Transfer Pricing and Employee Stock Options

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P R É C I S
Le principe de pleine concurrence des prix de transfert exige que les opérations entre entités liées soient réalisées à des prix et à des conditions qui auraient existé si les entités n’avaient entre elles aucun lien de dépendance. L’application du principe de pleine concurrence aux options d’achat d’actions accordées aux employés pose des problèmes pratiques et théoriques qui sont difficiles à régler et à réconcilier. Les employeurs n’octroient pratiquement jamais à leurs employés, ou employés de leurs filiales, des options d’achat d’actions de sociétés sans lien de dépendance, puisque cette façon de faire serait contraire à toute politique d’orientation des avantages aux employés. De plus, les options d’achat d’actions sont difficiles à évaluer puisqu’elles ont été expressément conçues pour n’être ni négociables, ni transférables, et ne pas être exercées avant « l’acquisition », et qu’elles peuvent venir à échéance si l’emploi prend fin avant « l’acquisition ». De ce fait, la demande très limitée pour les options d’achat d’actions et l’illiquidité des options rendent leur évaluation imprécise à toutes les fins — fiscales, comptables et économiques.

Dans cet article, les auteurs examinent le principe de pleine concurrence et son application au coût des options d’achat d’actions accordées aux employés dans les ententes de partage des coûts et accords de remboursement entre entités avec lien de dépendance. Ils analysent également la méthodologie et le calendrier de l’évaluation de ces options aux fins des prix de transfert.

A B S T R A C T
The arm’s-length principle of transfer pricing requires that transactions between related entities be undertaken at prices and on terms and conditions that would exist between entities dealing at arm’s length. Applying the arm’s-length principle to employee stock options introduces practical and theoretical issues that are difficult to reconcile and resolve. Employers almost never grant options to acquire shares of arm’s-length corporations to their employees or to employees of their subsidiaries, since to

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do so would not serve any incentive alignment purpose. Further, employee stock options are difficult to value because they are explicitly designed to be non-marketable, non-transferable, non-exercisable before vesting, and forfeitable if employment is terminated before vesting. The resulting limited demand for and illiquidity of employee stock options renders their valuation imprecise for all purposes—tax, accounting, and economic.

In this article, the authors examine the arm's-length principle and its application to employee stock options in cost-sharing arrangements and recharge agreements between non-arm's-length entities. They also explore the methodology and the timing of valuing such options for the purposes of transfer pricing.

**KEYWORDS:** TRANSFER PRICING ■ COST SHARING ■ EMPLOYEE STOCK OPTION PLANS ■ EXECUTIVE COMPENSATION ■ VALUATION

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**INTRODUCTION**

Companies grant stock options to their employees in order to align their employees’ interests and long-term incentives with the interests of their shareholders. In the context of a multinational enterprise (MNE), incentives are often aligned with
after-tax consolidated profits or global stock prices in order to ensure that employees do not focus solely on divisional or territorial interests. Such an alignment of incentives usually includes the granting of parent company stock options to employees of subsidiaries in other tax jurisdictions. This enables the MNE to convey the impact that employees of a local subsidiary can have on the parent company’s bottom line and to recognize and reward the employees’ achievements. A broad-based global employee stock option plan can facilitate dialogue about the MNE’s goals in a common financial language.

Option plans based on the parent company’s share prices can also be used to recruit and retain local employees, thereby allowing smaller MNEs to compete with larger ones in the labour market. When entities in different jurisdictions are merged, single global stock option plans can be used to align the two previously distinct entities. All of these factors have contributed to the growth of broad-based option plans on a global basis. A survey of 70 MNEs by PricewaterhouseCoopers in 2003 showed that 73 percent of the participants had broad-based option plans in place for more than five years, and 84 percent of the participants already granted or planned to grant equity-based compensation to local employees (where they were not prevented by local laws).¹ In a 2004 survey of 350 global employers, Mercer Human Resource Consulting reported that 85 percent had a global compensation strategy in place and 54 percent had a broad-based stock option plan (compared with 47.4 percent in 2000).² In 2005, Inderst and Mueller found that broad-based option compensation “minimizes the firm’s expected future wage payments in states of nature where the firm is only marginally profitable, thus making continuation as attractive as possible in precisely those states of nature where, e.g., a high fixed wage would lead the firm’s owners to inefficiently exit.”³

Appropriate incentive alignments also help an MNE to successfully trade off costs against benefits across tax jurisdictions for the overall good of the MNE. One of the key areas requiring coordination is the management of global tax liability. Taxes are a cost of doing business, and managers should ideally consider taxes a controllable expense and incorporate them in management decisions about matters such as pricing.⁴

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⁴ Local managers need appropriate incentives to shift their thinking away from maximizing after-tax local income and toward maximizing after-tax global income, since attaining the former may not necessarily attain the latter. See Deloitte, Unlocking the Value of Globalisation: Profiting from Continuous Optimisation (Deloitte, January 2005), 15, under the heading “Managing Taxation from a Global Optimisation Perspective.”
For many MNEs, the leading challenge in managing the global tax liability is transfer pricing. In Ernst & Young’s *Transfer Pricing 2003 Global Survey*, 86 percent of the MNE parent company respondents and 93 percent of the subsidiary respondents identified transfer pricing as the most important international tax matter that they faced. The Ernst & Young survey also indicated that MNE transfer-pricing policies were increasingly being scrutinized and subjected to audits by revenue authorities. Wrappe reports that the number of transfer-pricing cases in US federal courts for the first half of 2004 doubled from the same period in 2003, while the amounts in dispute increased by over 800 percent, according to BNA Tax Management’s analysis of court records.

The decision to grant stock options to employees of subsidiaries in other tax jurisdictions may trigger both the transfer-pricing rules and the employee stock option rules in two or more tax jurisdictions, creating unintended complexities and consequential tax implications that affect the MNE’s overall tax liability.

The arm’s-length principle of transfer pricing requires that transactions between related entities be undertaken at prices and on terms and conditions that would have been agreed upon by entities dealing at arm’s length. In the context of employee stock options, the arm’s-length principle introduces theoretical issues that are difficult to reconcile in practice. Employers almost never grant options to acquire shares of arm’s-length corporations to their employees or employees of their subsidiaries, since to do so would not serve any incentive alignment objective. At the same time, employers do not issue options to the general (arm’s-length) public on the same terms that are typically offered to employees. Further, the valuation of employee stock options has remained largely unresolved in the literature owing to the complexity of valuing such attributes as delayed vesting and non-marketability. These unique features make the application of the arm’s-length principle and traditional transfer-pricing methodologies to employee stock options extremely challenging.

We will explore the transfer-pricing issues related to employee stock options in a multijurisdictional context with reference to developments in selected countries and to the OECD’s tax policy study, *Employee Stock Option Plans: Impact on Transfer Pricing*. More specifically, we will examine the arm’s-length principle and its

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7 However, this is not likely to be the appropriate “comparable uncontrolled transaction” for transfer-pricing purposes.

8 The typical terms of employee stock options depend on the jurisdiction. In Canada and the United States, such terms normally include gradual vesting provisions of 3 to 4 years, an expiry date of 10 years, and an exercise price equal to the stock price at the grant date (that is, at the money).

application to employee stock options in cost-sharing arrangements and recharge agreements between a parent company and its subsidiaries. With respect to both cost-sharing arrangements and recharge agreements, the transfer-pricing questions summarized in the OECD report are as follows:

1. Does the arm’s-length principle require that employee stock options be included in determining the cost of services or goods transacted between non-arm’s-length entities (for example, in determining the development costs of property subject to a cost-sharing arrangement or the “service” provided when an MNE grants options to employees of its subsidiaries)?
2. If so, how should the cost of the employee stock options be determined?
3. At what point should the costs be measured?

Significantly, the OECD report was published as a non-prescriptive tax policy study highlighting the pros and cons of different approaches, underscoring the lack of consensus of the OECD member states on these issues.

The arm’s-length principle is at the core of transfer pricing. Both cost-sharing arrangements and recharge agreements require a discussion of the methodology and the timing of the valuation of employee stock options for the purpose of applying the arm’s-length principle. In the next section of the article, we present a theoretical discussion of the arm’s-length principle and the unique issues raised by employee stock options, including comparability issues. The interaction of accounting and domestic tax treatment of employee stock options with transfer pricing is also considered. We then turn to a specific discussion of cost contribution arrangements and option recharge agreements in light of developments in the United States, Canada, the United Kingdom, and Australia. This review is followed by a discussion of double taxation and mutual agreement procedures and concluding observations on stock options and transfer pricing.

**THE ARM’S-LENGTH PRINCIPLE**

Transfer pricing requires taxpayers to set prices for transactions between related or non-arm’s-length entities as though the entities were unrelated and dealing at arm’s length. The arm’s-length principle is enshrined in article 9(1) of the OECD model tax convention: 

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under article 9 and article 25 of the OECD model tax convention, infra note 10, with respect to employee stock option plans offered by publicly listed MNEs. For the purposes of the OECD report, employee stock option plans include dilutive plans, in which the corporation issues new shares to the employee upon the exercise of the option, and non-dilutive plans, in which the corporation acquires existing shares from the market to deliver to the employee upon the exercise of the option. Privately held MNEs are not considered in the report for practical reasons—for example, the difficulty of establishing the fair market value of shares that are not traded on open markets. Equity-based payments to non-employees, such as independent contractors, and “phantom” arrangements, such as stock appreciation rights plans, are also excluded from the scope of the OECD report, although the report acknowledges that similar transfer-pricing issues could arise with respect to independent contractors and phantom plans.
[When] conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.10

The purpose of the arm’s-length principle is to prevent MNEs from reducing their consolidated or overall tax liability by inappropriately shifting income from heavily taxed jurisdictions to lightly taxed jurisdictions. Member countries of the OECD, including Canada, have adopted the arm’s-length principle in their domestic transfer-pricing legislation, although there are differences in approach and interpretation.11 These differences are perhaps most evident with respect to transfer pricing and employee stock options: Canada has little in the way of formal policies, whereas detailed legislation and policies are evolving in the United States and the United Kingdom.

The first step in applying the arm’s-length principle is to identify the transaction and the parties to the transaction. In this regard, the decision to grant options (and the number of options granted) is not, in and of itself, a transfer-pricing issue, since employees and employers are presumed to transact at arm’s length. Instead, in the context of both cost-sharing arrangements and option recharge agreements it is the transaction between the MNE and its subsidiary that is subject to review.

With respect to cost-sharing arrangements, the transaction is the joint development of property for the mutual benefit of the MNE and its subsidiary. The issue for transfer-pricing purposes is whether arm’s-length parties would include employee stock options in their joint development costs.

With respect to option recharge agreements, the transaction is the provision, by the MNE, of the right to acquire shares to employees of its subsidiaries. Generally, the options are granted in respect of the employees’ services to the subsidiary, not to the MNE. In essence, the MNE has notionally agreed to provide shares to its subsidiary, which will in turn immediately deliver those shares to its employees upon the satisfaction of certain events—namely, the option exercise. For transfer-pricing purposes, the question is whether the MNE should be reimbursed for the notional provision of shares to the subsidiary and, if so, how the reimbursement should be determined.

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COMPARABILITY ISSUES AND EMPLOYEE STOCK OPTIONS

The underlying premise of the arm’s-length principle is the ability to compare the terms and conditions of a transaction between related entities (a controlled transaction) with terms and conditions in transactions between arm’s-length entities (an uncontrolled transaction). The most direct method of determining whether the terms of a transaction between controlled entities are arm’s-length is to compare the prices charged for property or services in the controlled transaction with prices charged in comparable transactions between arm’s-length entities. A significant difference between those two prices suggests that the terms of the controlled transaction were not at arm’s length.

For such comparisons to be meaningful, the economically relevant characteristics of the transactions must be comparable. In transfer pricing, a transaction is “comparable” if none of the differences (if any) between the transactions that are being compared could materially affect the condition examined in the methodology (for example, price or margin) or if reasonably accurate adjustments can be made to quantify the price effects of the differences in economic characteristics or functions between the controlled and uncontrolled transactions.\(^\text{12}\) Most transfer-pricing resolutions are expressed in the form of a range of prices that may overlap the pricing expectations of multiple parties.

The transfer-pricing question that arises in the context of employee stock options is this: If the controlled transaction of a tested party involves employee stock options, should the comparables also include employee stock options? The OECD report suggests that material differences in employee stock option plans must be considered in justifying and documenting transfer-pricing adjustments. The report further states that it may be advisable not to consider comparables that do not use employee stock options if the tested party uses them to a material extent. In some cases, the transfer-pricing adjustment for employee stock options may exceed other types of transfer-pricing adjustments, such as those for foreign exchange risk or warranty risk. Thus, one key issue is determining whether the employee stock options are material to an analysis of the economic characteristics of the transaction. If the employee stock options are not material, then the tested party’s choice of comparables may be quite different.

For those transactions in which employee stock options are material, the OECD report’s recommendations may not offer much practical help. First, there is a lack of available data on whether and how employee stock options are treated in transactions by arm’s-length entities. Second, there is a lack of consensus on how employee stock options should be valued. Third, even if a consensus on valuation is

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achieved, option valuation requires several subjective assumptions or valuation inputs that may create significant divergence in the value of options with similar terms. Fourth, there is little practical evidence of or experience in how to allocate the functions and risks associated with employee stock options to the related entities and the impact of such an allocation on the pricing of the transaction. Fifth, there are several ways of accounting for stock options, thereby making information that is publicly available from financial statements difficult to interpret and compare. As a result, there may be material differences in transactions involving stock options between arm’s-length entities and related entities. Furthermore, making sufficiently reliable adjustments to take into account these differences may prove problematic because of the valuation issues and inconsistent tax and accounting practices. Holowka says, “[c]omparability adjustments include reclassifying stock option costs for cost accounting purposes, and accounting for the value of options where the controlled entity but not the uncontrolled entity recognize[s] the stock option expense, or neither recognize[s] the expense.”

Lack of Available Data
A lack of publicly available data makes it difficult to determine whether transactions between arm’s-length entities are comparable to the transactions of related entities. Related entities may enter into a greater variety of contracts and arrangements than arm’s-length entities for a number of economic, tax, and legal reasons. A prime example is an MNE’s provision of stock options to employees of its subsidiaries. Although accounting standard setters around the world are becoming more consistent in requiring that employee stock options be valued at the grant date and expensed in the income statement, such information may not be sufficient for the purpose of assessing comparables. Information on option grants by a specific subsidiary is not publicly disclosed, since the disclosure in annual reports is generally restricted to aggregate information on vesting requirements, the maximum numbers of shares under options, and information on weighted and average exercise prices. Both the OECD report and the OECD transfer-pricing guidelines recognize that practical difficulties may arise when the arm’s-length principle is applied to transactions that are rarely undertaken by arm’s-length entities and that the lack of independent comparables may restrict the choice of transfer-pricing methodologies.

Valuation of Employee Stock Options
Employee stock options present unique valuation challenges even before the complexities of intercompany transactions are introduced. Asset valuation ideally requires an active market for the asset, with supply and demand forces that interact to

determine market prices. Employee stock options are difficult to value because they are explicitly designed to be non-marketable, non-transferable, non-exercisable before vesting, and forfeitable if employment is terminated before vesting. The terms of publicly traded options do not mirror the terms of employee stock options. The resulting limited demand for and liquidity of employee stock options renders their valuation imprecise for all purposes: tax, accounting, and economic.

Although many transactions in transfer pricing face the practical challenges of a lack of evidence of comparables, transactions involving employee stock options face the additional barrier of a lack of comparables even in theory. When no comparable transactions and/or no unrelated entities can be found, the tax authorities require documented economic analysis to objectively estimate the prices that arm’s-length entities would have negotiated.

Arguments establishing the economic value of employee stock options have been prevalent in the recent debates over whether the cost of the options should be expensed on financial statements. Court decisions have held that employee stock options have value even at grant dates, when they are not likely to be in the money. Such decisions recognize the economic value of stock options, even if the immediate cash return from their exercise is zero. Accounting standard setters in the United States (Financial Accounting Standards Board), Canada (Canadian Institute of Chartered Accountants), and internationally (International Accounting Standards Board) have been converging in their requirement to expense employee stock options at the grant date.

15 The OECD report, at paragraph 87, acknowledges this fact in discussing the fair value approach to employee options:

Although it starts with a review of what could be a potential Comparable Uncontrolled Price according to the 1995 TP Guidelines, this approach potentially represents a departure from the CUP method. In effect, while the CUP method relies on strong comparability requirements, the Fair Value approach described above does not rely on a comparison with a comparable uncontrolled transaction; in fact, in cases where TOPCO’s non-employee options are not tradable, it does not even rely on a comparison with comparable financial instruments. The reliability of the approach therefore depends upon the ability to measure and account for such differences.

16 For example, divorce courts have led the way in awarding ex-spouses 50 percent interest in employee stock options even if they were not vested or were out of the money at the time of divorce, as explained in Diya Gullapalli, “Divorcing Couples Spar over Worthless Options,” Wall Street Journal, August 7, 2002.

17 Warren Buffett, for example, makes it clear that “Berkshire [Hathaway] will be happy to receive options in lieu of cash for many of the goods and services we sell.” See Warren Buffett, “Stock Options and Common Sense,” Washington Post, April 9, 2002.

18 At a general level, all three standards require employee stock options to be valued at the grant date using option-pricing models such as the Black–Scholes model, infra note 19, or the binomial model, and disallow the use of intrinsic values. Once estimated, the expense is recognized over the period in which the employees provide service. The compensation expense is recognized on the basis of the number of options expected to vest and is “trued up” on the basis of options that actually do vest. In other words, previously recognized expense is reversed for options that
Two common valuation methods have become generally acceptable: the Black-
Scholes model or some variation thereof (for example, the binomial model), 19
adopted under the accounting standards, and the intrinsic value or spread, which is
measured as the excess of the share price over the exercise price. A third possibility
is to value the options from the perspective of the recipient entity (for example, the
subsidiary). Each valuation method, however, can produce very different results on
the same set of facts. The intrinsic value method is inherently more objective and
less subject to manipulation, but it suffers from two shortcomings: (1) it requires
the valuation of the employee stock options to be inappropriately deferred to the
exercise date, and (2) the option recipient’s benefit (or intrinsic value) on the exercise
date has a very remote connection to the value given up by the option grantor on
the grant date. Other valuation models selected can be manipulated by the choice of
assumptions or inputs used. Inappropriate assumptions or valuation inputs can lead
to the inappropriate valuation of employee stock options, which, in turn, can lead to
inappropriate transfer prices. All of these choices and the accompanying uncer-
tainty make valuation a clear battleground, with MNEs potentially selecting valuation
methodologies that suit their tax-planning purposes.

Black-Scholes Valuation

The opportunity cost or value given up by the employer corporation for tradable
call options can be objectively estimated by the Black-Scholes option valuation
model. However, such a valuation may not be as relevant to employee stock options
because their terms are significantly different from those of options that are pub-
licly traded and sold to diversified investors.

The economic valuation based on the Black-Scholes formula relies on the follow-
ing six input variables: (1) the risk-free interest rate; (2) the stock price at the option
valuation date; (3) the exercise price; (4) the time to maturity; (5) the expected variance

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19 Fischer Black and Myron S. Scholes, “The Pricing of Options and Corporate Liabilities” (1973)
vol. 81, no. 3 Journal of Political Economy 637-54. A binomial model values options on the basis of
the underlying stock price and recursively works back from the option maturity date. The
underlying stock price is assumed to change to only one of two possible values in the next period.
Binomial valuation can incorporate exercise prior to the option's maturity (as in the Black-Scholes
model) as well as a changing expected volatility over the life of the option (not feasible in the
Black-Scholes model). Although the binomial model allows for more realistic inputs and
assumptions than the Black-Scholes model, its greater complexity makes it less popular.
of stock returns; and (6) the dividend yield. Raabe, Whittenburg, and Doran further describe the use of the Black-Scholes option model in tax valuation, while Eaton and Prucyk describe the new US accounting standard.

The risk-free rate, the stock price, and the expected variance of stock returns are generally beyond the corporation’s control. However, while expected volatility of past stock returns is generally beyond the corporation’s control, the estimate selected by the corporation for the Black-Scholes valuation model is arguably subjective. Corporations can choose longer or shorter periods over which they measure this volatility to justify higher or lower variance measures, and therefore higher or lower option valuations. In most cases, a shorter estimation period will result in higher volatility estimates. Increased volatility makes the call option more valuable, since the option holder enjoys all of the benefits of higher stock prices while losses are restricted to the purchase price of the call option (usually zero in the case of employee stock options). The higher the volatility, the greater the expected amount by which call options can be in the money before expiration, and therefore the greater the option’s value.

Domestic corporations may face a tradeoff between wanting to understate the value of employee stock options for accounting purposes and wanting to overstate the value for tax purposes. MNEs, however, may not face a similar tradeoff. The value placed on options by two related corporations can affect the taxable profits of the two corporations in two jurisdictions. The incentive to understate or overstate value will depend mostly on the relative tax rates of the two corporations, since intercorporate accounting transfers are cancelled out or neutralized under consolidated accounts.

**Intrinsic Value or Spread**

An alternative measure of value given up by the employer is the intrinsic value of an option, or the spread between the stock price at exercise ($P_e$) and the exercise price ($X$). Intrinsic values are never less than zero, since call options entitle their holders to the right but not the obligation to exercise. Therefore, out-of-money

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20 Black-Scholes values of call options increase with increases in the risk-free rate of interest (since option holders can earn higher interest on their exercise price, which can be invested profitably until exercise); with increases in the underlying stock price (since they increase the probability of finishing in the money); and with increases in volatility (since they increase the number of states where the option will be in the money). Black-Scholes values of call options decrease with decreases in the time to maturity (since there is less time remaining to finish in the money); with increases in the exercise price (since they reduce the probability of finishing in the money); and with increases in the dividend yield (since dividends reduce the underlying stock price at the dividend declaration dates).


options can simply be discarded for a zero intrinsic value. The “value” connotation in “intrinsic value” can be misleading when the spread \((P_e - X)\) is zero or close to zero, since the economic or Black-Scholes value can be—and usually is—significantly greater than the intrinsic value.\(^{23}\)

The Black-Scholes value of options can be greater than or less than the intrinsic value before exercise, although both values converge at the option expiry date. Financial economic theory suggests that from the employees’ perspective the optimal exercise of stock options is at maturity. However, employees are generally undiversified in both their financial and their human capital and are therefore eager to exercise early, thereby giving up value. In their study of exercise behaviour of over 50,000 employees, Heath, Huddart, and Lang report that most employees exercise earlier than may be financially optimal, thereby giving up untapped value (in Black-Scholes terms).\(^{24}\)

The appeal of the intrinsic value measure for employee stock options is that a zero intrinsic value implies that options are not exercised, thereby signalling that no value has been transferred from the employer, including any costs of reporting diluted earnings per share.\(^{25}\)

However, the tax authorities are not always comfortable with the intrinsic value of employee stock options. The value of options given up by the employer cannot always be determined by reference to how much (if anything) the employees gain on exercise, since the intrinsic value or spread normally has no relation to the economic cost (as measured by the Black-Scholes valuation model) given up by the corporation on the grant date. Therefore, the intrinsic value of employee stock options may not constitute an arm’s-length price.\(^{26}\)

In the United Kingdom, for example, the position of HM Revenue and Customs (HMRC, formerly Inland Revenue) on cost-plus and cost-sharing arrangements is that transfer-pricing methods that rely on the profit made by the employee (that is, the intrinsic value) will not likely result in an arm’s-length price of the option (based on the Black-Scholes value), except in the unusual circumstances when exercise occurs at the option maturity date (at which time both the intrinsic value and the

\(^{23}\) This factor has been commonly relied upon to justify not expensing stock options for accounting purposes.


\(^{25}\) Current US tax rules on non-qualifying options generally follow this symmetric argument by allowing the employer to deduct the spread and requiring the employee to include the spread in income, both on the exercise date.

\(^{26}\) Although the Black-Scholes formula measures the opportunity cost to the employer, it overstates the subjective value to the employee. The lack of diversification and the trading restrictions placed on employee stock options make them less valuable to the employee relative to the market value of an unrestricted option with similar features that can be traded at any time. However, the fact that employee stock options may be worth less to employees owing to the employees’ undiversified human and financial capital does not influence the (opportunity) cost to the corporation of awarding such options.
Black-Scholes option value are identical). This position seems consistent with financial economic theory and inconsistent with Green, Franklin, and Heimert, who state that “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.” However, the OECD report still retains this method as a viable alternative, perhaps because the existing tax rules in some jurisdictions (such as the United States) allow the intrinsic value or spread to be deducted.

**Valuation from the Subsidiary’s Perspective**

Another approach considered by the OECD report is the valuation of employee stock options from the perspective of the recipient entity. Such an approach is supported by the OECD transfer-pricing guidelines, which generally state that proper regard should be given to the value of the transaction to the recipient entity and the value that an arm’s-length party would assign to a comparable transaction.

Identifying the benefits from the non-arm’s-length transaction first requires identifying the recipient or the intended recipient of the goods or services (options, in this case), since valuation of the benefits may be contingent on the identity of the recipient. For example, the parent company (Topco) may benefit by having a well-aligned, coordinated, and synergistic workforce that is able to successfully trade off costs against benefits across tax jurisdictions for the overall good of the MNE. Its subsidiary (Subco) may benefit from the distinct comparative advantage in its local competitive labour market.

The valuation of stock options is clearly linked to the identity of the benefit recipient. If Topco is the only beneficiary, it can be argued that the out-of-pocket cost plus the opportunity cost of the employee stock options will best approximate the arm’s-length price. The OECD report requires a transfer-pricing adjustment only if Subco benefits from the option plan. In most cases, however, it is difficult to demonstrate that the subsidiary did not benefit from the stock options.

If Subco is the only beneficiary, it can be argued that the value to Subco (perhaps in terms of cash compensation saved) will best approximate the arm’s-length price.

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30 See, for instance, the OECD transfer-pricing guidelines, at paragraphs 1.15, 1.16, 6.14, and 7.29.
31 The “intended recipient” category in this context covers situations such as those in which employees end up receiving no benefit or even incurring a liability for the taxes triggered on in-the-money options exercised, followed by the subsequent decline in the value of the underlying shares to the extent that all of the economic benefit of the option has evaporated.
32 OECD report, at paragraph 36.
33 Although the OECD report does not mention it, a related alternative is to look at the savings realized by the subsidiary by using the parent company’s options instead of a parallel phantom stock option plan or a stock appreciation rights plan.
It can also be argued that the subjective value to the employee of the option award can be used as a proxy for valuing the transaction from Subco’s perspective (for example, determining a minimum floor value), although such an approach is likely to prove impractical from a valuation perspective and may cause transactional focus to be lost.

Alternatively, the OECD report suggests that a transfer-pricing method that examines the profit indicator of the subsidiary could be adopted under the profit-split method. However, the report expresses concern that such a method potentially impairs transactional focus, since the provision of the stock options is merely one component of other transactions undertaken by the subsidiary. Despite these concerns, the OECD report suggests that this approach could be a useful “sanity check.”

Theoretical and practical transfer-pricing issues arise in part because it can be very difficult to assess the real beneficiary of a global option plan. Such issues may be resolved to some extent by arguing that, in ideal economic circumstances, the range of arm’s-length prices determined in the above cases should overlap with each other. For example, Topco’s opportunity cost of granting the options may not be very different from the amount that Subco can save in cash compensation as a result of receiving options from Topco, which in turn may not be very different from the value determined by standard option-pricing models.

**Impact of Option Valuation on Transfer-Pricing Methodologies**

Transfer-pricing methods are sensitive to the imprecision inherent in the valuation of employee stock options. If the imprecision is material, then the valuation methodology is likely to affect the arm’s-length price of the controlled transaction. The issues at the intersection of employee stock options and transfer pricing affect both the definition and the measurement of the costs of the controlled transaction as well as the identification of the costs incurred by third parties in comparable uncontrolled transactions. The inclusion of employee stock option costs in both cost-sharing arrangements and option recharge agreements potentially affects the cost base. The OECD report highlights three transfer-pricing methods that are particularly sensitive to option valuation—the cost-plus method, the transactional net margin method, and the profit-split method. Arguably, all transfer-pricing methods are equally sensitive to the imprecise valuation of employee stock options.

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34 OECD report, at paragraph 126.

35 Ibid., at paragraph 166. The cost-plus method compares the costs incurred by a supplier of property or services in a controlled transaction with the costs incurred by a supplier of property or services in a comparable uncontrolled transaction. An appropriate markup is then added to the cost in the uncontrolled transaction to reflect an appropriate profit. Under the transactional net margin method, the profit margin relative to an appropriate base (for example, costs, sales, or assets) in a controlled transaction is compared with the profit margins that would have been realized by entities to an uncontrolled transaction. The profit-split method is used to determine the division of profits that arm’s-length entities would have agreed to where the transaction consists of highly interrelated activities.
Cost-based transfer-pricing methods compare the costs of an uncontrolled transaction to the costs of a controlled transaction; therefore, an under- or overvaluation of employee stock options can have obvious implications for transfer prices. Cost differentials also have direct one-to-one impact on profit differentials; therefore, an under- or overvaluation of employee stock options has similar dollar implications for transfer prices under both profit-based and cost-based methods.

With respect to the cost methods, the OECD report concludes that employee options should be included in the cost basis regardless of their respective accounting treatment. If the costs of options are not recorded in the financial statements, the report recommends that the cost base be adjusted, using an appropriate valuation method. Further, the report cautions that option-pricing models adopted for accounting standards are a useful starting point, but they may require adjustments in light of the different policy goals of transfer-pricing tax legislation and financial accounting standards.

With respect to profit-split methods, the OECD report recommends that the cost of employee stock options be deducted in computing and comparing the transactional net margins or the profit splits, since remuneration costs are normally deducted when net margins or profits are determined.

Functional Analysis and Employee Stock Options

Functional analysis allows price adjustments for differences in functions and risks assumed, such as which party (buyer or seller) bears the foreign exchange risk, the inventory obsolescence risk, the accounts receivable collection risk, and the warranty risk. These kinds of functional differences can be analyzed and documented to quantitatively justify why a particular transfer price may deviate from arm’s-length average or arm’s-length median prices. Tax authorities allow transfer prices between related entities to increase (decrease) if the seller takes on more (fewer) value-added activities or more (less) risk. This process recognizes that rewards (in the form of higher selling prices or lower costs) in arm’s-length markets are commensurate with risks, and therefore the entity that bears greater foreign exchange risk or inventory obsolescence risk (in comparison with a peer group) can be expected to be rewarded with higher selling prices or lower costs.

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36 Ceteris paribus, a $1 increase in cost results in a $1 drop in profits.
37 OECD report, at paragraph 167.
38 Ibid., at paragraph 175.
39 Ibid., at paragraph 86.
40 Ibid., at paragraphs 177-78.
41 MNEs may strategically allocate assets, functions, and risks to low-tax-rate jurisdictions in order to justify the allocation of higher corresponding rewards to the low-tax-rate jurisdictions and thereby maximize global after-tax income. For an example of such a strategy, see Amin Mawani, Quantifying Foreign Exchange Risk for Transfer Pricing, Working Paper (Toronto: York University, Schulich School of Business, 2005).
When price adjustments are allowed for differences in general functions and risks assumed, an appropriate allocation of stock option risks and functions is critical under both cost-based and profit-split methods.

In determining the pricing of comparable arm’s-length transactions, it is appropriate to allocate risks in proportion to each party’s ability to control those risks.\footnote{OECD report, at paragraph 61.} The type and magnitude of risks will ultimately depend on the actual structure of the arrangements between the MNE and the subsidiary. The OECD report identifies two primary risks with respect to global option plans: (1) the risk of share price appreciation (depreciation) and (2) the likelihood of options being exercised.\footnote{Ibid., at paragraph 59.} One of the key issues discussed in the OECD report is whether an arm’s-length party would be willing to bear such risks or whether some appropriate hedging strategy would be adopted. The OECD report suggests that such a decision is to be determined on the particular facts of a case.\footnote{Ibid., at paragraph 105.} However, most firms with employee stock option plans do not seem to hedge against stock price increases that result in a payout to employees, which the OECD report confirms as “a legitimate business decision.”\footnote{Ibid.}

The unique nature of employee stock options makes it inherently more difficult to allocate risks between the non-arm’s-length entities. The OECD report suggests reviewing the contractual terms, the relative roles of the MNE and its subsidiaries in establishing the plan and option grants, and the overall economic circumstances. However, the current practices of many MNEs in establishing global option plans may not necessarily include a consideration of transfer-pricing concerns. In fact, a multitude of factors—such as accounting and tax considerations and securities and employment law—drive the plan design and implementation, likely resulting in tradeoffs and compromises.

In conclusion, the OECD report emphasizes that the option plan arrangements between the MNE and the subsidiary should reflect an appropriate risk allocation through a comparability analysis at the time the plan is established and the risk minimization technique, if any, is adopted. The report explicitly recognizes that “[t]aking risk allocation and risk minimisation techniques into account... is important as this will directly impact the price of the transaction.”\footnote{Ibid.} However, the report also acknowledges that “the lack of comparable transactions may complicate this exercise and require that taxpayers and tax authorities determine what arm’s length parties would have done in comparable circumstances.”\footnote{Ibid., at paragraph 64. This statement also echoes the general principles set out in the OECD transfer-pricing guidelines (see, for example, paragraph 1.10 of the OECD transfer-pricing guidelines).}

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42 OECD report, at paragraph 61.
43 Ibid., at paragraph 59.
44 Ibid., at paragraph 105.
45 Ibid.
46 Ibid.
47 Ibid., at paragraph 64. This statement also echoes the general principles set out in the OECD transfer-pricing guidelines (see, for example, paragraph 1.10 of the OECD transfer-pricing guidelines).
Apportionment and Measurement Issues

Another issue relevant to comparability is the period to which the employee stock option relates. Possible measurement dates include the option grant date, the option vesting date, and the option exercise date. Imprecise apportionments can create unacceptable arm’s-length transfer prices. The OECD report recommends that employee stock options be valued at the grant date and apportioned over the relevant period to which the services giving rise to the options relate.\textsuperscript{48} For cost methods, the OECD report recommends that only the apportioned stock option expense that is remuneration for that year be included in the cost base. This can be problematic if the option expense is deferred until the year of exercise. For example, assume that options are granted in year 1 but do not vest until year 4. If the value of the options is not accounted for until year 4, the remuneration costs will be understated in year 1 even though service for the option was provided in that year. The OECD report also questions whether arm’s-length entities will accept a charge of some unknown amount in year 4.\textsuperscript{49} The appropriate measurement and allocation of stock option costs is also relevant to profit-split methods. For example, stock option costs attributed to services performed in year 1 should be reflected in the profits of year 1 regardless of when the costs are actually charged.\textsuperscript{50}

The apportionment question is difficult, and the answer may depend on the terms of the stock option plan—that is, whether the options are granted for past or future service. However, the language in most employee stock option plans is fairly general and typically does not specify whether the option grant is for past, future, or current service, although vesting conditions often imply that the options are for current or future service.\textsuperscript{51} This issue is not resolved by the accounting–tax dichotomy.

From the employees’ perspective, options for tax purposes may be attributable to services rendered, and thus taxable, in the year of grant or exercise.\textsuperscript{52} Some countries have preferential stock option rules whereby, if certain statutory conditions are met, the option gain is treated as a capital gain (or at capital gains tax rates) for income tax purposes, and the point of employee taxation is delayed until

\textsuperscript{48} OECD report, at paragraph 199.
\textsuperscript{49} Ibid., at paragraph 201.
\textsuperscript{50} Ibid., at paragraph 180.
\textsuperscript{51} One could argue that options that vest over time reasonably relate to future services (to be performed over the period during which the options vest) and that options that are granted fully vested reasonably relate to either past or current services. However, other language in the stock option plans may contradict such inferences.
\textsuperscript{52} For example, Belgium and the Netherlands tax options on the date of grant.
\textsuperscript{53} For example, Canada, the United States, and the United Kingdom generally tax options on the date of exercise. For Canada, see ITA paragraph 7(1)(a). For the United States, see IRC section 83 and Treas. reg. sections 1.83-7(a) and 7(b). For the United Kingdom, see schedule 22 of the Finance Act 2003 (UK), 2003, c. 3.
the shares are sold. Preferential capital gains treatment may further cloud the issue of the period of service to which the option relates because there may be no amount that is taxed as compensation under the domestic tax laws.

From the employer’s perspective, employee stock options are expensed at the date of the grant and prorated over the vesting period on the basis that some additional services are still to be provided beyond the date of the grant. However, this fiction for accounting purposes may not represent the economic reality of when the company incurs the expenditure or opportunity cost. For tax purposes, the tax deduction—if available—is matched to the time that the employee must include the option benefit.55

The domestic tax rules of employee stock options add a further layer of complexity to the transfer-pricing issue. For example, three related entities in three separate jurisdictions with different tax laws may allow employee stock options to be deductible fully, partially, or not at all. The deductibility of employee stock options clearly affects after-tax costs for entities with positive marginal tax rates. In the following sections, we explore the interaction of domestic taxation of employee stock options and transfer-pricing rules in the context of cost-sharing arrangements and option recharge agreements.

COST-SHARING ARRANGEMENTS

A cost contribution arrangement, or CCA (the OECD’s term for a cost-sharing arrangement), is defined in the transfer-pricing guidelines as follows:

a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights.56

54 In Canada, for example, 50 percent of the stock option benefit may be deducted by the employee, and taxation of the option benefit may be deferred until the shares are sold in certain circumstances. See ITA subsection 7(1.1), paragraphs 110(1)(d) and (d.1), and subsections 7(8) to 7(16). In the United States, options that receive favourable tax treatment are known as incentive stock options (ISOs) and must meet a number of statutory conditions: see IRC sections 421, 422, 423, and 424. In the United Kingdom, options that qualify as approved share schemes receive preferential tax treatment. The preferential tax rules for approved share schemes are found in chapters 6 to 9 of the Income Tax (Earnings and Pensions) Act 2003 (UK), 2003, c. 1.

55 Canada generally does not permit a deduction for the option gain: ITA paragraph 7(3)(b). The United States does not permit a corporate deduction in respect of ISO options: IRC section 162 and Treas. reg. section 1.83-6(a)(1). In the United Kingdom, a corporate deduction for the option gain that is included in the employee’s income (or that would have been included if exempt because of the approved share scheme rules) is generally available in respect of accounting periods commencing on or after January 1, 2003: see schedule 23 of the Finance Act 2003.

56 OECD transfer-pricing guidelines, at paragraph 8.3.
Under a CCA, each participant’s expected benefit from the arrangement is proportionate to its contribution under the arrangement. Further, each participant is able to exploit its interest in the CCA without paying a royalty or other consideration rather than as a licensee. CCAs are commonly used by MNEs to develop intellectual property in a tax-efficient manner. Most jurisdictions have adopted or recognize CCAs under their domestic legislation. For example, in Canada, such an arrangement is known as a “qualifying cost contribution arrangement” and is defined as an arrangement whereby two or more entities share the costs and risks of producing, developing, or acquiring any property or acquiring or performing any services, in proportion to the benefits which each participant reasonably expects to receive as a result of the arrangement. The United States, however, has restricted the concept of a CCA to the development of intangible properties (a “qualified cost-sharing arrangement,” or QCSA). The advantage of using a CCA is that it limits the ability of domestic tax authorities to impose penalties or to recharacterize the payments and allocation of profits to the participants in the CCA.

Development costs under a CCA include compensation costs, which in turn can include the costs (if any) of employee stock options. The OECD report recommends that the cost of employee stock options be included in CCAs despite the valuation difficulties and accountants’ reluctance (up to now) to include such costs in the main body of financial statements. The report recommends that the cost of employee stock options be included in CCAs on the grounds that independent arm’s-length entities, acting in rational self-interest, would not enter into a CCA that did not take into consideration a significant element of the participants’ contributions, whether in cash or in kind. Consistent with the economic substance of employee stock options, the OECD report concludes that the arm’s-length principle requires the inclusion of employee stock options despite very limited evidence as to what independent arm’s-length entities actually do. The substantive view of employee stock options as economic assets and a valuable form of employee remuneration outweighs the limited practical evidence. This is in contrast

57 A CCA can be viewed as a compromise in terms of managing tax compliance and tax revenue; it avoids “the uncertainty and administrative burden of annual royalty adjustments and provides U.S. multinationals with a predictable approach to managing their worldwide tax liability.” Damian Laurey, “Untangling the Stock Option Cost Sharing Loophole” (2002) vol. 55, no. 3 The Tax Lawyer 761-808, at 772.

58 ITA subsection 247(1).

59 Treas. reg. section 1-483-7(b). A QCSA is an arrangement to develop intangibles that meets certain conditions set out by the IRC and the administrative policies of the IRS, under which the participants share in the intangible development costs in proportion to the benefits reasonably expected to be derived from developing of the intangibles.

60 In the United States, for example, the IRS may make adjustments to cost allocations under a QCSA only to ensure that the costs and risks are shared appropriately: Treas. reg. section 1.482-7(2).

to Meldman and Schadewald’s view that “the primary focus in selecting a transfer price is the reliability of the result, not its theoretical accuracy.”\(^\text{62}\) However, the notion of reliability may not be well grounded if there is a lack of independent comparables, and attempts are made to adjust prices that reflect functions and risks that may have been strategically allocated by the MNE.

**Stock Option Transfer-Pricing Issues in CCAs**

At the heart of the debate is the potential erosion of a jurisdiction’s tax base if employee stock options contributed by a Topco or Subco with a high tax rate are not included in the cost base of CCAs. A determination of the value of each entity’s contribution is critical to CCAs; excluding the cost of employee stock options can change the respective proportion of costs contributed and thereby change the gross and net revenues to be allocated between the entities, with the latter determining the respective tax liabilities. Thus, if stock options are a material component of one or both entities to the CCA, the choice of the valuation method (grant date valuation, or intrinsic value or spread valuation) and the measurement date can potentially have a significant impact on the determination of each entity’s contribution to the CCA and, ultimately, on the allocation of profits from the CCA and the overall global tax liability.

The valuation issues are similar if Subco provides stock options to its employees but the options are to acquire the shares of Topco. If the valuation is based on the spread at the option exercise date, then the cost of the options should be appropriately allocated to the corporation (Subco or Topco) that incurs the opportunity cost of selling the shares at the lower exercise price instead of the higher market price on the exercise date. If Topco gives out the shares to Subco’s employees on the exercise date, then Topco will be deemed to have contributed the opportunity cost of the spread to the CCA to the extent that the opportunity cost is not reimbursed by Subco. Reimbursement, if any, can ultimately determine which entity bears the cost.

**The US Experience**

Two high-profile US cases—Seagate\(^\text{63}\) and Xilinx\(^\text{64}\)—have triggered a public debate on whether the arm’s-length principle requires stock options to be included in the cost base of cost-sharing arrangements. The Seagate and Xilinx cases also illustrate why this issue is so important to the tax authorities. The adjustments sought by the Internal Revenue Service (IRS) in Seagate totalled US$16 million for the two years in question; the adjustments currently being litigated in Xilinx are reported at US$10 million, also in respect of a two-year period.\(^\text{65}\)

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64 *Xilinx Inc.*, TC docket nos. 4142-01 and 702-03. The trial commenced on July 14, 2004.

65 Lewis and Kochman, infra note 66, at 550.
The Seagate Decision

The IRS litigated Seagate to establish a legal precedent in support of its longstanding position that the cost of employee stock options ought to be shared under a QCSA for US tax purposes. At issue was whether unrelated companies would share the cost of employee stock options under the 1968 cost-sharing regulations, which governed the tax year in dispute. In general, the 1968 cost-sharing regulations required that the terms and conditions of the cost-sharing arrangement be comparable to those that would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. Consequently, one of the key issues in Seagate was finding evidence of what third parties actually did. Failure to find comparables could imply that the regulation did not require the sharing of employee stock option costs.

The IRS was not able to offer direct evidence of option costs being included in cost-sharing arrangements. Instead, the IRS pointed to Sun Microsystems’ contribution of warrants (similar to call options) in exchange for a price break on products from Computervision Corporation—an arm’s-length or unrelated entity as a comparable transaction of arm’s-length entities taking into account option costs. Underlying the IRS position is the principle that employee stock options have an opportunity cost that should be recognized.

Seagate responded by stating that employee stock option costs should not be shared because they are not a cost to the corporation but rather are capital transactions that dilute shareholder ownership, since US generally accepted accounting principles (GAAP) did not require options to be expensed for the years in dispute. Seagate distinguished the Sun Microsystems example on the grounds that stock options were granted as consideration; it was not a case where stock option costs were

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67 Treas. reg. section 1.482-2A(d)(4) (repealed 1996):

Where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, the district director shall not make allocations with respect to such acquisition except as may be appropriate to reflect each participant’s arm’s length share of the costs and risks of developing the property. A bona fide cost sharing arrangement is an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. . . . In order for the sharing of costs and risk to be considered on an arm’s length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. If an oral cost sharing arrangement, entered into prior to April 16, 1968, and continued in effect after that date, is otherwise in compliance with the standards prescribed in this subparagraph, it shall constitute a bona fide cost sharing arrangement if it is reduced to writing prior to January 1, 1969.

68 Laurey, supra note 57, at 783.
being shared. Seagate further argued that unrelated entities would never want to share the costs of employee stock options for the following reasons:

- Valuation issues may be difficult to resolve between unrelated entities.
- Allocation issues may be difficult to resolve if employee stock options are granted before the cost-sharing agreement commences or exercised after the cost-sharing agreement has expired.
- There may be “[a]n unwillingness to reimburse the issuing company for a cost that requires no cash outlay and is based on the appreciation of the issuing company’s stock.”

Ultimately, the IRS and Seagate settled the issue, and the IRS subsequently released an industry directive stating that it would not require stock options to be included under the 1968 cost-sharing regulations. However, the IRS continues to take the position that the 1995 cost-sharing regulations do require options to be included.

**The Xilinx Decision**

The Xilinx case deals with the inclusion of stock option costs under the 1995 cost-sharing regulations. The regulations emphasize sharing of intangible development costs commensurate with each party’s expected benefits under the arrangement rather than what costs would be shared by unrelated parties. In general, the 1995 regulations adopt a definition of “cost” that appears to follow US GAAP. For the years in dispute, US GAAP did not require options to be expensed, lending support to Xilinx’s position that stock options are not a cost for the purposes of cost-sharing agreements. The IRS’s main counterarguments were that GAAP does not determine the definition of “cost” for the purposes of the 1995 cost-sharing regulations and that stock options are a form of compensation which, like any other form of compensation, is properly included in the cost base.

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69 Ibid., at 785.
70 Ibid.
71 “Seagate and IRS Settle Tax Dispute,” Press Release, August 1, 2001 (online: http://www.seagate.com/cda/newsinfo/newsroom/releases/).
73 Laurey, supra note 57, at 798-99.
74 Treas. reg. section 1.482-7(i). In general, “intangible development costs” includes all costs incurred by the participant with respect to the development of the intangible, plus cost-sharing payments made to other parties, less cost-sharing payments received from other parties. The term “costs incurred” is further defined to mean operating expenses as defined in Treas. reg. section 1.428-5(d)(3), other than depreciation and amortization, plus (to the extent that it is not included in operating expenses) the charge for the use of any tangible property made available to the QCSA. “Operating expense” includes all expenses not included in the costs of goods sold except for interest expense, income taxes, and any other expenses not related to the operation of the relevant business activity.
Notwithstanding the interpretation of “cost” under the 1995 cost-sharing regulations, the fundamental issue is still what the arm’s-length principle requires. The lack of available data continues to be problematic. One of the few studies on the inclusion of stock option costs in cost-sharing arrangements was conducted by PricewaterhouseCoopers, which surveyed 100 research and development (R & D) agreements filed with the US Securities and Exchange Commission (SEC). Such third-party agreements are required to be included in mandatory annual SEC filings if they are financially material to the filing company. The survey found 12 examples of agreements in which third parties did not share stock option costs and three in which stock option costs were explicitly excluded from the cost-sharing arrangement.\(^7\)

Xilinx also argued that advance pricing agreements had not been concluded with option costs taken into account. The difficulty in finding third-party evidence also led Xilinx to argue that the IRS should bear the burden of proving that the cost sharing of employee stock options meets the arm’s-length standard.\(^6\)

Although the Xilinx case has not yet been decided, it is considered to “have ramifications far beyond just the substantive issues involved,” making it one of the 10 top areas of concern that the US Internal Revenue Service likely will focus on over the next year.\(^7\) The concern appears to be that an unfavourable ruling not only will undermine the IRS’s position under the 1995 cost-sharing regulations, but also has potential implications for the 2003 regulations, as discussed below. In 2004, Xilinx filed a further petition that included a US$16.8 million allocation in relation to stock option costs which, the IRS said, the company should have shared with its Irish subsidiary in 2000.\(^7\)

**The IRS’s Response: The 2003 Cost-Sharing Regulations**

In light of the ongoing debate over whether stock option costs should be taken into account in QCSAs, the IRS introduced revised cost-sharing regulations effective August 26, 2003.\(^9\) Under the 2003 regulations, employee stock option costs are

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\(^6\) Ernst & Young, “Transfer Pricing Update,” January 28, 2005.


\(^7\) The 2004 petition by Xilinx challenged a total of $76 million in allocations for 2000.

\(^9\) TD 9088, 2003-42 IRB 841. Interestingly, the IRS has also issued proposed regulations setting out the transfer-pricing method to be used in determining an arm’s-length cost of service transactions between controlled entities: REG-146893-02 and REG-115037-00, 2003-44 IRB 967. However, the proposed regulations are silent on whether stock-based compensation should be included in the determination of the costs of services. On August 22, 2005, the Treasury Department released proposed regulations to improve compliance with and administration of the cost-sharing rules. The primary focus of these regulations is the valuation of the buy-in payments. However, certain technical amendments are made with respect to the
included in QCSAs if the options relate to intangible development costs on the date that the option is granted.\textsuperscript{80} The “cost” of the stock options may be either the intrinsic value of the options at the date of exercise (“the default method”)\textsuperscript{81} or the fair value of the options at the date of grant as reported for financial reporting purposes (“the elective method”).\textsuperscript{82} All parties to the QCSA must use the same method—that is, one participant cannot use the elective method if another participant is using the default method. Under the default method, if options are not exercised before the termination or expiration of the QCSA, the options are deemed to be exercised immediately before that time to the extent that the options have vested and the fair market value of the share is greater than the exercise price.\textsuperscript{83}

The Canadian Context

The IRS’s position is directly contrary to the CRA’s position with respect to the inclusion of stock options in the cost base of cost-sharing arrangements. The CRA does not allow a deduction for the Canadian affiliate’s contribution to employee stock option costs within a CCA. For Canadian tax purposes, contributions to a CCA are treated as though they are made outside the scope of the CCA to carry on the activities that are subject of the CCA. The deductibility of the costs to the participants is determined in accordance with the ITA, and the fact that contributions are made pursuant to a CCA (with the intention of earning global income) does not render them automatically tax-deductible.\textsuperscript{84} ITA paragraph 7(3)(b) denies a corporate deduction of stock option costs. Accordingly, the CRA’s position seems to be that no cost is incurred from the issuance of stock options and no deduction is available if a Canadian company pays part of the stock option costs as a party to the stock-based compensation regulations previously issued. In addition, the Treasury Department and the IRS are considering extending the elective method to other forms of stock-based compensation for publicly traded corporations (see http://www.irs.gov/pub/irs-regs/14461502.pdf).

\textsuperscript{80} Treas. reg. section 1.482-7(d)(2)(ii).

\textsuperscript{81} Even though ISOs are not deductible, their cost must also be measured in the same way for the purposes of these regulations. The default method does not require prorating of the cost over vesting periods, nor does it require specifying the time period during which the employee was engaged in the activities covered by the QCSA: Treas. reg. section 1.482-7(d)(2)(iii)(A).

\textsuperscript{82} The elective method is available only when options are used to acquire stock publicly traded on a US securities market and the company’s financial statements are prepared in accordance with US GAAP, or in accordance with accounting principles other than US GAAP if certain requirements are met. Specifically, the other financial accounting principles will be deemed to be in accordance with US GAAP if the fair value of the stock options is reflected in a legally required reconciliation between the applicable GAAP and US GAAP or if the applicable GAAP requires the fair value of stock options to be expensed in the audited financial statements or disclosed in footnotes to such statements: Treas. reg. section 1.482-7(d)(2)(iii).

\textsuperscript{83} Treas. reg. section 1.482(d)(4).

CCA. As a result, the current practice of Canadian companies is, by and large, not to include stock option costs in their cost base.

**The Alcatel Decision**

The Tax Court’s recent decision in *Alcatel Canada Inc. v. The Queen* may have implications for the deductibility of stock option costs under Canadian CCAs. In *Alcatel*, Bonner J found that the intrinsic value of employee stock options was an expenditure for the purposes of scientific research and experimental development (SR & ED), and therefore eligible for an investment tax credit. Bonner J concluded “that a very real expenditure is accomplished when shares having an established market value are sold for less than that value in the context of a scheme for the compensation of the employees who buy them. . . . The expenditure consists of the consideration which the Appellant foregoes when it issues its shares for less than market value.” Further, Bonner J found that the ordinary usage of the term “expenditure” described “tax revenues foregone due to exemptions, deductions, rate reductions, rebates, etc. that reduce the amount of the tax that would otherwise be payable.” In conclusion, Bonner J noted that if the intrinsic value or the spread fell “within the meaning of salary or wages as defined in section 248 of the Act,” it was difficult “to see how salary or wages can flow from employer to employee without expenditure on the part of the employer.” The *Alcatel* decision was not appealed, and the CRA subsequently announced that it accepted the decision.

The classification of employee stock options as an expenditure for SR & ED purposes recognizes that the stock options have an opportunity cost to the MNE and thus should appropriately be classified as expenditures. This argument may be extended to justify the deductibility of stock options for transfer-pricing purposes.

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86 The Ernst & Young survey (supra note 5) reported that 92 percent of Canadian subsidiaries and 100 percent of Canadian parent companies do not include stock options in their cost base.

87 2005 TCC 149.

88 In accordance with ITA subsection 37(10), which allows the proxy method based on ITA subclause 37(8)(a)(ii)(B)(IV).

89 Pursuant to ITA section 127.

90 *Alcatel*, supra note 87, at paragraph 31.

91 Ibid., at paragraph 32.

92 Ibid., at paragraph 33.


94 In *Apple Computer, Inc.*, 98 TC 232 (1992) and *Sun Microsystems, Inc.*, 69 TCM 1884 (1995), the US Tax Court held that the spread income was wages for the purposes of determining the R & D credit. These decisions were necessary even though employee stock options are deductible for income tax purposes in the United States. The Tax Court clarified in *Apple Computer* that the aggregate spread amount in the year of exercise was to be included in the R & D credit base, even if some of the spread was attributable to past services. None of these US cases were referenced in the *Alcatel* decision.
Australian Developments

In 2004, the Australian Tax Office (ATO) issued a comprehensive ruling on CCAs. Although the general conclusion was that stock options should be included in the cost base of CCAs on the basis that employee options are a form of remuneration, the ATO emphasized that the real issue was how to measure the cost or value of the contribution—namely, the services of the employees.95 The cost or value of the options is simply a proxy for estimating the value of the employee’s services remunerated through the options. Consequently, the option value should not necessarily be determined by the accounting value. The ATO recognized that in certain cases, arm’s-length entities might agree to exclude the options from the value of the employee’s services under the CCA.96

This approach is laudable to the extent that it focuses on the facts and circumstances and the commercial and economic rationale of the parties to the CCA. At the same time, such an approach places a greater onus on tax authorities and MNEs in terms of determining what arm’s-length entities would do in the circumstances, thereby resulting in greater potential differences in practice.

OPTION RECHARGE AGREEMENTS

In the previous section on CCAs, we examined whether the cost or value of Topco’s options granted to its own employees affected the transfer prices of transactions with Subco. In this section on option recharge agreements, we look at whether the cost or value of Topco’s options granted to Subco’s employees should be reimbursed by Subco, and how the charge should be determined. Often, Topco will require the local subsidiary to reimburse it for the costs associated with the issuance of the options plus any administrative costs. Option recharge agreements may also be entered into in order to secure a tax deduction in the local jurisdiction.

In contrast to a CCA, Subco employees typically do not provide any direct services to Topco. Thus, the first question is whether the establishment of an employee stock option plan by Topco and the granting of options to Subco employees constitutes a “commercial or financial relationship” for the purposes of article 9(1) of the OECD model tax convention. The OECD report concludes that it does, and that the subsidiary receives a benefit if the options are provided without charge, or at a charge other than what an arm’s-length party would have imposed, on the premise that an arm’s-length party would not grant options or provide any other remuneration to employees of an unrelated party without receiving something in return.97

To determine what an arm’s-length party would charge, one must understand the exact nature of the commercial or financial relationship that arises when Topco

96 Ibid., at paragraph 89.
97 OECD report, at paragraph 36.
grants options to Subco employees. (For example, the possible characterization of the relationship as a capital transaction is glossed over in the OECD report.)\textsuperscript{98} In some countries, the issuance of stock options to employees of related entities is treated as a capital contribution. In the United States, for example, a recharge payment by Subco to Topco is considered a return of capital by Subco to Topco because the issuance of shares pursuant to the option is considered a capital contribution by Topco.\textsuperscript{99} The United Kingdom also considers such a transaction to be on account of capital if only new shares are issued on the exercise of the options.\textsuperscript{100} The OECD report acknowledges that in these circumstances no charge may be required under the arm’s-length principle.\textsuperscript{101}

**UK Developments**

Option recharge agreements have attracted considerable attention in the United Kingdom because of the Special Commissioners’ 2001 tax ruling in \textit{Waterloo}.\textsuperscript{102} HMRC’s position on option recharge agreements since the \textit{Waterloo} decision illustrates some of the pragmatic difficulties associated with determining an arm’s-length cost of employee stock options.

**The Waterloo Decision**

In \textit{Waterloo}, the company established a trust in connection with an employee share option scheme under which it made an interest-free loan to the trust, which in turn acquired the company’s shares with the proceeds of the loan. The company then granted options on the shares held in trust to its employees and the employees of its subsidiaries. On the exercise of the option, the employees of the subsidiary paid the exercise price to the trustee, who then used the proceeds of the exercise price to repay the loan. The company also undertook to issue shares to the trustee at the exercise price in the event that the shares held in trust were exhausted. The issue

\textsuperscript{98} Ibid., at paragraph 30.

\textsuperscript{99} Treas. reg. section 1.1032-3. Specifically, the US corporation that granted options is considered to have contributed cash to the subsidiary equal to the fair market value of the underlying shares ($P_e$) at the option exercise date, and the subsidiary is deemed to have acquired the parent company shares for the same amount ($P_a$). The subsidiary then receives the exercise price ($X$) from its employees on the exercise date and transfers the shares to its employees in fulfilling the option exercise transaction. Therefore, the subsidiary is deemed to have paid out $P_e$ and received $X$ for a net outlay of $(P_e - X)$. If the US parent actually receives cash from the subsidiary, the amount of cash deemed contributed by the parent is the difference between the fair market value of the shares ($P_e$) and the amount of money received as payment. As a result, there is no gain or loss with respect to the transfer of shares. In addition, payment for the US parent’s shares is not deemed to be a (taxable) dividend distribution subject to withholding tax liability.

\textsuperscript{100} Tax Bulletin 63, supra note 27.

\textsuperscript{101} OECD report, at paragraph 30.

\textsuperscript{102} Waterloo Plc, Euston & Paddington v. CIR, [2001] SpC 301.
was whether this arrangement constituted a “business facility” under the transfer-pricing legislation in force at the time.\textsuperscript{103}

The Special Commissioners found that this arrangement constituted a “business facility” for giving benefits to employees of subsidiaries in the form of options. Further, it was their conclusion that the business facility as a whole needed to be priced, not the individual transactions such as the interest-free loan or the provision of shares to employees at a price below fair market value.\textsuperscript{104} Although the Special Commissioners were not specifically asked to comment on what the arm’s-length price of the business facility should be, they did say that the establishment of an arm’s-length price by reference to the employee option gain was unlikely to be appropriate, given that most of the employer’s costs were related largely to interest rates and not to increases in share prices.\textsuperscript{105}

What is interesting about this decision is the idea that the arrangement had to be viewed as a whole and could not be broken down into discrete transactions. This determination—whether to view the arrangement as a whole or as a series of separate transactions—has implications for both the transfer-pricing methodology to be adopted and the overall determination of the arm’s-length price. Furthermore, \textit{Waterloo} illustrates the extent to which the arm’s-length price depends on the facts. The finding in \textit{Waterloo} that the intrinsic value or spread method of determining the costs was not appropriate is reasonable, given the facts of the case. However, such a conclusion may not be appropriate in other types of stock option plan arrangements. In Canada, for example, stock option plans are typically not structured through a trust arrangement as they are in the United Kingdom. Thus, the “costs” associated with a Canadian stock option plan may be different from the costs associated with a UK option plan. This has implications for comparables: is a stock option plan that utilizes a UK-like trust structure comparable to an option plan that does not? If it is not comparable, can adjustments be made with sufficient reliability?

\textbf{The UK Policy on Option Recharge Agreements}

As a result of the \textit{Waterloo} decision, UK companies were at risk of having deemed income inclusions under the transfer-pricing legislation if they did not enter into recharge agreements with their subsidiaries. However, the implementation of recharge agreements became very complicated as a result of guidance subsequently issued by HMRC and legislative amendments that provided a statutory corporate tax deduction for employee stock options for periods beginning on or after January 1, 2003. In general, HMRC’s current policy is as follows:\textsuperscript{106}

\begin{itemize}
  \item \textsuperscript{103} ICTA 1988 section 770.
  \item \textsuperscript{104} \textit{Waterloo}, supra note 102.
  \item \textsuperscript{105} Ibid.
  \item \textsuperscript{106} Tax Bulletin 63, supra note 27.
\end{itemize}
Transfer-pricing rules will apply to determine the amount of the income inclusion to a UK parent company based on arm’s-length comparables. In this regard, HMRC will generally not accept the transfer-pricing amount to be calculated on the spread or intrinsic value, but rather will insist that it be based on an option-pricing methodology such as the Black-Scholes model.

If only newly issued shares are used to satisfy the option, no transfer pricing is required. However, if a company uses both shares that are newly issued and shares purchased on the open market to satisfy options or other employee share awards under one or more plans, all such plans will be subject to the transfer-pricing rules.

A UK employer is entitled to a statutory deduction for the intrinsic value or the spread of the employee stock options on the exercise dates.

To the extent that a statutory deduction is available to the UK employer, no other deduction is allowed. Thus, any amount recharged by an MNE to a UK subsidiary in respect of employee stock options will not be deductible by the subsidiary for tax purposes.

These aspects of HMRC’s current policy suggest the potential for a significant mismatch between the income inclusion to the parent (based on the grant date valuation using an option-pricing model) and the deduction to the subsidiary (based on the intrinsic valuation or spread on the exercise date).

As a result of this mismatch and subsequent complaints by taxpayers, HMRC conducted a review of its position on transfer-pricing and option recharge agreements. Its review resulted in draft guidance that was circulated to interested stakeholders in May 2005. The draft guidance purports to eliminate the unfairness inherent in the transfer-pricing regime as it applies to employee option plans by requiring that the tax implications of any actual or imputed receipt generally follow the accounting treatment. The International Financial Reporting Interpretations Committee has issued a draft interpretation on the accounting treatment of share options and awards in group situations. Under this draft interpretation, the receipt of an arm’s-length recharge should not give rise to an income receipt for accounting purposes and consequently should not result in taxable income. HMRC’s draft guidance also makes no distinction between shares that are newly issued and shares purchased on the open market. The draft guidance was recently finalized with no substantive changes, and is effective for accounting periods beginning on or after January 1, 2005.


Recharge Agreements in the Canadian Context

There has been little public discussion in Canada with respect to option recharge agreements in the context of transfer pricing. Presumably, option recharge agreements could be viewed by the CRA as an intragroup service for transfer-pricing purposes. Since a corporate deduction for employee stock options is generally not available in Canada, the historical question is how a reimbursement made pursuant to a stock option plan recharge agreement should be treated for Canadian tax purposes. The CRA has stated that an amount reimbursed by a subsidiary to a foreign parent is not deductible by the subsidiary. Thus, if a Canadian subsidiary reimburses its foreign MNE parent for options conferred on its employees, the question is whether the payment is taxable under ITA subsection 15(1) as a shareholder benefit, which is treated as a deemed dividend under ITA paragraph 214(3)(a) for part XIII withholding tax purposes. In such an event, the amount paid as a reimbursement is subject to 25 percent withholding tax by virtue of ITA subsection 212(2). Conversely, if a Canadian-resident MNE enters into recharge agreements with its foreign subsidiaries, the question is whether the reimbursement is taxable income.

The CRA has ruled that a reimbursement by a Canadian subsidiary to a foreign parent in respect of stock option benefits will not be deductible to the subsidiary. In addition, the reimbursement will not be considered a shareholder benefit if the payment is made from a Canadian subsidiary to a foreign MNE or brought into income as a deemed dividend if the payment is made by a subsidiary to a Canadian parent, provided that a legal obligation is in place, as evidenced by a written agreement between the subsidiary and the parent, and the reimbursement does not exceed the actual cost incurred by the parent on behalf of its subsidiary. “Cost” is generally considered to be the intrinsic value or spread of the option for the period covered by the option recharge agreement, plus any administrative costs that can

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110 IC-87R2, supra note 84. Pursuant to paragraphs 154 and 155 of IC-87R2, in applying the arm’s-length principle to intragroup services, a taxpayer must first determine whether a specific activity performed by a member of the group for another member is a service for which a charge is justified. An arm’s-length party will be willing to pay for an activity only to the extent that the activity confers on it a benefit of economic or commercial value. The test to determine whether a charge for an activity is justified involves the following question: Would the entity for whom the activity is being performed (1) have been willing to pay for the activity if performed by an arm’s-length entity or (2) have performed the activity itself?

111 See CRA document no. 9910975, August 6, 1999.

112 This withholding obligation may be reduced by treaty.

113 The penalty for failing to withhold part XIII tax is 10 percent of the tax owing, or 20 percent if the failure amounts to gross negligence. Interest will also be assessed: ITA subsections 227(8) and 227(8.3).

114 Possible bases for taxation include section 9, section 90, subsection 15(1), subsection 56(2), and paragraph 12(1)(a) of the ITA.

115 The situation of option reimbursements by a foreign subsidiary to a Canadian parent company is considered in CRA document nos. 2002-0179805, May 13, 2003; 2002-0129803, October 30,
reasonably be allocated to the subsidiary. For example, if a recharge agreement was
established on the option grant date for options that were granted at the money
with an exercise price of $10 and subsequently exercised when the fair market value
of the underlying share was $18, the amount that will be treated as a reimburse-
ment is limited to $8. However, if options were granted at an exercise price of $10,
and if the recharge agreement was subsequently entered into when the fair market
value of the share was $15, the amount that will be treated as a reimbursement is
limited to $3.

In some cases, the cost allowed may be less than the intrinsic value or spread.
For example, assume that a Canadian subsidiary was obliged to reimburse its foreign
parent for the cost of the shares covered by the options pursuant to a recharge
agreement. Assume that the options were granted at the money with an exercise
price of $15 and are exercised when the underlying share price is $25. Further
assume that in anticipation of settling the options, the parent acquires an inventory
of its own shares at a cost of $20. In this case, the actual out-of-pocket cost to the
parent of settling the options is only $5 ($20 – $15) even though the opportunity
cost is $10 ($25 – $15). If the subsidiary were to reimburse the parent $10, the CRA
would view the subsidiary as having conferred a benefit of $5 to the parent, since
the actual out-of-pocket cost incurred by the parent was limited to $20.\(^\text{116}\)

Traditionally, the CRA has not accepted a grant date valuation method for
determining cost. Although the CRA is currently reviewing its policy on the meth-
odology for calculating the costs of option recharge agreements, it is not known
when the review will be completed or whether grant date valuation methods will
be accepted.

**DOUBLE TAXATION AND THE MUTUAL AGREEMENT PROCEDURE**

Given the lack of data on how arm’s-length entities deal with employee stock
options and the different approaches to valuation, there is the potential for tax
jurisdictions to take conflicting positions and make transfer-pricing adjustments
that may lead to instances of double taxation. One avenue open to MNEs is to apply
for competent authority relief under the mutual agreement procedure. The mutual
agreement procedure is set out in article 25 of the OECD model tax convention and
is contained in many tax treaties.\(^\text{117}\) To use the mutual agreement procedure, one


\(^{117}\) For example, article XXVII of the Convention Between Canada and the United States of
America with Respect to Taxes on Income and on Capital, signed at Washington, DC on
must demonstrate that the taxation in question is not in accordance with the OECD model tax convention. However, the arm’s-length principle does not prescribe whether an option gain is tax-deductible by the entity that grants the option or how the option gain is included in the employee’s income; this is an issue to be decided under domestic law. Whether a transfer-pricing adjustment is made with respect to stock options will largely depend on whether stock options are deductible under domestic law.

For example, suppose that an MNE charges its subsidiary in Treatyland an amount equal to the intrinsic value (on the exercise date) for options granted to the employees of its subsidiary. Assume that Treatyland normally allows employers to deduct the intrinsic value of options on the exercise date. However, if Treatyland does not consider the intrinsic value to meet the arm’s-length standard for transfer-pricing purposes, the subsidiary may be denied a deduction for some or all of the recharge amount. In this context, the MNE will be able to claim an adjustment in its own tax jurisdiction for the amount that was denied as a tax deduction to its Treatyland subsidiary. In the absence of such a claim, the MNE may be subject to double taxation on the amount reimbursed. However, if the MNE grants options to the employees of its Canadian subsidiary on similar recharge terms, the double taxation will not be avoidable even under tax treaties, since Canadian tax law explicitly denies a tax deduction for employee stock options.

The OECD report discusses how various domestic tax rules interact with tax treaties in the treatment of employee stock options. Assume that Topco’s profits are adjusted to account for arm’s-length compensation for options granted to employees of Subco, where no such compensation was initially provided. A corresponding adjustment to Subco’s tax basis is required only if

- the amount added back to Topco’s profits corresponds to an amount that was included in Subco’s profits and taxed, and
- the arm’s-length charge for the stock option costs is deductible by Subco.\(^{118}\)

Thus, the mutual agreement procedure may not be a complete or practical answer if situations of double taxation arise because of conflicting policies on stock options and transfer pricing.

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\(^{118}\) OECD report, at paragraph 138.
CONCLUSION

Global employee stock option plans continue to be a relevant and important way for MNEs to align the interests of their employees worldwide to consolidated or global performance measures. The recognition of employee stock options as a form of employee remuneration is critical to transfer pricing. On this basis, it may be argued that the value of options should be included in determining whether prices charged for services or property in controlled transactions are arm's-length, just as any other form of employee compensation is included, regardless of its accounting treatment or its domestic tax treatment. However, significant comparability issues—namely, the lack of available data and the lack of consensus on option valuation—make it difficult to analyze employee stock options under traditional transfer-pricing methodologies. Nevertheless, the substantive view of employee stock options as a valuable form of employee remuneration and policy concerns about lost tax revenues have outweighed the limited practical evidence of what arm’s-length entities actually do in this area of practice.

The OECD report represents an important first step in developing an international dialogue on these issues. In the absence of consensus, a fundamental question is whether tax authorities will develop prescriptive rules to mandate the recognition of options and the method of valuing them for transfer-pricing purposes. This development can already be seen in the United States’ introduction of regulations mandating the inclusion of stock options in QCSAs and, to a lesser extent, in the United Kingdom’s transfer-pricing policies in respect of option recharge agreements. The development by tax authorities of independent rules for transfer pricing and stock options increases the risk of double taxation of MNEs and creates potential opportunities for tax arbitrage.

To proactively address these issues, MNEs will be required to view employee stock option plans in a new strategic light. MNEs must become more thoughtful about the purpose of their equity compensation plans and the employment services to which stock options relate in order to manage their transfer-pricing exposure. A comprehensive analysis of the potential transfer-pricing impact of a global stock option plan should be undertaken at the commencement of the plan. It is critical that the stock option plans and related documentation support the transfer-pricing position that the MNE wishes to take. This will require greater internal dialogue between the tax, finance, and human resource functions of the MNE.