Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:
, ID No.

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Refer Reply To:
CC:INTL:B06
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Date:
September 30, 2009

Re:

FY:

Legend

Taxpayer =

State X =
Z Corp =
Country Y =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Tax Year 1 =
Tax Year 2 =
Tax Year 3 =
Tax Year 4 =
Tax Year 5 =

Dear :

This letter responds to a letter dated February 17, 2009, supplemented by letters dated August 3, 2009, and September 14, 2009, submitted by you and your representatives. The correspondence requests that the Internal Revenue Service ("Service") grant Taxpayer consent to retroactively change its method for measuring and identifying

employee stock options and restricted shares pursuant to Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(C) and Treas. Reg. § 301.9100-3 for purposes of determining the amount Taxpayer must include in its cost sharing arrangement[1] cost pool for Tax Year 1 and subsequent tax years. Alternatively, the correspondence requests that the Service grant Taxpayer consent to prospectively change its method for measuring and identifying employee stock options and restricted shares pursuant to Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(C).

The consent granted by this letter is based on facts and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the factual information, representations, and other data may be required as a part of the audit process.

Facts

Taxpayer, a State X corporation, and its wholly owned subsidiary, Z Corp, an entity organized under the laws of Country Y and treated as a corporation under Treas. Reg. § 301.7701-2(b), entered into a CSA in the form of two contracts: a license of preexisting intangibles and an agreement for development of intangible assets on Date 1, a date after the effective date of T.D. 8632 (Dec. 20, 1995), 60 Fed. Reg. 6555301 ("the 1995 cost sharing regulations") but before the issuance of T.D. 9088 (Aug. 26, 2003), 68 Fed. Reg. 5117102 ("the 2003 cost sharing regulations"). On Date 2, a date after the effective date of the 1995 cost sharing regulations but before the issuance of the 2003 cost sharing regulations, Taxpayer and Z Corp amended their CSA to include stock option costs as part of R&D costs, specifying a measurement method not ultimately adopted in the 2003 cost sharing regulations. Taxpayer used the measurement method provided in its amended CSA from the inception of the CSA.

Starting in Tax Year 1, a taxable year beginning after the effective date of the 2003 regulations but before the issuance of Notice 2005-99, 2005-2 C.B. 1214, Taxpayer stopped issuing employee stock options and began issuing restricted shares to its employees. Neither Taxpayer's original contract establishing its CSA ("original contract") nor any amended contract amending its CSA ("amended contract") elected to measure employee stock options using the method provided by Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B)[2] or measure restricted shares using the method provided by Notice 2005-99 (collectively, "elective method"). In addition, neither the original contract nor any amended contract elected to identify employee stock options or restricted shares (collectively, "stock-based compensation" or "SBC") using the method provided

[1] For purposes of this ruling, the terms "qualified cost sharing arrangement" (Treas. Reg. § 1.482-7(b)(1995)) and "cost sharing arrangement" (Temp. Treas. Reg. § 1.482-7T(b)) have materially the same meaning. This ruling uses the term "cost sharing arrangement" or "CSA" to signify both, as appropriate.
[2] Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B) provides the same measurement method as Treas. Reg. § 1.482-7(d)(2)(iii)(B) of the 2003 cost sharing regulations.

by Notice 2005-99 ("period-by-period method"). Therefore, Taxpayer and Z Corp were required to use the measurement method provided in Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(A)[3] ("default method") and identify SBC as of the date of grant under Temp. Treas. Reg. § 1.482-7T(d)(3)(ii).[4]

Taxpayer discovered that it had not properly adopted the elective method of measurement and the period-by-period method of identification sometime after Date 3, a date after the periods provided by Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B)(4) and Notice 2005-99 for making the elections without the Commissioner's consent. Thereafter, Taxpayer, with assistance of counsel, filed this request for Commissioner consent to retroactively adopt the elective method of measurement for both employee stock options and restricted share compensation and the period-by-period method of identification. After being informed that the Office of Associate Chief Counsel (International) was tentatively adverse to such retroactive elections, Taxpayer and its counsel requested, in the alternative, to be granted consent to prospectively adopt the elective method of measurement and the period-by-period method of identification. For purposes of its alternative request, Taxpayer made several representations, including:

(1) With regard to its CSA, Taxpayer is and will remain in compliance with all record-keeping requirements of the Internal Revenue Code of 1986, as amended, and the regulations thereunder, including Temp. Treas. Reg. § 1.482-7T(k)(2)(ii)(E). Upon request, Taxpayer will timely provide to the Commissioner records kept pursuant to such requirements;

(2) Taxpayer will file amended returns for Tax Year 1, Tax Year 2, Tax Year 3, and Tax Year 4 using the default method of measurement and grant date identification provided in Temp. Treas. Reg. § 1.482-7T(d)(3)(ii) and (iii)(A), respectively;

(3) For all SBC granted before Date 4 ("Legacy SBC"), the first day of the first taxable year following receipt of Commissioner consent, Taxpayer will use the default method of measurement and grant date identification until the Legacy SBC has been exercised or has lapsed; and

(4) For all SBC granted on or after Date 4 ("New SBC"), Taxpayer will use the elective method of measurement and the period-by-period method of identification.

Therefore, beginning with the return for Tax Year 5, Taxpayer will include the Legacy SBC costs in its cost pool using the default method of measurement and grant date identification and will include the New SBC costs in its cost pool using the elective

[3] Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(A) provides the same measurement method as Treas. Reg. § 1.482-7(d)(2)(iii)(A) of the 2003 cost sharing regulations.
[4] Temp. Treas. Reg. § 1.482-7T(d)(3)(ii) provides the same identification rule as Treas. Reg. § 1.482-7(d)(2)(ii) of the 2003 cost sharing regulations.

method of measurement and the period-by-period method of identification. In addition to these and other representations, Taxpayer has represented to our satisfaction that the service and performance vesting restrictions will not have a substantial effect on the fair value of the SBC under U.S. generally accepted accounting principles ("GAAP") and will not result in unreasonably long vesting periods. As a condition to granting Commissioner consent to change to the elective method and period-by-period method for SBC granted on or after Date 4, Taxpayer and the Service executed a Form 872 ("Consent to Extend the Time to Assess Tax") extending the statute of limitations with no restrictions to Date 5 in order to give the Service sufficient time to examine the amended returns Taxpayer has agreed to file.

Law

Measurement of Stock-Based Compensation Related to Intangible Development

The 1995 cost sharing regulations required participants to a CSA to share all costs related to intangible development. See Treas. Reg. § 1.482-7(b) and (d) of the 1995 cost sharing regulations. The Service has always interpreted the "all costs" requirement to include SBC costs. See Xilinx, Inc., and Cons. Subs. v. Commissioner, 567 F.3d 482 (9th Cir. 2009). However, the 1995 cost sharing regulations did not provide specific methods for measuring and identifying SBC. It was not until the issuance of the 2003 cost sharing regulations that specific methods for measuring and identifying SBC were required.

In the 2003 cost sharing regulations, the Service and Treasury Department added the provision now contained in Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B). Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B)(1) generally provides that, with respect to SBC in the form of options on publicly traded stock, the controlled participants in a CSA may elect to take into account all intangible development costs attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with GAAP by or on behalf of the company issuing the publicly traded stock. The 2003 cost sharing regulations did not extend the elective method of measurement to restricted shares.

Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B)(4) provides that the election provided in Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B) is made by an explicit reference to the election in the written contract required by Temp. Treas. Reg. § 1.482-7T(k)(1) or in a written amendment to the CSA entered into with the consent of the Commissioner pursuant to Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(C). In the case of a CSA in existence on August 26, 2003, the election by written amendment to the CSA may be made without the consent of the Commissioner if such amendment is entered into not

later than the latest due date (with regard to extensions) of a federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003.

Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(C) provides, in part, that if controlled participants already have granted stock options that have been or will be taken into account under the general rule of Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(A), then except in cases specified in the last sentence of Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B)(4), the controlled participants may make the election described in Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B) only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

Notice 2005-99 extended the elective method provided by Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B) to restricted shares and restricted share units. Notice 2005-99 provides that the consent of the Commissioner is not required to elect the elective method for restricted shares and restricted share units in the case of a CSA if the election is made by a written amendment to the CSA not later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after December 8, 2005.

If a taxpayer that issues SBC with respect to a CSA does not elect the elective method for measuring employee stock options and restricted shares, then the default method of Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(A) applies. Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(A) provides in general that, except as otherwise provided in Temp. Treas. Reg. § 1.482-7T(d)(3)(iii), the cost attributable to SBC is equal to the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that SBC (for example, under section 83(h)) and is taken into account as an intangible development cost under Temp. Treas. Reg. § 1.482-7T for the taxable year for which the deduction is allowable.

Identifying Stock-based Compensation Related to Intangible Development

Notice 2005-99 provides that a taxpayer may elect to determine whether SBC measured by the elective method is related to the intangible development area by analyzing the activities of the employee recipients of the SBC by reference to financial reporting periods, identifying the related compensation on a period-by-period basis. The Notice further provides that the consent of the Commissioner is not required to elect the period-by-period method for identifying SBC that is measured under the elective method in the case of a CSA if the election is made by a written amendment to the CSA not later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after December 8, 2005. See Temp. Treas. Reg. §§ 1.482-7T(d)(3)(iii)(B)(4) and (C).

If a taxpayer does not elect the period-by-period method for identifying SBC, then the grant date identification method of Temp. Treas. Reg. § 1.482-7T(d)(3)(ii) applies. Temp. Treas. Reg. § 1.482-7T(d)(3)(ii) provides that the determination of whether SBC is directly identified with, or reasonably allocable to, the intangible development activity is made as of the date that the SBC is granted. Accordingly, all SBC that is granted during the term of the CSA and, at date of grant, is directly identified with, or reasonably allocable to, the intangible development activity is included as an intangible development cost.

Analysis

Pursuant to Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(B)(4), Taxpayer had until Date 6 to elect, without the consent of the Commissioner, the elective method for measuring employee stock options. Pursuant to Notice 2005-99, Taxpayer had until Date 7 to elect, without the consent of the Commissioner, the elective method for measuring restricted shares and restricted share units. Also pursuant to Notice 2005-99, Taxpayer had until Date 7 to elect, without the consent of the Commissioner, the period-by-period method for identifying SBC measured by the elective method.

Because Taxpayer did not make the applicable elections by Date 6 and Date 7, respectively, Taxpayer must use the default method of measurement and grant date identification method for measuring and identifying SBC until the Commissioner grants consent for Taxpayer to change from those methods and until Taxpayer makes an explicit reference to the applicable elections in the written contract required by Temp. Treas. Reg. § 1.482-7T(k)(1) or in a written amendment to the CSA. The Commissioner's consent to change the method for measuring and identifying SBC can apply only to SBC granted in taxable years subsequent to the taxable year in which consent is obtained. See Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(C). Therefore, the Commissioner cannot grant Taxpayer's request for section 9100 relief to retroactively change its methods for measuring and identifying SBC. However, the Commissioner is authorized to grant Taxpayer's request to change its methods of measurement and identification prospectively for SBC granted after the taxable year Commissioner consent is granted.

Based on the execution of the Form 872 and the representations Taxpayer made, the Service grants Taxpayer prospective consent to change its methods of measuring and identifying employee stock options and restricted shares or restricted share units pursuant to Temp. Treas. Reg. § 1.482-7T(d)(3)(iii)(C) for purposes of determining the amount Taxpayer must include in its CSA cost pool. This consent is effective for 60 days from the date of this letter. Therefore, if Taxpayer chooses to change its method for measuring and identifying employee stock options and restricted shares or restricted share units, it must file its amended returns for Tax Year 1, Tax Year 2, Tax Year 3, and Tax Year 4, and make the written election in its CSA within 60 days from the date of this letter.

Caveats

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

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John E. Hinding
Senior Technical Reviewer, Branch 6
Office of Associate Chief Counsel
(International)

Enclosures (2)
Copy of this letter
Copy for section 6110 purposes

cc: