

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-144997-12
Date:
December 18, 2012

TY:

Legend

- Taxpayer =
- Company Z =
- Country Y =
- Year 1 =
- Year 2 =
- Year 3 =
- Year 4 =
- Date 1 =
- Date 2 =

Dear _____ :

This responds to a letter dated October 16, 2012, supplemented by a letter dated December 13, 2012, submitted by your representatives. The letters request that the Internal Revenue Service (“Service”) grant Taxpayer consent to use the methods described in Treas. Reg. § 1.482-7(d)(3)(iii)(B) and Notice 2005-99, 2005-2 C.B. 1214, for measuring and identifying employee stock options, restricted shares, and restricted share units for purposes of determining the amount Taxpayer must include in its cost sharing arrangement (“CSA”) as intangible development costs (“IDCs”) for Year 4 and subsequent tax years.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and its representatives 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 rulings. Verification of the factual

information, representations, and other data may be required as part of the audit process.

FACTS

Taxpayer, a domestic corporation, was incorporated in Year 1. In Year 2, Taxpayer adopted two stock-based compensation (“SBC”) plans pursuant to which it issued equity awards with respect to shares of Taxpayer’s common stock to employees, directors, and consultants (“Year 2 Plans”). On Date 1, Taxpayer and its wholly-owned indirect subsidiary, Company Z, entered into a CSA. The CSA defines IDCs as including SBC granted on or after Date 1 to the extent required by law as measured pursuant to the method provided in Treas. Reg. § 1.482-7(d)(3)(iii)(A) (“default method”).

In Year 3, Taxpayer formally registered its initial public offering of Taxpayer’s common stock. On Date 2 in Year 3, Taxpayer’s common stock was listed on an established U.S. securities market. Also in Year 3, Taxpayer adopted a new SBC plan that replaced the Year 2 Plans (“Year 3 Plan”). Pursuant to the Year 3 Plan, Taxpayer is permitted to issue, among other types of awards, stock options, restricted stock awards (“RSAs”), and restricted stock units (“RSUs”) with respect to its common stock.

For financial reporting purposes, Taxpayer recognizes SBC expense in accordance with Statement of Financial Accounting Standards No. 123, “Share-Based Payment,” Financial Accounting Standards Board (rev. 2004) (“SFAS 123R”).¹ Accordingly, Taxpayer values its SBC at fair value, net of estimated forfeitures, and generally recognizes the corresponding compensation expense over the period during which the recipient is required to perform services in exchange for the award.

Taxpayer’s stock options generally vest over a service period of four to five years, unless subject to a special vesting period. RSAs and RSUs granted in Year 3 or later are similarly subject to a service condition that may be satisfied over a service period of four to five years, unless subject to a special vesting period. Other SBC that Taxpayer grants may be subject to other vesting or performance requirements as determined by Taxpayer’s compensation committee. Taxpayer intends to continue providing additional SBC awards under the Year 3 Plan.

Taxpayer filed this request for Commissioner consent to prospectively adopt the method described in Treas. Reg. § 1.482-7(d)(3)(iii)(B) for measuring and timing of options on publicly traded stock, which was extended to certain restricted shares and restricted share units by Notice 2005-99 (“elective method”). Taxpayer also requested consent to prospectively use the basis for identification of SBC with the intangible development activity (“IDA”) described in Notice 2005-99.

¹ SFAS 123R has been re-codified as Accounting Standards Codification Topic 718, but will be referred to herein as SFAS 123R for the sake of familiarity.

Taxpayer has made the following representations, as stated in its submissions:

- (1) With respect to its CSA, Taxpayer is in compliance, 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). Upon request, Taxpayer will timely provide to the Commissioner records kept pursuant to such requirements.
- (2) Taxpayer requests to use the Elective Method of measurement and timing and period-by-period identification with respect to SBC that it issues with respect to its _____, which are now publicly traded within the meaning of Treas. Reg. § 1.482-7(d)(3)(iii)(B)(2).
- (3) Taxpayer's SBC issued in Year 4 or thereafter will not be subject to market conditions or significant post-vesting restrictions within the meaning of FAS 123R.
- (4) With respect to any SBC the fair value of which is not reflected as a charge against income in audited financial statements, Taxpayer will identify such SBC for purposes of Treas. Reg. § 1.482-7 as if the fair value of such compensation were reflected as a charge against income in audited financial statements.
- (5) Taxpayer will treat SBC granted, but not vested, during the term of the CSA, as vesting immediately before expiration or termination of the CSA for purposes of Treas. Reg. § 1.482-7, as provided for in Notice 2005-99.
- (6) Taxpayer will continue to utilize the Default Method of measurement and timing and grant-date identification for all SBC issued since Date 1 up to the end of Year 3.
- (7) For all stock options issued with respect to publicly traded stock within the meaning of Treas. Reg. § 1.482-7(d)(3)(iii)(B)(2) granted in or after Year 4, Taxpayer and all controlled participants to the CSA will use the Elective Method of measurement and timing and period-by-period identification.
- (8) For all RSAs and RSUs issued with respect to publicly traded stock within the meaning of Treas. Reg. § 1.482-7(d)(3)(iii)(B)(2) granted in or after Year 4 that are: a) nonvested equity shares or nonvested equity share units within the meaning of FAS 123R, and b) are not subject to market conditions or significant post-vesting restrictions within the meaning of FAS 123R, Taxpayer and all controlled participants to the CSA will use the Elective Method of measurement and timing and period-by-period identification.

LAW**Measurement and Timing of SBC Related to Intangible Development**

Treas. Reg. § 1.482-7(d)(3)(iii)(A) provides the default method for measurement and timing of SBC 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 alternative elective method for measurement and timing of SBC 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 2005-99² 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 SBC Related to Intangible Development

Treas. Reg. § 1.482-7(d)(3)(ii) provides the rule for identification of SBC with the 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.

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

² 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.

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."

In applying period-by-period identification, Notice 2005-99 provides:

[A]ctivities 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.

ANALYSIS

Based on the representations Taxpayer has made, the Service grants Taxpayer prospective consent to change to the elective method for measurement and timing of employee stock options, restricted shares, or restricted share units pursuant to Treas. Reg. § 1.482-7(d)(3)(iii)(B) and Notice 2005-99 for purposes of determining the amount Taxpayer must include IDCs. The Service also grants Taxpayer prospective consent to change to period-by-period identification of SBC with the IDA pursuant to Notice 2005-99. This consent is effective for 60 days from the date of this letter. Therefore, if Taxpayer chooses to adopt the elective method and period-by-period identification, it must make the written election in its CSA within 60 days from the date of this letter.

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, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter, including the CSA, or concerning the validity of any provisions within the CSA.

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,

Christopher J. Bello
Chief, Branch 6
Office of Associate Chief Counsel (International)

cc: