnotes).\textsuperscript{32}

Revised Arm’s Length Rule for QCSAs

The proposed regulations amend Regs. §1.482-1 to provide that Regs. §1.482-7 is the specific method to be used to evaluate whether a QCSA produces results consistent with an arm’s length result. Crucially, the proposed regulations state that a QCSA “produces results that are consistent with an arm’s length result within the meaning of §1.482-1(b)(1) if, and only if, each controlled participant’s share of the costs . . . of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development . . . .”\textsuperscript{33} Together with the new requirement that shared intangible development costs include stock-based compensation, the proposed regulations thus dictate that a QCSA that does not share stock-based compensation fails the arm’s length standard.

Other Changes

The proposed regulations also amend Regs. §1.482-5 to provide that, under the “comparable profits method” (one of the key approaches for determining the arm’s length nature of various types of controlled transactions), it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of, or accounting for, stock-based compensation among the tested party and comparable parties.\textsuperscript{34}

IRS Position

The preamble to the proposed regulations does not explicitly state the legal rationale for including stock


\textsuperscript{32} Prop. Regs. §1.482-7(d)(2)(iii)(B). The election must be explicitly referenced in the original QCSA or, for QCSAs entered into prior to the effective date of the proposed regulations, in an amendment to the QCSA executed not later than the due date of the return for the first taxable year beginning after the effective date of the proposed regulations. Such an election generally must be followed by all QCSA participants for all options on publicly traded stock with respect to the subject QCSA. Prop. Regs. §1.482-7(d)(2)(ii)(C).

\textsuperscript{33} Prop. Regs. §1.482-7(a)(3) (emphasis supplied).

\textsuperscript{34} Prop. Regs. §1.482-5(c)(2)(iv).

option expenses in the QCSA cost pool; it simply refers to the participants’ “respective economic activity” under the commensurate-with-income standard. However, the rationale can be gleaned from FSA 200103024. Briefly:

1. QCSAs must be consistent with the statutory commensurate-with-income standard applicable to transfers of intangibles.

2. The legislative history of the commensurate-with-income standard indicates Congress’s intent that the income allocated among the parties to a CSA reasonably reflect the actual economic activity undertaken by each, and that all R&D costs be shared. The 1995 cost sharing regulations implement these concepts, and require researcher compensation, e.g., salaries, inter alia, to be taken into account.\textsuperscript{35}

3. Under LoBue,\textsuperscript{36} compensatory stock options are treated as compensation for income tax purposes when exercised, and under Apple Computer\textsuperscript{37} and Sun Microsystems,\textsuperscript{38} the amounts incurred for tax purposes upon the exercise of nonstatutory stock options and upon the disqualifying disposition of incentive stock options may represent wages for qualified research for purposes of the research tax credit. Compensation can be incurred in the form of property (e.g., stock options) as well as in cash.

4. A distortion of income would result from ignoring a significant element of the value of the researchers’ compensation (because it is part of the “actual economic activity” of the parties), and from not correlating tax deductions for options with CSA-determined income. The IRS is authorized by §482 to prevent such distortions.

\textsuperscript{35} Prop. Regs. §1.482-7(d)(2), Ex. 2.

\textsuperscript{36} Comr. v. LoBue, 351 U.S. 243, 247 (1956).


5. A particular taxpayer’s failure to expense options for financial statement purposes is irrelevant for QCSA purposes, both because the FASB, though permitting non-expensing, prefers expensing and because case law provides that there is no required conformity between tax and financial accounting (citing Thor Power Tool Co. v. Comr., 439 U.S. 522 (1979)).

Opposition to IRS Position

The two key arguments posed by taxpayers against including stock option costs are: (1) stock options are “costless” and therefore not properly included in costs to be shared, and (2) unrelated parties would not share option costs in similar situations.

Accounting Treatment Argument

In FSA 200003010 (Seagate), the taxpayer asserted that the applicable financial accounting guidance during the years in issue (APB 25) provided that cost was not recognized when options were issued or at any later date. The same argument was made in FSA 200103024 (Xilinx) under the current FAS 123. The taxpayers further argued that option costs should not be shared because they represent only a “shareholder-level” cost, rather than a corporate-level cost, to the extent that they dilute earnings per share.

Arm’s Length Argument

The taxpayers in the FSAs also asserted that arm’s length CSAs between unrelated parties would not incorporate stock option compensation costs because of their volatility, unpredictability, and lack of necessary relationship to the services rendered. They argued that the IRS could not identify any actual arm’s length arrangements incorporating such costs; to the contrary, innumerable cost-plus government contracts under the Federal Acquisition Regulations System (FARS) expressly preclude the inclusion of stock-based compensation. With respect to the IRS’s inability to identify comparables, the Tax Court in Seagate held, in denying partial summary judgment to the taxpayer, that actual examples of arm’s length transactions did not have to be shown under the 1968 regulatory provision that looked to terms and conditions “comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement.”

Issues to Resolve

Has the IRS seized on the stock option accounting controversy to attempt to resolve through regulations what it thus far has not been able to resolve through litigation? Although it seems doubtful that the IRS is simply being opportunistic — the issue has festered for years and nothing in the proposed regulations depends on new accounting rules — two key questions emerge:

1. Is it legitimate and appropriate to require the inclusion of stock-based compensation in the cost pool for a QCSA?
2. If such inclusion is appropriate, is the approach of the proposed regulations reasonable?

Are the Proposed Regulations Appropriate?

The preamble to the proposed regulations states that they “clarify that stock-based compensation is taken into account in determining the operating expenses treated as a controlled participant’s intangible development costs for purposes of the cost sharing provisions; provide rules for measuring the costs associated with stock-based compensation; clarify that utilization and treatment of stock-based compensation is appropriately taken into account as a comparability

40 A third line of argument, posed by the taxpayer as the basis for a motion for partial summary judgment in Xilinx, is that reimbursement of stock option costs would be nontaxable under Regs. §1.482-7(h) and Code §1032, and the issuer’s §83(h) deduction would be unaffected (citing the 1997 FSA). Petitioner’s Memorandum of Law (02/04/02).
41 Title 48 of the Code of Federal Regulations.
42 T.C. Memo 2000-388, 80 T.C.M. 912.

factor for purposes of the comparable profits method under §1.482-5; and clarify the coordination of the cost sharing rules of §1.482-7 with the arm’s length standard as set forth in §1.482-1.” 44 The assertion that the proposed regulations are simply a “clarification” is unsettling. Given the IRS’s concession in Seagate, the ongoing controversy, and the absence of any direct legal or empirical precedent requiring sharing of option costs, the proposed regulations go beyond a mere clarification. The threshold question therefore is whether the proposed approach is correct and/or legally permissible.

The Arm’s Length Standard Applies to QCSAs

To make allocations under §482, the IRS must first determine that a taxpayer has not reported its true taxable income. The general provisions of the §482 regulations — unchanged from the 1968 regulations — state flatly that “[i]n determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer.” 45 Although the 1995 cost-sharing regulations do not contain the same explicit references to the arm’s length standard that were included in the more general 1968 cost-sharing regulations, the 1995 regulations certainly do not suggest that QCSAs are an exception to that standard.

Nor is there a basis for arguing that the commensurate-with-income requirement that imbues the 1995 regulations limits the application of the arm’s length standard to CSAs. Even though the legislative history of the 1986 Act uses somewhat different language — “the income allocated among the parties [should] reasonably reflect the actual economic activity undertaken by each” 46 — the 1988 White Paper goes to great pains to point out that the commensurate-with-income requirement is both consistent with and does not supplant the arm’s length standard: “... Treasury officials publicly stated that Congress intended no departure from the arm’s length standards, and that the Treasury Department would so interpret the new law.” 47 Against this backdrop, the preamble to the newly proposed regulations expressly acknowledges the application of the arm’s length standard to CSAs. The tough analytical issue is whether the proposed regulations in fact apply the arm’s length standard — or turn it on its head by saying that all of the prescribed requirements for a QCSA, including the sharing of stock-based compensation costs, “must be met” in order to produce “results consistent with an arm’s-length result.”

How Does the Arm’s Length Standard Apply to CSAs? The Role of Comparability

The Conference Committee Report on the 1986 Act states that a CSA can be “an appropriate method of allocating income attributable to intangibles among related parties” if: (1) a cost-sharer is expected to bear its portion of all R&D costs, on unsuccessful as well as successful products within an appropriate product area, (2) the allocation of costs generally is proportionate to profit (before R&D deductions), and (3) a party receives an appropriate return on investment to the extent that it contributes funds towards R&D at a significantly earlier point in time than the other participants or is otherwise putting funds at risk to a greater extent. 48 In context, one must presume that Congress believed the cited requirements were consistent with how unrelated parties would enter into a joint venture for the development of intangibles, tempered by some anti-abuse features. The incorporation of these requirements in Regs. §1.482-7 consistently implies that a QCSA is intended to satisfy the arm’s length standard.

The introductory provisions of the §482 regulations state that “[w]hether a controlled transaction produces an arm’s length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances.” Comparability is evaluated by considering all the facts and circumstances that could affect prices or profits in arm’s length dealings, including functions, contractual terms, risks, economic conditions, and property or services. 49 The arm’s length standard focuses on “results” of transactions; there is no requirement that each and every aspect of the transaction meet the comparability standard. Indeed, it seems improbable that unrelated parties would enter into an arrangement with all the features of a QCSA. 50 Thus, it may not be enough to say (or even prove) that unrelated parties would not share option costs; rather, an evaluation of the overall effect of the transaction from a comparability perspective is needed.

This distinction would nevertheless be a weak reed to support the IRS position. The 1968 regulations re-

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44 REG-106359-02, 67 Fed. Reg. 48997 (7/29/02), under “Background” (emphasis provided), with similar comments in the last paragraph under “Overview.”
45 Regs. §1.482-1(b)(1) (emphasis provided); see also Regs. §1.482-1A(b)(1).
47 1986-2 C.B. at 475 (footnotes omitted); see also 1986-2 C.B. at 458, 472.
49 Regs. §1.482-1(d).
50 For instance, third-party arrangements containing a 20% variance threshold for adjusting cost-shares seem unlikely.
garding Bona Fide CSAs required “terms and conditions” comparable to those that would be adopted by unrelated parties, and there is no suggestion that this perspective was intended to be altered in the 1995 regulations. Moreover, if option amounts are significant, one would be unlikely to get a comparable result if comparable treatment were not given to options, directly or indirectly.

Thus — absent a safe-harbor situation, as discussed below — attention must be paid to how unrelated parties would handle option costs in similar circumstances, at least if the amounts involved are significant. To impose sharing of such costs simply by flat in all cases is at odds with the contours of the pervasive arm’s length standard. While the IRS has a mandate under §482 to avoid the distortion of income, it does not have authority to distort income vis-a-vis third party comparables.

Are the QCSA Regulations a Safe Harbor to Which Different Standards Apply?

Could the QCSA rules be viewed as a “safe harbor” exception to the arm’s length standard, to which the IRS is free to attach special conditions? IRS regulations are replete with elective rules that, at the taxpayer’s option, trade a broader view of the applicable provision for relative ease and certainty in its application. Close to home, for example, Regs. §1.482-2(b)(3) permits certain kinds of intercompany services to be priced at cost (the arm’s length charge is deemed to be equal to cost) unless the taxpayer establishes a more appropriate charge under the normal arm’s length standard.

It is hard to view the QCSA rules as simply a safe harbor. Although they appear, in a sense, elective, they purport to occupy the field, implicitly prescribing the only kind of CSA that will be recognized for transfer pricing purposes. Moreover, a safe harbor arguably could not legitimately impose extr statutory, non-arm’s-length requirements, although it remains to be seen whether the option sharing feature is beyond the pale.

Nor does it seem accurate to view the QCSA regulations as providing an exception to the otherwise applicable commensurate-with-income requirement in a way that somehow offers the IRS more leeway to impose restrictions. To the contrary, the QCSA rules incorporate commensurate-with-income concepts.

For these reasons, the arm’s length standard cannot readily be flouted in the QCSA regulations.

Relationship Between the Arm’s Length Standard and Interpretation of the “All-Costs” Requirement; Is the Accounting Issue a Red Herring?

A major focus of the adversaries on the stock option issue has been the interpretation of the “all costs” requirement expressed in the legislative history of the 1986 Act and in the 1995 cost-sharing regulations, and the accounting rules to be applied for this purpose. While some guidance may be derived from this analysis, the significance of these issues appears to be overstated.

One of Congress’s commensurate-with-income/arm’s-length criteria was that each participant bear its appropriate proportionate share of “all” R&D costs. Proponents of the view that stock option costs need not be shared point to the failure to specifically identify option costs in either the legislative history of the 1986 Act or in the 1968 or 1995 regulations, and argue that this is both determinative and intentional. But silence on details of this sort is hardly unusual, nor is there anything necessarily illogical about inferring that stock-based compensation could be considered “costs,” “operating expenses,” or “salaries” (or, in the IRS’s view, “economic measures of cost”) for this purpose.

This latter reasoning seems particularly apt to the extent stock-based compensation generates tax deductions (e.g., nonstatutory stock options). The overarching objective of §482 is to clearly reflect “the income” of related parties, and “income,” when used in the Code, is undoubtedly a tax-based concept. Indeed, another one of the 1986 Congressional criteria for CSAs, that the allocation of costs be proportionate “to profit as determined before deduction for R&D,” suggests a tax-based definition of operating profit (in that tax talk usually refers to “deductions” rather than financial accounting “expenses”). There is a certain hypocrisy to the inconsistent standards sought to be

51 Admittedly, Regs. §1.482-7(a)(1) permits the IRS to apply the Regs. §1.482-7 rules to any arrangement that in substance constitutes a cost-sharing arrangement notwithstanding a failure to comply with any requirement of Regs. §1.482-7, but this is intended as an audit threat and is not a taxpayer option. See Preamble to 1992 proposed CSA regulations, INTL-0372-88, 57 Fed. Reg. 3571 (1/30/92). Similarly, although the proposed regulatory language is somewhat circular — “Section 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm’s length result” (emphasis supplied) — the IRS’s intent to mandate sharing of option costs before any CSA is considered arm’s length is implicit. See “Do QCSAs Occupy the Field?,” below.

52 Although the IRS generally is perceived as having “broad authority” to prescribe rules under §482 (White Paper at 460), these are not “legislative regulations” in that the Code does not specifically authorize the IRS to prescribe operating rules with respect to §482. Rather, the §482 regulations are “interpretative” regulations, clarifying the meaning of §482.

53 See SoFTEC, Xilinx Amicus Brief, at 48-54 (4/30/02), reprinted at 2002 TNT 129-37. The AEA Xilinx Amicus Brief at 16-17 (6/6/02) argues, differently, that the all-costs language was directed at the scope of the research program, not the accounting rules for measuring costs.
applied to CSAs and R&D deductions — proponents of the “costless” argument have not altruistically agreed to forfeit deductions for options to which they are otherwise entitled under §§83(h), 162, and 274 — and the reasoning in Sun Microsystems and Apple Computer is not fully distinguishable.

There has been considerable back and forth in the §482 and CSA regulations between tax accounting and financial accounting. The 1968 §482 regulations were intended to be GAAP-compliant, the 1988 White Paper proposed use of tax accounting for CSAs, the 1992 proposed CSA regulations reserved on the issue and invited taxpayer comments, and the 1995 final CSA regulations intimate a preference for GAAP accounting but do not require it. The §482 regulations frequently intermingle the concepts. For instance, the cost safe harbor for intercompany services refers to the amount of “the costs or deductions incurred,” and the comparable profits method under Regs. §1.482-5 recognizes that different accounting standards may be used, simply requiring adjustments for material differences to achieve appropriate comparability.

From an abstract comparability perspective, the universality of financial accounting has some appeal, although unlike the comparable profits method the basic exercise in CSAs does not consist of directly comparing financial statement data. Moreover, a standard or presumptive approach to calculating costs has obvious administrative benefits. However, in the overall context of the Code the gross disconnect that could result between tax deductions and CSA deductions (at least under the current version of GAAP) is troubling.

At bottom, it appears to be within the prerogative of the IRS to draft regulations to suit itself on either the definition of costs to be shared under CSAs or the accounting method to be used for purposes of that determination — provided that the arm’s length standard and inherent comparability requirements are not violated or overridden.

Would a Comparable Arm’s Length CSA Incorporate Stock Option Costs?

Ultimately, the question devolves to whether a comparable CSA involving uncontrolled participants would incorporate stock option costs and if so, how. Despite obvious litigating and revenue incentives to do so, the IRS seems so far not to have located evidence that stock-option costs are included in the cost pool in arm’s length cost sharing arrangements. On the other hand, the taxpayers in Seagate, Adaptec, and Xilinx do not appear to have produced arm’s length agreements refuting the IRS’s position. Instead they have pointed to the FARS prohibition on stock option cost reimbursement in government research, development, test, and engineering services contracts. Whether or not government contracts are a world unto themselves and reflect policy considerations not applicable to the private sector, services contracts are arguably different from cost-sharing agreements in which both parties will share ownership of the intangibles being developed. The entrepreneurial feature of CSAs might make the participants amenable to taking into account more speculative aspects of costs.

Absent direct proof, one can theorize about whether unrelated parties would ever share option costs. One commentator sets forth the following quite plausible reasons as to why unrelated companies never explicitly agree to share compensatory option costs: (1) valuation and timing problems; (2) potential manipulation by selective grant and exercise of the options; (3) a weak connection between the values of options and employee services; and (4) a reluctance to reimburse the issuer in cash for a cost that requires no cash outlay and is based on the appreciation of the issuer’s stock. On the other hand, in an extreme case where one participant pays its researchers mostly in cash and the other provides mostly stock-based compensation, real-world logic dictates that the latter company would seek some contribution for its stock-based compensation costs. For the moment, resolution of this factual issue, whether hypothetical or provable, should be left to the dueling litigants in Xilinx and other cases. But it does seem conceivable that unrelated parties would reflect in some way the use of significant amounts of stock-based compensation.

As to how such compensation would be taken into account, consideration of financial statement valuations, whether or not expensed, seems more likely be-

54 Id., at 46 (citing Treas. Dept. Releases F-645, F-824, F-1069, and F-952).
57 Regs. §1.482-7(h)(2)(iv).
58 Regs. §1.482-2(b)(3) (emphasis supplied).
59 Under the comparable profits method, the taxpayer’s “reported operating profit” — operating profit reported on its tax return — is the starting point for comparing the taxpayer’s results with those of the comparable companies, subject to adjustments to account for material differences between tax return and financial statement amounts if the comparison is based on financial ratios derived from the comparables’ financial statements.
60 The courts will decide how to interpret existing regulatory language, with inclusion of option costs hardly a foregone conclusion. A court loss by the IRS could pose additional hurdles for the regulatory process, depending on the basis for the decision.
61 SoFTEC, Xilinx Amicus Brief, at 35 (citing Respondent Answer to Petition, ¶5(a)(41)).
62 48 CFR §31.205-6(i).
63 Laurey, at 766.
cause unrelated parties probably would not provide each other with tax-based cost data. At the same time, if the impact of stock options on the terms of the deal is indirect, one would expect related tax benefits to enter into the balance. In this connection, it should be noted that the OECD Guidelines on arm’s-length cost contribution arrangements (“CCAs”), the OECD equivalent of CSAs, look to the value of each participant’s contributions (possibly including savings from tax incentives) in determining proportionality between contributions and expected benefits.

Where Does This Leave Us?

The focal issue in the instant controversy should be whether any stock option costs would be reflected in arm’s-length CSAs. The issue from a regulatory perspective should not be whether GAAP controls the definition of costs for QCSA purposes, whether the award or exercise of stock options represents a cost under GAAP, or whether the IRS agrees or disagrees with GAAP treatment of stock option costs for tax purposes. Those questions become relevant only if option costs should be shared under the arm’s-length standard and, then, only as a consideration in developing a rule of administrative convenience, a requirement of participant and year-to-year consistency, or a reference point for comparability purposes. (Indeed, the current GAAP accounting debate shows how readily parties arguing for one view or the other may be hoisted on their own petard.)

Although the Tax Court holding in Seagate that empirical evidence is not required seems right — the regulatory standard is a conjectural one — the absence of empirical evidence supporting the inclusion of stock option costs in arm’s-length CSAs is nevertheless problematic. Absent such evidence, the proposed regulations seem presumptuous at best and illegitimate at worst. Viscerally, one senses that some amount relating to stock option costs ought to be taken into account in cases where option costs are significant, but a mandatory rule seems wrong.

Are the Proposed Regulations Reasonable?

Despite reservations as to the legitimacy of the proposed regulations, they merit evaluation at face value. That is, assuming arguendo that stock-based compensation is a cost that would be reflected in an arm’s-length CSA, do the proposed regulations present a reasonable approach for accomplishing this? Absent empirical evidence of arm’s-length behavior, this exercise becomes an amalgam of aiming for clear, administrable rules and speculating what a CSA participant who was taking option costs into account would do.

Timing and Amount of Inclusion

The key issue is the timing and amount of the inclusion of stock-based compensation in the CSA cost pool. In FSAs 200003010 and 200103024, the IRS stated that any reasonable method of timing and valuation could be utilized, so long as it was applied consistently. The proposed regulations depart from that flexibility, requiring that amounts be included at the time of exercise and that they be measured by the spread between the exercise price and the underlying value of the stock. The only exception to this rule is for options on publicly traded stock of companies subject to financial reporting under GAAP. For such options, an election can be made to include the “fair value” of the options as and when reflected in the company’s audited financial statements. Typically, that value will be determined at the date of grant using an economic pricing model.

Certainty

The approach taken in the proposed regulations has the benefit of certainty. Under the general rule, only options that are both granted and exercised during the term of the CSA are included, and the timing and amount match the company’s tax deductions (except for statutory options, discussed below). The additional rule that “deems” all exercisable but unexercised options remaining at the end of the CSA term to be exercised at that time has obvious practical advantages to the IRS, though it is potentially distortive (because the eventual spread may be substantially different or the option may never be exercised). This concern could be ameliorated by allowing a subsequent “true-up” based on the actual exercise or expiration of the option. Alternatively, application of the deemed exercise rule could be limited to potentially abusive situations measured, for example, by the proportion of unexercised options.

The elective method for options on publicly traded stock also provides a measure of certainty, because the amount can be tied to the amount determined for financial reporting purposes. As discussed below, however, the accuracy of that amount is questionable. It is not clear, in any event, why the grant-date alternative is restricted to publicly-traded stock. A similar choice should be provided for non-publicly-traded stock of companies (including foreign companies) with GAAP-based audited financial statements, so long as the taxpayer applies the method consistently.

Matching

From the perspective of the proposed regulations’ objective of including all economic costs in the CSA

64 See AeA Xilinx Amicus Brief, at 4, 20-26 (6/6/02).
cost pool, the better approach would be to require inclusion — not just identification — at the time of grant. The proposed regulations have instead opted for administrability and general consistency with the related R&D tax deductions. Inclusion at the time of grant would require measurement using an economic model. Although there are several alternative models, each has shortcomings for pricing compensatory stock options (e.g., failure to reflect forfeiture risks and non-transferability) and all require a number of speculative assumptions as to which the issuer has little control. Although comfort levels may improve as the current movement to require companies to expense compensatory stock options in their financial statements advances, debate continues over how that should be done and occurs in the context of the different purposes of financial accounting.

Amount

Evaluating the Black-Scholes method and other option pricing models is beyond the scope of this article. Concern over the speculative aspects of pricing models undoubtedly bears on the IRS’s selection of the exercise approach as the regulations’ primary method. However, it would be possible to temper the inaccuracy of grant-date models with some kind of one-time “true up.” This approach would allow an adjustment to future cost pools to reflect both forfeitures and actual spreads on exercise. Also, it may be that further study by the IRS and private-sector experts could lead to usable models that are more appropriate to the task. Viewed benignly, perhaps the IRS’s approach was intended to stimulate this debate.

One proposal to get around the accuracy dilemma for financial reporting purposes is that options be marked to market and reflected on a company’s balance sheet. A similar approach for CSAs would likely be unacceptable due to volatility as well as inconsistency with other countries’ rules.

Weighing the competing considerations, the regulations’ nod to administrability and tax consistency over “economic” concepts seems reasonable (subject to the comments above), if a bit disingenuous. It would, nevertheless, be preferable to allow alternatives more freely and to accommodate demonstrable simulations of arm’s length situations as well as diverse theoretical views.

Stock-Based Compensation — Defined

The definition of stock-based compensation in the proposed regulations is broad, effectively covering any arrangement under which an employee receives an equity interest or the right to acquire an equity interest in the future, as well as a right determined by reference to the value of equity in the company. This broad definition suggests either that the IRS is concerned that other forms of stock-based compensation besides stock options are being excluded from the CSA cost pool due to accounting methods used, or that improving matching and consistency between different forms is desirable. Such goals seem appropriate, subject to the overriding arm’s length considerations discussed earlier.

That said, the most curious aspect of the definition is the inclusion of statutory stock options without regard to whether the employer is entitled to an income tax deduction for them. Under §421, an employee holding a statutory stock option does not recognize income at the time of exercise, nor does the employer receive a deduction. A statutory option has tax effect only if there is a disqualifying disposition, defined as a transfer of the stock by the employee within two years of grant of the option or within one year of receipt of the stock. Most statutory stock options do not have any tax effect, and it seems odd to include them in the cost-sharing cost pool (as if they were nonstatutory options) in the effort to determine the participants’ “true taxable income.”

Including statutory stock options in the cost pool could lead to distortions in taxable income, at odds
with the overall objective of §482. A U.S. participant that awards statutory options to its researchers will be required to include costs associated with those options in the cost pool and to receive a cost-sharing payment from the foreign participants with respect to those option costs. That payment will increase taxable income for the U.S. participant because it will represent a reimbursement of a portion of a cost that it cannot deduct. On the other hand, if statutory options are awarded to a researcher by a foreign participant, the U.S. participant will receive a deduction for its share of those “costs.” That is, the U.S. participant would be able to achieve the same ownership interest in the intangibles, but at a lower tax cost, by moving the research activity to a foreign participant. While it seems unlikely that this aspect of the proposed regulations would actually cause shifts in the location of research activities, the regulations should strive to avoid distorting tax effects.

Perhaps this falls in the “two wrongs . . .” school — in response to the nonsharing of deductible amounts, the IRS should not propose the sharing of nondeductible amounts.72 However, as noted earlier, there is no perfect answer to the dichotomy between tax accounting and financial accounting concepts, and the propriety of this feature ultimately reverts to evaluation of an arm’s length result.

Stock-Based Compensation — Included

In Apple Computer, the Tax Court held that stock option costs — taken into account, in the case of non-statutory options, in the year of exercise — are wages for research credit purposes even if the research services for which the options were awarded were performed in a year other than the year in which the options were exercised.73

Although the IRS acquiesced in Apple Computer, the proposed regulations include in the cost pool only stock-based compensation granted during the term of the CSA. Thus, only costs associated with services performed during the term of the CSA are included.

One might expect consistency between the treatment of stock-based compensation for research credit and CSA purposes, since both require a determination of research costs. However, costs for research credit purposes are clearly tax-based, whereas the proposed regulations also consider costs in an economic sense. If the objective is to capture economic cost in the cost-sharing cost pool, the approach in the proposed regulations appears correct. Only compensation cost “related to” the activity covered by the CSA should be included, and costs associated with the exercise of an option are not related to the CSA activity unless the option is granted for services performed during the CSA term.

Do QCSAs Occupy the Field?

The proposed regulations “clarify” that in order for a QCSA to produce an arm’s length result all requirements ofRegs. §1.482-7 must be met. Does this mean that a CSA that fails to qualify as a QCSA does not produce an arm’s length result, or does it just describe what it takes to be a QCSA?

The advantage to being treated as a QCSA is that the IRS can only make allocations to the extent necessary to make each controlled participant’s share of intangible development costs equal to its share of reasonably anticipated benefits attributable to such development. The IRS interprets such allocations to include adjustments to the pool of costs shared.74 But what if a CSA is not a QCSA? In that case, does the IRS analyze the results under Regs. §§1.482-1 through 1.482-6 and the commensurate-with-income standard, or does it analyze the agreement under Regs. §1.482-7 in any case, under its authority to “apply the rules of [Regs. §1.482-7] to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding a failure to comply with the requirement of [Regs. §1.482-7]?”75 As discussed earlier, the latter authority seems more of an IRS sword than a taxpayer shield. However, even absent a QCSA-like framework, is the result likely to be the same?

In thinking about these questions, an oversimplified example may be helpful.76 Assume that two controlled parties, one domestic (A) and the other foreign (B), agree to share equally (50/50) the costs of an intangible development project, with A receiving the right to exploit the intangible in the United States and B receiving the right to exploit it everywhere else. Assume further that A and B contract with an unrelated third party to perform the development work, the development costs are 100x, A earns 100x by exploiting the intangible, and B earns 400x. Since the agreement does not calculate shares of development costs based

72 A similar rule in the proposed regulations, hypothesizing deductions for stock-based compensation granted by foreign CSA participants, does not present the same potential for distortion. Rather, it tends to ameliorate the potential distortion that could occur if only U.S.-side inclusions were required or allowed.

73 98 T.C. at 239-41.

74 Preamble to 1995 CSA regulations, T.D. 8632, 60 Fed. Reg. 65553 (12/20/95) (“As under the proposed regulations, the district director may adjust the pool of costs shared in order to properly reflect costs that relate to the intangible development area.”); Regs. §1.482-7(d)(2), Ex. 2 (“The district director may determine that the field testing costs are intangible development costs that must be shared.”).

75 Regs. §1.482-7(a)(1).

76 The example would get considerably more complicated with consideration of the intangibles co-ownership or “developer/assister” rules of Regs. §1.482-4(f)(3), inter alia.
on reasonably anticipated benefits or provide for adjustments to the shares, it will not be a QCSA under the regulations. If, however, the IRS were to treat the agreement under the cost sharing regulations, it would allocate 20% of the costs to A and 80% to B, as opposed to the 50% each would bear under the agreement.

If the agreement is not analyzed under the cost sharing regulations, how would the other §482 rules and commensurate-with-income standard apply? Arguably, there would be no transfer of an intangible between related parties, because each participant acquired its rights by paying a third party for R&D services (or for the intangible itself, depending on how the third-party transaction is structured). Alternatively, the arrangement could be analyzed, inter alia, as a joint venture that owns the intangible and licenses (or otherwise transfers) it to A and B, or as a joint venture that exploits the intangible and distributes profits to A and B based on where the intangible is exploited. These perspectives could generate very different results from a QCSA to the extent a commensurate-with-income markup must be charged on the intangibles transfers (on the license or other transfer in the first case, or on a possible deemed transfer of a partial interest from A to B in the second). But if the parties’ agreed cost-sharing percentages were in fact proportionate to the exploitation benefits (rather than 50/50 and 20/80, respectively), these differences would largely evaporate via netting (aside from characterization issues, e.g., for withholding tax purposes). For example, if A and B were viewed as buying their interests from the joint venture, A would pay 20x plus markup for its interest and B would pay 80x plus markup for its interest, but they would receive the same amounts back through the joint venture, proportionate to their 20/80 ownership interests therein.

The IRS’s position on stock-based compensation has the effect of changing an arrangement that the parties posit to be proportionate in terms of costs and benefits to one that is not, by adjusting the costs. This, in turn, could change the situation from one where the §482 results would be largely the same whether under the QCSA rules or not, to one where the results are potentially very different. This means that the QCSA rules effectively occupy the field.

If the regulations do not allow taxpayers to demonstrate that unrelated parties would enter into a CSA like that of the taxpayers, the transaction must be broken into pieces which yield a different result under the commensurate-with-income rules. Yet the fundamental objective of §482 ought to be satisfied if the overall relationship is comparable to how unrelated parties would handle the same transaction under the same circumstances.

For these reasons, the better approach would be to limit the adverse consequences to adjusting each participant’s costs if the only “defect” in the CSA relates to costs, rather than altogether disqualifying the arrangement from CSA characterization (with markedly different results). That, after all, is what the IRS has been doing in the litigated cases, not throwing the taxpayers out of the Bona Fide CSA or QCSA rules altogether. The regulations could — and should — be interpreted so that a CSA which does not share option costs is a QCSA subject to potential adjustments of cost shares. In any event, however, the proposed regulations go too far by effectively mandating cost-sharing of stock-based compensation as the price of CSA characterization, without clear arm’s length justification and without the opportunity for taxpayers to demonstrate how this matter would be treated in an arm’s length relationship.

CONCLUDING OBSERVATIONS

The issues in the stock-option cost-sharing debate are complex and not susceptible of easy resolution. The proposed regulations are not an altogether unreasonable first step at coordinating the alternatives if the arm’s length threshold is legitimately crossed. But this is a big “if” — the significant uncertainties as to the arm’s length treatment of stock-based compensation in cost sharing situations strongly suggest that the by-fiat approach of the proposed regulations is excessive.

This article (like the regulations) leaves some related, and equally difficult, issues for further consideration — handling of stock-based compensation in the context of intercompany services, the comparable profits method (e.g., computation of pertinent financial ratios) as applied to various intercompany transfers,77 and CSA buy-in calculations. The interplay of foreign tax treatment of CSAs and the effect of international treaties is also a topic unto itself.

Although the current business furor over stock options may have little direct bearing on the tax issues, the tax issues seem destined to be equally controversial.

77 The proposed regulations’ nibble at the comparable profits method issue, suggesting that adjustments may be appropriate to account for material differences in the utilization of (or accounting for) stock-based compensation, seems noncontroversial on the accounting point, in that material differences on any accounting aspect (here, whether compensatory options are expensed or just footnoted) should be adjusted for an elemental aspect of the CPM. Adjustments to reflect differences in companies’ utilization of options in the compensation mix, on the other hand, are not only subject to the CSA-related issues discussed above but pose the further concern of divining pertinent details from published financial statements.