

20, 2002. After consideration of all the comments, the proposed regulations under section 482 of the Code are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

These final regulations are the first in a series of regulatory guidance under section 482 through which Treasury and the IRS intend to update, clarify and improve current regulatory guidance in the transfer pricing area. A broader regulatory project on the treatment of QCSAs and a regulatory project on the transfer pricing of services are in progress, and Treasury and the IRS intend to issue proposed regulations with respect to each project in the near term.

These final regulations set forth explicit provisions clarifying that stock-based compensation is taken into account in determining the operating expenses treated as intangible development costs of a controlled participant in a QCSA under § 1.482-7. These final regulations provide rules for measuring the cost associated with stock-based compensation; clarify that the utilization and treatment of stock-based compensation is appropriately taken into account as a comparability factor for purposes of the comparable profits method under § 1.482-5; and provide rules that coordinate the rules of § 1.482-7 regarding QCSAs with the arm's length standard as set forth in § 1.482-1.

Treasury and the IRS received comments with respect to the proposed regulations. Most commentators objected to the proposed regulations in their entirety or suggested postponement of their finalization. Some commentators suggested modifications to be adopted in the event that the proposed regulations were finalized in some form.

After fully considering these comments, Treasury and the IRS continue to believe that the proposed regulations reflect a sound application of established principles under section 482. At the same time, Treasury and the IRS have concluded that certain suggested modifications to the administrative provisions of the proposed regulations are appropriate. These modifications are incorporated into the final regulations.

A. Stock-Based Compensation as a Cost To Be Shared and the Arm's Length Standard as Applied to QCSAs— §§ 1.482-7(d)(2)(i) and (a)(3), and 1.482-1(a)(1), (b)(2)(i) and (c)

A QCSA subject to the rules of § 1.482-7 is an arrangement to develop intangibles which meets certain administrative and other requirements and in which the participants to the arrangement share intangible development costs in proportion to their shares of reasonably anticipated benefits attributable to the intangibles developed under the arrangement. In the case of a QCSA, § 1.482-7(a)(2) limits the ability of the Commissioner to make allocations, except to the extent necessary to make each controlled participant's share of the costs equal its share of reasonably anticipated benefits. An arrangement in which significant intangible development costs are not shared in proportion to reasonably anticipated benefits (or are not shared at all) would not in substance constitute an arrangement to which the rules of § 1.482-7 are applicable.

The proposed regulations address the treatment of stock-based compensation under a QCSA, and the interaction between the rules applicable to QCSAs and the arm's length standard. The proposed regulations provide that stock-based compensation related to the covered intangible development area must be taken into account in determining the costs to be shared by participants in a QCSA. The proposed regulations further provide that a QCSA produces results consistent with an arm's length result if, and only if, all costs related to the intangible development, as determined in accordance with the specific guidance in § 1.482-7(d), are shared in proportion to reasonably anticipated benefits.

Commentators objected to this rule on the basis of interpretations of the arm's length standard and on other grounds.

1. Comments Relating to Arm's Length Standard

Commentators asserted that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard unless there is evidence that parties at arm's length take stock-based compensation into account in similar circumstances. Commentators asserted that third-party evidence, such as the government's own procurement contracting practices and agreements between unrelated parties with some characteristics similar to QCSAs, would show that parties at arm's length do not take stock-based compensation into

account in determining costs to be reimbursed.

Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for purposes of QCSAs is consistent with the legislative intent underlying section 482 and with the arm's length standard (and therefore with the obligations of the United States under its income tax treaties and with the OECD transfer pricing guidelines). The legislative history of the Tax Reform Act of 1986 expressed Congress's intent to respect cost sharing arrangements as consistent with the commensurate with income standard, and therefore consistent with the arm's length standard, if and to the extent that the participants' shares of income "reasonably reflect the actual economic activity undertaken by each." See H.R. Conf. Rep. No. 99-481, at II-638 (1986). The regulations relating to QCSAs implement that legislative intent by using costs incurred by each controlled participant with respect to the intangible development as a proxy for actual economic activity undertaken by each, and by requiring each controlled participant to share these costs in proportion to its anticipated economic benefit from intangibles developed pursuant to the arrangement. In order for the costs incurred by a participant to reasonably reflect its actual economic activity, the costs must be determined on a comprehensive basis. Therefore, in order for a QCSA to reach an arm's length result consistent with legislative intent, the QCSA must reflect all relevant costs, including such critical elements of cost as the cost of compensating employees for providing services related to the development of the intangibles pursuant to the QCSA. Treasury and the IRS do not believe that there is any basis for distinguishing between stock-based compensation and other forms of compensation in this context.

Treasury and the IRS do not agree with the comments that assert that taking stock-based compensation into account in the QCSA context would be inconsistent with the arm's length standard in the absence of evidence that parties at arm's length take stock-based compensation into account in similar circumstances. Section 1.482-1(b)(1) provides that a "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that *would have been realized* if uncontrolled taxpayers *had engaged* in the same transaction under the same circumstances." (Emphasis added). While the results actually realized in similar transactions under