2002

An Arm's Length Struggle: To Include or Not to Include Stock Options in Cost Sharing Arrangements and Non-Integral Service Agreements

Kenneth Blackburn
University of Kentucky

Follow this and additional works at: https://uknowledge.uky.edu/klj

Part of the Business Organizations Law Commons

Click here to let us know how access to this document benefits you.

Recommended Citation
Available at: https://uknowledge.uky.edu/klj/vol91/iss2/6

This Note is brought to you for free and open access by the Law Journals at UKnowledge. It has been accepted for inclusion in Kentucky Law Journal by an authorized editor of UKnowledge. For more information, please contact UKnowledges@lsv.uky.edu.
An Arm’s Length Struggle:  
To Include or Not to Include Stock Options in Cost Sharing Arrangements and Non-Integral Service Agreements  

BY KENNETH BLACKBURN*  

INTRODUCTION  

Every year corporations issue stock options to all levels of employees. In the United States, approximately ten million workers have a total grant value of $1 trillion in stock options.¹ Stock options give employees the opportunity to buy a set number of shares of the corporation’s stock at a given price for a certain period of time.² As early as 1988, stock options were being provided to middle and lower level managers as well as non-management employees.³ To illustrate the impact stock options have on employees’ income, consider that during the months of May through July of 2000, the employees of San Jose-based Cisco Systems exercised stock options resulting in approximately $4.5 billion in taxable gains.⁴ Indeed, stock options have become an important component of compensation to all levels of American workers.

* C.P.A. Commonwealth of Kentucky. M.B.A. 2000, University of Kentucky; J.D. expected 2003, University of Kentucky. The author would like to thank Shawn Johnson and Todd Hauss for their insight and review. The author would also like to give credit to his loving wife, Shea, for her patience and encouragement throughout the entire law school experience.


² *Id.*


A controversy has arisen regarding the inclusion of compensation, taxed to American employees upon exercising stock options, as a cost in cost sharing arrangements between related parties.\(^5\) The Internal Revenue Service ("IRS") has expanded this position to encompass service agreements for non-integral services between related parties.\(^6\) With a value of over $1 trillion in outstanding stock options,\(^7\) multinational corporations face a large dilemma concerning whether to include stock option gains taxed to employees in the cost sharing and non-integral service expense pools billed to affiliates.\(^8\)

Imagine the complexity and uncertainty of including stock options as costs to be billed under cost sharing or other similar arrangements. Under the IRS's approach of including the perceived value of the stock options upon issuance in the cost pools, corporations issuing stock options may potentially have to value the option using an economic-based valuation method, such as the Black-Scholes Method.\(^9\) These valuation methods consist of a series of variables that are predicated on risk-adjusted probabilities and advanced statistics.\(^10\) With probabilities in the equation, corporations making these calculations are guaranteed an audit adjustment. The IRS will argue that the variables and probabilities used by the corporation are incorrect, further adding a layer of complexity and uncertainty to the system of tax compliance and audit.

The proposed inclusion of the stock option's value as a component of the cost pools shared under a cost sharing arrangement creates other

\(^5\) I.R.S. FSA 200103024 (Jan. 19, 2001) (The IRS ruled that Treas. Reg. § 1.482-7 requires the value of compensatory stock options be included in cost sharing pools. Although a Field Service Advisory ("FSA") is only applicable to the party involved in the FSA, it is a clear indication of the intention and views of the IRS on the issue.).


\(^7\) Simon, supra note 1.

\(^8\) Even though the stock market is currently in a downturn, the stock option inclusion in cost sharing arrangements will continue to be a focal point for corporate tax professionals. As stock values decline, the exercise price of new stock options will be decreased, equating to potentially large gains to the option holders when the market rebounds. See generally infra note 106 and accompanying text.

\(^9\) See infra note 12 and accompanying text (The IRS has provided options for valuation in proposed regulations issued on July 29, 2002. The options allow for valuation without the use of Black-Scholes.).

complications and potential injustices. For example, what if the stock option's perceived value is billed to an affiliate participating in a cost sharing arrangement, and subsequently the stock of the corporation performing the services loses half of its value? Now the exercise price of the stock option is above the market price at which the employee holding the option can exercise the stock on the open market. If the market price does not again exceed the purchase price, the stock option will be worthless and the employee will allow the option to lapse. The affiliate participating in the cost sharing arrangement will have paid for the stock option, but the stock option will not have resulted in income to an employee. Is it the correct answer to have charged an affiliate for a stock option that ultimately becomes worthless? This is one example of the several issues raised by the IRS's position in Field Service Advisory 200102003, which includes stock option costs in arrangements for non-integral services and cost sharing.

This Note proposes that the IRS should abandon its position of including stock option paper gains in cost sharing arrangements and non-integral service contracts. The IRS's position contradicts the arm's length standard, which is required to value transactions between related parties. To meet an arm's length standard, a transaction between related parties must be consistent with results that unrelated parties conducting the same transaction would have achieved under similar circumstances. The main problem with the IRS's position that stock option gains are costs of compensation is that unrelated parties do not consider stock options when entering cost sharing arrangements or service agreements. Therefore, inclusion of the perceived value of stock options on the grant date would not be in line with the arm's length standard.

Taking the IRS's position to its logical end, an IRS agent could argue that the transfer prices for goods should include stock option gains. This position would follow the premise that stock options granted to manufacturing employees are costs of compensation to be included in the product's transfer price. Clearly this is illogical, but the position

12 See Prop. Treas. Reg. § 1.482-5, 67 Fed. Reg. 48,997 (July 29, 2002) (to be codified at 26 C.F.R. pt. 1) (proposing an amendment to the comparable profits method whereby taxpayers would have to adjust comparables results to reflect stock options). Under this regulation, a taxpayer using the comparable profits method as a transfer pricing methodology for the sale of tangible goods would have to start including the perceived cost of stock options in their results and the comparable's results. Id.
13 This assertion is based on the broad application of the IRS theory that stock option gains or the stock option's value is compensation to be included in cost sharing arrangements and service agreements. Under this logic, the IRS could apply
follows the IRS's rationale that stock option gains are costs of compensation.\(^4\)

This Note is divided into three parts. Part I provides background information on the sources of law underlying transfer pricing and stock options and introduces cost sharing and non-integral service agreements.\(^5\) Part II analyzes the IRS's position regarding the inclusion of stock options in cost sharing arrangements and service agreements, while highlighting criticisms of the IRS's position.\(^6\) Part III discusses the newly issued proposed regulations requiring the inclusion of stock options in cost sharing arrangements.\(^7\)

I. BACKGROUND LEGAL CONCEPTS

This Part provides an overview of two tax concepts: transfer pricing and stock options. The first sub-part explains transfer pricing, including the general aspects of transfer pricing, cost sharing arrangements, and non-integral service agreements. Several examples in this sub-part provide the reader with an understanding of the processes and interactions of transfer pricing. Most of the examples will entail transfers of tangible property, but the same concepts apply to services and the transfer of intangibles. The second sub-part explains stock options, including non-statutory stock options, statutory stock options, and the accounting treatment of both types. Part I will only provide a general explanation of each of these principles, as the detailed technicalities are beyond the scope of this Note.

A. Transfer Pricing

1. General Concepts

Section 482 of the Internal Revenue Code of 1986 ("Code") was enacted to ensure that taxpayers "clearly reflect income attributable to

the compensatory theory to stock options granted to manufacturing employees, and argue that the stock option gains or value must be included in the transfer price of goods sold to related parties. See I.R.S. FSA 200102003 (Jan. 12, 2001) for a general discussion of the IRS theory.\(^4\)

In addition, the IRS is proposing an allocation of stock option gains to non-deductible lobbying expenses. See generally I.R.C. § 162(e) (1998). The IRS's position is that stock options are allocable to lobbying as labor costs, therefore denying the deduction of the stock option gains of employees found to be performing lobbying activities. See I.R.S. FSA 200102003 (Jan. 12, 2001). This Note does not opine on the accuracy of this IRS position.\(^5\)

\(^4\) See infra notes 18-110 and accompanying text.
\(^5\) See infra notes 111-37 and accompanying text.
\(^6\) See infra notes 138-56 and accompanying text.
controlled transactions, and to prevent the avoidance of taxes with respect
to such transactions.\textsuperscript{18} Code Section 482 is intended to put "a controlled
taxpayer on a tax parity with an uncontrolled taxpayer" by computing the
"true taxable income" of the taxpayer participating in a controlled
transaction.\textsuperscript{19} The definition of a controlled taxpayer is a "taxpayer . . .
owned or controlled directly or indirectly by the same interests, and
includes the taxpayer that owns or controls the other taxpayers."\textsuperscript{20}
Accordingly, an uncontrolled taxpayer is a taxpayer not controlled either
directly or indirectly by another taxpayer.\textsuperscript{21} All corporations within a web
of control are titled "members of a controlled group."\textsuperscript{22}

In this context, the term "controlled" includes all types of control,
regardless of its form or mode.\textsuperscript{23} A corporation is presumed to control
another corporation if it has the ability to shift income or deductions
between members of the controlled group.\textsuperscript{24} To illustrate, if Corporation $A$
(U.S. corporation) has the ability to determine the price that Corporation $B$
(non-U.S. corporation) will charge Corporation $A$ for widgets, Corporation
$A$ is presumed to have control over Corporation $B$. The ability of Corpora-
tion $A$ to determine Corporation $B$'s revenue and the corresponding cost of
goods sold of Corporation $A$ reflects the required control. The term
"controlled transaction" adequately describes this hypothetical buy-sell
arrangement, since the transaction is between taxpayers within the
controlled group.\textsuperscript{25}

The IRS uses the arm's length standard to determine the "true taxable
income" of taxpayers within a controlled group.\textsuperscript{26} For controlled transac-
tions to meet the arm's length standard, the financial results of the
controlled transactions must be consistent with financial results that two
uncontrolled parties would have achieved if they conducted the same
transactions.\textsuperscript{27} The arm's length standard will generally be determined by
analyzing the financial results of comparable transactions under similar
circumstances, that is, a transaction between unrelated parties.\textsuperscript{28} Taxpayers

\textsuperscript{19} Id. See Comm'r v. First Sec. Bank, 405 U.S. 394, 400 (1972).
\textsuperscript{20} Treas. Reg. § 1.482-1(i)(5) (1994).
\textsuperscript{21} Id.
\textsuperscript{22} Id. § 1.482-1(i)(6).
\textsuperscript{23} Id. § 1.482-1(i)(4).
\textsuperscript{24} Id.
\textsuperscript{25} See id. § 1.482-1(i)(8).
\textsuperscript{26} Id. § 1.482-1(b)(1).
\textsuperscript{27} Id.
\textsuperscript{28} Id.
are required to establish documentation by the filing of that year’s tax return, which should reflect that the taxpayer’s results in controlled transactions have met the arm’s length standard during the year. The arm’s length standard is far-reaching and applies to “transfers of property, services, loans or advances, and rentals” among members of the controlled group. Due to the complexities of transfer pricing, multi-national corporations allocate enormous amounts of time and resources in their efforts to comply with the arm’s length standard and reporting requirements. Transfer pricing complexities are heightened by the fact that most transfer pricing issues involve more than one country, with each country attempting to maximize its own tax revenue.

Returning to the aforementioned buy-sell hypothetical, the arm’s length standard can be easily illustrated. Assume Corporation A determines the price that Corporation B will charge for its widgets to be $1.00 per widget. In addition, assume that Corporation B only sells to Corporation A during the year. At the end of the year, Corporation B reports operating income as a percentage of sales (hereinafter “operating income percentage”) of five percent. To determine if Corporation B’s results meet the arm’s length standard can be easily illustrated. Assume Corporation A determines the price that Corporation B will charge for its widgets to be $1.00 per widget.

---

29 I.R.C. § 6662(e)(3)(B)(II) (1989) (To avoid substantial penalties, the taxpayer is required to maintain contemporaneous documentation that sets forth the method and the reasonableness of the method of determining the Section 482 transfer price.).


31 In the cost sharing context, the country containing the taxpayer who is billing the costs (Country A) will want to maximize the amount included in the cost pool. By maximizing the amount included in the cost pool, Country A will reduce the taxpayer’s deductions from taxable income. This is because each dollar of cost billed out under a cost sharing arrangement is a reduction in the amount of deductions on the tax return. For example, if the Country A corporation initially includes $1 million of costs in the cost sharing pools and the taxing authorities of Country A increases this amount to $2 million, the Country A corporation will have $1 million less deductions for that year because the deductions will have shifted to the cost sharing participant. On the other hand, the taxing authorities of the Country B, where the cost sharing participant resides, will want to decrease the costs paid by its participant because this billing will result in tax deductions for the Country B corporation. Therefore, Country A will want to increase the cost pool to reduce the Country A corporation’s tax deductions, while Country B will want to decrease the costs eligible for the cost pool to decrease the deductions on Country B corporation’s tax return. This can become a very contentious situation for tax-payers.

32 The operating income is calculated by taking all revenue from operations, subtracting cost of goods sold, and subtracting operating expenses. In order to get the operating income percentage, take the operating income figure and divide it by the amount of revenue from operations.
standard, the corporation must compare its five percent operating income percentage to the operating income percentages of unrelated corporations selling similar products under similar circumstances. An unrelated corporation is termed a “comparable.” Analysis of the comparable’s results establishes a range of operating income percentages. If Corporation B’s operating income percentage of five percent is within the established range of comparable operating income percentages, the transactions between Corporation A and Corporation B will meet the arm’s length standard. If Corporation B determines that its achieved results are outside the comparables range, Corporation B will make an adjustment to move its results to within the comparables range.\(^{33}\) This is an extremely simplified explanation of the arm’s length standard, but it provides a representation of the process corporations go through when analyzing transfer pricing.\(^{34}\)

The buy-sell arm’s length standard can hypothetically be modified to accommodate a cost sharing arrangement. To meet the arm’s length standard under a cost sharing arrangement, Corporation A (corporation billing the costs) must include the same cost structure in the cost pool as would an unrelated party billing another unrelated party for shared costs. If the costs included in the cost pool are deemed to be the same costs that two unrelated parties would bill and accept as part of a cost sharing arrangement, the transaction will meet the arm’s length standard.

The IRS has broad authority to make allocations among members of a controlled group if the IRS determines that the true taxable income has not been properly allocated among members of the controlled group.\(^{35}\) This broad authority allows the IRS to allocate income, allowances, deductions, basis, credits, or any other item that affects taxable income.\(^{36}\) If the IRS determines that an allocation is warranted, the taxpayer bears the burden of proving that the IRS’s allocations are arbitrary, capricious, or unreasonable.\(^{37}\) Whether the IRS exceeds its discretion is a question of

\(^{33}\) The adjustments are termed “compensating adjustments.” The adjustments will have an effect on Corporation A and Corporation B’s financial results, so each entity will book the necessary adjustments and take the adjustments into account in calculating their respective taxable incomes. See Treas. Reg. § 1.482-1T(e)(2).

\(^{34}\) Id. § 1.482-1T(e) (The example within this regulation reflects the analysis and adjustments performed to achieve the results required per the arm’s length standard.).


\(^{36}\) See Edwards, 67 T.C. at 230.

\(^{37}\) See, e.g., Your Host, Inc. v. Comm’r, 489 F.2d 957, 960 (2d Cir. 1973); G.D. Searle & Co. v. Comm’r, 88 T.C. 252, 358 (1987). See also Altama Delta Corp. v. Comm’r, 104 T.C. 424, 457 (1995); Seagate Tech. Inc. v. Comm’r, 102 T.C. 149,
The reasonableness of an IRS allocation under Section 482 is determined based on the reasonableness of the result, not the details of the methodology. Therefore, if the IRS's allocation is shown to have been within its discretion and is reasonable, a court will sustain the allocation.

To illustrate the IRS's approach upon audit, we will return to the buy-sell hypothetical. Suppose Corporation B has determined its operating income percentage of five percent is within the arm's length range of the comparables determined by Corporation B. In its audit, the IRS will review Corporation B's comparables to verify that they are truly comparable to Corporation B's business. If the IRS determines that either all or some of the comparables are not true comparables, the IRS will establish its own set of comparables. By establishing a new set of comparables, the IRS will also establish a new range of operating income percentages. It will then compare Corporation B's operating income percentage of five percent to the new range of comparable operating income percentages. If the five percent is above the IRS's established range, it will propose an adjustment to reduce the income of Corporation B and a corresponding decrease for Corporation A of cost of goods sold. Alternatively, if the five percent is below the IRS's established range, the IRS will propose an adjustment to increase the income of Corporation B and a corresponding increase of cost of goods sold for Corporation A. Corporation B would then have to accept the adjustment or challenge it at either the appellate stage of the audit process or in court.

163-64 (1994).

40 See Paccar Inc. v. Comm'r, 85 T.C. 754, 787 (1985), aff'd, 849 F.2d 393 (9th Cir. 1988).
41 The adjustment to Corporation B's revenue will decrease the operating income, resulting in a decrease in taxable income. The corresponding adjustment to Corporation A's cost of goods sold will increase operating income, resulting in an increase in taxable income. If Corporation A and Corporation B pay taxes at the same tax rate, generally the adjustment will not cause a change to the tax position of either corporation, but if they pay taxes at different rates, the tax position can drastically change for the two corporations. Typically, differing tax rates occur when the two corporations reside in different countries.
42 The adjustment to Corporation B's revenue will increase the operating income, resulting in an increase in taxable income. The corresponding adjustment to Corporation A's cost of goods sold will decrease operating income, resulting in a decrease in taxable income. This outcome can have dramatic outcomes on the tax bill of each of these corporations. Treas. Reg. § 1.482-1(g)(2)(iii)(E) (1994).
The same process applies to cost sharing as to non-integral service agreements. If the IRS determines that costs should have been included in the cost pools but were not, it will propose an adjustment to correct the perceived error.

2. Non-Integral Service Agreements

As previously stated, the transfer pricing rules govern the charges for services provided between members of a controlled group. The IRS may make allocations of income and deductions among taxpayers within a controlled group when a service, such as “marketing, managerial, administrative, technical, or any other services,” is performed by a member of a controlled group that benefits another member of the controlled group, but is not charged at an arm’s length price. These allocations may be made for services performed exclusively for another member of the controlled group or for services undertaken for the joint benefit of all members of the controlled group. A limitation is placed on the IRS’s ability to allocate when the anticipated benefits to other members of the controlled group are so remote that an unrelated taxpayer would be unwilling to pay for the services or benefits due to the remoteness of the benefit. As previously stated, the goal of the arm’s length standard is to assure that the results of controlled transactions mirror the results obtained in transactions between unrelated parties.

The charges for services that are integral to the business of the member performing the service or of the member receiving the benefit of the service should be based on the normal arm’s length standard. However, if the services are not an integral part of the business activity of either member of the controlled group, the arm’s length charge will be equal to the costs or deductions incurred by the member performing the services.

The regulations place an emphasis on the taxpayer keeping adequate books and records to verify the costs and deductions to be reimbursed by the member of the controlled group receiving the benefit. The costs or deductions taken into account in billing the non-integral services must include all costs directly or indirectly related to the services performed.

---

43 Id. § 1.482-2(b)(1).
44 Id. § 1.482-2(b)(2)(i).
45 Id.
46 Id. § 1.482-2(b)(3).
47 Id.
48 Id.
49 Id. § 1.482-2(b)(4)(i).
A “direct cost” is defined as a cost that has been incurred specifically for the performance of the service.\textsuperscript{50} Such costs include, but are not limited to, costs of compensation and bonuses, travel expenses of employees directly involved with performing the service, and materials and supplies consumed during the performance of the service.\textsuperscript{51}

Indirect costs include costs that are not incurred specifically for the performance of the service, but are generally related to the direct costs incurred in performing the service.\textsuperscript{52} Examples of indirect costs include occupancy costs, supervisory and clerical costs, general and administrative costs, utilities, or any other overhead costs of the departments performing the service.\textsuperscript{53} In addition, indirect costs include costs incurred by departments that provide support for the performance of the services.\textsuperscript{54}

The method of determining which costs directly relate or support the performed service must be consistent, reasonable, and maintain sound accounting principles.\textsuperscript{55} Direct costs are generally easy to determine since the costs are incurred specifically for the services provided, but indirect costs do not have a direct link to the services performed, resulting in a required allocation of indirect costs to the performed services. The allocation requirements apply to both allocating costs to the performed services and determining how much to bill each entity when the services are performed for the joint benefit of all members of the controlled group.\textsuperscript{56}

Several costs do not have to be taken into account when calculating the charge to the controlled corporation for non-integral services. These costs include: interest expense on debt incurred for the benefit of the incurring corporation,\textsuperscript{57} costs of issuing stock and the related investor relations expenses,\textsuperscript{58} and expenses of complying with governmental regulations that have no correlation to the performed service.\textsuperscript{59}

To illustrate the application of allocations to a non-integral service agreement, assume the tax department of Corporation A performs tax

\begin{itemize}
  \item \textsuperscript{50} Id. § 1.482-2(b)(4)(ii).
  \item \textsuperscript{51} Id.
  \item \textsuperscript{52} Id. § 1.482-2(b)(4)(iii).
  \item \textsuperscript{53} Id.
  \item \textsuperscript{54} Id. (An example of supporting costs are costs incurred by an accounting group paying the bills and payroll of the department actually performing the services.).
  \item \textsuperscript{55} Id. § 1.482-2(b)(6)(i).
  \item \textsuperscript{56} Id. § 1.482-2(b)(6)(ii).
  \item \textsuperscript{57} Id. § 1.482-2(b)(5)(i).
  \item \textsuperscript{58} Id. § 1.482-2(b)(5)(ii).
  \item \textsuperscript{59} Id. § 1.482-2(b)(5)(iii).
\end{itemize}
services for Corporation B. Corporation A will incur salary expense, travel costs, supplies cost, etc., for performance of these services. These costs are considered direct costs, since the costs are incurred specifically for the tax services performed by Corporation A. The costs will be allocated between the tax services performed by Corporation A for its own tax needs and the services performed for Corporation B’s tax needs. An example of a method used to perform this allocation would be to base the allocation on time spent by Corporation A’s tax department on Corporation A’s tax needs and Corporation B’s tax needs. The costs allocated to Corporation B’s tax needs will go into a cost pool to be billed to Corporation B. Since Corporation A is not in the business of providing tax services, the services are considered non-integral services; therefore, Corporation A may bill Corporation B the actual costs of the services performed, without inclusion of a profit margin.

The second component of the cost pool billed to Corporation B is indirect costs. In order for Corporation A to perform the tax services, the tax department of Corporation A must use computers that are maintained by the information technology department (“IT department”) of Corporation A. These costs will be charged to the tax department based on established rates used to allocate costs for budgetary purposes. These costs are considered indirect costs, because the department’s services are not direct tax services, but are services that support the tax services. The same allocation performed to allocate the direct costs of Corporation A’s tax department between the work performed for Corporation A’s tax needs and the work performed for Corporation B’s tax needs will be used to split the indirect costs between Corporation A’s services for its own needs and the services performed for Corporation B.

When all the allocations are finalized, the direct and indirect costs associated with tax services performed on Corporation B’s behalf will be billed to Corporation B. As you can see, the calculations that determine Corporation B’s bill rely heavily upon established accounting principles and budgeting processes.

3. Cost Sharing Arrangements

When a corporation enters into a cost sharing arrangement for research and development (“R&D”) projects, the corporation agrees to share the

---

60 The rates used to allocate costs of an IT department could be based on time spent servicing each particular department receiving services. Another approach may be to allocate costs to departments based on the number of computers used by that particular department. With allocating costs, a method must be established to spread costs among a group of departments based on a logical basis of allocation. *Id.* § 1.482-2(b)(6)(i).
costs and risks of the R&D in connection with projects governed by the agreement. In return, the taxpayer making the cost sharing payments will not be required to pay royalties for exploiting the intangible property because they own rights to the property, due to having paid a part of the R&D costs. The costs to be shared will include the costs associated with successful as well as unsuccessful projects, since the risks must also be shared. The shared costs must include all of the R&D costs necessary to develop the property, and should be contemporaneously reimbursed to the taxpayer incurring the original cost. A cost sharing arrangement allows U.S. corporations to transfer the fruits of their R&D efforts in the United States to foreign members of the controlled group in exchange for reimbursement of a portion of the R&D costs, without having to charge royalties.

If specific rules are met, the cost sharing arrangement will be considered a qualified cost sharing arrangement by the IRS. The IRS will not

---

62 Id.
64 Id.
65 Treas. Reg. § 1.482-7(b) (as amended in 2001) provides:
A qualified cost sharing arrangement must—
(1) Include two or more participants;
(2) Provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits;
(3) Provide for adjustment to the controlled participants' shares of intangible development costs to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement; and
(4) Be recorded in a document that is contemporaneous with the formation (and any revision) of the cost sharing arrangement and that includes—
(i) A list of the arrangement's participants, and any other member of the controlled group that will benefit from the use of intangibles developed under the cost sharing arrangement;
(ii) The information described in paragraphs (b)(2) and (b)(3) of this section;
(iii) A description of the scope of the research and development to be undertaken, including the intangible or class of intangibles intended to be developed;
(iv) A description of each participant's interest in any covered intangibles. A covered intangible is any intangible property that is
propose allocations to a qualified cost sharing arrangement, except to make each party's share of costs equivalent to each party's anticipated economic benefits attributable to the R&D projects. For a controlled taxpayer to be a participant in a qualified cost sharing agreement, the controlled taxpayer must anticipate deriving an economic benefit from the R&D projects. This ensures the division of costs is commensurate with the future income attributable to the intangible being developed, preventing the sharing of costs by a taxpayer who does not anticipate receiving any benefit from the project. To allow a corporation to pay the costs of a research project in which the corporation does not expect to derive income would defeat the purpose of the arm's length standard.

The R&D costs to be included as shared costs consists of all costs incurred by the participant developing the property, plus all cost sharing payments made to other participants, minus any cost sharing payments received from other participants. The costs incurred by the developing participant include operating expenses, minus depreciation and amortization, plus the cost of using any tangible property in the development of the property governed by the cost sharing arrangement.

To illustrate the rules regarding a cost sharing arrangement, assume Corporation A is a U.S. corporation and Corporation B is a German corporation. Corporation A and Corporation B enter a qualified cost sharing arrangement to develop a new cellular phone. This agreement states that

---

66 Id. § 1.482-7(a)(2) (as amended in 2001).
67 Id. § 1.482-7(c)(1)(i).
68 Id. § 1.482-7(d)(1).
69 Id. § 1.482-5(d)(3) (1994) provides: Operating Expenses includes all expenses not included in cost of goods sold except for interest expense, foreign income taxes (as defined in § 1.901-2(a)), domestic income taxes, and any other expenses not related to the operation of the relevant business activity. Operating expenses ordinarily include expenses associated with advertising, promotion, sales, marketing, warehousing and distribution, administration, and a reasonable allowance for depreciation and amortization.
70 Id. § 1.482-7(d)(1) (as amended in 2001).
71 Id.
Corporation A and Corporation B will share the costs of the R&D facility located in the U.S., salaries of the researchers, reasonable overhead, and the costs associated with support groups indirectly assisting in the development of the new cellular phone. If the IRS audits the cost sharing arrangement and finds that supplies were used in the development project but not included in the cost sharing pool of costs, the IRS will make an adjustment resulting in an additional cost billed to Corporation B.

Next, assume the costs are split between Corporation A and Corporation B on a fifty/fifty basis, due to the anticipated fifty/fifty split in the sales of the new cellular phone, but the IRS makes a determination that Corporation A and Corporation B benefited from the fruits of the R&D project on a twenty-five/seventy-five basis, respectively. The IRS will propose an adjustment to remove twenty-five percent of the costs from Corporation A’s books and add that twenty-five percent to the books of Corporation B. The IRS will base this adjustment on the assertion that Corporation B sells seventy-five percent of the new cellular phones, while Corporation A only sells twenty-five percent of the new cellular phones.

Therefore, Corporation A and Corporation B will have an audit adjustment for costs that have been excluded from the cost pool and an adjustment for the actual allocation of the costs among the members participating in the cost sharing arrangement. These adjustments would result in an increase in the cost pool, as well as a twenty-five percent increase in the amount billed to Corporation B and a corresponding twenty-five percent decrease in the amount on Corporations A’s books.

As you can see, the area of transfer pricing is very complex and differences will occur as to what constitutes an arm’s length charge. The calculation of prices to charge or costs to bill relies heavily on adequate accounting records and the financial results of the affected taxpayers.

B. Stock Options

There are two types of stock options that a corporation may grant to an employee. The first type of stock option is a “nonqualified stock option” (“NQSO”), which acquires its name from not having to meet specific tax rules. The second type of stock option is an “incentive stock option”

---

72 The adjustment will decrease the amount of the cost pool remaining on Corporations A’s books from fifty percent to twenty-five percent, while increasing the costs on Corporation B’s books from fifty percent to seventy-five percent. This adjustment would reflect the IRS’s perceived benefit to each corporation.

73 Simon, supra note 1.
AN ARM'S LENGTH STRUGGLE

(“ISO”), which has strict limits as to how many may be issued to employees, but carries special tax advantages. This section will discuss both types of stock options and explain the accounting treatment governing them.

1. NQSOs

An NQSO is taxable to an employee or contractor when it becomes substantially vested to that individual. The employer receives a deduction for the taxable year in which the employee is required to include the NQSO in his or her income. The deduction for the employer and the income to the employee are the fair market value at the time the NQSO becomes substantially vested over the amount paid by the employee for the stock.

To illustrate, assume Corporation A provides an employee with one hundred NQSOs at an exercise price of ten dollars, which vest sixty percent in the third year and twenty percent in each of the next two years. The options, therefore, will be fully vested in the fifth year after issuance. On the date sixty percent of the NQSOs vest, the employee exercises the entire sixty percent of his or her NQSOs when the market value of Corporation A’s stock is twenty dollars, resulting in the employee paying $600 for the sixty shares of Corporation A’s stock. The employee receives sixty shares with a fair market value of $1200 but is only out-of-pocket $600.

Therefore, the employee will have $600 of income, and Corporation A will get a deduction of $600. Both the income and deduction are calculated by taking the total fair market value of the stock received upon exercising the NQSOs, $1200, and subtracting the price paid for the stock, $600, resulting in the employee receiving $600 more than the amount he or she paid.

If the fair market value of the stock is below the exercise price of the NQSOs, the employee will not elect to exercise the options because the employee could pay less for the stock by buying it on the open market. Accordingly, the NQSO is considered out-of-the-money and will provide no income to the employee or deduction for the employer because the fair market value is below the price to be paid.

74 Id.
78 Id. § 1.83-1(a)(1)(ii).
79 The fair market value is calculated by multiplying the sixty shares by the $20 value of each share. The calculation results in a fair market value of $1200.
In order for a stock option to qualify as an ISO, strict requirements are placed on the stock options and on the recipient. To qualify as an ISO, the stock options must be granted pursuant to a director-approved plan that provides for the stock options. The plan must receive the approval of the shareholders of the corporation granting the stock options within a twelve-month period before or after the adoption of the plan by the directors. The options must be granted within ten years from the date on which the directors adopt the plan or the date of shareholder approval, whichever is earlier. Lastly, the option by its terms must be exercised within ten years or the stock option is forfeited.

In addition to these procedural requirements, strict value requirements must also be met. First, the option price must be at least equal to the fair market price at the date of grant. Secondly, an ISO is limited to $100,000 aggregate fair market value of stock per year; any amounts exercised above the $100,000 limit are governed by the rules pertaining to NQSOs. Finally, to qualify as an ISO, the recipient of the option must own less than ten percent of the total voting power of the outstanding stock; the recipient may only transfer the ISO by will or by applicable state law controlling descent and distribution.

In addition to restrictions on the issuing corporation, limitations are also placed upon the recipient exercising the ISO. In order for an individual to receive the ISO's favorable tax treatment, the share of stock received upon exercising the ISO must not be transferred "within 2 years from the date of the granting of the option nor within 1 year after the transfer of such share [of stock] to him." Also, the recipient must be an employee of the corporation granting the option or an employee of a controlled group, including the granting corporation. This employment must exist from the

---

80 I.R.C. § 422(b)(1) (1981) (providing that the plan must include the aggregate number of shares to be issued and the employees eligible to receive options).
81 Id.
82 Id. § 422(b)(2).
83 Id. § 422(b)(3).
84 Id. § 422(b)(4).
85 Id. § 422(d)(1).
88 Id. § 422(b)(5) (providing that he must only exercise the option during his lifetime).
89 Id. § 422(a)(1).
90 Id. § 422(a)(2).
grant date of the ISO and continue at least three months before the exercise date of the option.\(^9\)

If all the aforementioned requirements are met, the ISO does not result in taxable income to the recipient upon the exercise of the qualified ISO.\(^9\) While the ISO recipient is enjoying favorable tax treatment, the employing corporation is barred from taking a deduction regarding the exercise of the ISO.\(^9\) Consequently, corporations may use ISOs to provide a tax free benefit to corporate executives, although the corporation itself does not receive a tax deduction when all the requirements are met to qualify the ISO.

If an employee fails to hold the stock for the required period\(^9\) or otherwise disqualifies the ISO, the employee will forfeit the favorable tax treatment and will realize income in the year of the disqualifying disposition.\(^9\) Additionally, the employer will take a deduction in the year of disqualification.\(^9\) Thus, if the disposition of the stock causes a disqualification of the ISO, the income to the recipient and the deduction to the corporation will be calculated based on the rules used for NQSOs.\(^9\) Therefore, ISOs essentially become NQSOs upon disqualification.

To illustrate, assume Corporation A grants an ISO to its Chief Executive Officer ("CEO") pursuant to a plan that has been properly adopted by the directors and shareholders. The CEO sells the stock before the one year holding period has lapsed, resulting in a disqualification of the ISO. Further, assume that the price the CEO paid for the stock was $20, and that the CEO sold the stock for $50. Due to the forfeiture of the favorable tax treatment, the CEO will now have to report $30 of income, and Corporation A will deduct $30 on its tax return.\(^9\) The income will be taxed to the CEO at the CEO's ordinary income tax rate.\(^9\) If the CEO had not

\(^9\) Id.
\(^9\) Id. § 421(a)(2).
\(^9\) I.R.C. § 421(b) (2002).
\(^9\) Id.
\(^9\) Id.
\(^9\) When a disposition disqualifies an ISO, the exception to taxability does not apply. See I.R.C. § 83(e). Since I.R.C. § 421 is inapplicable upon disqualification, the amount of income to the employee and the deduction to the employer is the fair market value minus the amount paid upon exercising the option. Id. § 83(a).
\(^9\) The $30 is calculated from the difference in the proceeds of the disposition, $50, reduced by the price paid for the stock, $20.
\(^9\) It is safe to assume that a CEO of any corporation issuing ISOs will be in the highest ordinary income tax rates. The maximum ordinary income tax rate for the year 2001 was 39.6%. I.R.C. § 1(a)(2) (2001).
disqualified the ISO, the CEO would not have been taxed until he subsequently sold the stock received from exercising the qualified ISO. The difference between the proceeds received upon the subsequent disposition and the price paid for the stock upon exercising the qualified ISO would be taxed at the capital gain rates for individuals.¹⁰⁰

3. Accounting Treatment for Stock Options

The Financial Accounting Standards Board ("FASB") provides two methods of accounting for stock option plans: the fair value based method and the intrinsic value based method.¹⁰¹ The FASB prefers the fair value based method.¹⁰² The fair value based method provides compensation cost to be measured at the date of grant based on the value of the option and is recognized over the vesting period.¹⁰³ The fair value of the option is determined by taking into account the stock price at the grant date of the option, the exercise price of the option, the expected life of the option, volatility of the price of the underlying stock, any expected dividends paid on the stock, and the risk-free interest rate over the expected life of the option.¹⁰⁴ Essentially, the fair value based method requires companies issuing stock options to record compensation expense based on a valuation model on the grant date of the stock options.

The intrinsic value based method for valuing compensation cost requires compensation expense be recorded for the excess, if any, of the market price of the stock at grant date over the amount to be paid for the stock upon exercising the option.¹⁰⁵ In almost all cases, corporations issue stock options with an exercise price equal to the market price at the date of grant, resulting in a corporation utilizing the intrinsic value based method and not recording compensation expense on its respective income statement.¹⁰⁶ Under the intrinsic value method, a corporation only has to disclose the theoretical value of the stock options in the footnotes to the

¹⁰⁰ The maximum capital gains rate for sales of stock in the year 2001 was 20%. Id. § 1(h)(1)(c). One can see that the disqualification of the ISO can have a dramatic impact when comparing being taxed at 20% for qualified ISOs and being taxed at 39.6% on disqualified ISOs.


¹⁰² Id.

¹⁰³ Id.

¹⁰⁴ Id.

¹⁰⁵ Id.

financial statements. Thus, the major difference on the grant date between the two methods is that the intrinsic value method does not require compensation expense to be recorded when the exercise price equals the market price, while the fair value method requires compensation expense to be recorded.

By enacting Statement 123, the FASB was trying to force U.S. companies to recognize the value of employee stock options as a financial expense under the fair value method. To combat this attempt, corporations addressed Congress and the corporations’ allies within Congress threatened the existence of the FASB if it only allowed corporations to use the fair value method in accounting for stock options. Ultimately, the FASB concluded that the best approach was to allow corporations to choose which method to apply when accounting for stock options. The result, therefore, is the opportunity for corporations to choose between the intrinsic value method and the fair value method.

II. ANALYSIS OF THE IRS’S POSITION

This Part analyzes the various theories the IRS sets forth to support the inclusion of stock option gains in cost sharing arrangements and non-integral service agreements. The focus of the analysis is on cost sharing arrangements, but the theories could easily apply to non-integral service agreements as well. The first sub-part focuses on whether stock option gains must be billed to meet the arm’s length standard. The second sub-part discusses whether stock option gains are a true cost.

A. Inclusion of Stock Option Gains Conforms to the Arm’s Length Standard

As previously stated, transfer pricing “places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.” In order to determine the true taxable income of a controlled taxpayer, the arm’s length standard is applied to the transactions among members of a controlled group. A controlled transaction meets the arm’s length standard if the results are consistent with

107 Id.
108 Id.
109 Id.
110 Id.
112 Id. § 1.482-1(b)(1).
the results that would have been realized had two unrelated parties entered into the transactions.\textsuperscript{113}

Regarding cost sharing arrangements and non-integral service agreements, the IRS expressly asserts that inclusion of the value of stock options is mandated for compliance with the arm's length standard.\textsuperscript{114} The IRS illustrates this point with the following example:

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 74\% of the results. The business would be willing to proceed only if the parties receiving the 26\% interest reimbursed it for 26\% 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. The business would not just ignore a significant element of the value of the researchers' compensation on the purported rationale that the labor is "free of cost" when compensated in stock options. That is precisely the type of distortion that Section 482 authorizes the Service to prevent by appropriate adjustment.\textsuperscript{115}

The IRS further notes that "Corporation A receive[s] 100\% of the tax deductions attributable to R&D compensated through stock options, while reporting only 74\% of the corresponding income."\textsuperscript{116}

The IRS makes the point that a corporate taxpayer would be unwilling to pay 100\% of the costs of a research project while only retaining a portion of the rights to the project's results. This is because the cost sharer normally receives rights to the property in proportion to the costs shared.\textsuperscript{117} The cost sharer is gaining a property right without paying the related costs if stock option gains are not included in the cost sharing pools. The theory put forth by the IRS asserts that a corporate taxpayer would only agree to a cost sharing arrangement if 100\% of the compensation—including stock options—is included in the cost sharing pool of costs to be billed. Accordingly, in order to meet the arm's length standard, stock option gains must be billed as a shared cost under the IRS's theory.

One only has to read the federal government's own regulations to find proof contrary to the IRS's assertion that stock option gains must be included in order to meet the arm's length standard. Under the Federal

\textsuperscript{113} \textit{Id.}
\textsuperscript{114} \textit{I.R.S. FSA 200103024} (Jan. 19, 2001).
\textsuperscript{115} \textit{Id.}
\textsuperscript{116} \textit{Id.}
\textsuperscript{117} \textit{Id.}
Acquisition Regulations System, which governs all civil and military contracts with private business, the federal government is prohibited from reimbursing "[a]ny compensation which is calculated or valued based on changes in the price of corporate securities." In other words, if a corporation issues stock options to its employees with an exercise price equal to the prevailing market price at the grant date, any gains upon exercising the option would be ineligible for reimbursement under a governmental contract because the compensation relates to the change in price of a corporate security. The federal government is prohibited from paying for stock option gains, but the IRS asserts that stock options must be included in cost sharing arrangements in order to meet the arm's length standard. To illustrate the potential impact of the government's position of not including stock option gains as costs eligible as part of the contract price, the following example is included.

In 2000, the largest Department of Defense research and development contractor was Lockheed Martin. On December 31, 2000, Lockheed Martin had approximately 27.9 million exercisable stock options outstanding at an average exercise price of $31.91. This equates to potentially $56.9 million in gains that could have been exercised. Under the IRS's rationale, all employees of the contractor working on contract research projects for the government would have their gains billed as part of the contract price, even though the government itself prohibits such an arrangement.

Why would two unrelated parties agree to pay for stock option gains? Logically, the party sharing the stock option gains would be susceptible to large swings in the potential contract price if such a contingency existed in the contract. To illustrate, assume a party negotiated with Lockheed Martin agreeing to reimburse for stock option gains and that all Lockheed Martin employees will work on the contracted project. The potential exposure at the end of the year 2000 would have been $56.9 million in additional contract costs related to stock option exercises in 2000. If the number of

---

120 Lockheed Martin Ranked as Top Defense Contractor for Sixth Straight Year, GOV'T CONTRACTOR 56 (Feb. 7, 2001).
121 LOCKHEED MARTIN CORP., 2000 ANNUAL REPORT 60 (2001).
122 The difference in the exercise price and the closing market price on December 29, 2000 was $2.04. This difference multiplied by the outstanding exercisable stock options of $27.9 million equates to gains of $56.9 million. Historical Prices—LMT, at http://table.finance.yahoo.com/d?a=11&b=29&c=2000&d=11&e=29&f=2000&g=d&s=lmt.
outstanding exercisable stock options on December 31, 2001 mirrors the outstanding exercisable stock options on December 31, 2000, the additional contract price exposure would increase to $411.8 million. In only twelve months, the contract price exposure, due to the stock option gains, would have a four-fold increase.

This exposure brings a level of uncertainty to the business world that prudent corporations would be unwilling to assume. The stock option gains portion of the contract price would be driven by the volatility of the stock price, the number of options granted by the service providing organization, the vesting period on the stock options, and by whether the individual employees exercise their options during the period governed by the agreement. These factors are driven by economics, the employee's preferences and finances, and the issuing corporation's discretion regarding stock option grants. The aforementioned factors have no relationship to the research services provided to the party sharing the costs, so it is illogical to expect a party to pay for stock option gains.

Companies do enter contingent arrangements and it is arguable that these issues may be handled by careful contract drafting and negotiations. Stock options are not the typical type of contingency that companies agree to reimburse. Stock options are a perk given to employees at the discretion of the issuing corporation, but are not a necessity to the performance of the services. Therefore, companies unrelated to each other would not be willing to assume a contingency that is not even required for performance of the services. This is evident since the government, with its own regulations, refuses to reimburse service providers for the cost of stock option gains. This is proof that stock option gains are not shared or reimbursed in the marketplace because the federal government is a player in the marketplace.

To further support the conclusion that unrelated parties are not willing to contract for such a contingency, the IRS has admitted that it has been unable to locate an actual arm's length transaction, where the parties agreed to share the stock option gains. As previously stated, the IRS is unable

---

123 The closing stock price for Lockheed Martin on December 31, 2001 was $46.67. Historical Prices—LMT, at http://table.finance.yahoo.com/d?a=11&b=31&c=2001&d=11&e=31&f=2001&g=d&s=lmt. Taking the December 31, 2000 average exercise price of $31.91 and subtracting that number from $46.67, the average gain per each stock option is $14.76. Multiplying the $14.76 gain by the number of outstanding shares on December 31, 2000 (27.9 million), the result is a gain of $411.8 million. The December 31, 2000 stock option figures were the most current available as of November 1, 2002.

124 Seagate Tech., Inc. v. Comm'r, 80 T.C.M. (CCH) 912 (2000).
to provide proof of such a transaction because such a transaction does not exist.

Another point the IRS uses to support its assertion that failure to bill stock options results in failure of the arm's length standard is the fact that a corporation receives 100% of the tax deductions related to stock options, while not reporting income from the cost sharing of the stock options since the stock option gains have not been billed.\(^\text{125}\) The problem with this argument is that, by the very nature of the costs eligible for cost pool, corporations are going to have deductions which do not have a corresponding amount of income reported. This stems from the fact that depreciation and amortization are exempt from the cost pool that is to be billed to participating entities.\(^\text{126}\) Therefore, it is inherent in the cost sharing structure that a corporation will take deductions for amounts which the corporation is \textit{not} then required to include in the pool of costs to be billed. This results in deductions for which income will not be reported from the cost sharing.

Thus, the facts in the marketplace indicate that the IRS's basis for inclusion of stock option gains is contrary to reality. The best indicator is the fact that the federal government prohibits reimbursement of stock option gains. The second argument by the IRS is faulty since the very language of the cost sharing regulations provides for deductions for which income will not be reported from cost sharing.

\section*{B. Stock Option Gains Are Not a Cost for Section 482 Purposes}

Stock option gains fail to qualify as costs for Section 482 purposes. A detailed reading of Treas. Reg. § 1.482-7 reflects Congress's intent to rely upon Generally Accepted Accounting Principles ("GAAP"). Therefore, stock option gains reported under the intrinsic method for GAAP purposes should not be included in cost sharing pools. Secondly, the issuance of stock options by a corporation does not result in an out-of-pocket expense to the corporation. It follows from the aforementioned reasons that the IRS has no solid basis for the inclusion of stock option gains in cost sharing arrangements.

\subsection*{1. GAAP Standards Govern the Treatment of Stock Options for Section 482 Purposes}

The costs to be included in a cost sharing arrangement consist of all operating expenses, except depreciation and amortization, and the cost for

\(^{125}\) I.R.S. FSA 200103024 (Jan. 19, 2001).

the use of any tangible property. The definition of operating expenses for cost sharing purposes lists the typical GAAP operating expenses: advertising, depreciation, amortization, distribution, warehousing, promotion, sales, and marketing. By specifically listing costs considered to be operating expenses for GAAP purposes, the Treasury was reflecting its intent that GAAP principles govern the content of the costs to be included in cost sharing pools.

In almost all cases, corporations adopt the intrinsic method to report stock options on GAAP financial statements. With the election of the intrinsic method and the issuance of stock options at the prevailing market values on the grant date, corporations do not report a cost regarding stock option issuances on their financial statements. Following the Treasury's clear intention that GAAP treatment govern the costs eligible for the cost sharing pool, the stock options would not be included, since no expense is ever recorded as a cost to the corporation.

The IRS combats this fact by stating that a costless position "produces a distortive mismatch of tax deductions and income." As previously stated, the Treasury wrote this possibility into the regulations by excluding depreciation from the cost sharing pool. The corporation deducts depreciation but does not report income since the depreciation is never billed to the participating cost sharer. Therefore the IRS's argument is without merit.

Secondly, the IRS focuses on the fact that a corporation may choose to book an expense upon issuing the stock options by electing the fair value based method. The IRS's argument might have merit if its application were limited to instances where the fair market based method is adopted. To the contrary, the IRS makes the argument and attempts to apply it broadly to all situations, regardless of the method chosen for reporting stock options. As previously stated, inclusion of stock options in a cost sharing pool under the intrinsic method is contrary to the Treasury's stated intent that GAAP govern the costs included in a cost sharing pool.

Lastly, the IRS points out that "there is no required conformity between the Section 482 'cost' concept and financial accounting." To support this argument, the IRS states that the regulations themselves recognize the potential for differences between GAAP and tax cost sharing pools.

---

127 Id.
128 Id. § 1.482-5(d)(3) (1994).
129 See ACCOUNTING FOR STOCK-BASED COMPENSATION, supra note 101.
131 Id.
132 Id.
133 Id. at n.35.
The accounting method used to determine the costs and benefits of the intangible development (including the method used to translate foreign currencies), and, to the extent that the method materially differs from U.S. generally accepted accounting principles, an explanation of such material differences.  

The IRS is correct that the regulation recognizes the potential for differences between GAAP and the cost sharing method, but the IRS has failed to take this statement in the proper context. By stating "the accounting method used to determine the costs and benefits," there is a clear indication that GAAP determines the costs to be included in the cost sharing pool of costs. In addition, it requires an explanation for any deviations from GAAP since GAAP costs are the costs to be included in a cost sharing pool of costs.

The IRS uses the explanation requirement for any variances from GAAP to try to assert that this indicates that GAAP does not govern the cost pool. The language is clear; this interpretation takes the explanation requirement out of context. Not only does the Treasury state that the accounting method is used to determine the costs, the Treasury requires an explanation for any deviations from GAAP.

It is clear from the language that GAAP drives the costs to be included in a cost sharing pool. The fact that the Treasury requires an explanation for any deviations from GAAP further illustrates this point.

2. Issuance of Stock Options By a Corporation Does Not Result in an Out-of-Pocket Expense

The cost sharing regulations require that cost pools include "all" costs incurred related to the development project. The IRS asserts that stock option gains are "costs" to the issuing corporation; therefore, gains are to be included in the cost sharing pools.

The key words to focus on are "costs incurred." With stock options, the issuing corporation incurs no cost upon granting the stock options. It is merely an option to buy equity in the issuing corporation. If stock options are in the money at the vesting date, the employee exercising the option purchases equity in the issuing corporation. This purchase does not cost the corporation. The only effect the transaction has in relation to the corpo-
tion is to dilute the existing shareholders' value. The value of the corporation remains the same, but the percentage ownership of existing shareholders decreases, resulting in a decrease in the value held by them. Market pressures deal with this outcome by adjusting the stock price.

In reviewing the definition of "operating expenses," it is obvious that the regulations are geared toward including expenses involving cash outlays in the cost sharing pools. All operating expenses are included except depreciation and amortization.\(^{137}\) Depreciation is the recovery through deductions of the purchase price of a capital asset over the useful life of the said asset, but does not involve a cash outlay each year a deduction is taken. Operating expenses that are included in a cost sharing pool are expenses that are generated by a cash outlay during the year by the incurring corporation. A stock option is more similar to depreciation since the option typically does not vest for at least five years from the year the tax deduction is taken, and no cash is paid by the issuing corporation. Therefore, the treatment of stock option gains should be excluded due to the close similarity to depreciation and the clear intent that costs included in cost sharing pools be out-of-pocket expenses.

III. PROPOSED REGULATIONS REQUIRING STOCK OPTION INCLUSION IN COST SHARING PAYMENTS

On July 29, 2002, the IRS issued proposed regulations\(^{138}\) requiring the inclusion of stock options in cost sharing arrangements. The proposed regulations sought to "clarify that stock-based compensation is taken into account in determining the operating expenses treated as a controlled participant's intangible development costs for purposes of the cost sharing provisions . . . ."\(^{139}\) As previously pointed out, while the IRS has attempted to be creative by changing the law to achieve a desired result, this position does not stand up to scrutiny or reality.\(^{140}\)

A. Coordination of Cost Sharing and the Arm's Length Standard

The proposed regulations state that cost sharing arrangements meet the arm's length standard if and only if stock options are included in the

\(^{137}\) Id.


\(^{139}\) Id.

\(^{140}\) See supra notes 111-34 and accompanying text.
operating expenses of the cost sharing arrangement.\textsuperscript{141} This is in conflict with the established goal of the arm’s length standard, which is to achieve the same result from related party transactions as would have been achieved had two unrelated parties entered the same transaction.\textsuperscript{142} In the proposed regulations, the IRS legislated the definition of the arm’s length standard by requiring the inclusion of stock options in cost sharing arrangements. If the IRS is allowed to finalize the proposed regulations without change, a signal will be sent to the IRS that the easiest way around any shortcomings in its positions is legislating to achieve the desired outcome.

Congress has made it blatantly clear that the arm’s length standard applies when transfers are made to related parties. Congress has stated “[t]ransfers to related foreign corporations . . . are subject to an ‘arm’s-length standard.’”\textsuperscript{143} Congress further indicated that it did not intend to legislate what constitutes an arm’s length standard by stating “[u]ncertainty exists regarding what transfers are appropriate to treat as ‘arm’s-length’ comparables . . . .”\textsuperscript{144} The fact that Congress acknowledged uncertainty in identifying comparables for the arm’s length standard is an indicator that Congress had no intention of legislating what constitutes an arm’s length standard when transferring intangibles. Since Congress is the only body empowered to legislate such an issue, the IRS has clearly overstepped the bounds of its power by drafting proposed regulations legislating the definition of the arm’s length standard for cost sharing arrangements.

Even if the IRS did have the power to legislate such an issue, the position runs counter to the true concept of the arm’s length standard. The arm’s length standard aims to ensure that the results of transactions between related parties are consistent with the results between unrelated parties conducting the same transaction under similar circumstances.\textsuperscript{145} By legislating the definition of an arm’s length standard in the context of cost sharing arrangements, the IRS is replacing the true arm’s length standard established by the marketplace with a definition that provides the IRS an avenue to overcome the argument that inclusion of stock options violates the concept of arm’s length. The marketplace does not take stock options

\textsuperscript{141} Prop. Treas. Reg. § 1.482-7(a)(3), (d)(2), 67 Fed. Reg. 48,997 (July 29, 2002) (Section 1.482-7(a)(3) references § 1.482-7(d)(2), which requires a participant to include all costs including “stock-based compensation”).

\textsuperscript{142} See supra notes 18-42 and accompanying text.


\textsuperscript{144} Id. (emphasis added).

\textsuperscript{145} See supra note 11 and accompanying text.
into account when negotiating service contracts or cost sharing arrangements—as evidenced by the U.S. government’s own position to disallow the inclusion of stock options in the price of governmental contracts. The IRS should acknowledge the reality of the marketplace and cease to attempt legislating around the shortcomings of its position of stock option inclusion in cost sharing arrangements.

B. Stock-Based Compensation

The newly issued proposed regulations provide that “in determining a controlled participant’s operating expenses . . . all compensation, including stock-based compensation, must be taken into account.” Stock-based compensation includes “such forms of compensation as restricted stock, nonstatutory stock options, statutory stock options . . . stock appreciation rights, and phantom stock.” The proposed regulations further state that statutory stock options are included as stock-based compensation regardless of whether the employer can take an income tax deduction with respect to the options.

The IRS’s inclusion of statutory stock options as stock-based compensation is an interesting position. The IRS claims that this is an operating expense includable in the cost sharing pool, but there is no cost to the company issuing the statutory stock option, and the company in most instances does not even receive a tax deduction. Therefore, not only is it possible that the ISOs will not be reflected on the income statement, chances are that the issuing company will not even get a tax deduction for the ISOs. However, the IRS counter intuitively believes the perceived costs associated with the ISOs should be included in cost sharing arrangements. The weakness of the position taken by the IRS is reflected by the fact that the IRS is proposing the inclusion in cost sharing arrangements of a value for stock options that will not be reflected in an income statement or deducted on a tax return.

---

146 See supra notes 105-26 and accompanying text.
148 Id.
149 Id. See supra notes 80-100 and accompanying text (discussing ISOs and the deductibility of ISOs for the employer).
150 See supra notes 80-100 and accompanying text.
151 See supra notes 101-10 and accompanying text.
152 See supra notes 80-100 and accompanying text.
C. Inclusion at Cost Sharing Termination

Another interesting proposal by the IRS is the requirement that any vested stock options where the underlying stock has a fair market value in excess of the exercise price at the time the cost sharing arrangement terminates be includable in cost sharing arrangements.\(^\text{153}\) The IRS claims "the rule ensures that controlled participants take into account for cost sharing purposes all stock-based compensation that is attributable to the development of intangibles and has become exercisable during the term of the cost sharing arrangement."\(^\text{154}\)

This rule sets up the scenario whereby an issuer includes stock options upon termination of the cost sharing arrangement, the underlying stock drops below the exercise price after the cost sharing termination, and the stock options are never exercised because the options are out-of-the-money. Under this scenario, the participating party has paid for stock options that are never exercised due to the drop in the price of stock. With this scenario, there is obviously no cost involved because the stock options lapse without being exercised. Even if one believes there are costs involved with stock options, when the options lapse without being exercised one is hard-pressed to argue that a cost exists. The issuer provided the employee with a piece of paper that for all practical and economic purposes was just a piece of paper.

The proposed regulations state that "Treasury and the IRS believe that due regard must be given to the emphasis placed on economic factors in the legislative history of the commensurate with income standard . . . ."\(^\text{155}\) In addition, the proposed regulations make the point that "cost sharing arrangements must ‘reflect the actual economic activity’ of participants."\(^\text{156}\) Applying the IRS’s language to the aforementioned scenario where the stock options lapse, it is clear that the "economic activity of the participants," especially the issuer, is only the issuance of a piece of paper. How can one now be expected to pay large amounts of money for the issuance of a worthless piece of paper? The outcome in this situation when applying the proposed regulations does not make sense in the business world.

CONCLUSION

The basis for the theory that stock option gains must be included in cost sharing pools does not stand up to the language of the final regulations, nor

\(^{154}\) Id. at 49,000.
\(^{155}\) Id. at 48,999.
\(^{156}\) Id.
does it follow what unrelated parties do in the marketplace. The IRS argues that in order to meet the arm's length standard, stock options must be included in cost sharing pools and that stock option gains are a cost to corporations to be billed to cost sharers. The IRS is attempting to legislate this position by issuing proposed regulations requiring stock option inclusion for compliance with the arm's length standard.

First, it is obvious that unrelated parties do not share stock option gains. This is evident from the federal government's own regulations barring any reimbursements for stock option gains on services provided by private parties to the government. While the IRS is aware of this prohibition, it continues to argue that unrelated parties would bill stock option gains. The IRS makes the assertion but, as it has admitted, is unable to provide any transactions indicating that this is reality in the marketplace.

Second, the argument that stock options are a cost to the corporation is unfounded. The stock options are merely perks to an employee that allow the employee to purchase an equity share of the issuing corporation. Furthermore, the regulations are clear that GAAP drives what is included in a cost sharing pool. The IRS tries to negate the intent of the regulations by latching onto a phrase, taking it out of context, and arguing that the regulations acknowledge the potential for GAAP and tax differences. The IRS is correct that the regulations acknowledge such a potential, but the regulations require an explanation for such variations since they are a deviation from the intended method (GAAP) to be used for determining the cost sharing pool.

With the issuance of the proposed regulations, the IRS is overstepping its empowerment by going against the stated intentions of Congress. The proposed regulations are an attempt to legislate around shortcomings in the IRS's position. The IRS's position is apparently not well reasoned. As written, there are many scenarios that will not make sense when applying the proposed regulations.

To argue its overall position, the IRS makes unsupported assertions regarding the marketplace, takes the language of the regulations out of context, and now has proposed regulations to reach its desired outcome. In summary, the arguments put forth by the IRS for inclusion of stock option gains in cost sharing arrangements and non-integral service agreements, "wither[ ] in the light of objectivity to a heap of conclusory straws."157 Therefore, the courts should dispel the IRS's arguments and rule that stock option gains are not to be included in cost sharing arrangements and non-integral service agreements. In addition, the IRS should withdraw the

proposed regulations and face the reality that arm's length does not entail the inclusion of stock options in cost sharing arrangements.