IRS issues guidance on adjustments for CSAs with reverse claw-back provisions for stock-based compensation

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In brief

The IRS on July 16 released AM 2021-004, a legal advice memorandum issued by Associate Chief Counsel (International) (the "CCM"). The CCM provides non-taxpayer-specific legal advice regarding the potential timing and amount of adjustments arising from transfer pricing examinations of stock-based compensation (SBC) costs involving taxpayers' cost-sharing agreements (CSAs) that included so-called "reverse claw-back" provisions which are assumed to have been triggered by a final decision in the *Altera* litigation. (See our July 7, 2020 Tax Insight for details of the case.)

The CCM provides an indication of the adjustments that the IRS intends to pursue on examination of taxpayers that did not include SBC costs under their CSAs, and in particular how the IRS intends to coordinate such adjustments with the income inclusions triggered under taxpayers' contractual reverse claw-back clauses. The CCM represents the IRS's effort to provide definitive answers on this coordination issue.

The takeaway: Overall, the CCM can be seen as helpful in terms of providing taxpayers with more certainty as to how the IRS intends to handle the inclusion of SBC costs for prior years under CSAs, and by appearing to eliminate the chance that the same income will be double-counted in connection with prior-year adjustments and reverse claw-back true-ups. Taxpayers have been put on notice, however, that for SBC costs incurred in closed years, the IRS plans to hold taxpayers to their contractually established prices under such reverse claw-back provisions and thus could pursue adjustments that effectively include unshared SBC costs from closed years.

In detail

Background

The CCM's substantive discussion begins by noting that a number of taxpayers had begun including "claw-back" provisions in their CSAs after the 2003 CSA regulations became final. The desired effect of such provisions, the CCM notes, was to remove, or "claw back," SBC that was included in cost pools if, at some point after the

agreement was executed, the SBC regulation were to be invalidated as the result of a final decision in a court of law, revised, or withdrawn.

This eventuality came to pass in 2015 when a unanimous US Tax Court decision in *Altera* held the SBC regulation to be invalid. As a result, a number of taxpayers amended their cost-sharing agreements to stop sharing SBC altogether (the CCM refers to these as "Non-SBC CS Agreements"). The CCM notes that some of these taxpayers replaced their claw-back provisions with "reverse claw-back" provisions that essentially were the opposite, as they required the inclusion of previously excluded SBC amounts in those cost pools upon a certain triggering event.

The CCM states that the triggering event "often" was defined as the date when a final decision in *Altera* or another case upheld the validity of the SBC regulation. (***Note:*** This also raises another point — taxpayers need to consider the specific wording of their reverse claw-back provisions in analyzing the issues below.) Upon the triggering event, the cost-sharing participants become obligated to make a true-up payment to reflect the sum of SBC costs that should have been shared in prior years.

Issues

The CCM addresses three issues associated with such reverse claw-back provisions.

Issue 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?**

Citing Treasury regulations (sec. 1.482-7(i)(2)), the CCM concludes that the IRS may make allocations to adjust the results of a cost-sharing transaction (CST) so that the results are consistent with an arm's-length result, and that such allocation will be reflected for tax purposes in the year in which the SBC — which is an intangible development cost (IDC) under the regulations — was incurred. Some taxpayers have desired to use reverse claw-back provisions to try to fully "telescope" any adjustments for previously excluded SBC amounts into the year of the triggering event.

Observation: While such a result could make the computations and other ministerial tasks easier for both the IRS and taxpayers alike, the adverse conclusion by the CCM should not come as a surprise. The regulations provide that each controlled taxpayer's IDC share for each tax year is equal to its reasonably anticipated benefits (RAB) share, and 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.

Note: Footnote 6 of the CCM provides that if a primary allocation is made under Reg. sec. 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. This footnote is a reminder to be aware of the need to conform accounts if the taxpayer desires to file amended returns to include SBC in prior years. This process should involve evaluating whether to elect Revenue Procedure 99-32 treatment.

Issue 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 tax 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?**

The CCM concludes that if the IRS adjusts the results of a CST for a prior tax year to account for SBC costs, that adjustment should be treated as reducing the amount of any reverse claw-back true-up obligation payable in a later year by a corresponding amount, thereby avoiding an overpayment of the SBC costs. Thus, the IRS will not require

double-counting in the year the reverse claw-back is paid, but instead will allow taxpayers to reduce the reverse claw-back payment to account for the SBC costs already included in the prior-year adjustment.

The CCM justifies this result by analogizing the reverse claw-back provision to a contingent-payment obligation that contractually requires a true-up payment, which by necessity would not include amounts of SBC costs that already have been shared by the parties. According to the CCM, "[i]n such a 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." ***Observation:*** While this reasoning jumps to equate an adjustment made to reflect a sharing of SBC solely for US income tax purposes (e.g., an adjustment made in an IRS examination or on an amended return) with an actual sharing of SBC by the parties, the reasoning seems to reach the technically sound conclusion that SBC costs should not be required to be reimbursed for US tax purposes twice, once in the year the SBC costs were incurred and again in the year the reverse claw-back provision was triggered.

Observation: One question that has arisen on this issue is whether a taxpayer could lose the ability to obtain a reduction in a reverse claw-back payment under the CCM's reasoning if the taxpayer does not reflect the reduction on its original timely filed US return for the year the reverse claw-back obligation is triggered. The question arises because taxpayers generally cannot claim taxpayer-favorable Section 482 adjustments on amended returns under Reg. sec. 1.482-1(a)(3). Thus, the question is whether taxpayers that already have recognized the full amount of a reverse claw-back payment on their original US returns still have the opportunity to adjust this result — for example, through a later filed amended return or through a taxpayer-favorable adjustment made by the IRS on examination.

The CCM apparently concludes that such later adjustments should be permitted, stating that "to the extent the IRS makes adjustments (including when initiated by a taxpayer) 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)." (Emphasis added, footnotes omitted.) To achieve the apparent intent to provide for a reduction of reverse claw-back "over-inclusions" on IRS examination even if the full reverse claw-back previously has been paid, the reference to "timely filed returns" in this explanation could be read to refer to timely filed amended returns as well as timely filed original returns.

Issue 3: **If a Section 482 allocation to adjust the results of a CST in the year the IDCs were incurred is barred (e.g., by the statute of limitations), 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?**

The CCM makes clear that its position — that a reverse claw-back payment should be reduced to account for SBC costs included in prior-year adjustments — does not apply if the prior-year SBC inclusion was barred by the statute of limitations. In this situation, the CCM's position is to hold the taxpayer to its contractually established prices (e.g., not allow a reduction in the contractually required reverse claw-back payment). The CCM states that the IRS should first consider whether the period of limitations on assessment is still open and, if so, adjust the results in the year the IDCs were incurred under Reg. sec. 1.482-7(i)(2). If such adjustments are not possible, however (e.g., because the statute of limitations expired), then the IRS will make "appropriate allocations" in the year the reverse claw-back true-up is triggered for the full amount of unshared SBC costs since the inception of the CSA.

In this regard, the CCM states: "If a taxpayer [in this circumstance] 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 in the year the true-up is triggered for the full amount of unshared SBC costs that should have been shared in accordance with Treas. Reg. § 1.482-7 since the CSA began." (Footnote omitted.) The CCM cites *Nestlé Holdings Inc. v. Commissioner*, 152 F.3d 83, 87 (2d Cir. 1998), *The Coca-Cola Co. v. Commissioner*, 155 T.C. No. 10, 58 (2020), the clear reflection of income doctrine, and the tax benefit rule as authority for its position.

Observation: An issue raised by this reasoning is whether the CCM's position can be viewed as consistent with the overall mandate of the cost-sharing regulations, which require IDC sharing to be evaluated year-by-year based on the IDCs incurred in each year and thus prohibit multi-year approaches in evaluating CSTs. By effectively truing-up for prior-year SBC costs, a reverse claw-back payment may be considered to be inconsistent with this year-by-year approach of the regulations. The CCM's position also could produce disparate treatment of otherwise similarly situated taxpayers based solely on one taxpayer's contractual pricing provision, notwithstanding the regulatory authority in Reg. sec. 1.482-1(a)(3) permitting the taxpayer to disregard contractual pricing on a timely filed original return if necessary to reflect an arm's-length result.

Absent a contractual reverse claw-back clause, it seems that the IRS would be foreclosed by the statute of limitations from requiring a taxpayer to recover SBC costs incurred in a closed year. The CCM takes the position, however, that the IRS is not so foreclosed from making an adjustment for SBC costs incurred in a closed year if the taxpayer has a contractual reverse claw-back provision in its CSA (in which case, the adjustment would be for the year the reverse claw-back is paid rather than the closed year when the SBC cost was incurred). ***Observation:*** For these reasons, a question might arise as to whether the CCM's position is consistent with the purpose of the statute of limitations.

In addition to the case law and income tax doctrines mentioned above, the CCM also cites Reg. sec. 1.482-7(i)(5), which provides the IRS with authority to make certain allocations when CSTs are "consistently" and "materially" disproportionate to RAB shares. The application of this provision to the issue of SBC costs raises other issues, however, because those terms are not otherwise defined in the regulations, and if applied the resulting adjustment would entail a complex analysis to impute some additional interest in the cost-shared intangibles to the US participant.

Let's talk

For a deeper discussion of how this new IRS guidance may affect your business, please contact:

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