**DEPARTMENT OF STATE**

**22 CFR Part 120**

**[Public Notice 4440]**

**RIN AB–62**

## Bureau of Political-Military Affairs; Amendment to the International Traffic in Arms Regulations; Corrections

**AGENCY:** Department of State.

**ACTION:** Correcting amendments.

**SUMMARY:** This document makes corrections to the final regulations (Public Notice 4274), which were published in the **Federal Register** of Friday, February 14, 2003.

**EFFECTIVE DATE:** Effective on January 29, 2003.

**FOR FURTHER INFORMATION CONTACT:** Mary Sweeney, Office of Defense Trade Controls Management, Bureau of Political-Military Affairs, Department of State, (202) 663–2700.

**SUPPLEMENTARY INFORMATION:**

### Background

The Department of State published a final rule (Public Notice 4274) in the **Federal Register** of February 14, 2003, (68 FR 7417), amending § 120.1 General authorities and eligibility, of the International Traffic in Arms Regulations.

### Need for Correction

As published, the final regulations contain errors which may prove to be misleading and need to be clarified.

### List of Subjects in 22 CFR Part 120

Arms and munitions, Classified information, Exports.

■ Accordingly, 22 CFR part 120 is corrected by making the following correcting amendments:

## PART 120—PURPOSE AND DEFINITIONS

■ 1. The authority citation for part 120 continues to read as follows:

**Authority:** Secs. 2, 38, and 71, Pub. L. 90–629, 90 Stat. 744 (22 U.S.C. 2752, 2778, 2797); 22 U.S.C. 2794; E.O. 11958, 42 FR 4311; 3 CFR, 1977 Comp. p. 79; 22 U.S.C. 2658; Pub. L. 105–261, 112 Stat. 1920.

■ 2. Revise paragraphs (b)(2) and (b)(2)(ii) of § 120.1 to read as follows:

**§ 120.1 General authorities and eligibility.**

* * * * *

(b) * * *

(1) * * *

(2) In the Bureau of Political-Military Affairs, there will be a Deputy Assistant Secretary for Defense Trade Controls (DAS—Defense Trade Controls) and a Managing Director of Defense Trade Controls (MD—Defense Trade Controls). Initially, one individual will hold both the DAS—Defense Trade Controls and MD—Defense Trade Controls positions. The position of Director, Office of Defense Trade Controls will be abolished. The DAS—Defense Trade Controls/MD—Defense Trade Controls will assume all duties, responsibilities, and authorities held under the ITAR by that Director. The MD—Defense Trade Controls has responsibility for the Directorate of Defense Trade Controls, which will oversee the subordinate offices described in paragraph (b)(2)(i) of this section.

(i) * * *

(A) * * *

(B) * * *

(C) * * *

(D) * * *

(ii) Further amendments to the ITAR will be promulgated to reflect the specific changes as a result of this realignment.

* * * * *

Dated: August 21, 2003.

**Timothy Egert,**

*Federal Register Liaison, Department of State.*

[FR Doc. 03–21804 Filed 8–25–03; 8:45 am]

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**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Parts 1 and 602**

**[TD 9088]**

**RIN 1545–BA57**

## Compensatory Stock Options Under Section 482

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations that provide guidance regarding the application of the rules of section 482 governing qualified cost sharing arrangements. These regulations provide guidance regarding the treatment of stock-based compensation for purposes of the rules governing qualified cost sharing arrangements and for purposes of the comparability factors to be considered under the comparable profits method.

**DATES:** *Effective Date:* These regulations are effective August 26, 2003.

*Applicability Dates:* For dates of applicability of these regulations, *see* §§ 1.482–1(j)(5) and 1.482–7(k).

**FOR FURTHER INFORMATION CONTACT:** Douglas Giblen, (202) 435–5265 (not a toll-free number).

**SUPPLEMENTARY INFORMATION**

### Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545–1794. Responses to these collections of information are required by the IRS to monitor compliance with the federal tax rules for determining stock-based compensation costs to be shared among controlled participants in qualified cost sharing arrangements.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent or recordkeeper varies from 2 hours to 7 hours, depending on individual circumstances, with an estimated average of 4 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### Background

On July 29, 2002, Treasury and the IRS published in the **Federal Register** (67 FR 48997) proposed amendments to the regulations (REG–106359–02) under section 482 of the Internal Revenue Code (Code). These proposed regulations provide guidance regarding treatment of stock-based compensation for purposes of qualified cost sharing arrangements (QCSAs) and the comparable profits method and clarify the coordination of the rules regarding QCSAs with the arm's length standard. Written comments responding to these proposed regulations were received, and a public hearing was held on November

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 similar circumstances ordinarily provide significant evidence in determining whether a controlled transaction meets the arm's length standard, in the case of QCSAs such data may not be available. As recognized in the legislative history of the Tax Reform Act of 1986, there is little, if any, public data regarding transactions involving high-profit intangibles. H.R. Rep. No. 99–426, at 423–25 (1985). The uncontrolled transactions cited by commentators do not share enough characteristics of QCSAs involving the development of high-profit intangibles to establish that parties at arm's length would not take stock options into account in the context of an arrangement similar to a QCSA. Government contractors that are entitled to reimbursement for services on a cost-plus basis under government procurement law assume substantially less entrepreneurial risk than that assumed by service providers that participate in QCSAs, and therefore the economic relationship between the parties to such an arrangement is very different from the economic relationship between participants in a QCSA. The other agreements highlighted by commentators establish arrangements that differ significantly from QCSAs in that they provide for the payment of markups on cost or of non-cost-based service fees to service providers within the arrangement or for the payment of royalties among participants in the arrangement. Such terms, which may have the effect of mitigating the impact of using a cost base to be shared or reimbursed that is less than comprehensive, would not be permitted by the QCSA regulations. Further, the QCSA regulations would not allow the Commissioner to impose such terms in the context of a QCSA.

The regulations relating to QCSAs have as their focus reaching results consistent with what parties at arm's length generally would do if they entered into cost sharing arrangements for the development of high-profit intangibles. These final regulations reflect that at arm's length the parties to an arrangement that is based on the sharing of costs to develop intangibles in order to obtain the benefit of an independent right to exploit such intangibles would ensure through bargaining that the arrangement reflected all relevant costs, including all costs of compensating employees for providing services related to the arrangement. Parties dealing at arm's length in such an arrangement based on the sharing of costs and benefits generally would not distinguish between stock-based compensation and other forms of compensation.

For example, assume that two parties are negotiating an arrangement similar to a QCSA in order to attempt to develop patentable pharmaceutical products, and that they anticipate that they will benefit equally from their exploitation of such patents in their respective geographic markets. Assume further that one party is considering the commitment of several employees to perform research with respect to the arrangement. That party would not agree to commit employees to an arrangement that is based on the sharing of costs in order to obtain the benefit of independent exploitation rights unless the other party agrees to reimburse its share of the compensation costs of the employees. Treasury and the IRS believe that if a significant element of that compensation consists of stock-based compensation, the party committing employees to the arrangement generally would not agree to do so on terms that ignore the stock-based compensation.

An arrangement between controlled taxpayers for the development of intangible assets in which one taxpayer's share of significant costs exceeds its share of reasonably anticipated benefits from the exploitation of the developed intangibles would not in substance be a QCSA and therefore would be subject to analysis under the other section 482 regulations. For example, as in the transactions cited by commentators, a controlled taxpayer might agree at the outset of an arrangement to bear a disproportionate share of costs in an arrangement in which it receives a service fee or a contingent royalty from the exploitation of the developed intangibles. More generally, controlled taxpayers might agree at the outset of an arrangement to determine the compensation of one party based on a subset of that taxpayer's costs or on a basis that does not take that taxpayer's costs into account at all (*e.g.*, based on an amount determined with reference to a comparable uncontrolled price or transaction). In either case, such an arrangement between controlled taxpayers would not in substance constitute an arrangement to which the rules of § 1.482–7 would apply. Indeed, the limitations contained in § 1.482–7(a)(2) could produce results inconsistent with an arm's length result if applied to such an arrangement because the Commissioner would be precluded from making allocations that could be necessary to ensure that each controlled taxpayer is compensated appropriately. Rather, such an arrangement should be analyzed under the other section 482 regulations (in particular, sections 1.482–1, 1.482–2(b), and 1.482–4) to determine whether it reaches results consistent with the arm's length standard, and any allocations by the Commissioner should be consistent with such other section 482 regulations.

2. Other Comments

Commentators offered various other reasons for not taking stock-based compensation into account in the context of QCSAs. Commentators expressed the view that stock-based compensation should not be taken into account because it does not constitute an economic cost or require a cash outlay, or, to the extent such compensation does constitute a cost, because the cost is borne by shareholders whose share value is diluted when additional shares are issued on exercise. Commentators also noted that the treatment of stock-based compensation for financial reporting purposes should not mandate that stock-based compensation be taken into account in the context of QCSAs.

In response to such views, and as discussed above, Treasury and the IRS continue to believe that requiring stock-based compensation to be taken into account for in the context of QCSAs is appropriate. The final regulations provide that stock-based compensation must be taken into account in the context of QCSAs because such a result is consistent with the arm's length standard. Treasury and the IRS agree that the disposition of financial reporting issues does not mandate a particular result under these regulations.

One commentator suggested that even if stock-based compensation generates a cost to a participant, there is precedent within the regulations relating to QCSAs for excluding certain costs, notably interest and taxes. Treasury and the IRS believe that the technical treatment under the regulations relating to QCSAs of interest, taxes and other expenses not related to the intangible development area does not warrant failing to take into account an element of employee compensation that is clearly related to the intangible development area. Treasury and the IRS believe that in order for the costs incurred by a participant to reasonably reflect its actual economic activity consistent with the legislative intent in this area, those costs must be determined on a comprehensive basis and so must take into account all relevant costs, in particular critical elements such as employee compensation. As noted above, Treasury and the IRS do not believe that there is a basis for distinguishing between stock-based compensation and other forms of compensation in this context.

One commentator also claimed that the historical administrative practice of the IRS has been not to challenge the failure to take stock-based compensation into account in other transfer pricing contexts in which the determination of cost is relevant. Treasury and the IRS believe that such perceived practices of the IRS with respect to other section 482 contexts are not relevant to determining the appropriate regulatory rule applicable to QCSAs.

As an alternate approach, one commentator suggested that rather than requiring stock-based compensation to be taken into account in the QCSA context, Treasury and the IRS should promulgate a ''stock-based compensation safe harbor'' applicable to QCSAs. This suggested ''safe harbor'' has not been adopted in the final regulations. As noted above, Treasury and the IRS believe that in order for the costs incurred by a participant to reasonably reflect its actual economic activity, those costs must be determined on a comprehensive basis and so must take into account all relevant costs, in particular critical elements such as employee compensation. The final regulations therefore require employee compensation to be taken into account, rather than provide for a safe harbor under which such compensation could be ignored.

*B. Grant-Date Identification Rule—§ 1.482–7(d)(2)(ii)*

The proposed regulations identify the stock-based compensation to be included in the cost pool based on whether the compensation is related to the intangible development area on the date the option is granted.

One commentator noted that this identification rule is inconsistent with the IRS treatment of stock-based compensation in other tax areas such as sourcing, where IRS rulings trace the compensation to the entire period over which the employee performed the services compensated by the option.

The grant-date identification rule has been retained in the final regulations. As noted in the preamble of the proposed regulations, it is desirable in the QCSA context to select a single date for identification of covered stock-based compensation. The grant of compensation generally is the single economic event most closely associated with the services being compensated.

*C. Provision of Specific Methods of Measurement and Timing*

The proposed regulations prescribe two alternative methods for determining the operating expenses attributable to stock-based compensation. The default rule under § 1.482–7(d)(2)(iii)(A) provides that the costs attributable to stock-based compensation generally are included as intangible development costs upon the exercise of the option and measured by the spread between the option strike price and the price of the underlying stock. An elective rule under § 1.482–7(d)(2)(iii)(B) provides that the costs attributable to stock options are taken into account in certain cases in accordance with the ''fair value'' of the option, as reported for financial accounting purposes either as a charge against income or in footnoted disclosures.

Commentators claimed that parties at arm's length would not use either of the alternatives prescribed in the proposed regulations because they would produce results that are too speculative or not sufficiently related to the employee services that are compensated. One commentator suggested that the final regulations should not limit taxpayers to the two prescribed measurement methods but rather should codify the current IRS administrative practice of permitting any reasonable method. In the commentator's view, a standard based on any reasonable method should permit the intrinsic-value method, which measures the difference between strike price and underlying stock value at date of grant, exclusive of time value. However, the commentator suggested that if Treasury and the IRS consider an element of time value indispensable, an alternative would be to require the use of the ''minimum value'' method, which accounts for the time value of stock options by assuming the underlying stock will grow at the risk-free interest rate.

These suggestions were not adopted. Treasury and the IRS believe that it is appropriate for regulations to prescribe guidance in this context that is consistent with the arm's length standard and that also is objective and administrable. As long as the measurement method is determined at or before grant date, either of the prescribed measurement methods can be expected to result in an appropriate allocation of costs among QCSA participants and therefore would be consistent with the arm's length standard. The results under the default measurement rule are consistent with what would occur under an arm's length agreement at or before the grant date to take stock-based compensation into account at the date of exercise when more facts are known and therefore to share the risks associated with such compensation between the date of grant and the date of exercise. The results under the elective measurement rule are consistent with what would occur under an alternative arm's length agreement at or before the grant date to determine the value of the compensation up front and take such compensation into account at that time. With respect to the specific methods proposed by commentators, Treasury and the IRS believe that ''intrinsic value'' ignores significant elements of the economic value of stock-based compensation and ''minimum value'' ignores the important variable of volatility that enters into the economic pricing models used for financial reporting purposes.

The prescribed measurement methods are objective and administrable because they rely on valuations or measurements of stock-based compensation prepared for other purposes. The prescribed measurement methods do not require or permit valuations of stock-based compensation specifically for QCSA purposes. A standard under which the validity of the taxpayer's method would have to be analyzed on a case-by-case basis would be unduly difficult to administer and potentially could lead to significant disputes.

*D. General Rule of Measurement—§ 1.482–7(d)(2)(iii)(A)*

Under the default measurement rule, the amount taken into account for QCSA purposes generally is the amount allowable as a federal income tax deduction on exercise of the stock-based compensation. This amount generally is the ''spread'' between the option price and the fair market value of the underlying stock at the date of exercise.

One commentator suggested that this method would be improved if the amount taken into account for QCSA purposes were limited to the portion of the spread that accrued between date of grant and full vesting, as further prorated to reflect only the time during which the employee was engaged in cost-shared activities.

This suggestion has not been adopted in the final regulations. Treasury and the IRS believe that the grant-date identification rule already limits in an appropriate way the stock-based compensation taken into account. The purpose of the default measurement rule is to measure the amount attributable to stock-based compensation that must be taken into account under the grant-date identification rule. Accordingly, the default measurement rule does not 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 this provision contradicts the arm's length coordination rules for QCSAs because the treatment of stock-based compensation by unrelated parties is considered relevant for purposes of the comparable profits method but not relevant for purposes of QCSAs.

No revision was made in response to this comment. Treasury and the IRS believe that the rule provided in the proposed regulations with respect to the application of the comparable profits method is appropriate because the financial data with respect to similar business activities that generally is used as a reference point for that method is subject to adjustment to ensure comparability.

*H. Effective Date and Transition Rules—§ 1.482–7(k) and (d)(2)(iii)(B)(2)*

The provisions of the proposed regulations applicable to QCSAs would apply to stock-based compensation granted in taxable years beginning on or after publication of final regulations. Participants in a QCSA in existence on the effective date may, on a one-time basis, amend their agreement to elect the grant-date method of measurement without the Commissioner's consent. The election with respect to existing QCSAs must be made not later than the latest due date, without regard to extensions, for an income tax return of a controlled participant for the first taxable year beginning after the effective date of final regulations.

One commentator stated that the prospective effective date does not afford taxpayers a reasonable time to amend their cost sharing agreements or restructure complex international operations. A transition period of two years after the publication of final regulations was suggested.

This suggestion was not adopted. Treasury and the IRS consider the period stated in the proposed regulations adequate for the initial planning and recordkeeping that may be occasioned by the final regulations.

With respect to the special transition rule permitting taxpayers to elect the grant-date method of measurement by amendment of an existing written cost sharing agreement no later than the latest due date of an income tax return of a controlled participant, one commentator suggested that the due date should not disregard filing extensions. The commentator maintained that fairness dictates affording taxpayers this extra time for the analysis needed to make this significant decision.

In response to this comment, the final regulations provide that the due date for amendments to existing cost sharing agreements is determined with regard to filing extensions.

Some commentators urged Treasury and the IRS to postpone finalization of the proposed regulations until the OECD completes its ongoing consideration of the treatment of stock options for transfer pricing purposes and an international consensus begins to form so that the potential for international disputes and resulting negative effects on U.S. business can be minimized. Similarly, a commentator suggested that the effects of applying the principles of the proposed regulations to other areas of transfer pricing should be thoroughly studied and harmonized before finalizing the regulations to avoid creating traps for the unwary or other unforeseen consequences.

These suggestions were not implemented. Treasury and the IRS do not believe that international discussion of issues compels the suspension of the regulatory process. Also, Treasury and the IRS believe that it is important to provide timely guidance on issues such as those addressed by the proposed and final regulations.

Finally, the preamble to the proposed regulations states that the proposed regulations clarify that stock-based compensation must be taken into account in the QCSA context. Several commentators interpreted this language as in effect requiring the new rules to be applied retroactively. These commentators urged that the final regulations contain further assurances of prospective intent and explicitly recognize that these regulations represent a fundamental change to the traditional approach to section 482.

No revisions were made in light of these comments. As noted earlier, Treasury and the IRS believe that requiring stock-based compensation to be taken into account in the QCSA context is consistent with the arm's length standard and long-standing policies underlying section 482. The final regulations, like the proposed regulations, clearly specify that the specific rules provided therein are prospective in application. Moreover, as stated in the proposed regulations, while taxpayers may rely on the proposed regulations until the effective date of the final regulations, no inference is intended with respect to the treatment of stock-based compensation granted in taxable years beginning before the effective date of these final regulations.

*I. Paperwork Reduction Act and Regulatory Flexibility Act*

One commentator expressed the view that the compliance burden imposed by the proposed regulations on each taxpayer will significantly exceed the two to seven hours estimated under the Paperwork Reduction Act. The commentator also asserted that the estimated number of taxpayers affected by the rules was too low.

The burden estimates as stated in the final regulations reflect no change. Treasury and the IRS reviewed the estimates made in the proposed regulations and concluded that they are reasonable.

Similarly, with respect to the Regulatory Flexibility Act, the commentator challenged the statement in the preamble of the proposed regulations that the new regulatory requirements will not have a significant economic impact on a substantial number of small entities. Upon review of available information, Treasury and the IRS found no basis for a change in the statement or in the operative finding that the economic impact of the collections of information in the proposed regulations is not significant with respect to small entities.

*J. Documentation Requirements and Other Provisions on Which No Comments Received*

Section 1.482–7(j)(2)(i)(F) of the proposed regulations requires that controlled participants maintain specific documentation to establish the amount attributable to stock-based compensation that is taken into account in determining the costs to be shared, including the method of measurement and timing used with respect to that amount. No comments were received on this particular provision, and it is retained in the final regulations.

Treasury and the IRS intend that this provision will require controlled participants that use the elective method of measurement to maintain documentation establishing compliance with the requirements of § 1.482–7(d)(2)(iii)(B). For example, documentation should establish that applicable financial statements reflecting the value of stock options with respect to which the elective method is used, as well as applicable accounting principles under which such financial statements are prepared, are in conformity with the fair-value and reconciliation requirements adopted in the final regulations with respect to GAAP other than U.S. GAAP.

Several other provisions of the proposed regulations similarly were not commented upon and have been adopted without modification in the final regulations. These provisions include § 1.482–7(d)(2)(iii)(A)(*2*), relating to deductions of foreign controlled participants; the last sentence of § 1.482–7(d)(2)(ii), relating to repricing and other modifications of stock options; and § 1.482–7(d)(2)(iii)(C), providing consistency rules for measurement and timing of stock-based compensation.

**Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few small entities are expected to enter into QCSAs involving stock-based compensation, and that for those who do, the burdens imposed under § 1.482–7(d)(2)(iii)(B) and (j)(2)(i)(F) will be minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f), the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Drafting Information**

The principal author of these regulations is Douglas Giblen of the Office of Associate Chief Counsel (International). However, other personnel from Treasury and the IRS participated in their development.

**List of Subjects**

*26 CFR Part 1*

Income taxes, Reporting and recordkeeping requirements.

*26 CFR Part 602*

Reporting and recordkeeping requirements.

**Adoption of Amendments to the Regulations**

■ Accordingly, 26 CFR parts 1 and 602 are amended as follows:

## PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

**Authority:** 26 U.S.C. 7805 * * *

■ Sections 1.482–1, 1.482–5 and 1.482–7 also issued under 26 U.S.C. 482. * * *

■ **Par. 2.** Section 1.482–0 is amended by:

■ 1. Redesignating the entry for § 1.482–7(a)(3) as the entry for § 1.482–7(a)(4).

■ 2. Adding a new entry for § 1.482–7(a)(3).

■ 3. Redesignating the entry for § 1.482–7(d)(2) as the entry for § 1.482–7(d)(3).

■ 4. Adding new entries for § 1.482–7(d)(2).

The additions and redesignation read as follows:

### § 1.482–0 Outline of regulations under section 482.

* * * * *

### § 1.482–7 Sharing of costs.

(a) In general.

* * * * *

(3) Coordination with § 1.482–1.

(4) Cross references.

* * * * *

(d) Costs.

* * * * *

(2) Stock-based compensation.

(i) In general.

(ii) Identification of stock-based compensation related to intangible development.

(iii) Measurement and timing of stock-based compensation expense.

(A) In general.

(*1*) Transfers to which section 421 applies.

(*2*) Deductions of foreign controlled participants.

(*3*) Modification of stock option.

(*4*) Expiration or termination of qualified cost sharing arrangement.

(B) Election with respect to options on publicly traded stock.

(*1*) In general.

(*2*) Publicly traded stock.

(*3*) Generally accepted accounting principles.

(*4*) Time and manner of making the election.

(C) Consistency.

(3) Examples.

* * * * *

■ **Par. 3.** Section 1.482–1 is amended by:

■ 1. Removing the sixth sentence of paragraph (a)(1) and adding two sentences in its place.

■ 2. Adding a sentence at the end of paragraph (b)(2)(i).

■ 3. Adding a sentence at the end of paragraph (c)(1).

■ 4. Adding paragraph (j)(5).

The additions read as follows:

### § 1.482–1 Allocation of income and deductions among taxpayers.

(a) * * *

(1) * * * Section 1.482–7T sets forth the cost sharing provisions applicable to taxable years beginning on or after October 6, 1994, and before January 1, 1996. Section 1.482–7 sets forth the cost sharing provisions applicable to taxable years beginning on or after January 1, 1996. * * *

* * * * *

(b) * * *

(2) * * *

(i) * * *Section 1.482–7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result.

* * * * *

(c) * * *

(1) * * *See § 1.482–7 for the applicable method in the case of a qualified cost sharing arrangement.

* * * * *

(j) * * *

(5) The last sentences of paragraphs (b)(2)(i) and (c)(1) of this section and of paragraph (c)(2)(iv) of § 1.482–5 apply for taxable years beginning on or after August 26, 2003.

■ **Par. 4.** Section 1.482–5 is amended by adding a sentence at the end of paragraph (c)(2)(iv) to read as follows:

### § 1.482–5 Comparable profits method.

* * * * *

(c) * * *

(2) * * *

(iv) * * *As another example, it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of or accounting for stock-based compensation (as defined by § 1.482–7(d)(2)(i)) among the tested party and comparable parties.

* * * * *

■ **Par. 5.** Section 1.482–7 is amended by:

■ 1. Redesignating paragraph (a)(3) as paragraph (a)(4).

■ 2. Adding a new paragraph (a)(3).

■ 3. Redesignating paragraph (d)(2) as paragraph (d)(3).

■ 4. Adding a new paragraph (d)(2).

■ 5. Removing the word ''and'' at the end of paragraph (j)(2)(i)(D).

■ 6. Removing the period at the end of paragraph (j)(2)(i)(E) and adding ''; and'' in its place.

■ 7. Adding paragraph (j)(2)(i)(F).

■ 8. Revising paragraph (k).

The additions and revision read as follows:

### § 1.482–7 Sharing of costs.

(a) * * *

(3) *Coordination with § 1.482–1.* A qualified cost sharing arrangement produces results that are consistent with an arm's length result within the meaning of § 1.482–1(b)(1) if, and only if, each controlled participant's share of

the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

* * * * *

(d) * * *

(2) *Stock-based compensation*—(i) *In general.* For purposes of this section, a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term *stock-based compensation* means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) *Identification of stock-based compensation related to intangible development.* The determination of whether stock-based compensation is related to the intangible development area within the meaning of paragraph (d)(1) of this section is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(2)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation expense*—(A) *In general.* Except as otherwise provided in this paragraph (d)(2)(iii), the operating expense attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for Federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an operating expense under this section for the taxable year for which the deduction is allowable.

(*1*) *Transfers to which section 421 applies.* Solely for purposes of this paragraph (d)(2)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(*2*) *Deductions of foreign controlled participants.* Solely for purposes of this paragraph (d)(2)(iii)(A), an amount is treated as an allowable deduction of a controlled participant to the extent that a deduction would be allowable to a United States taxpayer.

(*3*) *Modification of stock option.* Solely for purposes of this paragraph (d)(2)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(2)(ii) of this section, to constitute the grant of a new stock option not related to the development of intangibles, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an operating expense as of the date of the modification.

(*4*) *Expiration or termination of qualified cost sharing arrangement.* Solely for purposes of this paragraph (d)(2)(iii)(A), if an item of stock-based compensation related to the development of intangibles is not exercised during the term of a qualified cost sharing arrangement, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the qualified cost sharing arrangement, provided that the stock-based compensation is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an operating expense as of the date of the expiration or termination of the qualified cost sharing arrangement.

(B) *Election with respect to options on publicly traded stock*—(*1*) *In general.* With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a qualified cost sharing arrangement may elect to take into account all operating expenses attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

(*2*) *Publicly traded stock.* As used in this paragraph (d)(2)(iii)(B), the term *publicly traded stock* means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year.

(*3*) *Generally accepted accounting principles.* For purposes of this paragraph (d)(2)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either—

(*i*) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or

(*ii*) In the absence of a reconciliation between such other accounting principles and United States generally accepted accounting principles that reflects the fair value of the stock options under consideration, such other accounting principles require that the fair value of the stock options under consideration be reflected as a charge against income in audited financial statements or disclosed in footnotes to such statements.

(*4*) *Time and manner of making the election.* The election described in this paragraph (d)(2)(iii)(B) is made by an explicit reference to the election in the written cost sharing agreement required by paragraph (b)(4) of this section or in a written amendment to the cost sharing agreement entered into with the consent of the Commissioner pursuant to paragraph (d)(2)(iii)(C) of this section. In the case of a qualified cost sharing arrangement in existence on August 26, 2003, the election must be made by written amendment to the cost sharing agreement not later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003, and the consent of the Commissioner is not required.

(C) *Consistency.* Generally, all controlled participants in a qualified cost sharing arrangement taking options on publicly traded stock into account under paragraph (d)(2)(iii)(A) or (B) of this section must use that same method of measurement and timing for all options on publicly traded stock with respect to that qualified cost sharing arrangement. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the qualified cost sharing arrangement must join in requests for the Commissioner's consent under this paragraph. Thus, for example, if the controlled participants make the election described in paragraph (d)(2)(iii)(B) of this section upon the formation of the qualified cost sharing arrangement, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(2)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(2)(iii)(B)(*2*) of this section, the controlled participants may make the election described in paragraph (d)(2)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

* * * * *

(j) * * *

(2) * * *

(i) * * *

(F) The amount taken into account as operating expenses attributable to stock-based compensation, including the method of measurement and timing used with respect to that amount as well as the data, as of date of grant, used to identify stock-based compensation related to the development of covered intangibles.

* * * * *

(k) *Effective date.* This section applies for taxable years beginning on or after January 1, 1996. However, paragraphs (a)(3), (d)(2) and (j)(2)(i)(F) of this section apply for stock-based compensation granted in taxable years beginning on or after August 26, 2003.

* * * * *

## PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

■ **Par. 9.** The authority citation for part 602 continues to read as follows:

**Authority:** 26 U.S.C. 7805

■ **Par. 10.** In § 602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read in part as follows:

### § 602.101 OMB Control numbers.

* * * * *

(b) * * *

| CFR part or section where identified and described | Current OMB control No. |
|---|---|
| * * * | * * |
| 1.482–7 ................................ | 1545–1794 |
| * * * | * * |

**Robert E. Wenzel,**

*Deputy Commissioner for Services and Enforcement.*

Approved: August 11, 2003.

**Pamela F. Olson,**

*Assistant Secretary of the Treasury.*

[FR Doc. 03–21355 Filed 8–25–03; 8:45 am]

BILLING CODE 4830–01–P

## DEPARTMENT OF HOMELAND SECURITY

## Coast Guard

## 33 CFR Part 117

[CGD11–03–004]

RIN 1625–AA09

## Drawbridge Operation Regulation; Islais Creek, San Francisco, CA

**AGENCY:** Coast Guard, DHS.

**ACTION:** Temporary final rule.

**SUMMARY:** The Commander, Eleventh Coast Guard District is temporarily changing the regulation governing the Third Street Drawbridge, mile 0.4 Islais Creek, San Francisco, CA. The drawbridge need not open for vessel traffic and may remain in the closed-to-navigation position to allow seismic retrofit and rehabilitation of the bridge.

**DATES:** This temporary rule is effective from 12:01 a.m., September 3, 2003 until 12:01 a.m., September 2, 2004.

**ADDRESSES:** Documents referred to in this temporary rule are available for inspection and copying at Commander (oan), Eleventh Coast Guard District, Building 50–3, Coast Guard Island, Alameda, CA 94501–5100, between 8 a.m. and 4 p.m., Monday through Friday, except Federal holidays.

**FOR FURTHER INFORMATION CONTACT:** David H. Sulouff, Chief, Bridge Section, Eleventh Coast Guard District, telephone (510) 437–3516.

**SUPPLEMENTARY INFORMATION:**

### Good Cause for Not Publishing an NPRM

We did not publish a notice of proposed rulemaking (NPRM) for this regulation. Under 5 U.S.C. 553(b)(B), the Coast Guard finds that good cause exists for not publishing an NPRM. This rule is being promulgated without an NPRM because drawspan openings at this bridge are infrequent, the proposal has been thoroughly coordinated with the waterway users and it would be impracticable, unnecessary and contrary to the public interest to delay the proposed project start date.

### Good Cause for Making Rule Effective in Less Than 30 Days

Under 5 U.S.C. 553(d)(3), the Coast Guard finds that good cause exists for making this rule effective less than 30 days after publication in the **Federal Register** because the event has been thoroughly coordinated with waterway users, no objections were received and there is no justification to deny the request or delay the proposed project.

### Background and Purpose

The City of San Francisco requested a temporary change to the operation of the Third Street Bridge, mile 0.4 Islais Creek, in San Francisco, California. The bridge provides 4.4 feet minimum vertical clearance above mean high water in the closed-to-navigation position. Navigation on the waterway consists primarily of recreational watercraft. Presently, the draw is required to open on signal if at least one hour advance notice is given. The bridge was last opened for recreational waterway traffic on July 1, 2001. The City requested the drawbridge be allowed to remain closed to navigation from 12:01 a.m., September 3, 2003 until 12:01 a.m., September 2, 2004.