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Internal Revenue Service  
**Memorandum**

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from: Peter H. Blessing  
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subject: Section 482 Adjustments for Cost Sharing Agreements with Reverse Claw-Back Provisions

This memorandum provides non-taxpayer specific legal advice regarding the application of section 482 of the Internal Revenue Code. This advice should not be used or cited as precedent.

**Introduction**

This memorandum discusses issues related to transfer pricing examinations of stock-based compensation (“SBC”) costs involving taxpayers’ cost sharing agreements under which they did not contract to share SBC costs (“Non-SBC CS Agreements”) and included so-called “reverse claw-back” provisions in their contracts. This memorandum analyzes these issues under the current regulations for cost sharing arrangements (“CSAs”), which address the treatment of SBC as an intangible development cost (“IDC”) in Treas. Reg. § 1.482-7(d)(3) (defining IDC). This portion of the current cost sharing regulations is materially the same as the corresponding provisions of the prior SBC regulation. The validity of that prior regulation, Treas. Reg. §§ 1.482-7A(a)(3) and (d)(2) (the “2003 SBC regulation”), was upheld by the U.S. Court of Appeals for the Ninth Circuit in Altera Corp. & Subs. v. Commissioner, 926 F.3d 1061 (9th Cir. 2019), rev’g 145 T.C. 91 (2015), cert. denied, 141 S. Ct. 131 (2020).

The current and former cost sharing regulations provide the IRS with discretion to make allocations of IDCs so that the results of a CSA or other cost sharing agreement (including a Non-SBC CS Agreement) are consistent with an arm's length result. Treas. Reg. § 1.482-7(b) of the current regulations refers to the CSA participants' cost sharing transactions ("CSTs") whereby the participants make payments to each other so that in each taxable year each participant's IDC share is in proportion to its reasonably anticipated benefits ("RAB") share.

As further explained in the Background section of this memorandum, it is assumed for purposes of the memorandum that a reverse claw-back provision that is triggered by a final decision in Altera or other event requires a cost sharing participant to make a true-up payment for the cumulative amount of unshared SBC costs from prior years.

### **Issues**

- (1) What is an appropriate year for a section 482 adjustment to include SBC costs in the cost pool for a Non-SBC CS Agreement that contains a reverse claw-back provision?
- (2) If the IRS adjusts the results of a CST in a Non-SBC CS Agreement that contains a reverse claw-back provision for a taxable year to account for SBC costs, does that IRS adjustment reduce the outstanding amount of the contractual true-up obligation in the reverse claw-back provision?
- (3) If a section 482 allocation to adjust the results of a CST in the year the IDCs were incurred is not possible for certain years, may the IRS make an adjustment in another year to ensure that SBC costs are appropriately accounted for in a Non-SBC CS Agreement that contains a reverse claw-back provision?

### **Conclusions**

- (1) Under Treas. Reg. § 1.482-7(i)(2), the IRS may make allocations to adjust the results of a CST so that the results are consistent with an arm's length result, including any allocations to make each controlled participant's IDC share equal to that participant's RAB share. See also Treas. Reg. §§ 1.482-7(a)(4) and (b)(5)(ii). Under Treas. Reg. § 1.482-7(i)(2)(iii), if the IRS makes an allocation to adjust the results of a CST, the allocation will be reflected for tax purposes in the year in which the IDCs were incurred.
- (2) If the IRS adjusts the results of a CST for a taxable year to account for SBC costs, that adjustment should be treated as reducing the amount of any reverse claw-back

true-up obligation by a corresponding amount, thereby avoiding an overpayment of the SBC costs.

- (3) If allocations to adjust the results of a CST in the year the IDCs were incurred are not possible for certain years, the IRS may make other adjustments, if necessary, to reflect the contract or to ensure that the Non-SBC CS Agreement produces results that are consistent with an arm's length result within the meaning of Treas. Reg. § 1.482-1(b)(1). For example, the IRS may make allocations under Treas. Reg. § 1.482-7(i)(5) when CSTs are consistently and materially disproportionate to RAB shares. In addition, if a taxpayer disregards a reverse claw-back clause in a Non-SBC CS Agreement (or modifies the clause to modify, defer or remove the obligation to make a true-up payment in accordance with the contract), the IRS may make appropriate allocations in the year the true-up is or (but for the modification) would have been triggered to produce results consistent with the unmodified contract or otherwise to reflect an arm's length result.

## **Background**

Many taxpayers historically have included provisions, commonly referred to as "claw-back" provisions, in their cost sharing agreements.<sup>1</sup> The desired effect of such provisions is to remove, or "claw back," SBC that is included in cost pools if, at some point after the agreement is executed, the SBC regulation is invalidated as the result of a final decision in a court of law, revised, or withdrawn.

In connection with the litigation in Altera Corp. & Subs. v. Commissioner, 145 T.C. 91 (2015), certain taxpayers amended their agreements to stop sharing SBC and to include so-called "reverse claw-back" provisions.<sup>2</sup> These reverse claw-back provisions are essentially the opposite of claw-back provisions and require taxpayers who excluded SBC from their cost pools to include the previously excluded SBC amounts in those pools upon a certain triggering event. That triggering event was often defined as the date when a final decision in Altera<sup>3</sup> or another case upheld the validity of the SBC regulation. Upon the triggering event, the cost sharing participants become obligated to make a true-up to reflect the sum of SBC costs that should have been shared in prior years. This memorandum addresses reverse claw-back provisions in Non-SBC CS Agreements that obligate cost sharing participants to true-up unshared SBC costs from prior years in the year of the triggering event.

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<sup>1</sup> Some taxpayers started adding claw-back provisions to their cost sharing agreements after the 2003 SBC regulation became final.

<sup>2</sup> In some cases, taxpayers removed and replaced claw-back provisions (which had triggered a "claw back" of all SBC shared up until that date) with reverse claw-back provisions.

<sup>3</sup> See I.R.C. § 7481.

## **Law and Analysis**

### **Cost Sharing Regulations – In General**

Treas. Reg. § 1.482-7(a)(4) provides that in order for a CSA as defined in the regulations to produce results consistent with an arm's length result within the meaning of Treas. Reg. § 1.482-1(b)(1), each controlled participant's share of IDCs<sup>4</sup> must equal its RAB share and all other requirements of Treas. Reg. § 1.482-7 must be satisfied. A CSA is an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their RAB shares. Treas. Reg. § 1.482-7(b). An arrangement qualifies as a CSA if and only if it satisfies certain requirements, including the substantive requirement that all controlled participants commit to, and in fact, engage in CSTs. Treas. Reg. § 1.482-7(b)(1). In CSTs, the controlled participants make payments to each other (CST Payments) as appropriate, so that in each taxable year each controlled participant's IDC share is in proportion to its respective RAB share. Id.; see also Treas. Reg. § 1.482-7(j)(3)(i) (describing characterization of CST payments).

If it is determined that the rules of Treas. Reg. § 1.482-7 provide the most reliable measure of an arm's length result, the IRS may exercise its discretion and apply those rules to arrangements that do not automatically qualify as CSAs and make appropriate allocations under Treas. Reg. § 1.482-7(i). See Treas. Reg. § 1.482-7(b)(5)(ii) (noting Commissioner's discretion for certain arrangements).

### **Application of Cost Sharing Regulations to Non-SBC CS Agreements With Reverse Claw-back Provisions**

One type of allocation authorized under Treas. Reg. § 1.482-7(i)(2) is an adjustment to the results of a CST so that each controlled taxpayer's IDC share for each taxable year is equal to its RAB share, a result consistent with an arm's length result.<sup>5</sup> This allocation may result from adjustments to redetermine IDCs by adding any costs that are directly identified with, or are reasonably allocable to, the intangible development

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<sup>4</sup> A controlled participant's IDC share for a taxable year is equal to the controlled participant's cost contribution for the taxable year, divided by the sum of all IDCs for the taxable year. Treas. Reg. § 1.482-7(d)(4).

<sup>5</sup> Similarly, the clear reflection of income doctrine supports a section 482 allocation when the disputed transaction results in an artificial mismatching of a party's income and expenses. See, e.g., Rooney v. United States, 305 F.2d 681 (9th Cir. 1962), aff'g 189 F. Supp. 733 (N.D. Cal. 1960); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1952), rev'g and remanding on this issue 16 T.C. 882 (1951). In a CSA, such a mismatch occurs when the participants' shares of IDCs (expenses) are not borne in proportion to their RAB shares (income).

activity (“IDA”). Treas. Reg. § 1.482-7(i)(2)(i)(A). If the IRS makes an allocation to adjust the results of a CST, the allocation must be reflected for tax purposes in the year in which the IDCs were incurred.<sup>6</sup> Treas. Reg. § 1.482-7(i)(2)(iii).

Under Treas. Reg. § 1.482-7(d)(1)(iii), IDCs mean all costs, in cash or in kind, including SBC costs that are directly identified with, or are reasonably allocable to, the IDA. Under the default measurement rule,<sup>7</sup> the amount of SBC costs taken into account for CSA purposes generally is the amount allowable to the controlled participant as a federal income tax deduction with respect to that SBC. Treas. Reg. § 1.482-7(d)(3)(iii) (further noting that such amount “is taken into account as an IDC under this section for the taxable year for which the deduction is allowable”).

Taxpayers in Non-SBC CS Agreements have IDC shares that are not equal to their RAB shares. The IRS has the authority to correct this imbalance by, for instance, adjusting the results of a CST in the year in which the IDCs were incurred. See Treas. Reg. § 1.482-7(i)(2). The IRS’s authority to make allocations under Treas. Reg. § 1.482-7(i) exists regardless of the existence or lack of a reverse claw-back provision in a Non-SBC CS Agreement.

A reverse claw-back provision may not address the effect of prior year SBC inclusions pursuant to IRS-initiated section 482 adjustments in an examination, or as a result of taxpayer-initiated adjustments attempting to conform the transfer pricing of the Non-SBC CS Agreement to Treas. Reg. § 1.482-7. In particular, the reverse claw-back clause may be silent regarding the effect of prior year section 482 adjustments on the amount of the true-up obligation arising in the year of the triggering event (e.g., a final decision in Altera).

Although reverse claw-back provisions may be silent as to the effect of prior year adjustments, it is possible to analogize the situation faced by the controlled participants to a contingent obligation, contractual or otherwise, that may arise in the ordinary course of commercial dealings between uncontrolled parties. On that basis, it is anticipated that the amount of the contractual true-up payment that is to be made when the reverse claw-back is triggered generally would not include an amount for the payment of any SBC costs that already have been shared, as those amounts

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<sup>6</sup> If a primary allocation is made under Treas. Reg. § 1.482-7(i), the district director will take into account appropriate collateral adjustments with respect to allocations under section 482, including correlative allocations, conforming adjustments, and setoffs. See Treas. Reg. § 1.482-1(g)(1).

<sup>7</sup> The regulations also permit an elective method of measurement and timing for options on publicly traded stock. Treas. Reg. § 1.482-7(d)(3)(iii)(B)(1); see also Notice 2005-99, 2005-52 I.R.B. 1214 (extending the elective method to certain restricted shares and restricted share units). An election may be made in an amended agreement only with the consent of the Commissioner. Treas. Reg. §§ 1.482-7(d)(3)(iii)(B)(4); -7(d)(3)(iii)(C). For such purpose, a ruling may be requested.

necessarily would reduce the amount of the contingent obligation.<sup>8</sup> In such case, the sharing of SBC in the year in which the costs are incurred for Federal income tax purposes effectively would reduce any contractual SBC true-up obligation for such costs, resulting in a corresponding reduction in the outstanding amount of the later year contractual SBC true-up obligation. Thus, the reduction in the amount of such contingent obligation generally would not constitute a change in a price term<sup>9</sup> of a Non-SBC CS Agreement.

Similarly, to the extent the IRS makes adjustments (including when initiated by a taxpayer<sup>10</sup>) to a year before the triggering event yet after a taxpayer has already made a true-up payment pursuant to its reverse claw-back clause, any resulting true-up overpayment that would otherwise have been reported as income for Federal income tax purposes may be reduced on a timely filed return for the taxable year of the triggering event to avoid an overinclusion of income (for example, by excluding for the year of the triggering event the amount equal to such earlier year adjustments).<sup>11</sup>

If allocations to adjust the results of a CST in the year the IDCs were incurred are not possible for certain years,<sup>12</sup> other adjustments may be necessary to reflect the contractual rights and obligations of the parties or to produce results that are consistent with an arm's length result. For example, the IRS may make allocations in an appropriate year under Treas. Reg. § 1.482-7(i)(5) (allocations when CSTs are consistently and materially disproportionate to RAB shares). In addition, a taxpayer may not disavow the terms of its contract to obtain a tax benefit. See, e.g., Nestlé Holdings Inc. v. Commissioner, 152 F.3d 83, 87 (2d Cir. 1998) (full purchase price paid by parent company to subsidiary for intangibles included in amount realized though in excess of fair market value); The Coca-Cola Co. v. Commissioner, 155 T.C. No. 10, 58 (2020). If a taxpayer disregards a reverse claw-back clause in a Non-SBC CS Agreement and fails to make a true-up payment in accordance with the contract, the IRS may make appropriate allocations<sup>13</sup> in the year the true-up is triggered for the full

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<sup>8</sup> Nothing in this memorandum is intended to suggest that particular contract terms (contingent or otherwise) in a cost sharing agreement necessarily will be respected by the IRS. See, e.g., Treas. Reg. § 1.482-1(d)(3)(ii)(B) ("If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.").

<sup>9</sup> Cf. Treas. Reg. § 1.482-1(a)(3).

<sup>10</sup> Taxpayers may, for example, file amended returns for open years with unshared SBC to avoid IRS-initiated allocations under Treas. Reg. § 1.482-7(i)(2) and thereby limit their true-up payment to the amount of unshared SBC for the closed years.

<sup>11</sup> In addition, the IRS may correct any overinclusion of income in the triggering event year by reason of a true-up overpayment under its authority in Treas. Reg. § 1.482-1(a)(2).

<sup>12</sup> Where, for example, the relevant period of limitations on assessment has expired. See I.R.C. § 6501.

<sup>13</sup> Such allocation may include the amount of the contractually required true-up payment and an appropriate charge for interest. As noted, a true-up payment for unshared SBC costs generally would not

amount of unshared SBC costs that should have been shared in accordance with Treas. Reg. § 1.482-7 since the CSA began.<sup>14</sup> See Treas. Reg. § 1.482-1(b)(1). Similarly, if a taxpayer modifies its intercompany contract to modify, defer or remove a reverse claw-back provision, the IRS may make appropriate adjustments to reflect the unmodified contract or otherwise to account for the modification to ensure that the results are consistent with an arm's length result and clearly reflect income.<sup>15</sup> See Treas. Reg. § 1.482-1(b)(1); cf. Gulf Oil v. Commissioner, 87 T.C. 548, 566-68 (1986) (retroactive decrease in charter rate payable by liquidating charterer was constructive dividend by vessel owner to parent, as if the amount had been received by vessel owner, based on evidence that rate adjustments were primarily motivated by direct tax benefit to parent).

In addition, the reversal of the Tax Court's decision in Altera, in conjunction with the reverse claw-back provision, implicates the tax benefit rule. Under that rule, because prior deductions of SBC would be fundamentally inconsistent with a contractual right to be reimbursed for the amount of such SBC if that contractual right had arisen in the year of the deduction, a taxpayer must take amounts attributable to deductions claimed in prior years into income upon a triggering event to the extent the prior deductions resulted in a tax benefit to such taxpayer. See Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 383-84 (1983) ("[T]he tax benefit rule will 'cancel out' an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction."); Frederick v. Commissioner, 101 T.C. 35, 41 (1993) ("A current event is considered fundamentally inconsistent with the premises on which the deduction was originally based when the current event would have foreclosed the deduction if that event had occurred within the year that the deduction was taken."); Rev. Rul. 2019-11, 2019-17 I.R.B. 1041.

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include any SBC costs that already have been shared, as those amounts would reduce the amount of the contingent obligation.

<sup>14</sup> If, however, the relevant period of limitations on assessment has not yet expired, the IRS should first consider whether it is appropriate to adjust the results of a CST under Treas. Reg. § 1.482-7(i)(2) (i.e., in the year in which the IDCs were incurred).

<sup>15</sup> As provided in Treas. Reg. § 1.482-1(d)(3)(ii)(B)(1), the contractual terms set forth in a written agreement antedating the transactions at issue will be respected provided such terms are consistent with the economic substance of the underlying transaction.