DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Steven A. Musher
Chief, CC:INTL:BR6

SUBJECT:

This Field Service Advice responds to your memoranda dated May 3, 1999 and July 1, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Corporation X
Product A
Year 1
Year 2
Corporation Y
Country Y
Corporation Z
Country Z
Amount 1
Amount 2
Amount 3
Amount 4
Amount 5
Amount 6

ISSUES:

1. Whether the value of compensatory stock options[1] is a cost that must be shared with or charged out to affiliates under Treas. Reg. §§ 1.482-2A(d)(4) and 1.482-2(b)(1).

2. Whether the value of compensatory stock options should be measured on the date of grant of the options, on the date of their exercise, or on some other date, and how the value should be measured on the relevant date.

3. Whether the Federal Acquisition Regulations disallow the value of compensatory stock options as a cost in government contracts; if they do disallow the cost, whether there is any relevance of this fact to the issues above.

CONCLUSIONS:

1. The value of compensatory stock options is an item of compensation for tax purposes that must be included in the pool of costs shared with or charged out to affiliates. Treas. Reg. §§ 1.482-2A(d)(4), 1.482-2(b)(1); see Commissioner v. LoBue, 351 U.S. 243, 274 (1956); Apple Computer, Inc. v. Commissioner, 98 T.C. 232 (1992); Sun Microsystems, Inc. v. Commissioner, T.C. Memo 1995-69. Compensation for researchers and other personnel is no less a cost when incurred in the form of property, including stock options, than when incurred in cash. At arm's length, a business would be unwilling to expend 100% of the time of its researchers on a project in which the business retained only 5% of the results, on the purported rationale that the labor is "free of cost" when compensated in stock options. The business would be willing to proceed only if the parties receiving the 95% interest reimbursed it for 95% of the compensation value and so defrayed the real opportunity cost to the business of not employing its R&D labor on a project in which it was entitled to 100% of the fruits. While valuation of stock options may present factual issues, this cannot change the fundamental conclusion this is a compensation cost that must be shared or charged out. Taxpayer's position that stock options are cost-less produces a distorting mismatch in tax deductions and income. The taxpayer received 100% of the tax deductions attributable to R&D compensated through stock options, while only reporting 5% of the income, with the balance of the income going to

[1]For the purposes of this memorandum, we will refer to stock options (and transfers of property pursuant to the exercise of stock options) covered by section 83 and by sections 421-424 as compensatory stock options.

offshore affiliates that may be entitled to deferral. That is precisely the type of distortion section 482 authorizes to the IRS to prevent by appropriate adjustments.

2. In the absence of specific regulations under section 482 for valuing compensatory stock options, any reasonable method and timing of valuation may be utilized, so long as it is applied consistently. At arm's length, parties to a cost sharing or services agreement could choose to measure the cost of compensatory stock options at various points in time using various methods. Because this taxpayer did not make a good faith effort to measure the cost of compensatory stock options on any basis and omitted them from the pool of costs to be shared or charged out, a section 482 allocation must be made based on a reasonable measure of the value of the stock option compensation. In our view, both alternative bases relied upon by the Service in this case, i.e., measurement at grant under a modified Black-Scholes option pricing model, or measurement upon exercise or disqualifying disposition equal to the spread between the value of the underlying stock at such time and the exercise price, constitute reasonable measures under the facts and circumstances of this case.

3. The unallowability of certain stock option costs under the Federal Acquisition Regulations does not negate that stock options are compensation costs, nor suggest that parties at arm's length would ignore the stock option compensation of researchers in cost sharing or services agreements. The reason FAR generally disallows certain stock option compensation is based on administrative concerns that companies could manipulate the time between grant and exercise of the stock options to coincide with a period of major performance of Government cost-type contracts. <u>Singer Company v. United States</u>, 225 Ct. Cl. 637, 639 (1980). Opposite administrative concerns are present for tax purposes, namely, that a failure to take account of stock option costs on some reasonable basis would facilitate an inappropriate manipulation of the income of commonly controlled parties to such arrangements.

<u>FACTS:</u>

The taxpayer, Corporation X, is a U.S. corporation that designs, manufactures and markets Product A. During Years 1 and 2, Corp. X entered into research and development cost sharing and services agreements with two of its controlled foreign corporations: Corp. Y, a Country Y corporation, and Corp. Z, a Country Z corporation.

The research and development cost sharing agreements provided that the parties would share the costs of all research and development activities performed by the parties in connection with the development of Product A and related items, in proportion to the benefits to be derived by each party from manufacturing and marketing products utilizing the developed technology. Research and development activities included basic research, product-specific development, the creation of improvements, adaptations, or other modifications to existing products, and the design or improvement of manufacturing processes. Costs to be shared in connection with these activities included:

1. Direct costs incurred by a party during the term of this Agreement for the conduct by it of the Research Program as reported for financial statement purposes;

2. Indirect costs incurred by supporting cost centers properly allocable to the research and development activities;

3. Amounts properly chargeable to a party by a Related Party which is not a party to this Agreement with respect to assistance rendered by such Related Party in connection with the Research Program; and

4. Amounts paid or accrued by any party for the acquisition, by purchase, license, services agreement or otherwise, of intangible property relating to a product which is or thereafter is deemed covered by this Agreement.[2]

The services agreements provided that the entities would reimburse each other, generally at cost, for expenditures for administrative services incurred for the other's benefit.

The costs shared or charged out under the agreements included the costs of labor booked by research and development departments. Labor costs included salaries and wages, vacation, holiday and sick pay, payroll taxes, medical expenses, and worker's compensation.[3] Costs were initially shared by the parties in the following percentages: Corporation X – 5%; Corporation Y – 65%; Corporation Z – 30%.[4]

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[2]Agreement for Sharing Research and Development Costs, Article II G.

[3]As noted in the Agreement, costs shared or charged out were derived from the records used by Corporation X for financial accounting purposes. These records did not show any expense related to the issuance of compensatory stock options.

[4]Agreement for Sharing Research and Development Costs, Article IV B.

For Years 1 and 2, Corporation X claimed deductions under section 162 of Amounts 1 and 2, respectively, attributable to the exercise of non-statutory stock options (section 83(h)) and disqualifying dispositions of statutory stock options (section 421(b)). While some of these amounts were attributable to options exercised by employees in the departments from which costs were allocated pursuant to the cost sharing and services agreements, none of the amounts was shared or charged out to Corporations Y and Z.

The Service allocated income from Corporations Y and Z to the taxpayer of Amount 3 and Amount 4 for Years 1 and 2, respectively. These amounts were determined by valuing the options granted by the taxpayer to employees in the relevant departments during the years in issue, and adding that value to the pool of costs shared or charged out. The options were valued using the Black-Scholes option pricing model, with modifications to adapt assumptions in the model in a manner appropriate to the facts. In the alternative, the Service disallowed the portion of the deductions claimed by the taxpayer (attributable to the exercise of non-statutory stock options and disqualifying dispositions of statutory stock options) that should have been shared with or charged out to Corporations Y and Z. Under the alternative position, Corporation X's deductions were decreased by Amount 5 and Amount 6 for Years 1 and 2, respectively.

LAW AND ANALYSIS

1. Legal Background

a. Section 482

Section 482 provides that the Service may distribute, apportion or allocate gross income, deductions, credits or allowances among controlled entities if necessary "in order to prevent evasion of taxes or clearly to reflect the income" of those entities. Section 482 is intended to be broadly interpreted.[5] Its purpose is to "prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of "milking")."[6]

In order to achieve a clear reflection of each entity's income, the section 482 regulations provide that the Service should consider what each entity's income would be had the controlled entities been dealing with each other at arm's length. Treas. Reg. § 1.482-1A reads in part as follows:

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[5] Foglesong v. Commissioner, 691 F. 2d 848, 850 (7th Cir. 1982).

[6] H. Rep. 2, 70th Cong., 1st Sess., 1939-1 C.B. (Part 2) 426.

> The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer.[7]
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> * * *
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> The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[8]

If a controlled entity's intercompany transactions meet the arm's length standard of the regulations, then the entity's income should meet the clear reflection of income standard of the statute.

The second sentence of section 482 was added in 1986. It provides 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." This commensurate with income standard is generally effective for taxable years beginning after December 31, 1986, and it applies to the years in issue.[9] While it sparked a revision of the section 482 regulations pertaining to transfers of intangibles, the statute itself was <u>self-executing</u>. Treas. Reg. § 1.482-1(j)(3) (1994 final regulations, T.D. 8552) notes that "[f]or the period prior to the effective date of these regulations, the final sentence of section 482 must be applied using any reasonable method not inconsistent with the statute."

Congress' purpose in enacting the commensurate with income standard was to use the amount of income derived from a transferred intangible as the starting point of a section 482 analysis. The legislative history indicates that case law had been failing to adequately address the problem of selective transfers of high profit intangibles to tax havens. In the case of such transfers, taxpayers had argued successfully for the use of inappropriate comparables, resulting in an insufficient

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[7]Treas. Reg. § 1.482-1A(b)(1).

[8]Treas. Reg. § 1.482-1A(c).

[9]Pub. L. 99-514, § 1231(g)(2).

return to the U.S. transferor. The commensurate with income standard was therefore added as a clarification of the arm's length standard.[10]

The legislative history to the 1986 Act noted that Congress intended to continue to allow intangibles to be developed by means of cost sharing arrangements. With respect to intangibles developed by means of cost sharing, there would be no transfer or license for purposes of section 482. However, Congress expected cost sharing arrangements "to produce results consistent with the purposes of the commensurate with income standard in section 482 – i.e., that "the income allocated among the parties reasonably reflect the actual economic activity undertaken by each."“[11]

In particular, the Conference Report to the 1986 Act noted:

> Under a bona fide cost sharing arrangement, the cost sharer would be expected to bear its portion of all research and development costs, on successful as well as unsuccessful products within an appropriate product area, and the cost of research and development at all relevant development stages would be included.[12] (Emphasis added.)

Thus, if all of the research and development costs at all stages related to an intangible's development are not shared, a cost sharing arrangement may fail the commensurate with income standard. Cost sharing arrangements must reflect each entity's actual economic activities.

b. Cost Sharing and Services Regulations

The cost sharing rules of Treas. Reg. § 1.482-2A(d)(4)[13] provide that, in the case of intangibles that are developed pursuant to a bona fide cost sharing arrangement, no allocation will be made with respect to the development of the intangibles, "except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property." That is, if a bona fide cost

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[10]Section 482 White Paper on Intercompany Pricing, Notice 88-123, 1988-2 C.B. 458, 472.

[11]1988-2 C.B. at 495.

[12]H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-638 (1986).

[13]References to the cost sharing and services regulations are to the 1968 regulations, which apply to the years in issue. However, as previously discussed, the commensurate with income standard also applies to the years in issue.

sharing arrangement exists, the Service may only adjust the taxpayer's share of its intangible development costs in order to reflect the share of costs that would be charged at arm's length.

Treas. Reg. § 1.482-2A(d)(4) defines an "arm's length share of the costs and risks" as follows:

> In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of <u>all</u> the costs and risks of development on an arm's length basis. In order for the sharing of costs and risks to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. (Emphasis added.)

Therefore, in order to determine whether a cost must be shared under Treas. Reg. § 1.482-2A(d)(4), it is necessary to determine whether the cost would be shared by similarly situated unrelated parties. If the cost is a cost that would be shared at arm's length, then it should be shared under the cost sharing regulations.

Under the section 482 regulations pertaining to intercompany services, an arm's length fee must be charged whenever one member of a group of controlled entities performs marketing, managerial, technical or other services for the benefit of, or on behalf of another group member.[14] Treas. Reg. § 1.482-2(b)(2) notes that "[a]ny allocations made shall be consistent with the relative benefits intended from the services, based upon the facts known at the time the services were rendered, and shall be made even if the potential benefits anticipated are not realized."

An arm's length charge is deemed to equal the costs or deductions of the renderer unless the services are an integral part of the business activity of either the renderer or the recipient of the services.[15] In such cases "it is necessary to take into account on some reasonable basis <u>all</u> the costs or deductions which are directly or indirectly related to the service performed."[16] Costs or deductions to be taken into account "include, but are not limited to, costs or deductions for

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[14]Treas. Reg. § 1.482-2(b)(1).

[15]Treas. Reg. § 1.482-2(b)(3).

[16]Treas. Reg. § 1.482-2(b)(4)(i)(emphasis added).

compensation, bonuses, and travel expenses attributable to employees directly engaged in performing such services. . ..”[17]

c. Case Law

In Commissioner v. LoBue, 351 U.S. 243, 247 (1956), the Supreme Court held that “[w]hen assets are transferred by an employer to an employee to secure better services they are plainly compensation. It makes no difference that the compensation is paid in stock rather than in money.” In that case, the taxpayer had argued that his receipt of stock options was a receipt of a proprietary interest in the corporation, and therefore not taxable. The Court nevertheless found that the character of the transaction was an arrangement “by which an employer transferred valuable property to his employees in recognition of their services.”[18] Therefore, the taxpayer realized taxable gain when he purchased the stock.[19]

In Apple Computer, Inc. and Consolidated Subsidiaries v. Commissioner, 98 T.C. 232 (1992), and Sun Microsystems, Inc. v. Commissioner, T.C. Memo 1995-69, the Service argued that the spread upon the exercise of nonstatutory stock options and the spread upon the disqualifying disposition of incentive stock options, respectively, were not “wages” for purposes of determining the research credit under section 44F or section 41. This provision authorized a credit as a function of expenses which the taxpayer paid or incurred during the taxable year. Expenses included any wages paid or incurred to an employee for qualified research services. “Wages” were defined by section 3401(a) to include all remuneration for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash. The Tax Court held that the taxpayers’ gains upon exercise/disqualifying disposition of stock options were wages for this purpose.[20] It did not matter that the spreads were not treated as expenses for financial reporting purposes.[21] The Service acquiesced with respect to both cases.[22]

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[17]Treas. Reg. § 1.482-2(b)(4)(ii)(emphasis added).

[18]351 U.S. at 248.

[19]Id.

[20]98 T.C. at 237; 69 T.C.M. at 1887.

[21]98 T.C. at 241; 69 T.C.M at 1887.

[22]1992-2 C.B. 1; 1997-2 C.B. 1.

In Apple Computer, the Service also argued that in order for wage costs to qualify for the credit, the services generating those costs had to be performed in the year in which the credit was claimed. The Tax Court held that even though the services were performed in a year prior to the year in which the options were exercised and a research credit taken, the Court would not disregard the wage expenses for purposes of the research credit.[23]

2. The Value of Compensatory Stock Options Is a Cost That Must Be Shared With or Charged Out to Affiliates under Treas. Reg. §§ 1.482-2A(d)(4) and 1.482-2(b)(1)

LoBue, Apple, and Sun Microsystems all confirm that amounts in consideration for services are none the less compensation expenses simply because they are incurred in the form of property, specifically as stock options, rather than in cash.[24] As stated in Apple, "there is no requirement that an expense must be paid in cash (as opposed to property)." 98 T.C. at 238.

As discussed, the cost sharing and services regulations both require that all relevant costs be shared with or charged out to affiliates. It has similarly been noted that in order for a cost sharing arrangement to comply with the self-executing commensurate with income standard of the second sentence of section 482, all costs at all stages of development of an intangible must be included. There is no suggestion that compensation costs may be ignored when incurred in the form of a property, rather than as a cash, obligation.

Parties dealing at arm's length would not ignore compensatory stock options. At arm's length, a business would be unwilling to expend 100% of the time of its researchers and other personnel on a project in which the business retained only 5% of the results, on the purported rationale that the labor is "free of cost"

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[23]98 T.C. at 239-41.

[24]When employees are compensated with stock rather than with cash, they must include in gross income the fair market value of the stock when the stock becomes substantially vested. I.R.C. § 83(a);Treas. Reg. § 1.83-1(a)(1). When employees are compensated with nonstatutory stock options, section 83(a) applies upon the grant of the options if their value is readily ascertainable at such time or, if not, when the options are exercised or disposed of. Treas. Reg. § 1.83-7(a). Although section 83 does not apply to options which, when granted, meet the requirements of section 421(a) (statutory stock options), upon a disqualifying (early) disposition of the stock purchased through a statutory option, the rules of section 83 are used to determine the amount of the employee's compensation income. A corporation may take a deduction under section 162 or 212 for the amount included as compensation in the employee's gross income. Treas. Reg. §§ 1.83-6(a)(1), 1.421-8(b)(1).

when compensated in stock options. The business would be willing to proceed only if the parties receiving the 95% interest reimbursed it for 95% of the compensation value and so defrayed the real opportunity cost to the business of not otherwise employing its R&D labor on a project in which it was entitled to 100% of the fruits. While valuation of stock options may present factual issues, this cannot change the fundamental conclusion this is a compensation cost that must be shared or charged out.

Taxpayer's position that stock options are cost-less produces a distorting mismatch in tax deductions and income. The taxpayer received 100% of the tax deductions attributable to the R&D compensated through stock options, while only reporting 5% of the income, with the balance of the income going to offshore affiliates that may be entitled to deferral. That is the type of distortion section 482 authorizes the IRS to prevent by appropriate adjustments.

The taxpayer asserts that compensatory stock options need not be take into account under section 482 in light of their treatment in the years in question for financial statement purposes. Prior to 1995, financial accounting rules provided that no cost would be recognized upon the issuance of a stock option if the option price (at some future time) were the same as the price of the underlying stock on the option's date of issuance.[25] However, the Financial Accounting Standards Board became concerned that this method of accounting for stock option costs would not adequately reflect a corporation's costs for financial statement purposes. In 1993, FASB issued an Exposure Draft indicating a plan to require a fair value method of accounting for stock option costs. This plan was ultimately modified to a "choice" approach in FASB 123.[26] Effective December 15, 1995, a company may adopt a fair value method for accounting for stock option costs, or it may continue to use the APB 25 method, with footnotes disclosing (a) the net income and earnings per share as if the fair value method were used, and (b) the difference between the compensation cost recognized by APB 25 and the fair value method.[27] The fair value method is encouraged, and once a company has chosen that method, it may not return to the APB 25 method.[28]

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[25]APB 25, Accounting for Stock Issued to Employees.

[26]Jan R. Williams, 1999 Miller GAAP Guide 46.16.

[27]Id. at 46.20.

[28]Id. at 46.16.

The Tax Court considered and rejected similar arguments based on the financial accounting treatment of stock options in the Apple case.[29] The same considerations dictate rejection of such arguments in the instant matter as well. The Tax Court concluded that reliance on financial accounting principles is misplaced in light of the different objectives of the tax rules. The Tax Court cited the following statements by the Supreme Court:

> The court has long recognized “the vastly different objectives that financial and tax accounting have.” The goal of financial accounting is to provide useful and pertinent information to management, shareholders, and creditors. On the other hand, the major responsibility of the Internal Revenue Service is to protect the public fisc.[30]

The taxpayer further asserts that stock options are not a corporate level cost, but rather only represent a shareholder level cost to the extent they result in a dilution in earnings per share. As set forth above, expending R&D labor compensated in stock options on one project in which the corporation only receives 5% of the results, rather than on another in which the corporation receives 100% of the fruits, constitutes a true opportunity cost to the corporation. Moreover, when a corporation issues options to its employees to purchase stock for what it anticipates will be a bargain price at some point in the future, the corporation is forgoing the opportunity to sell that stock in the future at its fair market value.[31]

The taxpayer also asserts that because it cannot identify actual, arm’s length arrangements in which stock option compensation costs were shared or charged out, the arm’s length standard does not require that these costs be shared with or charged out to Corporations Y and Z. However, the fact that Corporation X may not have been able to find agreements that call for a sharing or charging out of stock option costs does not mean that such agreements do not exist. Moreover, the nonexistence of actual third party transactions is not conclusive of whether a controlled transaction is arm’s length within the meaning of the section 482 regulations. It has long been recognized that comparables may not exist for the transfer of certain high profit intangibles among related parties.[32] As elaborated above, parties dealing at arm’s length would not view the utilization of R&D labor as

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[29]98 T.C. at 239.

[30]United States v. Hughes Properties, Inc., 476 U.S. 593, 603 (1986).

[31]See Divine v. Commissioner, 500 F. 2d 1041, 1057 (2d Cir. 1974).

[32]Notice 88-123, 1988-2 C.B. at 473.

cost-less simply because the labor was compensated in the form of stock options rather than in cash.

In addition, the taxpayer asserts that parties dealing at arm's length would not share the cost of stock option compensation because it is too volatile. While the value of compensatory stock options may be volatile, it is still a cost incurred by the corporation issuing the options, and one which the issuing corporation would be certain to recover on some reasonable basis when pricing its services at arm's length. As discussed below, there are several methods for determining the cost of compensatory stock options, and an affiliated group may adopt a method (such as an option pricing model) that would anticipate future stock volatility when determining present costs.

3. <u>In the Absence of Specific Regulations under Section 482 for Valuing Compensatory Stock Options, Any Reasonable Method and Timing of Valuation May Be Utilized on a Consistent Basis</u>

In determining when and how the value of compensatory stock options should be shared with or charged out to the taxpayer's foreign affiliates, the standard which controls is the arm's length standard. As noted above, the cost sharing regulations require "an effort in good faith by the participating members to bear their respective shares of all the cost and risks of development on an arm's length basis" which in turn requires that "the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement."[33] The services regulations provide that "[w]here the amount of an arm's length charge for services is determined with reference to the costs or deductions incurred with respect to such services, it is necessary to take into account on some reasonable basis all the costs or deductions which are directly or indirectly related to the service performed."[34] Finally, a cost sharing arrangement must comply with the self-executing commensurate with income standard of the second sentence of section 482 by taking into account all costs at all stages of development of an intangible "using any reasonable method not inconsistent with the statute."[35]

Accordingly, we conclude that in the absence of specific regulations under section 482 for valuing compensatory stock options, any reasonable method and timing of valuation may be utilized, so long as it is applied consistently. At arm's

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[33]Treas. Reg. § 1.482-2A(d)(4).

[34]Treas. Reg. § 1.482-2(b)(4)(i)(emphasis added).

[35]Treas. Reg. § 1.482-1(j)(3).

length, parties to a cost sharing or services agreement could choose to measure the cost of compensatory stock options at various points in time using various methods.[36] In our view, both alternative bases relied upon by the Service in this case, i.e., measurement at grant under a modified Black-Scholes option pricing model, or measurement upon exercise or disqualifying disposition equal to the spread between the value of the underlying stock at such time and the exercise price, constitute reasonable measures under the facts and circumstances of this case.[37]

At arm's length parties might agree to an option pricing model similar to that which companies are now encouraged to use for financial accounting purposes.[38] The reason is because, as one article notes, "[a]n advantage of grant-date accounting is it reflects the value the company and employee had in mind when they agreed on the exchange."[39] The same article contains the following statement concerning option pricing models:

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[36]There are at least six points in time when, at arm's length, the cost of compensatory stock options could be measured: when the option plan is adopted, when the options are granted to employees, when the employees have performed any conditions precedent to the exercise of the options, when the employees may first exercise the options, when the options are exercised by the employees, and when the employees dispose of the stock acquired. See Jan R. Williams, 1999 Miller GAAP Guide 46.06.

[37]Note that Treas. Reg. § 1.482-7(f)(4) is consistent with this result. The regulation, which does not apply to the years in issue, is entitled "Timing of allocations," and it notes that "[i]f the district director reallocates costs under the provisions of this paragraph (f), the allocation must be reflected for tax purposes in the year in which the costs were incurred." Here, the "year in which the costs were incurred" could be any of the times described above at which unrelated parties could decide to take the cost of stock option compensation into account. The chief requirement is consistency. This is embodied in Treas. Reg. § 1.482-7(i) (1995 regulations), "Accounting requirements": "The accounting requirements of this paragraph are that the controlled participants in a qualified cost sharing arrangement must use a consistent method of accounting to measure costs and benefits, and must translate foreign currencies on a consistent basis."

[38]Financial Accounting Standards Board, Accounting Standards Current Text (1999) (hereafter "FASB Accounting Standards"), vol. 1, Section C36, ¶ .101.

[39]"Financial Reporting: Stock Compensation Accounting," Journal of Accountancy, June 1993.

> Some critics charge option pricing models aren't useful because they don't accurately predict the exact value received upon future exercise. Why? While an estimate of value must be reduced to a point amount, a whole range of values could occur. For example, assume an option has only two possible outcomes, $0 and $10, each with an equal chance of occurring. Ignoring complicating factors, a rational person would be willing to pay about $5 for the option. Yet the estimated value compared to either of the values at exercise would be 100% wrong 100% of the time! Does that mean the estimated value is meaningless, since it can differ frequently and significantly from the ultimate value? Many believe the answer is no, since the estimate represents the option's current value rather than a prediction of exact value.[40]

An option pricing model may therefore be a reasonable method for valuing the cost of compensatory stock options.[41]

Alternatively, at arm's length parties might agree to value options based on the spread at the time of exercise or disqualifying disposition of the options. This approach has the advantage of administrative simplicity. While a new participant to the cost sharing or services agreement might be paying compensation costs related to services already performed, parties at arm's length might agree that was an appropriate measurement time and method because services performed in the past may have added value to intangibles still under development. In addition, at the end of the cost sharing arrangement, the later-joining participant would not pay the costs related to options that had not yet been exercised.

Depending on the facts and the method, the value of compensatory stock options may turn out not to be taken into account in the same year in which services are performed. Because stock option costs and the related services are generally incurred and performed over several years, there is no perfect way to match services performed in a given year with the stock option costs related to those services in that year. Consistent application of a selected method over time should tend to mitigate any mismatch. The Tax Court in Apple considered the

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[40] Id.

[41] We note that option pricing models rely on a number of assumptions which may vary in reliability. The Financial Accounting Standards Board has provided guidance in selecting assumptions and illustrative computations using the Black-Scholes model and a binomial model. FASB Accounting Standards at ¶¶ .152-.235. The Service in this matter used a Black-Scholes option pricing model with modifications to adapt assumptions in the model in a manner appropriate to the facts.

mismatch phenomenon and held that stock options yielded expenses for purposes of the research credit even though some services may have been performed in tax periods other than the period in which nonstatutory stock options were exercised.[42]

The taxpayer in this matter did not make a good faith effort to measure the cost of the compensatory stock options in issue on any basis. It omitted them from the pool of costs to be shared or charged out. A section 482 allocation must, therefore, be made based on a reasonable measure of the value of the stock option compensation.

4. The FAR Disallowance of Stock Options Does Not Warrant a Similar Disallowance Under Section 482

The Office of Federal Procurement Policy issued the Federal Acquisition Regulation (FAR), effective April 1, 1984, which superseded the Defense Acquisition Regulation and the Federal Procurement Regulation. The goal of the FAR was to standardize procedures for the acquisition of supplies and services by executive branch departments and agencies.[43] Part 31 of the FAR contains cost principles and procedures for pricing contracts whenever cost analysis is performed, and the determination of costs when required by a contract clause.[44]

FAR § 31.205-6(a) defines compensation for personal services. It reads as follows.

> Compensation for personal services includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance (except as otherwise provided for in other paragraphs of this subsection). It includes, but is not limited to, salaries; wages; directors' and executive committee members' fees; bonuses (including stock bonuses); incentive awards; employee stock options, and stock appreciation rights; employee stock ownership plans; . . .

However, FAR § 31.205-6(i) notes that "[a]ny compensation which is calculated or valued, based on changes in the price of corporate securities is unallowable."

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[42] 98 T.C. at 239-41.

[43] Eugene W. Massengale, Fundamentals of Federal Contract Law, 40 (1991).

[44] 48 C.F.R. § 31.000.

The unallowability of such stock option costs under FAR does not negate that stock options are compensation costs, nor suggest that parties at arm's length would ignore the stock option compensation of researchers in cost sharing or services agreements. The reason FAR generally disallows certain stock option compensation is based on administrative concerns that companies could manipulate the time between grant and exercise of the stock options to coincide with a period of major performance of Government cost-type contracts. See Singer Company v. United States, 225 Ct. Cl. 637, 639 (1980). Opposite administrative concerns are present for tax purposes, namely, that a failure to take account of stock option costs on some reasonable basis would facilitate an inappropriate manipulation of the income of commonly controlled parties to such arrangements.

If you have any further questions, please call (202) 874-1490.

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