

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.

Telephone Number:

In Re:

Refer Reply To:

CC:INTL:B06

PLR-123934-13

Date:

December 20, 2013

TY:

Legend

Taxpayer =

Company Z =

Year 1 =

Year 2 =

Month 1 =

Date 1 =

Dear :

This responds to a letter dated May 16, 2013, supplemented by a letter dated December 13, 2013, 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 1 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 2. On Date 1, Taxpayer and its wholly-owned subsidiary, Company Z, entered into an agreement that they intended would constitute a CSA within the meaning of Treas. Reg. § 1.482-7(b). The CSA provides that stock-based compensation (“SBC”) is an IDC that Taxpayer and Company Z must share. The CSA also provides that SBC is measured pursuant to the method provided in Treas. Reg. § 1.482-7(d)(3)(iii)(A) and that SBC is identified with intangible development activity pursuant to the method in Treas. Reg. § 1.482-7(d)(3)(ii).

In Month 1, Taxpayer had an initial public offering and became a publicly traded company.

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

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

- (1) Regarding 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). Upon request, Taxpayer will timely provide to the Commissioner records kept pursuant to such requirements.
- (2) The SBC with respect to which Taxpayer requests to use the method of measurement and timing and period-by-period identification provided in Treas. Reg. § 1.482-7(d)(3)(iii)(B)(1) and Notice 2005-99 are publicly traded stock within the meaning of Treas. Reg. § 1.482-7(d)(3)(iii)(B)(2).
- (3) Taxpayer’s SBC is not subject to market conditions or significant post-vesting restrictions within the meaning of Statement of Financial Accounting Standards No. 123, “Share-Based Payment,” Financial Accounting Standards Board (rev. 2004) (“FAS 123R”).
- (4) The service and performance vesting restrictions do not have a substantial effect on the fair value of the SBC under U.S. generally accepted accounting principles (“GAAP”) and do not result in unreasonably long vesting periods within the meaning of FAS 123R.

- (5) 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.
- (6) 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 in Notice 2005-99.
- (7) For all SBC granted before the first day of the first taxable year following receipt of the Service's consent ("Legacy SBC"), Taxpayer and all controlled participants to the CSA will use the methods of measurement and timing provided in Treas. Reg. § 1.482-7(d)(3)(iii)(A) and grant date identification provided in Treas. Reg. § 1.482-7(d)(3)(ii) until all Legacy SBC has been exercised or lapsed.
- (8) 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 on or after the first day of the first taxable year following receipt of the Service's consent, Taxpayer and all controlled participants to the CSA will use the methods of measurement and timing and period-by-period identification provided in Treas. Reg. § 1.482-7(d)(3)(iii)(B)(1) and Notice 2005-99.
- (9) For all restricted shares and restricted share units issued with respect to publicly traded stock within the meaning of Treas. Reg. § 1.482-7(d)(3)(iii)(B)(2) granted on or after the first day of the first taxable year following receipt of the Service's consent 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 method of measurement and timing and period-by-period identification provided in Treas. Reg. § 1.482-7(d)(3)(iii)(B)(1) and Notice 2005-99.
- (10) Taxpayer will apply the period-by-period identification methodology provided in Notice 2005-99 consistently, under the principles of Treas. Reg. § 1.482-7(d)(3)(iii)(C).

LAW

Measurement and Timing of SBC Related to Intangible Development

Treas. Reg. § 1.482-7(d)(3)(iii)(A) provides the general 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 an alternate method for measurement and timing of SBC IDCs with respect to options on publicly traded stock (the “elective method”) 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:

Generally, all controlled participants in a CSA taking options on publicly traded stock into account under paragraph (d)(3)(ii), (d)(3)(iii)(A), or (d)(3)(iii)(B) of this section must use that same method of identification, measurement and timing for all options on publicly traded stock with respect to that CSA. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner’s consent is obtained. All controlled participants in the CSA must join in requests for the Commissioner’s consent under this paragraph (d)(3)(iii)(C). Thus, for example, if the controlled participants make the election described in paragraph (d)(3)(iii)(B) of this section upon the formation of the CSA, the election may be revoked 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. Similarly, if 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 SBC 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 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:

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 and period-by-period identification. 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 Tax Information Authorization 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)