

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person To Contact:

, ID No.

Telephone Number:

In re:

Refer Reply To:

CC:INTL:B06

PLR-118753-12

Date:

December 17, 2012

Legend

Taxpayer =

State =

Accounting Firm =

Z Corp =

Country A =

Country B =

Date 1 =

Date 2 =

Month 1 =

Tax Year 1 =

Dear _____ :

This responds to a letter dated April 30, 2012, supplemented by letters dated August 23, 2012, and October 12, 2012, submitted by Accounting Firm requesting that the Internal Revenue Service ("Service") grant Taxpayer consent to change its methods for measuring and timing (together referred to hereinafter as "measuring") and identifying employee stock options, restricted stock units, and performance-based restricted stock units (collectively referred to hereinafter as "stock-based compensation" or "SBC") pursuant to Treas. Reg. § 1.482-7(d)(3)(iii)(C) for purposes of determining the amount Taxpayer must include in its cost sharing arrangement ("CSA") as intangible development costs ("IDCs") beginning in Tax Year 1.

The consent granted by this letter is based upon information and representations submitted by Taxpayer and Accounting Firm, and accompanied by penalty of perjury statements executed by appropriate parties. This office has not verified any of the materials submitted in support of the request for a ruling. Verification of the information, representations, and other data may be required as part of the audit process.

Facts

Taxpayer, a State corporation, and its wholly owned subsidiary, Z Corp, an entity organized under the laws of Country A, entered into a CSA on Date 1. Taxpayer thereafter entered into a first amendment to the CSA on Date 2.

Since the formation of the CSA, Taxpayer has granted SBC in the form of employee stock options, restricted stock units, and performance-based restricted stock units. The standard vesting terms for SBC granted by Taxpayer to employees consist of four-year periods with percent vesting each year (“standard four-year/ percent vesting”). However, some vesting periods for SBC vary from the standard four year/ percent vesting. The SBC in the form of employee stock options and restricted stock units do not contain service or performance vesting restrictions other than the requirement that employment not be terminated prior to the vesting date. The SBC in the form of performance-based restricted stock units also contains, in addition to the requirement that employment not be terminated prior to the vesting date, requirements that certain company performance tests (for example, tests based on Taxpayer’s revenue and operating income performance compared with specified peer companies) be met in order for the awards to vest.

The SBC granted by Taxpayer includes restricted shares issued to employees located in Country B. These restricted shares are subject to certain special provisions intended to facilitate Taxpayer’s compliance with the laws of Country B. In accordance with these special provisions, Taxpayer requires all employees who are nationals of Country B to liquidate their shares upon vesting. However, neither this nor any other SBC issued by Taxpayer is subject to any post-vesting restrictions that would prohibit or in any way limit the employee’s ability to sell his or her shares after vesting.

Taxpayer’s CSA provides that costs attributable to SBC “shall be calculated as the amount allowable to the parties as a deduction for U.S. federal income tax purposes,” consistent with the general method for measuring SBC costs in Treas. Reg. § 1.482-7(d)(3)(iii)(A) (hereinafter referred to as the “default method”). However, Taxpayer asserts that it had intended from the inception of the CSA to elect to measure SBC in the same amount and as of the same time as the fair value of the SBC reflected as a charge against income in audited financial statements as provided by Treas. Reg. § 1.482-7(d)(3)(iii)(B) and Notice 2005-99, 2005-2 C.B. 1214 (referred to hereinafter as the “elective method”). Taxpayer further asserts that it intended to determine whether SBC measured under the elective method is related to the intangible development activity by analyzing the activities of the recipients of the SBC by reference to financial reporting periods as provided in Notice 2005-99 (referred to hereinafter as “period-by-

period identification”).

In Month 1, Taxpayer discovered that it had not elected the elective method and period-by-period identification. Taxpayer thereafter filed a request for the Commissioner’s consent to prospectively change its methods for measuring and identifying SBC under Treas. Reg. § 1.482-7(d)(3)(iii)(B)(4) and Notice 2005-99.

For purposes of this request, Taxpayer made the following representations:

(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 Treas. Reg. § 1.482-7(k)(2)(ii)(E). Upon request, Taxpayer will timely provide to the Commissioner records kept pursuant to such requirements;

(2) The standard vesting terms for SBC granted by Taxpayer consist of four year vesting periods with 25-percent vesting each year. However, some SBC is subject to vesting terms that vary from the standard four year/25-percent vesting. None of the SBC is subject to significant post-vesting restrictions, vesting terms longer than four years, or service or performance vesting restrictions that will have a substantial effect on the fair value of the SBC under GAAP or result in unreasonably long vesting periods;

(3) For all SBC granted before the first taxable year beginning after receiving the Commissioner’s consent (referred to hereinafter as “Legacy SBC”), Taxpayer will use the default method of measurement and grant date identification until the Legacy SBC has been exercised or has lapsed;

(4) For all SBC granted on or after the first day of the taxable year beginning after receiving the Commissioner’s consent (referred to hereinafter as “New SBC”), Taxpayer will use the elective method and period-by-period identification; and

(5) Taxpayer will amend its CSA to elect the elective method of measurement and period-by-period identification within 60 days of receiving the Commissioner’s consent to change methods.

Therefore, beginning with the return for Tax Year 1, 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 method of measurement and the period-by-period method of identification.

In addition to making these and other representations, Taxpayer has explained that it intends to implement period-by-period identification by identifying the cost center to which each employee that has SBC vesting is assigned during the applicable financial reporting period. If SBC that vests during the financial reporting period was paid to an

employee assigned to a cost center classified as a research and development (“R&D”) cost center during that financial reporting period, then that SBC will be identified with the IDA of the CSA. For that purpose, Taxpayer classifies a cost center as an R&D cost center according to the definition of R&D activities for U.S. GAAP purposes.

Law

Measurement of Stock-Based Compensation Related to Intangible Development

Treas. Reg. § 1.482-7(d)(3)(iii)(A) provides the default method for measurement and timing of stock-based compensation IDCs as follows:

Except as otherwise provided in this paragraph (d)(3)(iii), the cost attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an IDC under this section for the taxable year for which the deduction is allowable.

Treas. Reg. § 1.482-7(d)(3)(iii)(B)(1) provides the elective method for measurement and timing of stock-based compensation IDCs with respect to options on publicly traded stock as follows:

With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a CSA may elect to take into account all IDCs 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 United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

Treas. Reg. § 1.482-7(d)(3)(iii)(B)(4) provides for the time and manner of making the election, in relevant part, as follows:

The election described in this paragraph (d)(3)(iii)(B) is made by an explicit reference to the election in the written contract required by paragraph (k)(1) of this section or in a written amendment to the CSA entered into with the consent of the Commissioner pursuant to paragraph (d)(3)(iii)(C) of this section.

Treas. Reg. § 1.482-7(d)(3)(iii)(C) provides, in relevant part:

[I]f controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(3)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(3)(iii)(B)(4) of this section, the controlled participants may make the election described in paragraph (d)(3)(iii)(B) of this section 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 2005-99¹ extended the elective method to

nonvested equity shares or nonvested equity share units within the meaning of Statement of Financial Accounting Standards No. 123, "Share-Based Payment," Financial Accounting Standards Board (rev. 2004) (SFAS 123R), provided that those shares or share units: (i) constitute or are issued with respect to publicly traded stock within the meaning of § 1.482-7(d)(2)(iii)(B)(2); and (ii) are not subject to market conditions or significant post-vesting restrictions within the meaning of SFAS 123R.

We refer to such shares and share units as "restricted shares and share units." An election to apply the elective method to restricted shares or share units is generally made in the time and manner set forth in Treas. Reg. § 1.482-7(d)(3)(iii)(B)(4). However, the consent of the Commissioner is not required to elect the elective method for restricted shares and share units 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.

Identifying Stock-based Compensation Related to Intangible Development

Treas. Reg. § 1.482-7(d)(3)(ii) provides the rule for identification of SBC with the intangible development activity ("IDA") ("grant date identification"), in relevant part, as follows:

The determination of whether stock-based compensation is directly identified with, or reasonably allocable to, the IDA is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the CSA and, at date of grant, is directly identified with, or reasonably allocable to, the IDA is included as an IDC under paragraph (d)(1) of this section.

¹ Notice 2005-99 refers to the SBC rules contained in Treas. Reg. § 1.482-7(d)(2) (2003), the materially similar predecessor of the rules in Treas. Reg. § 1.482-7(d)(3) that are applicable in the present case.

Notice 2005-99 provides that a taxpayer may choose to determine whether SBC measured by the elective method is related to the IDA using period-by-period identification rather than grant date identification. Specifically, Notice 2005-99 provides that:

[C]ontrolled participants may choose to determine whether stock-based compensation measured by the elective method is related to the intangible development area by analyzing the activities of the employee recipients of the stock-based compensation by reference to financial reporting periods, identifying the related compensation on a period by period basis. In this context, the Treasury Department and the IRS emphasize that activities within the intangible development area are not necessarily coextensive with those activities classified as “research and development” for financial reporting purposes. Consequently, nothing in this notice should be interpreted as eliminating the requirement to take into account all stock-based compensation costs related to the intangible development area. Controlled participants must identify the stock-based compensation that is related to the intangible development area, notwithstanding that the activities conducted to develop intangibles covered by the QCSA may differ from the activities classified as “research and development” for U.S. GAAP purposes.

Notice 2005-99 further provides:

Taxpayers’ implementation of this identification method based on financial reporting periods must meet four requirements. First, the identification methodology must be applied consistently (under the principles of § 1.482-7(d)(2)(iii)(C)). Second, any stock-based compensation the fair value of which is not reflected as a charge against income in audited financial statements (for example, as in the case of certain stock options the fair value of which was disclosed in footnotes prior to the effective date of SFAS 123R) must be identified for purposes of § 1.482-7 as if the fair value of such compensation were reflected as a charge against income in audited financial statements. Third, as under the grant-date identification rule, controlled participants using this identification methodology must exclude stock-based compensation granted prior to the term of the QCSA. Fourth and finally, stock-based compensation granted but not vested during the term of the QCSA must be treated as vesting immediately before expiration or termination of the QCSA for purposes of § 1.482-7. Under this final requirement, if costs attributable to stock-based compensation granted during the term of the QCSA are allocable under U.S. GAAP to reporting periods subsequent to the term of the QCSA, the determination of whether these costs must be taken into account as intangible development costs must be based on the employee’s activities

as of the financial reporting period during which the date of the expiration or termination of the QCSA occurs.

Generally, pursuant to Treas. Reg. § 1.482-7(d)(3)(iii)(C) and (B)(4), a change of identification method may be made only by a written amendment to the CSA entered into with the consent of the Commissioner. However, Notice 2005-99 further provides that the consent of the Commissioner is not required to change from grant date identification to period-by-period identification if such written amendment is “made no 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.”

Analysis

Based on Taxpayer’s representations, the Service grants Taxpayer prospective consent to change to the elective method and period-by-period identification. 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 SBC, it must make the written election in its CSA within 60 days from the date of this letter.

Caveats

The sole purpose of this private letter ruling is to grant consent for Taxpayer to use the elective method and period-by-period identification for purposes of including SBC as an IDC that Taxpayer must share for purposes of its CSA. 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 particular, no opinion is expressed or implied regarding: (i) whether all of the SBC issued by Taxpayer are eligible for the elective method under the criteria set forth in Notice 2005-99, (ii) whether, for purposes of implementing period-by-period identification during any financial reporting period, the SBC costs of employees assigned to R&D cost centers for financial reporting purposes are co-extensive with all of Taxpayer’s SBC costs directly identified with, or reasonably allocable to, the IDA of the CSA, and (iii) the APA that Taxpayer has requested, or any transactions or items discussed or referenced in this letter that may be covered by or otherwise relevant to, any such APA.

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.

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,

Jason M. Osborn
Senior Technical Reviewer, Branch 6
Office of Associate Chief Counsel
(International)