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Section 482 adjustments for cost-sharing agreements with reverse claw-back provisions (Chief Counsel legal advice memo)

The IRS today publicly released a legal advice memorandum¹ (from the Office of the Chief Council) regarding the application of section 482 and transfer pricing examinations of stock-based compensation (SBC) costs involving taxpayer cost-sharing agreements under which the taxpayer did not share SBC costs but included a “reverse claw-back” provision.

[AM 2021-004](#) [PDF 110 KB] (released July 16, 2021, and dated July 13, 2021)

Background

Following the Tax Court’s 2015 decision in *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015), *rev’d*, 926 F.3d 1061 (9th Cir. 2019), cert. denied, 141 S. Ct. 131 (2020), many taxpayers with cost-sharing arrangements (CSAs) ceased to share SBC costs. These CSAs are referred to as “Non-SBC SCAs.”

Many of these taxpayers included provisions, commonly referred to as “reverse claw-back” provisions, in their Non-SBC CSAs, requiring catch-up SBC payments if and when the SBC regulations challenged in *Altera* were upheld by a final decision in *Altera* or another triggering event.

The cost-sharing regulations provide the IRS with discretion to make allocations of IDCs so that the results of a CSA or other cost-sharing agreement are consistent with an arm’s length result. Reg.

¹ Legal advice memoranda are signed by executives in the National Office of the Office of Chief Counsel and issued to Internal Revenue Service personnel who are national program executives and managers. The memos are issued to assist IRS personnel in administering their programs by providing authoritative legal opinions on certain matters, such as industry-wide issues. The memos cannot be used or cited as precedent.

section 1.482-7(b) refers to the CSA participants' cost-sharing transactions (CSTs) whereby the participants make payments to each other so that in each tax year, each participant's IDC share is in proportion to its reasonably anticipated benefits (RAB) share.

The IRS memo focuses on reverse claw-back provisions that are triggered by a final decision in *Altera* or other event and require a cost-sharing participant to make a true-up payment for the cumulative amount of unshared SBC costs from prior years.

Issues and conclusions

The issues presented in the memo are:

1. What is an appropriate year for a section 482 adjustment to include SBC costs in the cost pool for a Non-SBC CSA that contains a reverse claw-back provision?
2. If the IRS adjusts the results of a CST in a Non-SBC CSA 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?
3. If a section 482 allocation to adjust the results of a CST in the year the IDCs were incurred is not possible for certain years, may the IRS make an adjustment in another year to ensure that SBC costs are appropriately accounted for in a Non-SBC CSA that contains a reverse claw-back provision?

In the memo, the IRS concluded:

1. Under Reg. section 1.482-7(i)(2), the IRS may make allocations to adjust the results of a CST so that the results are consistent with an arm's length result, including any allocations to make each controlled participant's IDC share equal to that participant's RAB share. Further, under Reg. section 1.482-7(i)(2)(iii), if the IRS makes an allocation to adjust the results of a CST, the allocation will be reflected for tax purposes in the year in which the IDCs were incurred.
2. If the IRS adjusts the results of a CST for a tax year to account for SBC costs, that adjustment is to be treated as reducing the amount of any reverse claw-back true-up obligation by a corresponding amount—thereby avoiding an overpayment of the SBC costs.
3. If allocations to adjust the results of a CST in the year the IDCs were incurred are not possible for certain years, the IRS may make other adjustments, if necessary, to reflect the contract or to ensure that the Non-SBC CSA produces results that are consistent with an arm's length result within the meaning of Reg. section 1.482-1(b)(1). For example, the IRS may make allocations under Reg. section 1.482-7(i)(5) when CSTs are consistently and materially disproportionate to RAB shares. In addition, if a taxpayer disregards a reverse claw-back clause in a Non-SBC CSA (or modifies the clause to modify, defer or remove the obligation to make a true-up payment in accordance with the contract), the IRS may make appropriate allocations in the year the true-up is or (but for the modification) would have been triggered to produce results consistent with the unmodified contract or otherwise to reflect an arm's length result.

KPMG observation

With regard to the first conclusion of the memo, taxpayers may need to consider filing amended returns for all open years if no true-up has been reported on a filed return.

Concerning the second conclusion, taxpayers that have made a true-up payment in 2020 but have not yet filed their 2020 returns need to consider reducing the amount reported as an IDC payment to the

amount of any SBC related to closed tax years, plus an appropriate interest charge.

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