

require further refinement through proration. Further, additional recordkeeping and analysis necessary to identify relevant time periods and employee activities involving the covered intangibles and to perform proration calculations are not warranted.

The proposed regulations set forth special rules for the application of the general rule of measurement in the event of modification of a stock option and expiration or termination of a QCSA. The final regulations retain these rules with technical modifications.

*E. Treatment of Statutory Stock Options—§ 1.482-7(d)(2)(iii)(A)(1)*

Under the default measurement rule in the proposed regulations, a special rule applies to statutory stock options (also referred to as incentive and employee stock purchase plan stock options). Under this special rule, the spread on statutory stock options generally is taken into account for QCSA purposes on exercise, even though section 421 denies a deduction with respect to statutory stock options unless and until there is a disqualifying disposition of the underlying stock by the employee.

One commentator suggested that the special rule for statutory stock options should be removed because it imposes an unnecessary administrative burden on taxpayers to apply different rules for different purposes. This suggestion was not adopted in the final regulations. Treasury and the IRS believe that the more important concern is consistent treatment of statutory and nonstatutory stock options for this purpose. This consistency is achieved only if the spread on both statutory and nonstatutory options is included in the cost pool on exercise.

*F. Elective Method of Measurement—§ 1.482-7(d)(2)(iii)(B)*

The proposed regulations permit an elective method of measurement and timing with respect to options on publicly traded stock of companies subject to financial reporting under U.S. generally accepted accounting principles (U.S. GAAP), provided that the stock is traded on a U.S. securities market. Under the election, the amount taken into account for QCSA purposes associated with compensatory stock options is their "fair value," generally measured by reference to economic pricing models as of the date of grant, as reflected either as a charge against income or as a footnote disclosure in the company's audited financial statements, in compliance with current U.S. GAAP.

One commentator proposed that the elective measurement method be made available to all taxpayers. The commentator further suggested that controlled participants should be permitted to use any reasonable method to measure stock-based compensation in the form of options on stock of foreign corporations as long as that method is consistent with international accounting standards or with accounting principles that are prevalent in the home country of the controlled participant. In the commentator's view, the limitations in the proposed regulations are not justified by difficulty of valuation and may be vulnerable to challenges under anti-discrimination clauses in U.S. income tax treaties.

Treasury and the IRS agree that the elective method should be more broadly available and have modified these rules in the final regulations. Specifically, the final regulations extend the availability of the elective method to options on the stock of certain companies that prepare their financial statements in accordance with accounting principles other than U.S. GAAP, while continuing to limit the availability of the elective method to options on stock that is publicly traded on a U.S. securities market. Thus, the availability of the elective method is not extended to options on stock of privately held companies or companies whose stock is traded only on foreign securities markets.

Treasury and the IRS believe that objectivity and ease of administration are important features of any method of measuring costs attributable to stock-based compensation for purposes of QCSAs. The elective method should be available only for options on stock whose value is readily determinable and for companies that are required to determine the fair value of stock options for a non-tax purpose. Treasury and the IRS recognize that foreign-based companies whose stock is traded on a U.S. securities market (directly or through the use of American Depository Receipts) are required to determine the fair value of options on their stock even though they do not necessarily prepare financial statements in accordance with U.S. GAAP. Companies satisfy that requirement by preparing financial statements in accordance with a comprehensive body of generally accepted accounting principles (GAAP) that is consistent with the U.S. GAAP requirement of determining the fair value of stock options, or by preparing reconciliations of their financial statements with U.S. GAAP in a manner that reflects the fair value of stock options.

Accordingly, the final regulations provide that in determining eligibility for the elective method, financial statements prepared in accordance with GAAP other than U.S. GAAP are considered as prepared in accordance with U.S. GAAP in two circumstances. First, financial statements are considered as prepared in accordance with U.S. GAAP where the fair value of stock options is reflected in a legally required reconciliation between the applicable GAAP and U.S. GAAP. In such a case, the fair value of stock options for purposes of the elective method of measurement will be the fair value reflected in such reconciliation. Second, financial statements are considered as prepared in accordance with U.S. GAAP where, under the applicable GAAP, the fair value of stock options is reflected as a charge against income in audited financial statements or is disclosed in footnotes to such statements. In such a case, the fair value of stock options for purposes of the elective method of measurement will be the fair value reflected in such audited financial statements.

Treasury and the IRS continue to believe that the elective method should be available only for options on stock whose value is readily determinable and for companies that are required to determine the fair value of stock options for a non-tax purpose. Accordingly, the final regulations do not extend the availability of the elective method to options on stock of privately held companies or companies whose stock is traded only on foreign securities markets.

One commentator suggested that the election to use the elective method should be made on the taxpayer's return rather than evidenced in the written cost sharing agreement. In the view of the commentator, such a procedure would be more practical from an enforcement perspective.

This suggestion was not adopted. Treasury and the IRS continue to believe that the most effective way to ensure that all participants are bound by the election is to incorporate it within the written cost sharing agreement.

*G. Modification of Comparable Profits Method—§ 1.482-5(c)(2)(iv)*

The proposed regulations provide that in applying the comparable profits method, if there are material differences among the tested party and uncontrolled comparables with respect to the utilization or treatment of stock-based compensation, such material differences are an appropriate basis for comparability adjustments. One commentator expressed the view that