Office of Chief Counsel
Internal Revenue Service

memorandum

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to:

from: Area Counsel, LMSB
(Financial Services)

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subject:

Sections 83 and 162 - 1996, 1997, and 1998 Taxable Years
UIL Nos. 83.00-00, 83.08-00, 162.02-00, 162.06-01, 162.07-00, 162.00-06, 482.00-00

This memorandum responds to your request for advice on whether Corp. Taxpayer may deduct compensation expenses attributable to stock options it awarded to expatriate employees of its foreign subsidiaries as a business expense under section 162 of the Internal Revenue Code. The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us. This memorandum should not be cited as precedent. This advice was informally coordinated with the International, Tax Exempt and Government Entity, and Income Tax and Accounting Associate Offices of the Chief Counsel and these offices informally concurred with our advice. Prior to issuance, this advice was formally reviewed by the National Office.

LEGEND

Corp. Taxpayer =
Year 1 =
Year 3 =
$A =
$B =
$C =

ISSUE

1. Whether section 83 overrides the “direct and proximate benefit” exception to the general rule that a parent

may not deduct the ordinary and necessary trade or business expenses of its subsidiary?

2. Whether a parent may deduct compensation expenses attributable to stock options it awarded to expatriate employees of its wholly owned foreign subsidiaries as a business expense under section 162?

   a. Whether royalties paid by a subsidiary to a parent are a direct and proximate benefit to the parent or an indirect benefit that inures to a parent company when its subsidiary performs successfully?

   b. Whether the services of a subsidiary's employee of promoting and protecting the parent's brands, trademarks, and reputation are direct or indirect benefits to the parent?

CONCLUSION

1. Section 83 governs a section 162 deduction in the situation where a parent grants stock options to the employees of its subsidiary and there is not a "direct and proximate benefit" exception to the application of the specific rules of section 83.

2. Royalties and an expatriate employee's services of promoting and protecting the parent's brands, trademarks, and reputation are the type of general and indirect benefit which obviously inures to a parent corporation when one of its subsidiaries successfully performs its functions, and therefore, does not satisfy the requirements of section 162 or the exceptions carved out by the case law.

FACTS

is a U.S. corporation that files consolidated returns as the common parent for its affiliated group. For the taxable years through , inclusive, granted stock options to expatriate employees of its foreign subsidiaries and claimed deductions on its income tax returns for the exercised stock options. For that same period, the expenses for the actual salaries and bonuses paid to these expatriate employees were paid by the foreign subsidiaries, stated on their books and records, and claimed as deductions on their tax returns. did not claim any deductions for the salary or bonuses paid to these expatriate employees.

stated that the compensation paid to the expatriate employees is composed of three components, salary, bonuses, and stock options. further alleges that salary and bonuses are based on the employee's performance in increasing the foreign subsidiary's net income and the stock options are awarded based on the employee's performance in increasing the overall success of , i.e. increasing royalty income. However, has no records allocating the time spent and the costs incurred between the various alleged activities and it has not presented any evidence in support of its allocation for those alleged benefits. During the period at issue, claimed deductions for stock option expenses in the amount of approximately . The foreign subsidiaries paid royalties for use of brands and trademarks. The subsidiaries also purchased the from for use in the manufacture of its products. only claimed a deduction for stock options it awarded to expatriate employees of its foreign subsidiaries that had U.S. social security numbers.

LAW AND ANALYSIS

Relationship Between Section 83 and Section 162

Section 83 determines when a transfer of property in the connection with the performances of services is taxable to a service provider. Property for purposes of section 83 includes all real and personal property other than money or an unfunded and unsecured promise to pay money or property in the future. Treas. Reg. § 1.83-3(e). The most common types of property covered by section 83 are stock and non-statutory stock options.

Section 83(h) and Treas. Reg. § 1.83-6(a)(1) provide that in the case of a transfer of property under section 83, the person for whom services were performed shall be allowed a deduction under section 162 equal to the amount included in the gross income of the person who performed the services, but only to the extent that such amount meets the requirements of section 162. See also Treas. Reg. § 1.83-6(a)(2). Furthermore, Treas. Reg. § 1.83-6(d) provides that if a shareholder of a corporation transfers property to an employee of such corporation in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of the corporation, and immediately thereafter a transfer by the corporation of the property to the service provider.

Even though, as discussed in detail below, Young & Rubicam, Inc. v. United States, 410 F.2d 1233 (Ct. Cl. 1969) and several other cases have held that under unique and compelling circumstances, a section 162 deduction may be allowable by a parent if it pays the subsidiary's business expense for its own direct and proximate benefit, there is not a "direct and proximate benefit" exception from the application of the specific rules of section 83. Thus, section 83 overrides section 162 in the situation where parent grants stock options to the employees of its subsidiary. Therefore, transfer of its shares to the employees of its subsidiaries should be treated as if had made nondeductible contributions of such shares to its subsidiaries' capital upon the exercising of the non-statutory options. To the extent allowed under the rules of section 83(h) and the regulations thereunder, the subsidiaries are entitled to a section 162 deduction associated with the options. Although, section 83 overrides the "direct and proximate benefit" exception to a section 162 deduction in situation, we will analyze the facts of this case under that exception.

Section 162

Section 162(a) allows a deduction for ordinary and necessary business expenses, including a reasonable allowance for salaries or other compensation for personal services actually rendered. Treas. Reg. § 1.162-7 specifies that stock options awarded to employees will constitute allowable deductions when such payments are made in good faith and as additional compensation for the services actually rendered by the employees. Business expenses which satisfy the ordinary and necessary expense requirements of section 162 are deductible if they are "proximately connected to the business of the taxpayer claiming deduction." Eustice, *Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations,* 23 TAX L. REV. 451, 475.

The basic tax rule is that a parent and its wholly-owned subsidiaries are treated as separate entities no matter how closely affiliated. Generally, the courts have held a parent may not deduct the expenses of its subsidiary, even though those expenses would otherwise be ordinary and necessary trade or business expenses. Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943); Deputy v. Dupont, 308 U.S. 488 (1940). The concept is that the payment by the parent to cover such expenses is related to the business of the subsidiary and not its own business, and as such is not deductible by the parent. Interstate Transit Lines, 319 U.S. at 594; Young & Rubicam, 410 F.2d at 1238-39; Columbian Rope Co. v. Commissioner, 42 T.C. 800 (1964). This rule was designed to prevent the members of a controlled

group from voluntarily shifting expenses among themselves in order to maximize favorable tax consequences. National Carbide Corp. v. Commissioner, 336 U.S. 422, 434-36 (1949).

However, the courts have carved out a narrow exception to the general rule. Under unique and compelling circumstances, a section 162 deduction may be allowable by a parent if it paid the subsidiary's business expense for its own direct and proximate benefit or was incurred by the parent with the underlying motivating purpose of protecting and promoting its own business.[1] Young & Rubicam, 410 F.2d at 1238-39; Lohrke v. Commissioner, 48 T.C. 679 (1967); Columbian Rope, 42 T.C. at 815-16.

For the exception to apply, a parent must prove that each individual performed specific services clearly for the parent's own direct and proximate benefit. I.R.C. § 162(a); INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); Welch v. Helvering, 290 U.S. 111, 115 (1933); Young & Rubicam, 410 F.2d at 1239. Where the parent has proved, in detailed rather than simply general terms, that an individual was involved in this kind of activity, a deduction by the parent for the compensation paid for these activities is allowable. Columbian Rope, 42 T.C. at 815-16. A taxpayer is required to keep adequate records sufficient to enable the Commissioner to determine the taxpayer's correct tax liability. I.R.C. §6001; Meneguzzo v. Commissioner, 43 T.C. 824, 831 (1965). In the absence of persuasive corroborating evidence, the Commissioner is not required to accept the self-serving testimony of interested parties. Bose Corp. v. Consumers Union of U.S., Inc., 466 U.S. 485, 512 (1984).

In this case, has not provided any detailed proof that the expatriate employees performed specific activities directly for its benefit. It has relied entirely on generalized statements as to what the overall benefits were. Therefore, we do not believe could meet its burden of proof and establish that it is entitled to deduct any part of the exercised stock options as its own expense. Nonetheless, we will analyze whether generalized argument would meet the "direct and proximate benefit" exception.

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[1] We note that this "unique and compelling circumstances" doctrine is a judicially developed rule that has no specific support in the statute, the regulations, or the legislative history of section 162. The courts have sporadically applied the doctrine, and no definitive set of criteria for invoking the doctrine has emerged from the case law.

First Argument - Awarded Stock Options to the Expatriate Employees for Increasing Royalty Income

A parent may claim a 162 deduction for compensation it paid to employees working abroad at its foreign subsidiaries if the parent proves that the specific services rendered by each of the employees were performed for the parent's direct and proximate benefit. Young & Rubicam, 410 F.2d at 1238-39; Columbian Rope, 42 T.C. at 815-16. The general and indirect benefit which obviously inures to a parent corporation when one of its subsidiaries successfully performs its functions does not satisfy the requirements of section 162. Young & Rubicam, 410 F.2d at 1238-39; Columbian Rope, 42 T.C. at 815-16. Moreover, a parent cannot claim as its own expense, compensation paid for activities connected with the day-to-day operation of the subsidiary's business. Young & Rubicam, 410 F.2d at 1239; Columbian Rope, 42 T.C. at 815-16. Any benefit to the parent from these activities cannot be considered proximate and direct to its own business, and therefore, these expenses are not allowable deductions under section 162. Young & Rubicam, 410 F.2d at 1238-39; Columbian Rope, 42 T.C. at 815-16. Thus, a parent ordinarily may not deduct compensation paid by it to the employees of its wholly owned subsidiary, even though the indirect benefit of their services inures to the parent as sole shareholder of the employer. Young & Rubicam, 410 F.2d at 1238-39; Columbian Rope, 42 T.C. at 815-16. However, where an employee performed services proximately and directly benefitting both the parent and the subsidiary, a reasonable allocation to determine the parent's deduction should be made. Young & Rubicam, 410 F.2d at 1238-39; Columbian Rope, 42 T.C. at 815-16. Again, has not presented any contemporaneous evidence that such an allocation should be made nor how this allocation was made.

claims that the direct benefit it received from the rendered services was an increase in both royalty income earned from its subsidiaries and the sales of to its subsidiaries. During the period at issue, received from its subsidiaries approximately of royalty income and from the sales of . It states it provides its subsidiaries with the raw materials and the intellectual property (owns the licensed trademarks, patents, and copyrights) to produce their products. claims that royalties and the income from sales of are direct benefits to its own business, which are different than the indirect benefit that inures to a parent company when a subsidiary performs successfully.

cites as support, Fall River Gas Appliance Co., Inc. v. Commissioner, 42 T.C. 850 (1964), *aff'd,* 349 F.2d 515 (1st Cir.

1965); Snow v. Commissioner, 31 T.C. 585 (1958); Fishing Tackle Products Co. v. Commissioner, 27 T.C. 638 (1957); Dinardo v. Commissioner, 22 T.C. 430 (1954); Cepeda v. Commissioner, T.C. Memo. 1993-477. Once again, we note that has not presented any detailed proof that the expatriate employees performed specific activities that directly increased royalty income other than their general day-to-day activities.

In Fall River Gas Appliance, a parent gas company paid the installation, selling and miscellaneous expenses in connection with the sales of gas-consuming appliances of its subsidiary, a gas appliance seller. 42 T.C. 850 (1964). The Court found that the parent had an exclusive franchise to distribute gas at retail in the area and it experienced strong competition for customers from oil and electric companies, which threatened its gas sales and the success of its business. The parent endeavored to meet this competition by trying to increase its sales of gas to new customers by increasing its subsidiary's sales of gas consuming appliances. The Court held that the parent had a "substantial interest in increasing *its own* sales of gas, and the expenses paid by it were intended to promote its own business wholly apart from that of the subsidiary." Id. at 858. The Court also held that the direct relationship between an increase in the parent's gas sales and the number of appliances sold by the subsidiary was sufficient to allow the parent a deduction. Id.

In Fishing Tackle Products, a parent deducted reimbursements made to its subsidiary for losses incurred in the manufacture of a patented fishing rod. 27 T.C. at 641-43. The Court found that the subsidiary was the parent's *sole* source of supply of this particular distinctive type of fishing rod and the subsidiary produced such rods for *exclusive sale* to the parent. The Court also found that the parent needed the product of the subsidiary, without which the parent would have been unable to meet the demands of its customers, and both its sales and its position in the industry would have suffered. The Court held that the payments were deductible as a necessary business expense made to maintain and preserve the parent's source of supply, without which the parent would have ceased operation. Id. at 644.

In Snow, the taxpayers were partners in a law firm that earned substantial fees from real estate title work. However, fees from such work declined for several years. 31 T.C. at 586-89. To provide an additional source of legal abstract fees, the partnership organized a federal S&L association and agreed to make good any operating deficits of the association for the initial 3 years. The Court held that partners paid the deficits

with the explicit objective of promoting an additional source of fees. Id. at 595.

In Cepeda, the taxpayer operated a medical practice called ECPA. T.C. Memo. 1993-477. Also, Cepeda and other doctors created an outpatient medical clinic called VSMC. ECPA leased office space and the use of facilities and equipment from VSMC. ECPA paid some of VSMC's operating expenses. The Court found that ECPA made the payments, not to increase the VSMC's profits, but rather to keep VSMC in operation so that ECPA could continue to earn medical fees from patients who were referred to ECPA because of its access to VSMC. The Court also found that by keeping VSMC in operation, ECPA was able to avoid incurring the additional substantial expense of purchasing equipment it had access to at VSMC. The Court held that ECPA paid the expenses with the underlying motivating purpose of protecting and promoting his own business. Id.

In Dinardo, the taxpayers created a partnership to practice medicine and organized a nonprofit corporation to operate a private hospital. 22 T.C. at 431-34. The medical partnership received fees from patients referred to it by hospital. The partnership paid the hospital's operating deficits to keep the hospital in operation and to avoid the loss of medical fees. The Court found that the partnership did not pay the hospital's operating deficits with the purpose to make profits from the operation of a hospital, and thereby to augment the partnership income. Rather, the Court found that the payments were made to keep the hospital in operation in order for the medical partnership itself to earn medical fees from patients who would be hospitalized at the hospital, or who would be sent to the partnership because of referrals from or access to hospital's facilities. Id. at 435-436.

The above cited cases are distinguishable from case. In these cases, the parent paid the subsidiary's operating costs either to increase, or prevent a substantial decrease of, the parent's own income derived from unrelated third party consumers or to create an additional source of income to supplement the parent's own business income. The expenses were not incurred by the parent to increase the parent's income currently derived directly from its subsidiary or to make profits from the entity. In case, there is no comparable direct link between awarding stock options to its subsidiaries' employees and an increase domestic sales of consumer products to unrelated third party consumers. Also, did not award the stock options to create an additional source of income derived from the subsidiaries. Here, alleges its purpose was to

increase its royalty and sales income currently earned from its subsidiaries. situation is the more typical instance of the general and indirect benefit which inures to a parent corporation when its subsidiaries successfully performs their functions, such as with dividends paid to a parent or increased shareholder value. The residual benefit to a parent does not suffice for its claimed deduction.

situation is more similar to Columbian Rope, where the Court held that a parent corporation was not entitled to deduct one-half of the salaries and related expenses paid to employees of a wholly-owned subsidiary in order to induce such employees to accept work in the Philippine Islands. 42 T.C. 800 (1964). The Court found that the parent undertook these payments simply to aid its wholly owned foreign subsidiary to obtain the services of needed management personnel. Id. at 815. The Court stated, a successful operation of the foreign subsidiary, through the services of such personnel, would obviously inure to the benefit of the parent corporation, and the parent's willingness to undertake this obligation is understandable, but the payments could not be construed as the parent's own business expense. Id.

Furthermore, in Mensik v. Commissioner, the taxpayer owned a Savings and Loan and paid its advertising costs because the institution referred its insurance business to him. 37 T.C. 703 (1962), *aff'd*. 328 F.2d 147 (7th Cir. 1964), *cert. denied* 379 U.S. 827 (1964). The Court held that based on the taxpayer's control of the S&L, the taxpayer did not have to incur the costs in order to secure the additional business. Mensik, 37 T.C. at 750-51. Likewise, has absolute control over its foreign subsidiaries, which must follow exact instructions. provides its subsidiaries with the raw materials and the intellectual property for the products, and the subsidiaries must conform with production guidelines. The subsidiaries produce and sell products and pay royalties. There is no competing market for the foreign subsidiaries to obtain the licensed rights or raw materials.

In addition, the cases cited by deal with the situation, where the parent paid its subsidiary's non-employee-compensation operating costs, not the compensation of its subsidiaries' employees. Moreover, the cases involved a clear proximate danger to the parent and a payment made to by the parent to protect its existing business from imminent harm. None involved a situation where a parent attempts to allocate a portion of its subsidiaries employees' compensation in order to increase its earnings derived from its subsidiaries.

Here, supplemented the compensation of certain of its foreign subsidiaries' employees allegedly to increase its royalties and sales income derived from those subsidiaries. There is no clear proximate danger to own business or harm to its relationship with its own customers, for which awarded the stock options to prevent. only made unsupported allegations that it might lose royalty or sales income from its foreign subsidiaries if it did not award the stock options to the expatriate employees. has not presented any evidence that awarding stock options to its subsidiaries' employees would prevent a decrease in income or could increase royalty or sales income. Moreover, did not offer any contemporaneous proof that it had a motivating purpose to protect and promote its own business prior to incurring the expense of the stock options. Therefore, "ultimate purpose" in paying the stock options was to realize a return on its payment through corporate profits received from its subsidiaries. The courts do not allow the exception to the general rule for this type of motivating purpose. See e.g. Lohrke, 48 T.C. at 679.

In case, the stock options were general compensation expenses of a subsidiary for the day-to-day services of its employees, which paid to obtain and retain better personnel for its subsidiaries and any benefit to was indirect. The royalty and sales income received from its subsidiaries is the general and indirect benefit which obviously inures to a parent corporation when one of its subsidiaries successfully performs its functions, and therefore, does not satisfy the requirements of section 162.[2] Young & Rubicam, 410 F.2d at 1238-39; Columbian Rope, 42 T.C. at 815-16.

Second Argument - Awarded the Stock Options to the Expatriate Employees for Protecting and Promoting its Brands, Trademarks, and Reputation

[2] The license agreement between and its subsidiaries is subject to arm's length standard under section 482. attempt to pay portions of the employee compensation of its foreign subsidiaries, the licensees, is in effect a reduction of the royalty payments under these arrangements. This has the effect of shifting income outside of the U.S. and should have been considered in analyzing whether the royalties were arm's length under section 482.

The courts have also found that a parent may deduct the expenses of a subsidiary if the expenses were incurred by the parent with the underlying motivating purpose of protecting and promoting its own business. Young & Rubicam, 410 F.2d at 1241-43; Lohrke, 48 T.C. at 688; L. Heller and Son, Inc. v. Commissioner, 12 T.C. 1109 (1949). In Lohrke, the Tax Court set forth a two-prong test for determining whether a taxpayer falls within the narrow "protect or promote" exception to the general rule against a taxpayer deducting expenses incurred on behalf of the business of another. 48 T.C. at 688. First, the taxpayer must demonstrate that its "ultimate purpose" in paying the other taxpayer's obligation was to protect or promote its own business realizing a return on its payment through continued profits in that business, not to keep the other taxpayer in existence to earn corporate profits from that other taxpayer. Lohrke, 48 T.C. at 688; Snow, 31 T.C. at 591. Second, the taxpayer must also show that the expense is an ordinary and necessary expenditure in furtherance of its trade or business and not in furtherance of the trade or business of the other taxpayer. Lohrke, 48 T.C. at 688. In applying the first prong of the Lohrke test, the courts require that there be a "clear proximate danger" to the taxpayer and "the need for a payment made" to protect an existing business from harm. Young & Rubicam, 410 F.2d at 1243. If the taxpayer fails to demonstrate a direct nexus between the purpose of the payment and the taxpayer's business or income producing activities then the deduction will not be allowed. Lettie Page Whitehead Foundation, Inc. v. United States, 606 F.2d 534, 538 (5th Cir. 1979).

claims that it awarded stock options to its subsidiaries' employees to induce the expatriate employees to promote and protect its global-brand, trademarks, and reputation. claims that this global-brand strategy protected and enhanced reputation and goodwill, which increased royalty income and the sales of to its subsidiaries. claims that its interest in protecting its global-brand, trademarks, and reputation are at odds with the subsidiaries' interest in maximizing local profits, and therefore, must compensate the expatriate employees in a manner tied directly to overall success, rather than the success of the subsidiary. Therefore, claimed that it awarded stock options to encourage the employees to act in interest where that interest might be in conflict with the subsidiary's short term profit goals. presented no evidence to support this claim. Neither has it explained why it did not make such an allocation to the expatriate employees who did not receive the stock options.

argument implies that it may deduct the expenses because it was motivated by a purpose to protect and promote its own business and its relationship to its own customers. Coulter Electronics, Inc. v. Commissioner, T.C. Memo. 1990-186, *aff'd. without published opinion* 943 F.2d 1318 (11th Cir. 1991); Lohrke v. Commissioner, 48 T.C. 679 (1967); L. Heller and Son, Inc. v. Commissioner, 12 T.C. 1109 (1949). We do not believe that the circumstances surrounding the deductions claimed by are within the narrow exceptions espoused by the cited cases. These cases involved a clear proximate danger to the taxpayer and involved a payment made to protect the taxpayer's existing business from imminent harm. Young & Rubicam, 410 F.2d at 1243. None involved a situation where a taxpayer attempts to allocate a portion of its subsidiaries' employee compensation.

Here, is not faced with clear proximate danger to its own domestic business or harm to its relationship with its own customers, such as loss of domestic sales of consumer products. only claims that it might lose royalty income and income derived from sales of to its subsidiaries if expatriate employees do not follow its global-brand strategy. Therefore, "ultimate purpose" in paying the stock options was to realize a return through corporate profits received from its subsidiaries, and was not to keep its subsidiaries in existence to protect or promote own business by realizing a return on its payment of the stock options through continued profits from unrelated third parties. The courts do not allow the exception to the general rule for this type of motivating purpose. See e.g. Lohrke, 48 T.C. at 679. Here, was not in imminent harm and did not offer any proof that it had a motivating purpose to protect and promote its own business prior to incurring the expense of the stock options.

Furthermore, there is no need for to award the stock options to induce the expatriate employees to follow global-brand strategy. subsidiaries and their employees must follow corporate guidelines as part of their corporate and legal relationship with . concedes that the subsidiaries and their employees do not have any discretion to deviate from its corporate guidelines on brand goals, product and service quality, values, or behaviors. The subsidiaries must purchase the from and pay royalties for the use of brands and trademarks.

In case, the stock options were general compensation expenses of a subsidiary. In addition, has not offered any proof that it awarded the stock options either to prevent proximate harm or to protect its own domestic business from such harm. has not offered evidence that it was threatened with a direct and immediate loss of domestic business if the expatriate employee did not promote the "global brand" and keep the "brand promise" to the subsidiaries' consumers. The possibility of any loss of domestic business to , if the stock options were not awarded, was remote at best. The exception adopted by the above cases turns on a proximate danger or benefit and they generally do not involve payments by a parent corporation for the general operating costs of its subsidiary, and especially not for the compensation paid to the subsidiaries' employees. paid these costs primarily to obtain and retain better personnel for its subsidiaries and any benefit to it was indirect. Columbian Rope, 42 T.C. at 815.

Should you have any questions regarding this matter, please contact Keith Doce of this office at .

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