Caplin & Drysdale
ATTORNEYS

Reverse Claw-Backs Revisited: IRS Issues Post-*Altera* Guidance on Adjustments for Stock-Based Compensation Costs and Cost Sharing Arrangements

July 22, 2021

An IRS Office of Chief Counsel memorandum released July 16, 2021[1] provides a roadmap for IRS transfer pricing examinations involving cost sharing agreements[2] that omit stock-based compensation (SBC) from the pool of shared intangible development costs (IDCs).

At first blush, the new guidance appears focused on inter-company agreements with "reverse claw-back" provisions. As discussed in our September 2020 Alert,[3] these provisions typically require participants in non-SBC cost sharing agreements to make true-up payments in the event of a final court decision upholding Treasury's SBC regulations. The memorandum's scope is much wider, however. It clarifies issues around the timing and calculation of post-*Altera* SBC-related transfer pricing adjustments that are relevant for all non-SBC cost sharing agreements. More generally, the new guidance telegraphs the IRS' confidence in its broad authority to make SBC-related transfer pricing adjustments. The memorandum's core message seems to be: The IRS' authority to implement post-*Altera* adjustments in respect of non-SBC cost-sharing agreements, and the mechanics of those adjustments' implementation, are largely unaffected by the presence or absence of a reverse claw-back provision.

Reverse Claw-Back Provisions and *Altera*

As summarized in our prior Alert, some taxpayers added reverse claw-back provisions to their cost sharing agreements in connection with the *Altera* litigation. This litigation began in the U.S. Tax Court in 2012 when Altera Corporation challenged the regulations[4] that require SBC costs to be included in IDCs under a cost sharing agreement. In light of the uncertainty regarding whether the SBC regulations would be upheld, some taxpayers structured their cost sharing agreements to exclude SBC costs from the IDC calculation, but also required participants to make one-time true-up payments covering these excluded SBC costs—in other words, to make "reverse claw-back" payments—in the event that the SBC regulations were upheld in a final court decision.

---

[1] IRS Office of Chief Counsel (Peter H. Blessing, Associate Chief Counsel (International)), No. AM 2021-004, Section 482 Adjustments for Cost Sharing Agreements with Reverse Claw-Back Provisions (released July 16, 2021), https://www.irs.gov/pub/lanoa/am-2021-004.pdf [hereinafter "Memorandum"].

[2] In cost sharing arrangements, "controlled participants share the costs and risks" of developing intangible property such as patents and formulas. *See* Treas. Reg. § 1.482-7(b). Participants in cost sharing arrangements must make payments to each other so that for each taxable year, a participant's share of the costs to develop the intangible property is proportional to the participant's share of the "reasonably anticipated benefits" from exploiting the developed intangible property. *See* Treas. Reg. § 1.482-7(b)(1)(i).

[3] *IRS Kicks Off Post*-Altera *Audit Adjustments* (Sept. 21, 2020), https://www.caplindrysdale.com/files/27710_irs_kicks_off_post-altera_audit_adjustments.pdf

[4] *See* Treas. Reg. §§ 1.482-7A(d)(2). The new guidance describes the current SBC regulations in Treasury Regulation § 1.482-7(d)(3) as "materially the same as the corresponding provisions of" the prior regulations challenged and upheld in the *Altera* litigation. *See* Memorandum at 1.

Although the Tax Court in 2015 ruled in Altera's favor and invalidated the SBC regulations,[5] the U.S. Court of Appeals for the Ninth Circuit reversed the Tax Court and upheld the SBC regulations.[6] After the U.S. Supreme Court in 2020 declined to hear Altera's appeal, some reverse claw-back payments contingent on the final outcome of *Altera* came due. The new guidance from the IRS Office of Chief Counsel describes how the IRS plans to address timing and authority issues raised by SBC reverse claw-back provisions.

Timing of Adjustments and True-Ups

The new guidance addresses two timing issues related to IRS transfer pricing adjustments of payments made among participants in a non-SBC cost sharing agreement. By its terms, the memorandum discusses such issues only in respect of agreements that include reverse claw-back provisions,[7] but the positions and authority are much more widely applicable—signaling that taxpayers that added reverse claw-back provisions to their agreements are in no better position than those that did not (and in fact may be worse off).

- First, the memorandum notes that IRS adjustments to the results of a CST[8] may be reflected in the tax year in which the related IDCs were incurred.[9] Therefore, if that tax year is not yet closed, the appropriate year in which to include SBC costs after a section 482 adjustment is the tax year in which the SBC costs were incurred. This is true regardless of whether the non-SBC cost sharing agreement includes a reverse claw-back provision.

- Second, the memorandum addresses situations where the IRS is unable to adjust the results of CSTs in the year that related IDCs were incurred. In that case, in order to achieve an arm's length result or to respect the contractual obligations of the parties, the memorandum concludes that the IRS may make allocations—the amounts of which may include an appropriate charge for interest—"in an appropriate year."[10] Like its guidance on the timing of adjustments generally, the memorandum's guidance on closed years seems relevant for all non-SBC cost sharing agreements, not just those with reverse claw-back provisions. As the memorandum notes, this authority already exists under Treasury Regulation § 1.482-7(i)(5), even in the absence of a reverse claw-back provision.[11]

In addition, the memorandum offers guidance on the amounts of SBC-related transfer pricing adjustments where a reverse claw-back provision is present and has been triggered; in short, they are unaffected. A true-up

---

[5] *See Altera Corp. v. Commissioner*, 145 T.C. 91 (2015).

[6] *See Altera Corp. v. Commissioner*, 926 F.3d 1061 (9th Cir. 2019), *cert. denied*, 141 S. Ct. 131 (2020).

[7] *See, e.g.*, Memorandum at 1 ("This memorandum discusses issues related to transfer pricing examinations of stock-based compensation ('SBC') costs involving taxpayers' cost sharing agreements under which they did not contract to share SBC costs ('Non-SBC CS Agreements') *and included so-called 'reverse claw-back' provisions in their contracts*." (emphasis added)).

[8] Cost sharing transactions (CSTs) include the payments made among participants to share IDCs each year. *See* Treas. Reg. § 1.482-7(b)(1)(i).

[9] *See* Treas. Reg. § 1.482-7(i)(2)(iii); Memorandum at 5.

[10] *See* Memorandum at 6 & n.13.

[11] *See* Memorandum at 5, 6.

payment in a later year does not offset or reduce the amounts of adjustments for the years in which IDCs were incurred; rather, the reverse is true. Analogizing a reverse claw-back provision to a contingent obligation, the memorandum explains that an IRS adjustment of the results of a CST should be treated as reducing any true-up payment due under a reverse claw-back provision.[12]

Tactical Considerations for Taxpayers

The memorandum also addresses situations in which the presence of a reverse claw-back provision could complicate application of the timing rules described above—and ultimately leave the taxpayer worse off.

First, as the guidance acknowledges, an overinclusion of income could result if an event occurs that prompts a reverse claw-back payment, and the IRS later makes an SBC-related section 482 adjustment (including an adjustment initiated by a taxpayer filing an amended return) for a tax year before the year in which the event occurred. To avoid whipsaw, the taxpayer may exclude from income on its timely filed return the portion of any reverse claw-back payment that duplicates adjustments for earlier years.[13] But if the return for the triggering event year has already been filed, absent a further IRS transfer pricing adjustment to correct for the overinclusion, the taxpayer must pursue a claim for refund.[14] A taxpayer should therefore carefully assess the risks before making (or accepting) a reverse claw-back payment in the triggering event year, and Compliance Assurance Program taxpayers should coordinate such issues with their examination teams.

Second, many taxpayers with non-SBC cost sharing agreements involving closed years will enjoy an arbitrage benefit, having claimed deductions for SBC costs in a 35% corporate tax rate environment that may be reversed currently, at a 21% rate (or potentially lower, if the current inclusion qualifies as foreign-derived intangible income). Taxpayers whose cost sharing agreements do not include reverse claw-back provisions must include SBC in IDCs for post-*Altera* years but have no obligation to file amended returns for earlier years or to make a true-up payment in the current year. They can play the odds and await an audit. Taxpayers whose agreements include reverse claw-back provisions do not have this choice. As the memorandum warns, "a taxpayer may not disavow the terms of its contract to obtain a tax benefit."[15] If a taxpayer ignores, changes, delays, or deletes a reverse claw-back provision in a cost sharing agreement, the IRS may make allocations in the year the reverse claw-back payment was due for the full amount that should have been paid.[16]

IRS Authority to Make SBC Adjustments

Throughout, the memorandum emphasizes the IRS' broad authority—under the Treasury Regulations, the "clear reflection of income doctrine," and the tax benefit rule—to make SBC-related allocations to achieve an arm's

---

[12] *See* Memorandum at 5-6.

[13] Treas. Reg. § 1.482-1(a)(3).

[14] If the refund claim were denied, relief could be available through the mitigation rules *See* I.R.C. §§ 1311-1314.

[15] *See* Memorandum at 6.

[16] *See* Memorandum at 6-7. The memorandum applies the tax benefit doctrine to conclude that SBC-related deduction amounts claimed in previous years must be included as income during the year that the reverse claw-back provision is activated, to the extent that the deductions provided a tax benefit to the taxpayer.

length result. Although the precedential value of the holding in *Altera* is uncertain, the emphasis in this new guidance on the strength and variety of IRS authority to address SBC-related issues may signal that, regardless of how courts outside the Ninth Circuit view *Altera*, the IRS will not hesitate to pursue SBC-related adjustments.

On the whole, the new guidance underscores the importance of conducting the risk assessment described in our September 2020 Alert. This assessment includes quantifying the amounts of income and tax at stake for open tax years, with the possibility of a six-year statute of limitations, in which SBCs were omitted from IDCs. The next step is to develop and implement a strategy, consulting with counsel as needed on transfer pricing, procedural, and state and local tax considerations.

For further information on this Alert, please contact members of Caplin & Drysdale's International Tax Group:

J. Clark Armitage
carmitage@capdale.com
202.862.5078

Elizabeth J. Stevens
estevens@capdale.com
202.862.5039

Heather D. Schafroth
hschafroth@capdale.com
202.862.5051

Disclaimer
This communication does not provide legal advice, nor does it create an attorney-client relationship with you or any other reader. If you require legal guidance in any specific situation, you should engage a qualified lawyer for that purpose. Prior results do not guarantee a similar outcome.

Attorney Advertising
It is possible that under the laws, rules, or regulations of certain jurisdictions, this may be construed as an advertisement or solicitation.