OECD fails to deliver stock option certainty

In 2004 the OECD released a study on transfer pricing issues arising from employee stock option plans. Gareth Green of Transfer Pricing Solutions, William Franklin of Pinsent Masons and Mike Heimert of Ceteris consider what can be learned from it

Given that it is six months since the OECD released its study, *Employee Stock Option Plans: Impact on Transfer Pricing*, it has received surprisingly little comment and analysis in specialist publications. Perhaps it has been overshadowed by other more "glamorous" documents that were published about the same time, such as the separate report on how to apply double tax treaties to employment tax arising from stock options or the revised draft of part 1 of the Working Hypothesis for business profits attribution.

Perhaps interest in the study has been limited because of its non-prescriptive nature. Whereas the OECD recommends changes to the OECD Commentary on the Model Tax Convention in relation to employee taxation, the transfer pricing study is described as merely an "analysis". Of course, even the OECD transfer pricing guidelines are merely a consensus on good practice and so are strongly influential rather than binding. This study does not, however, set out even to describe a consensus; it merely even-handedly discusses the pros and cons of the alternative approaches.

It would be easy, therefore, for a cynic to consider the authors of the study to have "sat on the fence" and to have concluded merely what was already known, which is that it is all complicated and there are no clear answers. This would, however, be to misunderstand the objectives of the study. It would be a mistake to disregard the study on these grounds, because a careful examination does reveal some definitive answers to some issues and some clear preferences as to the reasons that should determine the answer on other issues.

Perhaps potential readers have also been put off by the academic and thorough approach adopted by the study. It is not an easy read and it is not always easy to apply the study to the practical issues tax directors are facing in real life.

Rather tham working page by page through the study, we have picked out a number of these issues for analysis.

The study stresses that there is more than one type of transfer-pricing issue arising from stock option plans. We will split these into what we will term direct issues and indirect issues.

- Direct issues are those relating to the price that company A should charge for granting stock options to company B's employees.
- Indirect issues are those relating to the effect a stock option plan has on other transactions. For instance, if company C grants stock options to its own employees, does this affect the transfer pricing of transactions it has with company D, such as cost-plus services or cost-sharing agreements, if those employees are involved in performing services under those transactions? And how does this affect comparability with other companies that may or may not have similar stock option plans in place?

The difference is illustrated by the examples in diagrams 1 and 2. In each case, the solid arrow shows the transaction that is subject to the transfer-pricing rules.

Direct issues

1. Corresponding adjustments under DTAs

Can multinational corporations (MNC) rely on being able to claim a corresponding adjustment under the relevant tax treaty if they suffer a tax adjustment in relation to a cross-border stock option plan? Such an adjustment should at least mean that the MNC will not be taxed on the same profits in two countries.

This is one of the questions to which the study gives a clear answer (in section C4). Corresponding adjustments are only available where the tax adjustment is a transfer-pricing adjustment, but not for other tax adjustments.

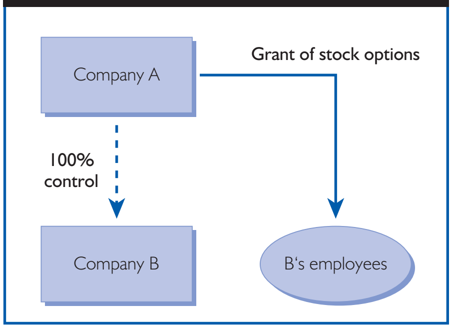
For instance, assume, in diagram 1, that A charges B for granting stock options to B's employees, and the charge is equal to the exercise spread (that is, the market value of the stock when transferred to B's employees less any price paid by the employees). If B's tax authority considers (as does, for instance, the UK Inland Revenue) that using the spread does not meet the arm's-length test, B might be denied a full deduction. As this is a transfer-pricing adjustment, A should be entitled to claim a corresponding adjustment, so that it is not taxable on the income that is more than an arm's-length amount. Or, if A's tax authority insists that the charge did meet the arm's-length test, A should have the right to oblige its tax authority to use mutual agreement procedures to force B's tax authority to grant a full deduction after all. Except on rare occasions when the two tax authorities cannot agree, this should ensure there is no double taxation.

If, however, the reason B is denied a tax deduction is that local tax law prohibits tax deductions for stock option remuneration, the tax treaty is unlikely to offer a means to remedy the resulting double taxation.

Authors' view: The OECD is probably correct. This does, however, increase the scope for cross-border employee stock option plans to give rise to double taxation.

Even on transfer-pricing adjustments, the current case of Glaxo in the US illustrates that where tax authorities have

Diagram 1: Direct issues



adopted entrenched and opposing policy positions on transfer-pricing matters, double taxation may arise. As stock option transfer pricing increasingly attracts the attention of tax authorities, it may develop into another area that is prone to failures of mutual agreement.

2. Plan solely for parent's benefit

Some parents of MNCs consider that their option scheme is for their own benefit as parent of the group, and so they make no charge to subsidiaries whose employees participate in the scheme. Such companies will wish to know whether the study supports this treatment.

The study does not provide a definitive view, but tax authorities that object to such a policy will draw support from the study. For instance, paragraph 36 says the parent "in general…would not grant options…or provide remuneration to employees of an unrelated party without getting anything in return". At first sight, the study seems to consider it self-evident that the subsidiary benefits from having its employees remunerated, which implies that a charge must be made.

However, on careful inspection, the study does seem to provide some grounds to argue that the benefit of the plan can, in some cases, be gained by the parent, so the arm's-length price is zero (or there is no transaction subject to transfer-pricing rules). Paragraph 36 says that a transfer-pricing adjustment would be required, but adds the condition "as long as [the subsidiary] gets benefits from the option plans". We can infer from this that if the subsidiary does not benefit, it would be acceptable to make no charge to it.

Paragraph 56 of the study says that in cases where the subsidiary's management plays no role in deciding to establish a stock option plan and deciding whether its employees should benefit from it, this "may provide an indication that the plan is intended to [provide] benefit to the parent company rather than to the subsidiaries". The study does not say what this would mean, but the obvious conclusion is that no charge would be required.

Authors' view: It is clear from general transfer-pricing principles that if there is no benefit to the subsidiary from the parent's stock option plan there need be no charge to the subsidiary. It would, however, be helpful if the OECD explicitly confirmed this.

In practice, MNCs will need an unusual fact pattern to show that there is no benefit to subsidiaries, despite their employees being granted options. In cases where the subsidiary can influence which employees are granted options, and how many they are granted, it may be virtually impossible to support making no charge.

such transactions. For instance, US Treasury Regulation section 1.1032-3(b) deems a grant of stock options to the employees of a subsidiary to have been a capital contribution of cash to the subsidiary, which the subsidiary is deemed to have used to pay full fair market price for the stock. The study does not explicitly express approval, but seems to adopt a position of tacit acceptance.

However, this is a major area of difficulty in some countries where treatment as a capital contribution is not used, and some tax authorities are taking positions. For instance, in February 2003 the UK Inland Revenue issued transfer-pricing guidance which made it clear that they would only accept capital treatment for UK parents if all stock is newly-issued. If any of the stock is market-purchased, the whole scheme is, in their view, revenue in nature, and if the UK parent has made no charge, deemed income would arise. The Inland Revenue recently announced that they are rethinking some of their policy on transfer pricing of stock options and there are fears they will decide that even new issue is revenue in nature.

Authors' view: Although this is not strictly a transfer-pricing issue, it is so closely interlinked that it is a pity the study does not cover it. Given the potential for capital treatment for the parent to give rise to one-sided deductions, it is unsurprising to see the UK taking an aggressive line on this. No doubt many other tax authorities would wish to adopt a similar position.

There is a strong case that receipts by a parent under a stock option plan are capital in nature, particularly to the extent that the parent issues new shares. We draw support for this view from the fact that the new international financial reporting standards (specifically, IFRS 2) require the equity instrument arising from the accounting expense for options to be treated as part of capital on the balance sheet. This applies whether or not the plan is dilutive.

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3. Capital or revenue?

Does the study agree with those MNCs that consider that payments to parent companies under stock option plans are capital in nature, and so are not taxable? This is more common with "dilutive plans", where the parent issues new stock so the payment it receives is just a subscription for stock. However, it can also be argued to apply where the stock has been bought on the market, as this is still a transaction of a capital nature from the perspective of the parent.

Regrettably, the OECD study does not consider this question. It says (at paragraph 154), "The arm's length principle does not address whether [parents] should be required to return an amount as taxable income". It does, however, observe (at paragraph 30) that if a parent simply exercises its discretion to "capitalise its affiliate in the form of its choosing, the stock options could be considered a capital contribution". This appears to be a recognition that this is how a number of countries treat

4. Use of the spread

One common pricing basis used by MNCs is to charge the exercise spread: the difference between the value of the stock at the exercise date and the price payable by the employee. In a strongly rising stock market (as in the late 1990s), this is likely to max-

Diagram 2: Indirect issues

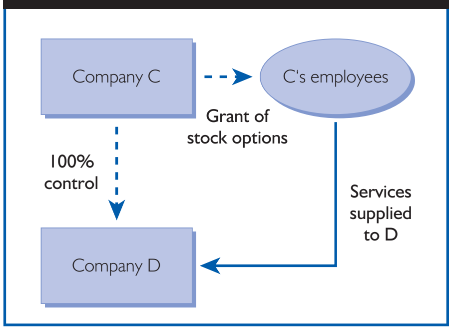

Table 1: Comparison of rules on using the spread

	OECD study	UK Inland Revenue transfer pricing policy	UK statutory deduction rules	US statute	IFRS 2
Treatment, in the hands of the parent, of payment from subsidiary	Out of scope of study. But tacit acceptance of capital contribution treatment.	Capital, if only new shares issued: not taxable. Otherwise, treated as revenue: taxable income.	No specific statute.	Capital contribution: not taxable	Entry goes to capital on balance sheet; no income in P&L.
Treatment for subsidiary	Out of scope of study.	Revenue: tax deductible, provided not in excess of IR's view of arm's-length price.	Revenue: tax deductible	Revenue: tax deductible	Expense in profit & loss
Basis for measurement	No clear preference (yet).	Black-Scholes option pricing model, OR cost of purchasing stock at grant date and holding to exercise date.	Exercise spread	Exercise spread	Black-Scholes option pricing model
Timing	Out of scope of study.	Income and expense accrued over period from grant to vesting	Deduction upon exercise of the option	Deduction upon exercise of the option	Debit and credit accrued over period from grant to vesting

imize the deduction claimed by subsidiaries, and for this reason tax authorities may object. The UK Inland Revenue, for instance, has issued policy that states this basis will rarely meet the arm's-length test. Many tax directors and tax authorities will wish to know whether the OECD agrees.

One has to dig a little to find the parts of the study that are relevant. Reference to the spread method is somewhat hidden in paragraph 99(ii). However, holders of both views will argue the study supports them. The Inland Revenue bases its opposition to the spread on the assertion that any prudent business would be unwilling to be exposed to the potential stock price increases, so it is not arm's-length behaviour for the subsidiary to agree to pay the spread. It will point to a number of statements in the study as endorsing this risk-based approach. For instance, paragraph 105 says: "Taking risk allocation and risk minimisation techniques into account…is important as this will directly impact the price of the transaction."

It goes on to say that where the parent chooses not to hedge: "it would be necessary to examine whether [the subsidiary] would have agreed to bear the risk itself, should it be dealing with an unrelated party."

Taxpayers and tax authorities who favour the use of the spread will, however, point out that the study pointedly stops there. It expresses no view on the likely conclusion from carrying out such an examination. They may argue that if the conclusion was as self-evident as the Inland Revenue asserts it could have been expected that the authors of the study would have at least hinted at the way they were leaning. The agnosticism of the OECD at least suggests the position is not as clear cut as the Inland Revenue argues.

The Inland Revenue asserts, in support of its position, that it is "difficult to find" parents that do not hedge their employee stock option plans in some way. Proponents of the spread will point out that this is contradicted by the study, which says (at paragraph 105) that deciding not to hedge is "a legitimate business decision" at the parent level.

The study does however seem at least equally comfortable with the two pricing approaches preferred by the Inland Revenue. These are both based on hedging approaches which, unlike the spread, which is charged upon exercise, would be charged when the option is granted. The first approach is to use option pricing models such as Black-Scholes. This is discussed at paragraph 83 of the study, and the OECD seems to express only relatively limited reservations about it.

The other approach is to base the charge on the costs that the parent incurred (or would hypothetically have incurred) in purchasing stock on the market when the options were granted and holding them until the options are exercised or lapse. The main element of the cost is likely to be the interest on loans to fund the acquisition of the stock. This is discussed at paragraph 97 of the study.

Authors' view: There will certainly be fact patterns where it is difficult to argue that charging the spread meets the arm's-length test. However, arguments that the spread inherently fails the arm's-length test appear to be motivated more by a concern to protect the tax base than on a dispassionate application of transfer-pricing principles.

The OECD should have built upon the statement in paragraph 158 of the study:

> Whatever the approach, the conclusion of this study is that the arm's-length pricing method for the transaction or components thereof should be determined upon establishment of the plan and agreement of [the subsidiary] to participate in it (in any case no later than grant date).

The real problem is taxpayers and tax authorities using hindsight to choose which method they prefer. If it turns out that stock prices rose steeply from grant to exercise, the spread will give a much higher transfer price than other methods. If the stock price fell or moved little, the spread might be lower than a hedging-based price, or even zero. The OECD should introduce a presumption that if the taxpayer has chosen a pricing approach at the grant date this choice should be accepted by the tax authorities as being arm's length, unless, exceptionally, it is a choice that is incompatible with the particular facts. The taxpayer's choice will usually be evident from their internal documentation relating to the option plan and whether or not the parent actually made a charge to the subsidiary when the options were granted.

The confusion in this area can be illustrated by the above table, which compares the position under IFRS 2, the OECD study, UK Inland Revenue transfer pricing policy, and the US statute.

Indirect Issues

In evaluating the indirect issues associated with employee stock options, the study's attention focuses on

- the effect on controlled transactions when employees benefiting from stock options are involved; and
- the effect on comparability analyses when there are differences in the accounting treatment or value of stock options between a tested entity/transaction and a potentially comparable entity/transaction.

5. Impact on controlled transactions

If a charge includes the cost of stock options, should it be based on the options granted in that year or the options that vested?

Paragraphs 170-173 of the study present an example in which TOPCO allocates stock options to Subco B. In turn, Subco B establishes performance criteria by which to award stock options to its employees. The performance criteria are based upon Subco B's successful completion of troubleshooting services requested by related parties. In year 1, Subco B provides its troubleshooting services to Subco C. These services are a success, and the employees of Subco B are rewarded with cash and stock options based in part on this success, which do not vest until year 4. In year 4, Subco B provides its troubleshooting services to Subco D, but the results were not as successful as with Subco C. The employees of Subco B receive a lower number of stock option awards in year 4, which partly reflects this lower level of performance.

The study concludes that under the cost-plus method (and effectively concludes the same under a profit split or transactional net margin method), the price of the services provided to Subco C should reflect the options awarded to the employees of Subco B in year 1. The study also rightly notes that even though the year 1 options do not vest until year 4, the cost of the options would not be attributable to services provided to Subco D in year 4.

Authors' view: The study's conclusion for this example is intuitive and obvious, and unfortunately it only provides definitive guidance on what taxpayers should not do charge Subco D for costs incurred by Subco B that are attributable to the services performed for Subco C. Unfortunately, the study falls silent in providing affirmative guidance on how to price intercompany transactions where the value may be indirectly affected by the value of employee stock options.

Yet, despite this silence, the study implicitly assumes that the cost of services rendered by Subco B would be higher when it provides successful performance. It states in paragraph 172, that:

> At arm's length, the price charged by Subco B to Subco C for services rendered in Year 1 should take into account the options attributed to Subco B's employees in remuneration of the successful mission in Year 1…

the study further states that it may be advisable to eliminate comparable information for which adjustments cannot be made

This is taking extreme liberties with the assumption of "arm's length," and it may be incorrect in many real-world instances. For example, one need only think of one's own company's experience with third-party vendors. If any vendor's employees have a stock option in place that rewards them for enhanced quality to its customers (such as greater success in troubleshooting) this does not imply that the vendor would increase the price of its services. In effect, the example in the study assumes that there is an implied performance guarantee or incentive bonus that is contractually tied to the services provided by Subco B to Subco C.

This, of course, may often not be the case. It is true that companies may reward employees with stock options or other enhanced compensation schemes when the employees raise customer satisfaction (such as successful troubleshooting). However, because success is often dependent upon more than just direct employee activity (there may be mechanical defects in machinery used by the employees, for example), such rewards are often used to incentivize a greater expected, or average, level of employee performance. In other words, the success of any given project (compare the services provided to Subco C versus Subco D) may be out of the control of the employees, even when they operate at peak performance. Thus, an arm's-length solution in the example may be that the price of services to Subco C or Subco D would be identical, even though the services provided to Subco C were considered, *ex post*, more successful than those provided to Subco D. In such situations, an alternative valuation method would include in the employee cost base an average expected stock option award each year, versus specifically identifying costs to the *ex post* results of the employees. Consequently, the cost base for the cost-plus pricing of Subco C would be lower and the cost base for pricing to Subco D would be higher than that implied in the example. It also should be noted that this conclusion is not limited to a cost-plus method. A change in cost base can affect the ultimate transfer price under a profit-split, transactional net margin method, or resale price method as well.

6. Considering stock options as a comparability criterion

Another issue considered by the study is differences between comparable transactions and tested party transactions when there are employee stock options awarded to employees directly involved in one of the transactions. Is this a comparability factor that must be considered?

The study takes considerable space to explain that when there are material differences in the treatment of employee stock options between comparable party information and tested party information, the differences need to be taken into account. If adjustments to the information are not possible because of insufficient information, the study further states that it may be advisable to eliminate comparable information for which adjustments cannot be made, or to consider methods that are less sensitive to employee remuneration.

Authors' view: There are probably few practitioners that would disagree with the study's conclusions in this instance. Such an approach is in keeping with general best practices for selecting methods and comparables. However, the fact that the study covers this topic in such great detail heightens the chance that taxpayers may believe that adjustments for differences in employee stock option compensation between comparables and tested parties are more important than other adjustments. We hope that this is not the case, as differences for such factors as bad debt experience, warranty risk and foreign exchange risk between comparables and tested parties may be of equal or greater importance, depending upon the specific fact pattern of any taxpayer. Stated differently, it is hoped that this section is meant to emphasize that differences in employee stock option rewards need to be considered only in material situations, and not in all situations or at the expense of other more important differences. If not, it may well lead to taxpayers spending an inordinate amount of time and effort dealing with tax authority disputes on definitions of appropriate comparables, an area that most practitioners realize is already an inexact science. It also may lead to the outright rejection of comparables or of certain methodologies even though accepting the comparables or methodologies despite an inability to adjust for differences in employee stock option treatment might still lead to a more accurate arm's-length measure.

Further work required

Although the OECD is clearly open-minded about many of these issues, some tax authorities are not. The OECD is to be commended for refusing to sanction any entrenched positions and recognizing that there is validity to the opposing arguments. However, in the real world, tax authorities and taxpayers cannot simply conclude that there are arguments on both sides; they must decide what is the better view. The study leaves sufficient uncertainty that different tax authorities or taxpayers are likely to form inconsistent conclusions about the same transaction, while all claiming to be consistent with the OECD's views. This is a recipe for controversy and double taxation.

The OECD does not appear to have set out any formal process for submissions in relation to this study, nor even to have any specific intention to take this study any further. (John Neighbour has, however, speculated about a new chapter on this topic in the OECD transfer pricing guidelines.) Nevertheless, MNCs that have a high level of exposure to potential double taxation from transfer-pricing adjustments should take the initiative and lobby the OECD to follow up this initial study with some clear (or at least clearer) answers. Certainly, a one-size-fits-all answer is not going to be appropriate, because, as the study ably demonstrates, the appropriate treatment is highly fact-dependent. However, this does not mean that the OECD should not aspire to lay down guidelines that are sufficiently clear that most reasonable taxpayers and tax authorities will tend to form the same conclusion for any particular fact pattern. The current study does not meet this standard.

Until such time as we receive such clear guidance, the study confirms the ample scope for cross-border stock option plans to give rise to double taxation and major transfer-pricing disputes with tax authorities. So far, it is only a few tax authorities that are making an issue of these points, but experience shows that these things tend to spread, as other tax authorities catch on that they are missing their "fair share". Multinational corporations are unlikely to be able to find any policy that will keep all tax authorities happy, so MNCs should make a clear choice where they stand on the issues considered in this report, and reflect it in their intercompany agreements and transfer-pricing documentation, to minimize the risk of penalties and double tax.

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