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In this article, the authors examine a recently released legal advice memorandum instructing IRS examiners on how to respond to cost-sharing rules compliance, and they argue that the IRS's guidance will challenge the compliance strategy of many taxpayers.

On July 16 the IRS released a chief counsel advice memorandum[1] instructing examiners on how to respond to taxpayers' efforts to comply with the cost-sharing rules of reg. section 1.482-7 following the Ninth Circuit's decision in *Altera*.[2] While one might have hoped for guidance that respected taxpayers' reasonable efforts to comply with the regulations that the Ninth Circuit upheld, the memorandum takes a rather different tack. It is directed at IRS examiners, not taxpayers, requiring adjustments to prior returns on a year-by-year basis, and this approach will pose serious challenges for the compliance strategies envisioned by many taxpayers.

Background

The state of the rules regarding the treatment of stock-based compensation (SBC) costs under cost-sharing arrangements (CSAs) has resulted in no small degree of taxpayer whiplash over the years. In the 1990s the IRS argued in *Seagate*[3] that SBC costs needed to be shared under CSAs, despite the lack of any mention of SBC in the then-applicable regulations and the absence of evidence that parties shared SBC costs at arm's length. The IRS ultimately backed down in *Seagate*, but it took up the issue again in *Xilinx*.[4] Again, the applicable regulations made no mention of SBC, and the Tax Court held for the taxpayer. A Ninth Circuit panel then reversed, only to withdraw its opinion and affirm the Tax Court. By the time *Xilinx* was decided, Treasury had already amended the regulations to expressly address SBC. Unsurprisingly, given the IRS's long-established position on the issue, those regulations required CSA participants to include SBC costs among the intangible development costs (IDCs) subject to cost sharing.

[1] AM 2021-004 (July 13, 2021).

[2] *Altera Corp. v. Commissioner*, 926 F.3d 1061 (9th Cir. 2019), *rev'g* 145 T.C. 3 (2015), *cert. denied*, 141 S. Ct. 131 (2020).

[3] *Seagate Technology Inc. v. Commissioner*, T.C. Memo. 2000-388.

[4] *Xilinx v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), *superseding* 567 F.3d 482 (9th Cir. 2009), *aff'g* 125 T.C. 37 (2005).

In 2015 the Tax Court in *Altera* held that the SBC regulations — materially identical to those in place today — were invalid in a unanimous 15-0 opinion. A divided Ninth Circuit then reversed the Tax Court, only to once again withdraw its opinion. In 2019 it issued a new opinion reversing the Tax Court, with Judge Kathleen O'Malley — a Federal Circuit judge sitting by designation — dissenting. A petition for rehearing en banc was denied, with three more dissenters, and in 2020 the Supreme Court declined to grant certiorari.

That is likely not the end of the saga. Because of the *Golsen* rule,[5] the current state of the law is far from certain for taxpayers outside the Ninth Circuit. The Tax Court opinion in *Altera* provides solid grounds for a position that the regulation is invalid, and other taxpayers may take up Altera's torch and bring regulatory challenges in other circuits, and potentially even to the Supreme Court. Moreover, taxpayers in the Ninth Circuit may pay the additional tax resulting from the application of the regulations and then sue for a refund in the Court of Federal Claims. Because an appeal from the Court of Federal Claims would go to the Federal Circuit, the Ninth Circuit decision in *Altera* would not be binding precedent. But any such challenges will take years to percolate through the system. It took almost 13 years for the IRS and courts to take *Xilinx* from tax return to a final decision; *Altera* took almost 15.[6] Many people assumed that the story ended with the denial of certiorari when in fact there is likely another chapter in the making.

After the 2015 Tax Court decision that invalidated the SBC regulations, many taxpayers stopped including SBC costs in IDCs. This wasn't opportunism; it was an exercise in following the law as these taxpayers understood it because the Tax Court had unanimously held that the inclusion of SBC costs was inconsistent with the arm's-length standard. In the authors' experience, nearly all these taxpayers had previously been abiding by the SBC regulations for many years, despite having serious reservations about the regulations' validity.

The selection of return positions in an uncertain legal environment is an especially fraught decision in the context of CSAs. Reg. section 1.482-1(a)(3) would preclude a taxpayer from later reducing its taxable income on an already-filed return. Thus, if a court later determines that the SBC regulations are invalid, a taxpayer who previously complied with the SBC rules may have procedural difficulty amending a return to align with that change in law.

Over the years, taxpayers have added terms to their CSAs in an attempt to cope with the frequent retroactive shifts of the law in this area. After the *Xilinx* decision, many taxpayers revised their CSAs to include so-called clawback provisions, which would require cumulative payback of previously shared SBC costs if the SBC regulations were withdrawn or invalidated by a final decision of a court. Likewise, after the Tax Court's decision in *Altera*, many taxpayers addressed the possibility of a different outcome on appeal by adding so-called *reverse* clawback provisions. These required a cumulative catch-up payment for unshared SBC costs in the event that the SBC regulations were upheld by a final decision in *Altera* or by another triggering event. Under most reverse clawback provisions, the triggering event occurred in 2020 when the Supreme Court denied certiorari in *Altera*, although some taxpayers may have viewed the event as occurring in 2019 when the Ninth Circuit issued its mandate upholding the SBC regulations. Importantly, these reverse clawback provisions would require a true-up payment for unpaid SBC costs in the year in which the provision is triggered.

IRS Position

Unfortunately for taxpayers with reverse clawback provisions, the chief counsel advice memorandum takes the position that the absence of SBC payments in earlier years generally cannot be adequately remedied by a true-up payment in the year of the triggering event. The memorandum cites regulatory language requiring that adjustments to cost-sharing

[5] *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd on other grounds*, 445 F.2d 985 (10th Cir. 1971), *cert. denied*, 404 U.S. 940 (1971). Under *Golsen*, the Tax Court will follow its own precedent unless the case is appealable to a circuit that has inconsistent precedent, in which case the Tax Court will follow the circuit's precedent as a matter of efficient and harmonious judicial administration.

[6] In fact, according to the Tax Court docket, even though certiorari was denied in June 2020, the Tax Court did not enter the final decision in *Altera* until July 2021.

transactions be made for the tax year in which the IDCs were incurred.[7]

The memorandum therefore recommends that adjustments for SBC costs be made to each of the open years at issue, either by the IRS exam team or by the taxpayer filing amended returns. To the extent that these adjustments are made, the IRS concedes that the adjustments will reduce the amount of any true-up obligation, freeing taxpayers from the need to make the payments twice.

Closed years are more problematic, and the memorandum suggests that the IRS may either make adjustments to open years under reg. section 1.482-7(i)(5) or require a taxpayer to adhere to the terms of its reverse clawback provision to include the closed-year amounts in the true-up year. An adjustment under reg. section 1.482-7(i)(5) would allow the IRS to impute an agreement under which the U.S. participant has an ownership interest in what were purportedly the foreign participant's interests in the cost-shared intangibles. In most cases, if a taxpayer affirmatively makes a true-up payment for closed years and includes an appropriate amount of interest, it appears that there is not a serious risk that the IRS would opt to make a reg. section 1.482-7(i)(5) adjustment instead.

Discussion

The IRS position that SBC adjustments should be made on a year-by-year basis is not surprising. That position is supported by the regulations, and it eliminates the need to consider the effect of the changes in tax rates and other international tax rules arising from the Tax Cuts and Jobs Act on true-up payments. In 2015, when taxpayers first entered into reverse clawback provisions, truing up unpaid SBC in a subsequent year and making annual adjustments would generally have had a materially similar tax effect. The TCJA changed that. New features of the U.S. tax system like a lower corporate rate, global intangible low-taxed income, and section 965 repatriation could affect whether a true-up yields results similar to annual adjustments. This could all be taken into account, of course, in calculating an appropriate substitute true-up payment. But verifying that would require the IRS to perform more work, and the chief counsel advice memorandum signals that it is not a task the agency is looking to take on.

Still, one wonders whether the approach articulated in the memorandum is actually in the interest of good tax administration. Taxpayers that adopted reverse clawback provisions have already articulated, and bound themselves to, an intent to include SBC costs in their CSAs if the rule requiring SBC inclusion is held to be valid. Several alternative approaches could have been taken here. The IRS could have simply allowed these true-up payments on taxpayers' 2020 returns. It could even have issued guidance explaining the need to adjust true-up payments to reflect relevant TCJA provisions, or relaxed reg. section 1.482-1(a)(3) in this context so that taxpayers could attempt to fully comply without the fear of whipsawing themselves. And it could have done all this without losing the power to later audit any true-ups it believed were inaccurate or inappropriate. Any of these approaches could have protected the fisc and encouraged voluntary compliance without requiring a tidal wave of amended returns that the IRS may not have the resources to review.

Instead, the position in the memorandum puts taxpayers in something of a bind: For taxpayers that made their true-up payments in 2019, there is no guarantee that double tax relief to eliminate the 2019 true-up would be available if they went back and amended returns. The memorandum notes that "the IRS may correct any overinclusion of income in the triggering event year by reason of a true-up overpayment under its authority in reg. section 1.482-1(a)(2)," but it does not go so far as to state that exam teams *should* actually do so. Relief may be available through the mutual agreement procedure for taxpayers whose CSA counterparties are located in treaty countries, but MAP is a lengthy process, and one that does not need to be overburdened with additional cases.

Taxpayers that made true-up payments in 2020 may fare better. If a 2020 return has not yet been filed, it may be possible to recharacterize the payment (for example, as a distribution); if a return has been filed, taxpayers may still be able

[7] Reg. section 1.482-7(i)(2)(iii).

to reach the same outcome through a superseding return. But these are complex questions, and the timing of the memorandum does not leave much time to address them before October 15, the 2020 return due date (taking into account the automatic six-month extension) for calendar-year corporate taxpayers. Inevitably, some taxpayers that have made true-up payments will find they are not in a position to amend returns.

One key takeaway from the memo is that the IRS is treating reverse clawback provisions as valid, but only as a backstop for adjustments that cannot be achieved through the regulations alone. This is reflected in the conclusion that the IRS can hold taxpayers to the terms of their contracts, and also in the conclusion that, if SBC adjustments are made to prior years, the true-up due is reduced accordingly. This approach to out-of-period true-ups is good news for taxpayers that adopted regular clawback provisions to claw back SBC payments if the SBC regulations are ever invalidated by a final decision. The IRS's legitimization of reverse clawback provisions would make it difficult for the agency to take a different stance on regular clawback provisions if *Altera* is ever reversed. Of course, whether taxpayers should keep regular clawback provisions in their CSAs is a separate question — since it could well take a decade for a potential circuit split to reach the Supreme Court, some taxpayers could be left with 25 years or more of SBC costs to unwind.

Whether amending returns or making true-ups, taxpayers should be aware that setoff opportunities may exist. If platform contribution transaction (PCT) payments were based on an income method that excluded SBC costs from projected IDCs, the PCT payments were likely overstated. Of course, quantifying these opportunities, and determining how to correctly report SBC inclusions in light of any overstated PCT payments, is a complicated exercise. With 2020 return deadlines looming, swift action is key.

Conclusion

An IRS approach that favored the carrot over the stick for post-*Altera* compliance might have been hoped for, but that is not what the chief counsel advice memorandum offers. Taxpayers with reverse clawback provisions now have a relatively short period to work through the implications of the memorandum and figure out what to include — and what to exclude — on their 2020 returns. Complying with the Ninth Circuit's *Altera* decision has become more fraught than many anticipated, but it is not all bad news, and PCT setoffs may provide a silver lining to some taxpayers facing increased tax bills as a result of SBC inclusions.[8] ■

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