Guidance on Valuation of Stock-Based Compensation for Purposes of Qualified Cost Sharing Arrangements

Notice 2005–99

PURPOSE

Treas. Reg. § 1.482–7(d)(2)(iii)(B) provides an elective method of measurement and timing that is applicable for taking certain options on publicly traded stock into account as intangible development costs of a controlled participant in a qualified cost sharing arrangement (QCSA). This notice extends that elective method to certain stock-based compensation commonly referred to as "restricted shares" or "restricted share units." It also addresses the determination of whether stock-based compensation subject to the elective method is related to the covered intangible development area. The Treasury Department and the Internal Revenue Service (IRS) expect to issue regulations that incorporate the guidance provided in this notice.

BACKGROUND

The Treasury Department and the IRS promulgated T.D. 9088, 2003–2 C.B. 841, on August 26, 2003, providing explicit guidance with respect to taking stock-based compensation into account as intangible development costs of a controlled participant in a QCSA under § 1.482–7. Section 1.482–7(d)(1) of the cost sharing regulations generally requires that all costs related to the intangible development area be taken into account. Section 1.482–7(d)(2)(ii) provides that the determination of whether stock-based compensation is related to the intangible development area (within the meaning of § 1.482–7(d)(1)) is made as of the date that the stock-based compensation is granted (the grant-date identification rule).

Under T.D. 9088, once stock-based compensation is identified by application of the grant-date identification rule, its cost must be measured to establish the amount taken into account for cost-sharing purposes. Generally, this cost is measured and taken into account in accordance with the tax-deduction-based rules set forth in § 1.482–7(d)(2)(iii)(A). In the case of certain options on publicly traded stock, however, controlled participants may choose the elective method of § 1.482–7(d)(2)(iii)(B). Under the elective method, controlled participants take into account stock-option costs in the same amount, and as of the same time, as the fair value of the stock options reflected in audited financial statements prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) by or on behalf of the company issuing the publicly traded stock.

On August 22, 2005, the Treasury Department and the IRS issued a notice of proposed rulemaking (REG–144615–02, 2005–40 I.R.B. 625) which would amend, *inter alia*, the regulations under § 1.482–7(d). The Preamble to the proposed regulation stated that the Treasury Department and the IRS are considering extending availability of the elective method to other forms of publicly traded stock-based compensation and requested comments on which forms of publicly traded stock-based compensation should be eligible for the elective method. In response to comments, this notice extends the elective method to certain stock-based compensation commonly referred to as "restricted shares" or "restricted share units" and addresses the determination of whether stock-based compensation measured under the elective method is related to the intangible development area.

DISCUSSION

A. Certain restricted equity shares or units eligible for the elective method.

The Treasury Department and the IRS believe that the use of the elective method for certain shares or units would provide a reliable and administrable method for measuring the intangible development costs attributable to such compensation for purposes of § 1.482–7(d)(2). Accordingly, the Treasury Department and the IRS have determined that controlled participants may choose to apply the elective method to such shares or units.

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

In general, an election to apply the elective method as modified by this notice is made at the same time and in the same manner as described in § 1.482–7(d)(2)(iii)(B)(*4*). In the case of a QCSA that predates December 8, 2005, if one or more controlled participants offer nonvested equity shares or units, an election to apply the elective method to such shares or units must be made by a written amendment to the cost sharing agreement not later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after December 8, 2005, and the consent of the Commissioner is not required.

B. Determination of whether stock-based compensation subject to the elective method is related to the intangible development area.

The grant-date identification rule directs that the "determination of whether stock based compensation is related to the intangible development area ... is made as of the date that the stock-based compensation is granted." Section 1.482–7(d)(2)(ii) further states that all stock-based compensation granted during the term of a QCSA and related to the intangible development area is included as intangible development costs. Under the elective method, stock options are taken into account at the same time, and in the same amount as the value of stock options reflected in financial statements prepared in accordance with U.S. GAAP.

Under U.S. GAAP, companies must classify stock-based compensation expense attributable to a financial reporting period in the same functional area (*e.g.*, research and development, cost of revenue, etc.) as the expense for cash compensation recognized for the employee in the income statement. *See* Staff Accounting Bulletin No. 107, Release No. SAB 107, 17 CFR Part 211 (Mar. 29, 2005); SFAS 123R ¶ 5. In the case of taxpayers utilizing the elective method of measurement, the Treasury Department and the IRS believe that determining whether stock-based compensation is related to the intangible development area on the basis of activities of employees during individual financial reporting periods is administrable both by taxpayers and the IRS and would likely produce results consistent with the purposes of T.D. 9088. Accordingly, provided that certain requirements are satisfied, controlled participants may choose to determine whether stock-based compensation measured by the elective method is related to the intangible development area by analyzing the activities of the employee recipients of the stock-based compensation by reference to financial reporting periods, identifying the related compensation on a period by period basis. In this context, the Treasury Department and the IRS emphasize that activities within the intangible development area are not necessarily coextensive with those activities classified as "research and development" for financial reporting purposes. Consequently, nothing in this notice should be interpreted as eliminating the requirement to take into account all stock-based compensation costs related to the intangible development area. Controlled participants must identify the stock-based compensation that is related to the intangible development area, notwithstanding that the activities conducted to develop intangibles covered by the QCSA may differ from the activities classified as "research and development" for U.S. GAAP purposes.

As an example of the identification of stock-based compensation by analyzing employee activities on the basis of financial reporting periods, assume that the stock-based compensation granted during the term of the QCSA and subject to the elective method vests over a total period that includes some periods in which the employee's activities are related to the intangible development area and other periods in which the employee's activities are not so related. Under these circumstances, in computing the intangible development costs related to the intangible development area, the portion of such stock-based compensation that vests during the former periods is taken into account even if the employee's activities were not related to the intangible development area during the financial reporting period during which such stock-based compensation is granted, while the portion that vests during the latter periods is not taken into account. In contrast, under the grant-date identification rule, the determination whether the stock-based compensation relates to the intangible development area is made with respect to the entire grant of stock-based compensation by reference to the recipient employee's activities at the time the stock-based compensation is granted.

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

In the case of a QCSA that predates December 8, 2005, a change of identification methodology pursuant to this notice will not require Commissioner consent under § 1.482–7(d)(2)(iii)(C) if made no later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after December 8, 2005.

EFFECTIVE DATE

This notice is effective for stock-based compensation granted in taxable years beginning on or after December 8, 2005. Until regulations incorporating the guidance set forth in this notice are issued, taxpayers may rely on the guidance contained in this notice. Taxpayers may elect to apply the provisions of this notice retroactively to grants of stock-based compensation occurring in open taxable years beginning on or after August 26, 2003.

REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS continue to request comments concerning other forms of publicly traded stock-based compensation that should be eligible for the elective method. In addition, comments are requested concerning the interaction of the grant-date identification rule and the elective method; whether the regulations should continue to exclude all stock-based compensation granted prior to the term of the QCSA; whether stock-based compensation that vests after the term of the QCSA should be treated as vested during the term of the QCSA; and what standard the Commissioner should apply in considering requests for consent to changes to or from the elective method. Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: John E. Hinding (Notice 2005–99), CC:INTL:6, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to *notice.comments@irscounsel.treas.gov.* Comments will be available for public inspection and copying.

The principal author of this notice is John E. Hinding of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact John E. Hinding at (202) 435–5265 (not a toll-free call).